A THEORY OF CALIBRATED FIDUCIARY DUTIES IN FIRMS

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Abstract

Although the laws of firms state the same traditional duty of loyalty, they diverge in expressing the duty of care and the concept of good faith. The differences are not subtle shades of refinement, but quantum contrasts of discrete legal states. The law shuffles, reclassifies, and relocates core elements of the duty of care and the concept of good faith uniquely in each form of firm. Why? Despite apparent legal divergence, a single fiduciary rule governs all forms of firms. This Article presents a theory of calibrated fiduciary duties that explains important variations in the formulation of fiduciary duty and standard of conduct. The law cannot state a uniform standard of conduct because forms of firms do not share a single optimal welfare state. To induce varying optimal ends of forms of firms, the law must uniquely calibrate fiduciary duties. This Article advances two important insights: (1) bilateral relational risk is the idea that owners and managers are exposed to an intrinsic risk arising from their relationship, comprising of the risk of agency cost for owners and the risk of liability for managers; and (2) intermediated risk preference is the idea that personal risk preferences of owners and managers are intermediated through the firm and the rule of fiduciary duty such that managerial actions, incentivized as such, actuate an intermediated risk preference that achieves an optimal welfare state for each form of firm. Based on this calculus, this Article derives four factors of calibration, each affecting the standard of conduct to achieve unique optimal welfare states for forms of firms. The theory of calibrated fiduciary duties explains why the law precisely varies fiduciary standards in forms of firms and why this variance is right. Lastly, this Article provides an important datum that corroborates the theory of calibrated fiduciary duties. It is an episode from the history of Goldman Sachs, which is its conversion from a private partnership to a public corporation.

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INTRODUCTION

At the heart of the laws of firms lies an unsolved enigma: Although all owners in all forms of firms presumably desire maximal profit, the rules of fiduciary duty markedly differ as if the law seeks discretely disparate managerial behavior and thus qualitatively different business outcomes for each form of firm. This observation raises a fundamental question: Despite apparent differences in the legal expressions of the standard of conduct, is there still a single fiduciary rule that governs all forms of firms? Yes, there is. That rule has been elusive, until now. This Article advances a theory of

calibrated fiduciary duties that unifies the fiduciary concept across the laws of all firms. It introduces important new concepts and new language to the understanding of the elementary relationship between equity owners and managers in firm governance.

The most common forms of business firms are partnerships, limited liability companies ("LLCs"), and corporations. These forms comprise the nucleus of economic enterprise in the United States, from the smallest storefront shops to the largest public companies. Firms are managed by fiduciaries who are agents, partners, members, managers, officers, and directors. Managers are bound by special legal duties that impose a minimum standard of high conduct. Fiduciary duty is the first and foremost legal tool to curb managerial agency cost.[1] Without it, the policy to minimize managerial misfeasance and malfeasance would be rendered futile. The fiduciary principle has always attached to firms,[2] but a longstanding enigma persists. Although the duty of loyalty in classic form, proscribing all types of conflict of interest dealings, is functionally identical in all laws,[3] the duty of care and the concept of good faith have markedly diverged along multiple pathways.

The scope of the duty of care is the broadest in the law of agency, then narrows in the law of noncorporate firms, and narrows further in corporate law. The law of agency adopts the tort standard of the reasonable agent.[4] The law of noncorporate firms states a substantive standard too, but limits it to proscribing gross negligence conduct and willful misconduct.[5] Corporate law constricts the standard to the narrowest expression, eschewing substantive review of conduct and prescribing only that a corporate manager must not be grossly negligent in the process of decisionmaking.[6]

The concept of good faith is also unique to the form of firm. It is called a "concept" here because it is not always a form of fiduciary duty. In the laws of agency and noncorporate firms, good faith invokes two distinct roles: firstly,

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1 *See* Robert J. Rhee, *A Liberal Theory of Fiduciary Law*, 25 U. PA. J. BUS. L. 451, 484 (2023) ("Trillions of dollars are held by or managed under fiduciaries. It could be that a majority of the wealth of Americans, including shareholding in corporations, are wrapped at some level in the protection of fiduciary law."); *infra* Section III.C. (discussing the concept of agency cost).

2 *E.g.*, Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928) (duty of partners); Dodge v. Ford Moto Co., 170 N.W. 668 (Mich. 1919) (duty of corporate managers).

3 *See infra* notes 49-50, 63-65, 85-86 and accompanying text.

4 *See infra* Section II.A.

5 *See infra* Section II.B.

6 *See infra* Section II.C.

good faith is a condition of scienter that attaches to all acts; secondly, good faith is the rule of implied contractual obligation of good faith and fair dealing that attaches to all contracts. Contrarily, corporate law conceptualizes good faith as a vital part of the duty of loyalty and identifies specific types of substantive misconduct that are defined as bad faith. The identified bad faith acts are sensible proscriptions and should inform the conduct of all managers irrespective of the form of firm. In fact, they do. But the law of noncorporate firms classifies them as a breach of the duty of care, and not the duty of loyalty.

The duty of care and the concept of good faith are uniquely calibrated, and thus are plainly dependent on the legal form of firm.[7] These differences are not small refinements or marginal adjustments that may be necessary to harmonize legal vocabulary or structural aesthetics. They constitute discrete legal states of different forms of firms.

The seemingly mishmash of law is more puzzling in light of the apparent common motive of all for-profit business enterprise—maximal profit.[8] With a common and constant profit motive, we could intuit that the standard of conduct should converge in all forms of firms to the most efficient expression. That is, since agency cost is endemic in all firms and all costs reduce profit, the law should formulate a single optimal standard of conduct that would minimize managerial agency cost to maximize profit in all firms. In fact, the duty of loyalty in classic form nicely conforms to our intuition; it is functionally identical in all firms, and little justification is required to understand that conflict of interest, as a starting position (prior to any cleansing procedures), is normatively bad.[9] The duty of care and the concept of good faith, we could further infer, likewise should converge to an optimal uniform standard and be independent of the form of firm. The law does not conform to this apparent logic.

When the law imposes different standards of conduct and culpability, it triggers cascading effects on managerial incentives and actions, and thus on business outcomes. Important unanswered questions loom. Is divergence the law's song of whimsy or labor of logic? Is it an expression of accidental mutations having no functionality or adaptive features in service of special needs? Does the law seek to induce varying levels of profitability, risk-taking,

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7 *See infra* Section II.D.

8 This statement is a generalization of the primary motive force of business venturing by owners. I recognize the existence of some firms that may have broader social purpose and laws that may permit such social enterprise.

9 *See infra* notes 49-50, 63-65, 85-86 and accompanying text.

or welfare in each form of firm? At first blush, the law appears to randomly assemble pieces of rules. Of course, this shouldn't be, and it isn't. The law eschews randomness; it avoids arbitrary expression. Rather, it understands the randomness of risk and precisely expresses rules that account for its effects on owners and managers.

This Article advances a normative and positive theory of calibrated fiduciary duties, explaining why standards of conduct diverge in forms of firms and why divergent standards are right. It demonstrates that a single fiduciary rule governs the laws of firms. Fiduciary duties are uniquely formulated because each set of rules achieves maximal welfare for the particular form of firm. All owners prefer more wealth than less, *ceteris paribus*; thus, an owner's desire for maximal profit is a constant in all for-profit firms. Of course, the assumption that all things being equal does not reflect reality.

This Article introduces a new conceptual language to the field of the laws of firms. Since the desire for maximal profit is a constant in all firms, it cannot explain variations in fiduciary duties. The critical variable is not the profit motive, but is risk. Forms of firms diverge in the risk exposures of managers and the risk preferences of owners, the set of which are unique to each form of firm. Each form of firm poses different considerations of risk, and thus the forms of firms cannot share a single optimal welfare state. A one-size-fit-all standard of conduct is infeasible. To induce varying optimal welfare states, the law must uniquely calibrate fiduciary duties.

This Article advances two ideas in the domain of firm governance: (1) *bilateral relational risk* is the concept that owners and managers are exposed to an intrinsic risk arising from their relationship, comprising of the risk of agency cost for owners and the risk of liability for managers; (2) *intermediated risk preference* is the concept that the personal risk preferences of owners and managers are intermediated through the firm such that managerial actions, incentivized as such, actuate an intermediated risk preference that achieves an optimal welfare state for each form of firm. The simple idea of the connection among bilateral relational risk, intermediated risk preference, and legal expression of the standard of conduct fully explains the bespoke nature of the fiduciary duty of care and the concept of good faith in forms of firms. A single coherent rule governs fiduciary duties in the laws of firms.

This Article starts with needed background. Section I states assumptions, identifies the prototypical features of each form of firm, and defines terms used herein. Section II identifies the blackletter rules of fiduciary duty for each form of firm as they are expressed in authoritative sources of laws, and it show

that the laws shuffle, reclassify, and relocate elements of the duty of care and the concept of good faith into sets of rules that are unique to each form of firm.

Section III constructs the normative theory of calibration. It introduces the important idea of bilateral relational risk. Business venturing is a mutual activity and is risky to all. The risk of loss from agency cost, a preoccupation in legal and economic scholarship for the past fifty years,[10] is simply the risk that directionally runs to owners. This preoccupation has diverted attention from a more holistic account of owner–manager relationship. The neglected half of the story is the manager's risk of liability. Given unavoidable mutual risk exposure, the form of firm intermediates personal risk preferences to achieve an optimal state of welfare between owners and managers. Fiduciary duties can alter individual risk preferences. Each form of firm must uniquely harmonize bilateral relational risks and intermediated risk preferences to achieve an optimal state of welfare between owners and managers. These theoretical considerations yields four factors of calibration of fiduciary duties and good faith.[11] Each factor affects the bilateral relational risks, either elevating or lowering the standard of conduct. The hydraulic interplay produces a unique standard that reflects the state of optimal welfare for each form of firm.

Section IV advances the positive theory of calibration. It predicts that the standard of conduct must be calibrated to be more lenient as: (1) the proximity of monitors becomes more remote, (2) the complexity of manager's work increases, (3) the manager's exposure to excessive risk is high, and (4) the owner has the ability to diversify away the risk of loss from managerial actions. The last three factors are intuitive. The first factor of calibration, availability of monitoring, contains a counterintuitive idea: Since monitoring contributes to joint production between owners and managers, it is a resource applied toward achieving the venture's end; as monitoring becomes more remote (diminishes), managers have less of this resource and thus their risk of liability increases; in light of an increase in potential liability, managers will demand a decrease in the standard of conduct to offset this risk. This counterintuition, along with the three other calibrating factors, explain why the agency relationship expresses the highest standard of conduct and corporations the lowest standard of conduct.

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10 Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976) (discussing agency cost). The invocation of "agency cost" in scholarship has ultimately reduced to a euphemism for strident adherence to shareholder wealth maximization.

11 *See infra* Section III.E.

Section V demonstrates the explanatory power of the theory of calibrated fiduciary duties by analyzing the conversion of Goldman Sachs from a private partnership to a public corporation. Goldman Sachs was and is the leading American investment banking firm. Its conversion is a large and important event in the history of Wall Street. We see the effects of bilateral relational risk and intermediated risk preference in this history. This datum is one, but if these dynamics are seen in a type of business that is the purest form of financial risk-taking (investment banking) and are felt by the savviest of its practitioners (leading financiers), we can infer that all other firms are also bound by same hydraulic mechanism.

I. BACKGROUND, ASSUMPTIONS, AND DEFINITIONS

Laws create legal forms of firms through which businesses venture. *Forms of firms* means here agency relationships, general partnerships, limited partnerships, LLCs, and corporations, which together comprise the nucleus of American business enterprise.[12] An *agency* relationship is not a "firm" as such (an entity), but its law is a lodestar for comparing the standards of conduct in the business context,[13] and for the limited purpose of this comparison this Article treats agency as a form of firms. *Noncorporate firms* are partnerships and LLCs, and they are treated as a single class of firms because their rules of fiduciary duty derive from the law of general partnership and are identical. *Corporations* are a separate class in terms of legal form and fiduciary doctrine.

This Article explores the theoretical foundation on which legal standards of conduct are built. Fiduciary rules in firms are state law. To inform the laws of firms, this Article relies on the latest versions of uniform laws, restatements, other model acts, and Delaware law.[14] This reliance is methodologically sound because these sources of law represent the leading thoughts on normative

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12 There are other business firms such as cooperatives. However, partnerships, LLCs, and corporations comprise the core of business enterprise in the United States.

13 *E.g.*, In re McDonald's Corp. S'holder Deriv. Litig., 289 A.3d 343, 364-66 (Del. Ch. 2023) (applying agency law to determine the scope of an officer's fiduciary duty).

14 *See* UNIF. P'SHIP ACT (Unif. L. Comm'n 1997 and amended 2013) ("RUPA"); UNIF. LTD. P'SHIP ACT (Unif. L. Comm'n 2001 and amended 2013) ("ULPA"); UNIF. LTD. LIAB. CO. ACT (Unif. L. Comm'n 2006 and amended 2013) ("RULLCA"); RESTATEMENT (THIRD) OF AGENCY (2006) ("RTA"); RESTATEMENT (SECOND) OF AGENCY (1958) ("RSA"); DEL. CODE ANN. tit. 8 ("DGCL"); MOD. BUS. CORP. ACT (2024) ("MBCA").

ideals.[15] When this Article asserts that laws are "identical" or "uniform," such comments shouldn't be construed literally (there are fifty states). Rather, model statutes are exemplars. Delaware corporate law, being the leading state law and a lodestar for other states, is also an exemplar.[16]

A basic review of the different forms of firms and the intricacies of fiduciary duties therein. A *general partnership* is an association of two or more persons who co-own a business for profit.[17] Partners are owners, owe fiduciary duties to each other[18] and have equal management rights.[19] A *limited partnership* is a partnership that has at least one general partner and one limited partner, where the former manages the firm and thus owes fiduciary duties, but a limited partner is a passive owner and thus owes no duties.[20] A *limited liability company (LLC)* can be structured in any way per the policy of freedom of contract,[21] but firms are generally structured in one of two broad forms. A *member-managed LLC* is a company that is jointly managed by all members, who are the owners.[22] This structure resembles a general partnership, and thus the rules of fiduciary duties and management reflect those applicable to general partners.[23] A *manager-managed LLC* is a company that is managed by a manager, who may or may not be a member, and non-managing member are passive.[24] This structure resembles a limited partnership, and thus rules of fiduciary duties and management resemble those of limited partnerships.[25] A *corporation* is characterized by a separation of ownership and control,[26] and directors and officers manage the firm for presumptively passive shareholders and thus owe fiduciary duty.

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15 The Restatements of the American Law Institute and the Uniform Laws of the Uniform Law Commission are enormously influential in law and policy.

16 *See* Robert J. Rhee, *The Irrelevance of Delaware Corporate Law*, 48 J. CORP. L. 295, 347 & n.207 (2023) (observing that "Delaware's consistent dealings in the area and the resulting production of law allow it to guide the laws of other states" and citing cases).

17 RUPA §§ 102(11), 202.

18 *Id.* § 409(a).

19 *Id.* § 401(h).

20 ULPA § 201(d), § 302, § 305, § 402, § 406(a), § 409(a).

21 *See infra* notes 72-73 and accompanying text.

22 RULLCA § 407.

23 *Id.* § 407, § 409.

24 *Id.* § 407(c).

25 *Id.* §§ 407, 409. A manager-managed LLC can differ from a limited partnership because the manager need not be an equity owner.

26 *See* DGCL § 141(a) (vesting management power in a board of directors).

Laws do not exist as contextless abstractions. Lawmakers and scholars have in mind prototypical characteristics and recurring pragmatic needs of each form of firm. Generalizations are necessary and state certain empirical truths about how lawmakers conceptualize the prototype firm. Certain kinds of businesses require certain sets of rules. We can think about it this way—it makes no sense to mass produce suits fitting the average professional basketball player for the average person. The laws of firms accommodate prototypical characteristics.[27]

All noncorporate firms are conceptualized as smaller ventures relative to corporations. General partnerships are communitarian ventures run by co-equal owner managers, prototypical examples being professional service firms. Limited partnerships are principally investment firms, such as venture capital firms, wherein the general partner manages an investment capitalized by passive limited partners. Because partnerships have certain constraints, such as owner management and multiple equity owners, lawmakers created the LLC form. This form does not envision a prototypical type of business so much as a prototypical need. Unlike partnerships, LLCs provide limited liability to owners and managers,[28] require only a single owner as opposed to two partners minimum, and permit the greatest degree of contracting for internal affairs including management by a non-owner manager.

Corporations have a reference prototype too. They are, first and foremost, large ventures with a broad base of passive shareholders, which are generally public companies. Of course, business firms come in all shapes and sizes, and all kinds of businesses venture through various forms of firms. Many noncorporate firms are bigger, more consequential or complex than many corporations. Corporations occupy two distinct economic spheres, the public equity market and private enterprise.[29] This dichotomy is still important, but needs a modern update. Since the 1990s, the LLC form has risen to become a preferred choice of entity for private firms that seek the benefits of limited

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[27] *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 26-28 (2010) ("The availability of multiple coherent business association statutes gives firms alternative sets of rules that fit their needs and that they can opt into without incurring extensive planning and drafting costs.").

[28] *Compare* RULCCA § 304(a) (providing limited liability to members and managers); *with* RUPA § 306(a) (imposing personal liability on all partners); ULPA § § 404(a) (imposing personal liability on general partners).

[29] Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 259 (1967).

liability and high degree of contracting for the rules of internal affairs.[30] In light of this development, an updated conceptualization of the two spheres of business firms is the public corporation and all private firms, including private corporations. The corporate form can certainly accommodate the full spectrum of size and complexity, from single-shareholder storefront shops to trillion-dollar public companies.[31] One may question the focus on public corporations since most corporations are private and only a minute fraction of all corporations is public.[32] Simple numbers don't tell the real story.

Albeit small in number, public corporations play the most important role in the national and global economies.[33] Corporate law is uniquely suited for aggregation of large pools of capital, management by professional managers who are distinct from passive equity owners, and commoditization of units of equity ownership that facilitates free transferability.[34] Berle and Means made this observation almost a century ago.[35] If, hypothetically, our society were to prohibit public equity ownership altogether, it could eliminate the corporate form entirely and society would be no poorer since a suitable modern substitute exist, *viz.*, the LLC.[36] The corporate form is not obsolete. It is needed

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30 *See* ROBERT J. RHEE, LLCS, PARTNERSHIPS, AND CORPORATIONS 6-8 (2021).

31 Corporate law is flexible enough. *See* DGCL 8, subch. XIV, §§ 341–356 (providing rules for close corporations). Smaller and simpler corporations can just as easily be structured as noncorporate firms, particularly the LLC. *See infra* note 36 (explaining why LLCs are suitable substitutes of the corporate form).

32 There are millions of private firms, including corporations, but only about 4,000 public corporations. *See* Asaf Eckstein & Gideon Parchomovsky, *Where the Wild Things Are: The Governance of Private Companies*, CATO INSTITUTE (Jan. 3, 2024) ("There are over 25 million private companies in the United States and less than 4,000 public ones."); Vartika Gupta, Tim Koller & Peter Stumpner, *Reports of Corporates' Demise Have Been Greatly Exaggerated*, MCKINSEY & COMPANY (Oct. 21, 2021) ("[T]he number of public companies listed in the United States dropped from about 5,500 in 2000 to about 4,000 in 2020.").

33 *See* Robert J. Rhee, *Do A.I.s Dream of Electric Boards?*, 119 NW. U.L. REV. 1007, 1016 (2025) (arguing that the corporate form was important to the advancement of the industrial revolution because it enabled "the aggregation of larger pools of capital from a broader base of investors").

34 With the exceptions of a few publicly traded limited partnerships and LLCs, virtually all public companies are corporations. *See* Rhee, *supra* note 16, at 314 n.94.

35 ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 5 (1933).

36 Before the invention of the LLC form, the major alternative to a corporation was the partnership form, which could not perfectly substitute for the corporate form. The LLC grants the privilege of limited liability, can be structured to mimic the corporation's separation of

for the public stock market, as empirically evinced by its overwhelming presence in this market.[37] Public companies are the most important business firms in terms of size, sophistication, influence, and consequence in the economy and society, and the corporate form and law serve *this* market, albeit quite small in number, first and foremost.

Explicit definitions of terms, even at the risk of tedium, may avoid unnecessary confusion. Forms of firms have their own legal vocabulary and structural aesthetic. They use different terms for managers and owners.[38] *Owners* hold equity interests in firms and are partners, members, and shareholders. *Managers* hold managerial authority and are general partners in partnerships, members in member-managed LLCs, managers in manager-managed LLCs,[39] directors and officers in corporations.[40] All managers are *fiduciaries* and owe duty to the firm and its owners,[41] who are referred to as *obligees* (beneficiaries) when this legal relationship is invoked. *Principal* and *agent* are the two parties in a legal agency relationship, which should not be confused with the "principal–agent" economic model of the firm.[42]

Lastly, a fine point must be made. This Article distinguishes *misfeasance* and *malfeasance*. Misfeasance is conduct that is wrongful because it fails to meet the standard of conduct. There is no obvious moral wrong. The fiduciary is good-hearted and did not intend the bad outcome, but was careless, incompetent, lazy, or simply unlucky, and as a result failed to meet the law's standard of conduct with respect to the fiduciary duty of care only. On the

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ownership and control and hierarchy of professional managers, requires only a single equity owner, and permits high degree of contracting among owners and managers. *See* Rhee, *supra* note 33, at 1017 ("Although the corporate form remains dominant in the realm of large and public companies, business venturers favor the LLC because it confers the benefit of the corporation's limited liability along with the pliability of almost-pure contracting for management and governance.").

37 *See supra* notes 32 & 34; Rhee, *supra* note 16, at 314 n.94.

38 *See infra* notes 17-25 (describing various forms of noncorporate firms).

39 *See supra* note 25 and accompanying text.

40 Owners and managers are not mutually exclusive. Some can be owner managers such as general partners in partnerships, members in member-managed LLCs, and shareholder directors or officers in corporations.

41 *See* Rhee, *supra* note 1, at 452 (articulating a theory of fiduciary law based on one's systemic and structural power over another's critical interest).

42 In advancing the theory of agency cost, economists use the terms "principal–agent" loosely to represent the shareholder–manager relationship. *See* Jensen & Meckling, *supra* note 10, 308-09. But the "principal–agent" economic model is descriptively doubly wrong. *See infra* note 144 (explaining the economists' error).

other hand, malfeasance is *mis*conduct that was done with a higher degree of culpability, such as intentional, willful, or knowing actions that harm the firm and owners, and this failure can breach either the fiduciary duty of care or the duty of loyalty. The distinction between misfeasance and malfeasance is substantively the same as the distinction between "conduct" and "misconduct" when the uniform laws express the duty of care in noncorporate firms.[43]

II. CALIBRATION OF FIDUCIARY DUTY IN LAWS OF FIRMS

A. Agency

Although agency is not restricted to business ventures, it is ubiquitous in business firms. It is the elementary representative relationship in business ventures. Managers generally have agency authority of some sort. The laws of firms state that general partners, managers in LLCs, and corporate officers are agents of the firm.[44] While limited partners, members in manager-managed LLCs, shareholders, and corporate directors are not agents,[45] any person can become one by dint of designation or circumstance so long as she meets the definition of an agent.[46] The law of agency applies from the top of the firm's managerial hierarchy to the lowest employees, and it is the broadest applicable

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43 *See infra* notes 66-68 and accompanying text.

44 *See* RUPA § 301 ("Each partner is an agent"); ULPA § 402 ("Each general partner is an agent"); RULLCA § 407 cmt. (explaining that members and managers are agent when they acquire authority under the operating agreement or in context); MBCA § 8.41 official cmt. (stating that officers may have actual or apparent authority).

45 *See* ULPA § 302 ("A limited partner does not have the right or the power as a limited partner to act for or bind the limited partnership."); RULLCA § 301(a) ("A member is not an agent of a limited liability company solely by reason of being a member."); Acosta v. La Piedad Corp., 894 F.3d 947, 952 (8th Cir. 2018) (noting that a shareholder is not an agent of the corporation); *Distinctness of Corporate Entity—Agency and Representation*, 1 FLETCHER CYCLOPEDIA OF L. CORPS. § 30 ("Generally, a shareholder is not an agent or representative of the corporation"); Hyde Park Venture Partners Fund III, L.P. v. FairXchange, LLC, 292 A.3d 178, 206 (Del. Ch. 2023) ("Delaware law does not view directors as agents."); Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996) (same); RSA § 14C ("Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members."); RTA § 1.01 cmt. f(2) (same).

46 *See* RTA § 1.01.

law with respect to fiduciary duties in firms.[47] Agents are fiduciaries and thus owe fiduciary duties.[48]

The duty of loyalty states that an agent may not materially benefit from the agency, act as or on behalf of an adverse party, compete with the principal, or misappropriate the principal's property and interests.[49] Together, these rules broadly proscribe abuse of position and trust such as conflict of interest transactions and self-dealing. The underlying normative idea is sound and uncontested. The set of conduct is the duty of loyalty *in classic form* that is universal in all laws of firms.[50]

The duty of care states that an agent must "act with the care, competence, and diligence normally exercised by agents in similar circumstances."[51] An agent has a duty "to act reasonably and to refrain from conduct that is likely to damage the principal's enterprise."[52] Care and competence incorporate tort-like duties of a substantive standard of care.[53]

The concept of good faith imbues agency. Good faith serves two roles. Firstly, because the scope of an agent's duties can be created through a real contract,[54] good faith is a contractual concept. When there is an underlying contract for agency, good faith is the contract rule of the implied obligation of good faith and fair dealing that attaches to all contracts and serves as a gap-

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47 *See id.* § 7.07 (providing for vicarious liability for employers when any employee acts as agents). Because agency relationships also exist among internal constituents in firms, the law of agency acknowledges that the laws of firms may be "relevant in determining the duties of care owed by an agent." *Id.* § 8.08 cmt. b.

48 *Id.* § 8.01.

49 *Id.* § 8.01.

50 *See infra* notes 63-65 and accompanying text (describing the duty of loyalty in noncorporate firms "in classic form"); notes 85-86 and accompanying text (same for corporations). *See also* Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1142 n.10 (2013) ("Outside of the good faith jurisprudence of the duty of loyalty . . . the traditional duty of loyalty is fairly uncontroversial as to basic principles."); In re Chelsea Therapeutics Int'l Ltd. S'holders Litig., 2016 WL 3044721 at *1 (Del. Ch. 2016) (describing classic loyalty as the "most straightforward part of the loyalty obligation").

51 RTA § 8.08.

52 *Id.* § 8.10.

53 *Id.* § 8.08 cmt. b.

54 *See id.* § 8.07, § 8.08. An agency does not require a contract, but simply mutual assent. *See id.* § 1.01 cmt. d ("[T]he consensual aspect of agency does not mean that an enforceable contract underlies or accompanies each relation of agency.").

filling term.[55] Secondly, when an agent acts, good faith is a condition to scienter. Whereas loyalty is grounded in dealings free of conflict of interest and care is grounded in the merit of the conduct, good faith is grounded in a connection between scienter and bad outcome.[56] Whenever an agent acts, she has "a duty to exercise the discretion in good faith."[57] An agent has a duty a duty of good conduct, which is "to act reasonably and to refrain from conduct that is likely to damage the principal's enterprise."[58]

B. Noncorporate Firms

Although the management structures of noncorporate firms differ, partnerships and LLCs share identical rules of fiduciary duties of managers therein. Limited partners and members in manager-managed LLCs do not owe fiduciary duties because they are passive owners.[59] Since general partners, managers, and members in member-managed LLCs exercise managerial authority, they owe fiduciary duties.[60] General partnership law provides the common template for the standards of conduct in all noncorporate firms.[61]

A partner owes the fiduciary duties of care and loyalty.[62] The duty of loyalty in classic form is:

> (1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner [including use of partnership property and taking a partnership opportunity] . . .; (2) to refrain from dealing with the partnership . . . as or on behalf of a

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55 *See id.* § 8.13 & cmt. b. *See also infra* note 78 and accompanying text.

56 *See supra* notes 49 & 51; RTA § 8.10.

57 RTA § 8.01 cmt. b. While a principal may consent to conduct that would otherwise violate the agent's fiduciary duty, the consent is valid only if "the agent acts in good faith." *Id.* § 8.06(1)(a).

58 *Id.* § 810.

59 RULLCA § 409(i); ULPA § 305. However, circumstance can impose fiduciary duties when they assume and exercise the powers of one who owes such duties. *E.g.,* Red River Wings, Inc. v. Hoot, Inc., 751 N.W. 2d 206, 219 (N.D. 2008) ("[L]imited partners who participate in the business of the partnership or act in concert with the general partner are subject to the fiduciary duties of loyalty and care and the obligations of good faith and fair dealing applicable to partners in a general partnership.").

60 RUPA § 409; ULPA § 409; RULLCA § 409.

61 *Compare* RUPA § 409; *with* ULPA § 409; RULLCA § 409.

62 RUPA § 409(a). *See* ULPA § 409(a); RULLCA § 409(a).

> person having an interest adverse to the partnership; and (3) to refrain from competing with the partnership . . . .[63]

These prohibitions form the duty of loyalty *in classic form*. They are universal proscriptions applicable to all fiduciaries, *i.e.*, agents, partners, members, managers, directors, and officers.[64] The descriptor "in classic form" is necessary because corporate law has identified bad faith acts, which do not involve self-dealing or conflict of interest, as another class of prohibitions under the duty of loyalty.[65]

The duty of care in noncorporate firms is stated as the duty "to refrain from engaging in grossly negligent or reckless *conduct*, willful or intentional *misconduct*, or a knowing violation of law."[66] This formulation prescribes a substantive standard of care, but is a lower standard than that in agency. When a partner engages in conduct in furtherance of the firm's business and affairs, the standard of care is "grossly negligent" or "reckless" rather than ordinary negligence.[67] The rule defines misconduct as acts with the more culpable level of scienter embodied in "willful," "intentional" and "knowing."[68]

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63 RUPA § 409(b). The laws of other noncorporate firms are identical. *See* RULLCA § 409(b); ULPA § 409(b).

64 *E.g., supra* notes 49-50 and accompanying text (providing identical prohibitions for agents); *infra* notes 85-86 and accompanying text (same for directors and officers).

65 *See infra* Section I.C. The Delaware Supreme Court recognized a difference between the duty of loyalty in classic form and other forms of loyalty, specifically the duty to act in good faith. *See* Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[T]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith."). Delaware courts sometimes attach the descriptors "traditional" or "classic" form of loyalty. *E.g.,* In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 751 (Del. Ch. 2005); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

66 RUPA § 409(c) (emphasis added). Like the duty of loyalty, the duty of care is identical in limited partnerships and LLCs. ULPA § 409(c); RULLCA § 409(c).

67 *See supra* note 51 and accompanying text (stating standard of care in agency). *See also See* RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 2 (2010) ("RTT") (defining recklessness); *id.* § 2 cmt. (defining gross negligence); Browne v. Robb, 583 A.2d 949, 953 (Del. 1990) (stating that gross negligence is "'an extreme departure from the ordinary standard of care").

68 *See* RTT § 1 (defining "intent").

Noncorporate firms are contract-based entities. Partnership and operating agreements are treated as real contracts.[69] The law provides mostly default rules that are subject to waiver, modification, or elimination per contract.[70] Owners and managers can contract for almost any term with respect to internal affairs, including contracting for fiduciary duties and defining good faith within specified limits that preserve the core of fiduciary duty.[71] Aside from a limited number of mandatory terms,[72] the contracts are subject to the principle of freedom of contract.[73]

Recognizing the essential contractual nature of noncorporate firms, the law mandates that partners bear the contractual obligation of good faith and fair dealing: "A partner shall discharge the duties and obligations . . . and exercise any rights consistently with the *contractual obligation* of good faith and fair dealing."[74] The obligation of good faith is *not* a fiduciary duty.[75] The uniform laws, for example, clearly distinguish the concept of "duty" and

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69 *See* Prodigy Ctrs./Atlanta No. 1 L.P. v. T-C Associates, Ltd., 127 F.3d 1021, 1023 (11th Cir. 1997) ("a partnership is a form of contract"); Lakes Region Gaming v. Miller, 62 A.3d 838, 842 (N.H. 2013) ("the operating agreement is a form of contract"); Jung v. El Tinieblo Int'l, Inc., 2022 WL 16557663, at *14 (Del. Ch. 2022) ("Operating agreements are contracts, and must be interpreted according to the same principles.").

70 *See* RUPA § 105(a)-(c) (providing the partnership agreement governs the firm's internal affairs and that "[t]o the extent the partnership agreement does not otherwise provide, this [Act] governs relations among the partners and between the partners and the partnership"); ULPA § 105(a)-(c) (same); RULLCA § 105(a)-(c) (same).

71 *See* RUPA § 105(d)-(e); ULPA § 105(d)-(e); RULLCA § 105(d)-(e). *See also supra* note 84.

72 *See* RUPA § 105(c); ULPA § 105(c); RULLCA § 105(c).

73 Delaware, among other states, explicitly state this policy in its statutes. DEL. CODE ANN. tit. 6, § 17-1101(c) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."); *id.* § 18-1101(b) (same with respect to operating agreements in LLCs). *See generally* Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503 (2017) (discussing how LLCs can contract around statutory default provisions).

74 RUPA § 409(d) (emphasis added). *See* ULPA § 409(d); RULLCA § 409(d).

75 *See* PA. UNIF. LTD. LIAB. CO. ACT OF 2016 § 8849.1, cmt. ("The contractual obligation of 'good faith' has nothing to do with the corporate concept of good faith that for years bedeviled courts and attorneys trying to understand: (i) Delaware's famous corporate law exoneration provision; and (ii) that provision's exception 'for acts or omissions not in good faith.' Del. Code Ann. tit. 8, § 102(b)(7) (2012). In that context, good faith is an aspect of the duty of loyalty. *See Stone v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006)."); *infra* note 80 and accompanying text. *See also infra* Section II.C. (describing the doctrine of bad faith, which is a subset of the duty of loyalty).

"contractual obligation."[76] Because noncorporate firms are contract-based,[77] the contractual obligation of good faith and fair dealing is simply the ordinary contract rule that all contracts are subject to "a duty of good faith and fair dealing in its performance and its enforcement."[78]

The obligation of good faith is a gap-filling term that ensure good faith compliance with a bargained for fruit as evinced in the firm's agreement.[79] It attaches to the underlying contract as agreed at the time of execution, and it does not exist as a free-floating duty to act equitably in all respects and circumstance in the present and the future, irrespective of whether or not owners and managers agreed on the matter in the past.[80] A fiduciary could engage in an inequitable, wrongful conduct that breaches fiduciary duty but not the implied obligation of good faith with respect to a bargained-for fruit struck at the time of the contract, and vice versa. Contractual obligation and fiduciary duty are different concepts.[81]

Because the structure of rights and duties are essentially contractual in nature,[82] the contractual obligation of good faith and fair dealing must be a mandatory term in firms. In other words, it would be a non sequitur if an agreement eliminates the very fruit bargain for in the agreement. Even Delaware, which permits the complete elimination of fiduciary duties in certain noncorporate firms (unlike the uniform law[83]), does not permit the elimination of the contractual obligation of good faith and fair dealing.[84]

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76 *See* RUPA § 409(a)-(d); ULPA § 409(a)-(d); RULLCA § 409(a)-(d).

77 *See supra* notes 69-70 and accompanying text.

78 RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

79 *See* Jeanes v. Allied Life Ins. Co., 300 F.3d 938, 942 (8th Cir. 2002); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir.1990); Dunlap v. State Farm Fire and Cas. Co., 878 A.2d 434, 441 (Del. 2005).

80 *See* Gerber v. Enterprise Prods. Hldgs., LLC, 67 A.3d 400, 418-19 (Del. 2013) ("The temporal focus is critical. Under a fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong. . . . An implied covenant claim, by contrast, looks to the past. It is not a free-floating duty unattached to the underlying legal documents.").

81 *See* Rhee, *supra* note 1, at 466-71 (explaining why equating fiduciary duty with a form of contract is "an extreme idea" and "wrong").

82 RUPA § 105(c)(6); ULPA § 105(c)(7); RULLCA § 105(c)(6); *infra* note 84.

83 *See* RUPA § 105(c)(5) (not permitting complete elimination of fiduciary duties); ULPA § 105(c)(6) (same); RULLCA § 105(c)(5) (same).

84 *See* DEL. CODE ANN. tit. 6, § 17-1101(d) ("[fiduciary] duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the

C. Corporations

The corporate duty of loyalty in its classic form is identical to the duty of loyalty under the laws of agency and noncorporate firms.[85] Directors and officers hold the corporation's interests, including property, profit, and business opportunity, and they must refrain from competing against the firm and from being in a position of conflict of interest by acting as or on behalf of a person who has an adverse interest.[86] This is where the similarities end. The corporate duty of care and the concept of good faith are strikingly different.

Firstly, corporate law fundamentally diverges on the duty of care. The seminal case of *Smith v. Van Gorkom* expresses the corporate duty of care as being informed in the decisionmaking process: "whether the directors have informed themselves prior to making a business decision, of all material information reasonably available to them."[87] This limited duty is subject to the gross negligence standard.[88] Delaware law makes clear that the concept of "substantive due care" is "foreign to the business judgment rule" and that the duty of care is limited to "the decisionmaking context [and] is process due care only."[89] So long as director fiduciaries are not grossly negligent in becoming informed with respect to their decisionmaking, the substance of the decision,

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partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing"); *id.* § 18-1101(c) (same with respect to LLCs).

85 *See supra* notes 49-50, 63-65 and accompanying text.

86 *See* MBCA § 8.31; Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests."); Thorpe v. CERBO, Inc., 676 A.2d 436, 442 (Del. 1996) ("directors may not compete with the corporation"); Krasner v. Moffett, 826 A.2d 277, 283 (Del. 2003) (holding that directors cannot have disabling conflict of interest in transactions).

87 Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)) (internal quotation marks omitted). *See* MBCA § 8.31(a)(2)(ii)(B) (imposing liability when "the director was not informed to an extent the director reasonably believed appropriate in the circumstances").

88 Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

89 Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000). *See supra* note 67 (defining "gross negligence"). *See generally* Rhee, *supra* note 92, at 1159-71 (describing the reasons for the substantive difference between corporation and tort laws, and explaining the theoretical tort foundation of the corporate duty of care).

smart or dumb, is irrelevant to culpability.[90] The duty of care is unlike duty in tort law, which mandates the duty to act as a reasonable person and finds culpability in unreasonable error.[91] A substantive standard of care cannot coexist with the business judgment rule, which is part and parcel of the primacy of board authority to manage the corporation.[92]

With respect to the concept of good faith, corporate law has no concept of a contractual obligation of good faith and fair dealing. The core managerial structure of a board of directors and the fiduciary duties of directors and officers are not contractual in nature.[93] Notwithstanding the articles of incorporation, bylaws, and shareholder agreements that are contracts or contract-like in character, real contracting in corporations do not form the foundation of fiduciary duties and their standards of conduct at the highest echelon of corporate management.[94] In contrast, the laws of noncorporate

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[90] *E.g.*, Kamin v. American Express Co, 383 N.Y.S.2d 807 (1976), aff'd, 387 N.Y.S.2d 993 (App. Div. 1976). *See* Rhee, *supra* note 50, at 1149-50 (describing how the business decision in *Kamin* was ex ante substantively erroneous and concluding that "[i]n spite of the demonstrably wrong decision, the court properly dismissed the plaintiff's complaint per the application of the business judgment rule").

[91] *See* RTT § 7(a) ("An actor ordinarily has a duty to exercise reasonable care when the actor's conduct creates a risk of physical harm.").

[92] The business judgment rule is the rebuttable presumption that directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). "Once applied, the business judgment rule precludes a substantive review of a board's action, irrespective of the correctness or the intelligence of a decision. The business judgment rule is striking in that not only does it protect risky decisions, but as courts and scholars cheerfully (and correctly) tell us it also protects foolish, awful, and egregious decisions, whereas tort law would never countenance the stupid person defense." Rhee, *supra* note 50, at 1150. *E.g.*, In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (stating that "degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability"); Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) (suggesting that "foolishly risky! stupidly risky! egregiously risky!" decisions provide no basis for liability).

[93] *See* DGCL § 141(a)–(b) (providing that the corporation's business and affairs "shall be managed by or under the direction of a board of directors" and that directors must be natural persons); *supra* note 97 and accompanying text (showing that fiduciary duties are mandatory and not subject to contracting).

[94] *See supra* note 37 (showing how corporate law provides fixed features in the structure of corporations); *infra* note 97 (showing that fiduciary duties are mandatory in corporate law, unlike the law of noncorporate firms). Obviously, if there is an underlying contract, such as an employment agreement involving officers or directors, contractual good faith would attach. As a contract doctrine, it applies to all real contracts. *See supra* notes 78-79 and accompanying

firms permit substantial contracting for duties or even their complete elimination in a minority of states such as Delaware.[95] For compelling reasons,[96] however, the contours of corporate fiduciary duties are mandatory and cannot be altered at all.[97] Thus, the concept of a *contractual* obligation of good faith and fair dealing is irrelevant to corporate fiduciaries.

Unlike the laws of noncorporate firms, good faith is a discrete component of the corporate duty of loyalty. Loyalty requires that corporate fiduciaries act in good faith. The Delaware Supreme Court defined bad faith as: "[1] where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, [2] where the fiduciary acts with the intent to violate applicable positive law, or [3] where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[98]

The first two classes of bad faith are ad hoc additions to the scope of fiduciary duties. A corporate fiduciary must not act in subjective bad faith. This form of duty covers a gap in the duty of loyalty in classic form, which is the distinction between motive and intent. It covers intentional misconduct

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text. However, the absence of the rule in ordinary discussion of fiduciary rules and standards of conduct in corporations confirms its irrelevance.

95 *See supra* notes 71 accompanying text; *supra* note 84 and accompanying text.

96 *See* Rhee, *supra* note 1, at 469 ("Perhaps the simpler explanation for why fiduciary duty in corporation law is mandatory and not subject to contracting . . . is that it would be a terrible idea in light of the fact that corporations are vitally important institutions in the economy. . . . . Contracting for corporate fiduciary duties would recklessly endanger the value inherent in the public equity markets and have the real potential for catastrophes that erode public trust."). *See also supra* note 81 and accompanying text. Contracting for fiduciary duties may result in greater opportunism. *See* Molk, *supra* note 73, at 557.

97 *See* Sutherland v. Sutherland, 2009 WL 857468, at *4 (Del. Ch. 2009) ("[eliminating fiduciary duty] is expressly forbidden by the DGCL."); Productivity Technologies Corp. v. Levine, 268 F.Supp.3d 940, 947 (E.D. Mich. 2017) (same); Williams v. 5300 Columbia Pike Corp., 891 F.Supp. 1169, 1183 n.30 (E.D. Va. 1995) ("Yet, a by-law amendment surely cannot eliminate directors' fiduciary duty of loyalty and fairness to shareholders.").

98 *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006) (quoting *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 755 (Del. Ch. 2005)). *See* Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369 (Del. 2006) (endorsing the *Disney* formulation). *See also* Marchand v. Barnhill, 212 A.3d 805, 820 (Del. 2019) ("[A] director must make a good faith effort to oversee the company's operations. Failing to make that good faith effort breaches the duty of loyalty and can expose a director to liability. "); In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 970 (Del. Ch. 1996) ("[I]t is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.").

where the fiduciary is not motivated by some personal benefit or interest.[99] A corporate fiduciary must also not intentionally violate positive law. This class of bad faith likewise does not fit within the paradigm of the duty of loyalty in classic form. The rule's rationale is that a firm is a child of law, and as such it must comply with the law.[100]

The third class of bad faith incorporates the *Caremark* doctrine. *Caremark* set forth the standard as: "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[101] *Caremark* imposes a duty of oversight of compliance with laws and regulations.[102] A failure of oversight constitutes bad faith and a breach of the duty of loyalty.

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[99] One type of subjective bad faith is when a fiduciary's conduct "motivated by an actual intent to do harm." In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 64 (Del. 2006); McElrath v. Kalanick, 224 A.3d 982, 991 (Del. 2020) (quoting *Disney*). "That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic." *Id.* at 67.

[100] This basic prescription is seen in the requirement that the certificate of incorporation must state a corporate purpose, which can be any activity under the sun so long as it is "lawful." *E.g.*, DGCL § 102(a)(3); MBCA § 3.01(a).

[101] In re Caremark Int'l Inc. Deriva. Litig., 698 A.2d 959, 971 (Del. Ch. 1996). *See* Stone ex real. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006) (approving the *Caremark* standard, but classifying it as a component of the duty of loyalty).

[102] *See* In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 131 (Del. Ch. 2009) ("Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company."). Cases under a *Caremark* theory of the case involve a failure of oversight of regulatory compliance of some sort, including *Caremark* itself. *E.g.*, In re Caremark Int'l Inc. Deriva. Litig., 698 A.2d 959 (Del. Ch. 1996); Stone ex real. AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006); Marchand v. Barnhill, 212 A.3d 805 (Del. 2019); In re McDonald's Corp. S'holder Deriv. Litig., 291 A.3d 652 (Del. Ch. 2023); In re Boeing Co. Deriv. Litig., 2021 WL 4059934 (Del. Ch. 2021); Teamsters Local 443 Health Servs. & Ins. Plan v. Chou, 2020 WL 5028065 (Del. Ch. 2020); In re Clovis Oncology, Inc. Derivative Litigation, 2019 WL 4850188 (Del. Ch. 2019). However, bad faith cases are also averred and recognized in contexts that do not have a nexus to regulatory compliance. *E.g.*, Lyondell Chemical Co. v. Ryan, 970 A.2d 235, 239-44 (Del. 2009) (analyzing bad faith in the context of decision on mergers and acquisitions); Allen v. Encore Energy Partners, L.P., 72 A.3d 93, 105 (Del. 2013). Although these cases cite *Caremark*, *Lyondell*, 970 A.2d at 240, the theory of the case in such failure of oversight cases is closer to subjective bad faith in the form of an intentional dereliction of duty, a conscious disregard for one's responsibilities. One who is derelict in duties does not subjectively believe that her conduct is in the best interest of the firm. Allen, 970 A.2d at 105.

Caremark is not as indubitably correct as the first two classes of bad faith are. Quibbles about its stringent standard aside,[103] it expresses a well-reasoned policy judgment of the Delaware courts. In principle, it is connected to the prohibition against intentional violation of positive law. A fiduciary's lawlessness *per se* harms the firm, even if motivated by profit maximization, because firms are creatures of law and thus should obey the law.[104] *Caremark* extends the principle to not just intentional violation of law, but also to the failure of oversight constituting gross disregard of regulatory or compliance obligation.[105]

The above three types of bad faith are not exclusive.[106] Corporate waste may also constitute a discrete form of bad faith.[107] The link between bad faith

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103 Satisfying the *Caremark* standard may be "the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." In re Caremark Int'l Inc. Deriva. Litig., 698 A.2d 959, 967 (Del. Ch. 1996). *Accord* Morris v. Spectra Energy Partners (DE) GP, LP, 246 A.3d 121, 133 n.57 (Del. 2021) (reciting *Caremark*'s "most difficult theory" comment).

104 *See supra* note 100; DGCL § 101(b) ("A corporation may be incorporated or organized under this chapter to conduct or promote any *lawful* business or purposes") (emphasis added); *id*. § 102 ("any *lawful* act or activity") (emphasis added); *id*. § 122(12) ("Transact any *lawful* business") (emphasis added). *See also* In re Massey Energy Co., 2011 WL 2176479, at *20 (Del. Ch. 2011) ("Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue 'lawful business' by 'lawful acts.'").

105 *See supra* note 102; In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 123 (Del. Ch. 2009) (commenting that the typical *Caremark* claim involve "a failure to properly monitor or oversee employee misconduct or violations of law"). *See also* Stephen A. Bainbridge, *Don't Compound the Caremark Mistake by Extending It to ESG Oversight*, 77 BUS. LAW. 651, 652 (2022) ("*Caremark* requires a board to proactively ensure that the corporation has established reasonable legal compliance programs."); Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2032 (2019) (stating that "*Caremark* has largely been cabined to the most extreme cases involving legal violations").

106 *See* Disney, 906 A.2d at 67 ("There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.") (quoting Disney, 907 A.2d at 756).

107 "Contemporary Delaware decisions have brought waste within the fiduciary framework of the business judgment rule by re-conceiving of waste as a means of pleading that the directors acted in bad faith." United Food & Com. Workers Union v. Zuckerberg, 250 A.3d 862, 880 (Del. Ch. 2020). *See* White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001) (equating waste to bad faith form of duty of loyalty); CanCan Dev., LLC v. Manno, 2015 WL 3400789, at *20 (Del. Ch. May 27, 2015) (same); Southeastern Penn. Transp. Auth. v. AbbVie Inc., 2015 WL 1753033, at *14 n.144 (Del. Ch. Apr. 15, 2015) (same). *See also* Benjamin B. Johnson, *A Theory of Corporate Fiduciary Duties*, 49 BRIGHAM YOUNG U.L. REV. 101, 131-34, 138 (2024) (discussing corporate waste as a form of constructive bad faith).

and waste can be traced as far back as the *Disney* line of cases.[108] Waste is defined as an irrational transaction, constituting the "outer limit" of the business judgment rule and good faith.[109] The irrationality goes beyond merely reckless, egregious, or dumb actions, all of which are covered by the business judgment rule.[110] Waste is an "equitable safety value,"[111] permitting judicial intervention when a transaction is so inexplicable that it breaks the hard judicial policy preference of not interfering with managerial decisions. Waste is really actual or constructive knowledge of corporate harm, which can easily be conceptualized as bad faith. Until recently, Delaware cases treated waste and bad faith as separate theories of liability despite recognizing their similarities,[112] and even recent cases sometimes treated the two theories as distinct.[113] However, a substantial line of recent cases now has functionally treated waste as a claim for bad faith.[114] The chancery court has also

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108 *See* Disney, 907 A.2d at 749 ("The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith."); Brehm v. Eisner, 746 A.2d 244, 263, 264 (Del. 2000) (noting that "*good faith judgment*" cannot constitute waste and that waste "may tend to show that the decision is not made in good faith") (emphasis in original).

109 *See* Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988) (stating that waste constitutes a transaction "so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid"). The irrationality of corporate waste cannot be explained under the conflict of interest paradigm.

110 *See supra* note 92 and accompanying text (discussing the business judgment rule).

111 Harbor Fin. P'rs v. Huizenga, 751 A.2d 879, 895 (Del. Ch. 1999).

112 White v. Panic, 783 A.2d 543, 554 & n.36 (Del. 2001); In re Rexene Corp. S'holders Litig., 1991 WL 77529, at *4 (Del. Ch. 1991). *See* Steiner v. Myerson, 1995 WL 441999, at *5 (Del. Ch. 1995) ("The waste claim entails no claim of bad faith or conflict of interest (if it did it would be a breach of fiduciary duty claim).").

113 *See* In re Boeing Co. Deriv. Litig., 2021 WL 4059934, at *35 (Del. Ch. 2021) (treating the theories as distinct, though they are "similarly stringent"); In re Essendant, Inc. S'holder Litig., 2019 WL 7290944, at *1 (Del. Ch. 2019) (distinguishing claims for fiduciary duty and waste).

114 *See* FMLS Hldg. Co. v. Integris BioServices, LLC, 2023 WL 7297238, at *8 (Del. Ch. 2023) ("KCAS argues that bad faith requires FMLS to plead conduct 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.' KCAS is requiring FMLS plead waste."); Knight v. Miller, 2022 WL 1233370, at *6 (Del. Ch. 2022) ("[Waste] is a close kin to a claim of bad faith."); In re Vaxart, Inc. S'holder Litig., 2021 WL 5858696, at *22 (Del. Ch. 2021) ("Plaintiffs' bad faith claim boils down to . . . essentially [a claim of] corporate waste."); Equity-League Pension Trust Fund v. Great Hill Partners, L.P., 2021 WL 5492967, at *9 (Del. Ch. 2021) ("Thus conceived, bad faith is similar to the much older fiduciary prohibition of waste, and like waste, is a *rara avis*.") (quoting In re Chelsea Therapeutics Int'l Ltd. S'holders Litig., 2016 WL 3044721, at *1 (Del. Ch. 2016));

announced explicitly that waste is the fourth form of bad faith.[115] Thus, barring a rejection by the supreme court, waste has now been folded into bad faith jurisprudence and thus constitutes a breach of the duty of loyalty.

Bad faith as a breach of the duty of loyalty is best understood as ad hoc gap-fillers in the scope of fiduciary duty. The duties of care and loyalty in

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McElrath v. Kalanick, 224 A.3d 982, 995 n.67 (Del. 2020) ("The plaintiff also briefly raises his waste claim. But because this claim requires finding waste on the same facts that we do not find bad faith, we also find it to be without merit."); REJV5 AWH Orlando, LLC v. AWH Orlando Member, LLC, 2018 1109650, at *4 (Del. Ch. 2018) ("[W]hen one fails to act in a manner that one reasonably believed, or should have believed, was in the best interest of the Company, one is failing to act in good faith and, consequently, one is acting in bad faith. [G]ood faith and bad faith are two sides of the same coin.").

115 *See* Conte v. Greenberg, 2024 WL 413430, at *11 (Del. Ch. 2024) ("A claim for waste derives from the duty of loyalty's subsidiary element of bad faith."); IBEW Local Union 481 Defined Contribution Plan & Tr. v. Winborne, 301 A.3d 596, 622 (Del. Ch. 2023) ("Although was historically viewed as a type of ultra vires act that was beyond a fiduciary's power to take, contemporary Delaware authorities have integrated the concept into the business judgment rule as a means of pleading bad faith."); In re McDonald's Corp. S'holder Deriv. Litig., 291 A.3d 652, 694 (Del. Ch. 2023) ("Contemporary Delaware decisions have brought waste within the fiduciary framework of the business judgment rule by receiving waste as a means of pleading that the directors acted in bad faith."); Harris v. Junger, 2022 WL 1657551, at *4 (Del. Ch. 2022) (stating that waste is "a subset of good faith under the umbrella of the duty of loyalty") (quoting Friedman v. Dolan, 2015 WL 4040806, at *5 n.32 (Del. Ch. 2015)); Bamford v. Penfold, L.P., 2022 WL 2278867, at *47 (Del. Ch. 2022) ("Contemporary Delaware decisions have brought waste within the fiduciary framework of the business judgment rule by reconceiving waste as a means of pleading that a fiduciary acted in bad faith."); United Food and Commercial Workers Union v. Zuckerberg, 250 A.3d 862, 879 n.4 (Del. Ch. 2020) ("Contemporary Delaware decisions have brought waste within the fiduciary framework of the business judgment rule by re-conceiving of waste as a means of pleading that the directors acted in bad faith."); In re Books-A-Million, Inc. S'holders Litig., 2016 WL 5874974, at *8 (Del. Ch. 2016) ("When the business judgment rule provides the operative standard of review, then a court will not consider the substance of the transaction unless its terms are so extreme as to constitute waste and thereby support an inference of subjective bad faith."); CanCan Dev., LLC v. Manno, 2015 WL 3400789, at *20 (Del. Ch. May 27, 2015) ("Although traditionally viewed as a separate cause of action, a waste claim is best understood as one means of establishing a breach of the duty of loyalty's subsidiary element of good faith.") (citing Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)); Se. Pa. Transp. Auth. v. Abbvie Inc., 2015 WL 1753033, at *14 n.114 (Del. Ch. 2015) ("This Court has found that, doctrinally, waste is a subset of good faith under the umbrella of the duty of loyalty ...."), *aff'd,* 132 A.3d 1 (Del. 2016) (TABLE), *overruled on other grounds by* AmerisourceBergen Corp. v. Lebanon Cnty. Empls.' Ret. Fund, 243 A.3d 417 (Del. 2020); Disney, 907 A.2d at 749 ("The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith.") (citing *White v. Panic*, 783 A.2d 543, 553–55 (Del. 2001)); Principal Growth Strategies, LLC v. AGH Parent LLC, 2024 WL 274246, at *9 n.8 (Del. Ch. 2024) ("A claim for waste is a type of claim for breach of fiduciary duty, with waste operating as a means of pleading bad faith.").

classic form focus on decisionmaking process and conflict of interest dealings, respectively. This scheme leaves gaps, not covering other kinds of bad conduct that Delaware courts recognized through the bad faith doctrine. Because the scienter accompanying bad faith acts is opprobrious, the conduct falls under the category of the duty of loyalty. The important pragmatic implication of this taxonomy is that fiduciaries who act in bad faith cannot be exculpated.[116]

D. Calibrated Fiduciary Duties

The laws of firms are substantively identical in the duty of loyalty in classic form.[117] They collectively prohibit the most common ways that a fiduciary can harm the firm for the motive of self-interest.[118] The core principle is undoubtable and redoubtable. From this common point, the law diverges. The duty of care and the concept of good faith have branched off into winding paths that intersect and diverge at different places in the laws of firms. The table below summarizes the different standards of conduct.

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116 *See* DGCL § 102(b)(7).

117 *See supra* note 49, 63, 86 and accompanying text.

118 Conflict of interest transactions are not void *per se*. The laws of firms provide different ways to maneuver around fiduciary duties. Partnership or operating agreements can permit certain transactions that would otherwise violate the duty. *See, e.g.*, RUPA § 105(c)(5), (d)(3) (providing for certain aspects of the duty of loyalty to alteration or elimination "if not manifestly unreasonable"); ULPA § 105(c)(6), (d)(2) (same); RULLCA § 105(c)(5), (d)(3) (same). Conflicted transactions may still be fair, typically when they arise from good intentions and business necessity. *See* RUPA § 409(g) (providing for a defense that the "transaction was fair"); RULLCA § 409(g) (same); ULPA § 409(g) (same). The taint of a conflict can also be cleansed through prophylactic measures ensuring that the taint is cordoned from decisionmaking. *See, e.g.*, RTA § 8.06 (providing that principal's consent may approve agent's action that would otherwise violate the duty of loyalty); DGCL § 144 (permitting approval of shareholders or disinterested directors); Kahn v. M&F Worldwide Corp., 88 A.3d 635, 645 (Del. 2014) (providing prophylactic measures that would cleanse the taint of a controlling shareholder buyout of minority shareholders).

TABLE 1: MAPPING DUTY OF CARE AND GOOD FAITH IN FORMS OF FIRMS

	Agency	Noncorporate Firms	Corporations
Duty of Care	"to act with the care, competence, and diligence normally exercised in similar circumstances"	"refrain from" (1) "grossly negligent or reckless conduct" or (2) "willful or intentional misconduct, or knowing violation of law"	to be "informed prior to making a business decision, of all material information reasonably available," and this duty is reviewed for gross negligence
Concept of Good Faith	(1) Good faith as condition of scienter on all actions (2) Contractual obligation of good faith and fair dealing	(1) Good faith is not independent fiduciary duty (2) "contractual obligation of good faith and fair dealing"	Bad faith breaches duty of loyalty when fiduciary (1) "intentionally acts with [subjective bad] purpose" (2) "acts with intent to violate positive law" (3) "intentionally fails to act in face of known duty to act, conscious disregard for duties" (4) irrationally wastes assets

The key differences are three. Firstly, the concept of contractual good faith and fair dealing plays no role in corporate law. Corporate fiduciary duties are not subject to contracting and are fixed by law.[119] Noncorporate firms, on the other hand, are contract-based firms and permit substantial contracting for the standard of conduct.[120] Thus, contractual good faith is an important element in the laws of noncorporate firms.

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119 *See supra* notes 93 & 97 and accompanying text. To the extent that real contracts are at work, they are likely found in contracts begetting or invoking agency, in which case the law of agency would apply. *See* RTA § 1.01 cmt. f(2) ("A director may, of course, also be an employee or officer (who may or may not be an employee) of the corporation, giving the director an additional and separate conventional position or role as an agent.").

120 *See supra* notes 21, 30, 69-73 and accompanying text. *See also* Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693, 1710-17 (2020) (discussing the possibility of contracting for internal rules, including fiduciary duties, in noncorporate firms).

Secondly, the duty of care in the laws of agency and noncorporate firms requires a review of the substance of the manager's action, whereas the corporate duty of care does not impose a minimum substantive standard. The duty of care in the law of agency is the tort standard of the reasonable person. The noncorporate duty of care is also a substantive standard, but proscribes the lower standard of "grossly negligent or reckless *conduct*" and "willful or intentional *misconduct*, or a knowing violation of law." In sharp contrast, the corporate duty of care is limited to the process of decisionmaking.[121]

Thirdly, corporate bad faith acts could also occur in the noncorporate context. In this regard, we see a perplexing overlap in laws. All four forms of corporate bad faith nicely overlap with the noncorporate duty of care. The table below summarizes how the corporate duty of *loyalty* under the doctrine of bad faith maps onto the noncorporate duty of *care*, which incorporates both misfeasance (conduct) and malfeasance (misconduct).[122]

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121 *See supra* note 89 and accompanying text.

122 Delaware characterizes "willful misconduct" and "bad faith" as corresponding to the duty of loyalty, and "gross negligence" as corresponding to the duty of care. *See* In re Cadira Grp. Hldgs., LLC Litig., 2021 WL 2912479, at *11 (Del. Ch. 2021) ("[A] contractual duty to refrain from 'willful misconduct' or 'bad faith' corresponds with the traditional duty of loyalty, and a contractual duty to refrain from 'gross negligence' corresponds with the traditional duty of care."). *See also* United Bhd. of Carpenters Pension Plan v. Fellner, 2015 WL 894810, at *4 (Del. Ch. 2015) ("Willful misconduct is one standard for evaluating whether a fiduciary breached the duty of loyalty by acting in bad faith."); Zimmerman v. Crothall, 2012 WL 707238, at *6 (Del. Ch. 2012), as revised (Mar. 27, 2012) (concluding that "self-dealing" and "willful misconduct" correspond with the duty of loyalty).

TABLE 2: MAPPING NONCORPORATE CARE ONTO CORPORATE BAD FAITH

	Corporations	Noncorporate Firms	
Duty of Loyalty (Bad Faith)	(1) "Intentionally acts with [bad] purpose"	(1) "Willful or intentional misconduct"	Duty of Care
	(2) "Intent to violate positive law"	(2) "Knowing violation of law" and "Grossly negligent or reckless conduct"	
	(3) *Caremark* duty: "Intentionally fails to act in face of known duty to act, a conscious disregard for his duties"	(3) "Reckless conduct" covering *Caremark*	
	(4) Waste, irrational squander of assets	(4) "Reckless conduct" covering waste	

Directors and officers breach the duty of *loyalty*, and partners, members, and managers breach the duty of *care* when these fiduciaries engage in the four forms of bad acts identified in the corporate bad faith doctrine. The only difference between the two laws is how they taxonomically classify these acts in the rubric of care and loyalty. Although corporate law provides the lowest standard of conduct under the duty of care, it expands the scope of culpability through the doctrine of bad faith. The laws of firms do not subsume the four forms of corporate bad faith into the duty of loyalty in classic form for the simple reason that bad faith acts do not neatly fit the paradigm of conflict of interest. They are normatively bad and should inform the law of noncorporate firms. In fact, they do. They fit snugly into the noncorporate duty of care.[123] All is good, except for the fact that corporate law categorizes bad faith acts as a *loyalty* problem and law of noncorporate firms as a *care* problem (this taxonomical difference too must be resolved[124]).

In summary, the laws of firms markedly differ on the scope of *misfeasance*. The law of agency mandates the highest standard of care, and corporate law the lowest. The fiduciaries duties are calibrated in the laws of firms.

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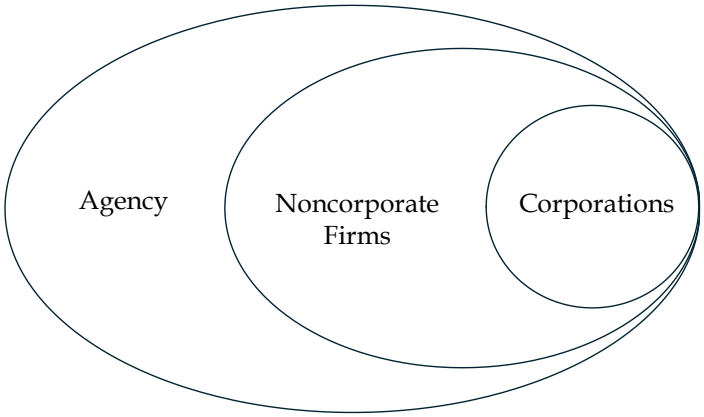
123 Likewise, equivalent misfeasant and malfeasant conduct would violate the good faith obligations under the law of agency. *See supra* notes 56-58 and accompanying text.

124 *See infra* Sections V.D. & notes 220-221 and accompanying text.

FIGURE 1: CALIBRATED FIDUCIARY DUTY



The law shuffles, reclassifies, and relocates elements of the duty of care and the concept of good faith in the forms of firms. Why? What is the theory of calibrated fiduciary duties in firms?

III. NORMATIVE THEORY OF CALIBRATION

A. Bilateral Relational Risk

As Rome is the eternal city, profit is the eternal motive. It is good and owners always want more. Based on this axiom, a natural intuition follows: If maximal profit is the end in all for-profit firms, and if fiduciary duty serves this motive, the standard of conduct should converge to a single expression that would optimally produce maximal profit irrespective of the form of firm. This reasoning, however, is wrong in fact and in theory. In fact, each form of firm formulates bespoke rules. In theory, a counterintuition must be correct: The motive force of maximal profit is *irrelevant* to an inter-form theory of legal divergence because the motive is a constant in all forms of firms and thus cannot explain variations in fiduciary rules that affect managerial incentives and business outcomes. We search not for a constant, but for a variable.

Although the profit motive is a constant, maximal profit is not always the optimal welfare state. The welfare of owners and managers takes into account their exposure to risk and their risk preferences, and thus the optimal welfare state varies among forms of firms. Risk, then, is the conceptual variable. Profit

and risk are conjoined because risk is unavoidable in venturing for profit.[125] Financial economics has long given us the insight that profit is good but risk is bad.[126] The two are tradeoffs and thus are correlated. An investor should expect ex ante greater profit as she assumes greater risk.[127] Business risk is an overarching concept, embodying many forms of risk, such as market risk, price risk, credit risk, political risk, fortuitous risk, competition risk, etc. The core managerial function is to arbitrate this risk–return duality in executing the firm's business strategy.

When managers and owners venture together, they are exposed to another form of risk. This Article introduces the idea of *bilateral relational risk*, which is the intrinsic risk that arises from the relationship between owners and managers as they venture together and are bound in a legal relation. The most familiar form of this risk is agency cost, which is the *owner's* risk of loss from managerial misfeasance and malfeasance.[128] A preoccupation in economic and legal literature for many years have been that firm governance must mitigate managerial agency cost to owners.[129] This passion skews the perspective. Agency cost is simply the bilateral relational risk that runs directionally to owners. The economic model revolving around the owner's welfare and agency cost tells only half the story.

When owners and managers venture together, they bear risks that are intrinsic in this relationship. The untold half of the story is the *manager's* risk

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125 *See* Rhee, *supra* note 50, at 1181 ("Business risk, which includes the risk of bad decisions, is part and parcel with a market economy. Uncertainty and profit are conjoined twins. In an efficient market, one must take risk to achieve return."). The capital asset pricing model in financial economics states that risk and investment return are linked. *See* ROBERT J. RHEE, CORPORATE FINANCE 48 (2d ed. 2023) ("As risk increases, investors demand more return and thus the investment must yield a greater return, and vice versa.").

126 *See* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 77 (1952) ("We next consider the rule that the investor does (or should) consider expected return a desirable thing and variance of return an undesirable thing. This rule has many sound points, both as a maxim for, and hypothesis about, investment behavior.").

127 Profit is never guaranteed. Only the risk-free rate provides a rate of return free from risk. Profit is an ex ante expectation based on the level of risk assumed.

128 *See* Jensen & Meckling, *supra* note 10, at 308-10 (discussing agency cost); *infra* Section III.C. (discussing the theory of agency cost).

129 *See supra* note 10 and accompanying text. Much of corporate governance has been preoccupied with mitigating agency cost. *E.g.*, George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1117-18 (2004); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1110 (1995).

of loss from liability to owners and the firm.[130] Of course, we have always known about the reality of liability ever since the law first imposed fiduciary duty and liability for breach,[131] but we have not connected the owner's risk of agency cost to the manager's risk of liability in a theoretical framework. The new conceptual language in the discourse on firm governance is the idea of bilateral relational risk: the concept that the owner's agency cost and the manager's liability cost should be considered as two halves of a single idea.

Fundamentally, a fiduciary relationship means that the fiduciary and the obligee have assented to be bound together in legal duty and relation. In theorizing governance according to the orthodox framework of agency cost, academic literature has always focused on owners and their burden of agency cost. This perspective is only half correct. We must consider relational risk holistically. Like profit and risk, bilateral relational risks are conjoined. Owners and managers mutually benefit each other, but also impose bilateral costs. When owners allege that managers bungled or betrayed trust, managers are exposed to liability. This risk of loss is the bilateral relational risk that runs directionally to managers.

B. Intermediated Risk Preference

Managers and owners bear the albatross of risk. Owners assume business risk for which they expect profit, and owners and managers bear bilateral relational risk. When venturing together, owners and managers do not shed their innate human nature. Their risk preferences come to fore and affect managerial incentives and actions, and thus business outcomes. Therefore, the optimal level of welfare state is the mix of profit expected and risk assumed.

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130 Liability cost is not a "bonding cost" form of agency cost. Bonding cost is incurred when the agent "expend[s] resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions." Jensen & Meckling, *supra* note 10, at 308. *See infra* notes 144-149 and accompanying text (describing the theory and the components of agency cost).

131 Lawyers and academics learned this lesson anew in the wake of *Smith v. Van Gorom*, 88 A.2d 858 (Del. 1985). They were shocked that the Delaware Supreme Court imposed liability for a breach of the duty of care. *E.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 139 (1988) (noting that the case exhibited a "mysterious anti-management bias"); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1454 (1985) ("Van Gorkom [is] surely one of the worst decisions in the history of corporate law.").

Empirically, most people are risk averse.[132] We reasonably assume that owners and managers start from the initial position of personal risk aversion.[133] Like the profit motive, individual risk aversion is a constant. But this preference is not always expressed in managerial actions because personal risk preferences are intermediated through the form of firm to produce managerial actions that express the firm's *intermediated risk reference*. This risk preference reflects each form of firm's optimal welfare level of profit expected and risk taken, and it is actuated by a set of rules that incentivizes managerial actions to achieve this welfare level in spite of any innate personal predilections. The degree of intermediation depends on the nature of each form of firm. Thus, expressed risk preference is not a constant but a variable.

Let's start with the agency relationship. It is not envisioned exclusively as a business venture. It serves the broadest segment of society, from family relations to real estate agents to corporate officers.[134] The core activity of an agency is not profit making, but instead representation. The motive force is fidelity to instructions and intent. From this perspective, agency is not fundamentally a risk-taking activity at all. Success is not measured by *ex ante* profit but by *ex post* accomplishment of explicated instructions. An agency relationship is not a firm. It imparts no firm intermediation, meaning that the natural preferences of individuals govern. Risk aversion is the strongest in agency.[135] However, since an agency relationship is assentual, duties arising

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132 RHEE, *supra* note 125, at 45; Robert J. Rhee, *A Production Theory of Pure Economic Loss*, 104 NW. U.L. REV. 49, 89 (2010); Richard A. Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159, 162 (1986).

133 Risk aversion means that a person will pay some amount in the form of foregone ex ante payout to avoid risk in favor of certainty. Suppose project A has a certain payout of 100 and project B has coin flip payouts of (220, 0) with an expected value of 110. Depending on the degree of risk aversion, a risk averse person may select project A even though ex ante it is less profitable than project B. On the other hand, a risk neutral person is indifferent to risk and chooses based on expected value alone. She will choose project B because it is more profitable. *See* RHEE, *supra* note 125, at 45.

134 *See* RTA § 1.01 cmt. c ("Agency encompasses a wide and diverse range of relationships and circumstances."); Hubert v. Harpe, 182 S.E. 167, 168 (Ga. 1935) ("A child, however, may occupy the position of a servant or agent of his parent, and for his acts as such the parent may be liable under the general principles governing the relation of master and servant, or principal and agent."); Hurney v. Locke, 308 N.W.2d 764, 768 (S.D. 1981) (stating that real estate agents are agents to their clients); MBCA § 8.41 official cmt. (stating that corporate officers may be agents).

135 In other words, if a buyer principal instructs her agent to make an offer for *X* (*e.g.*, a specific home) it would be unreasonable for the agent to make an offer for *Y* on the honest and expert thought that *Y* would clearly be a better economic deal.

therefrom can be subject to contracting.[136] If risk aversion is not preferred, contracting can intermediate the preference toward risk neutrality.

Noncorporate firms are business ventures that require risk-taking by owners and managers. The form of firm intermediates individual risk preferences, and the degree of this intermediation depends on the firm's optimal level of risk. Noncorporate firms are characterized by smaller ventures in which owners have closer proximity to the business and the manager.[137] They are less diversified in terms of products and business lines than public corporations. Owners often have their principal economic livelihoods tied to the firm, unlike public shareholders. They frequently manage the firm or work there as employees. Together, these characteristics suggest that owners are more sensitive to business risk because bad outcomes will sting more. Intermediated risk preference moves toward risk neutrality, but still retains some degree of personal risk aversion. However, since noncorporate firms are contractual in nature, duties arising therefrom can be subject to some degree of contracting.[138] If risk aversion is preferred, contracting can intermediate the preference toward risk neutrality.

Public corporations are large, complex ventures. They have the most owners, the biggest capital cushion, the greatest diversity of businesses, the most specialized managers, and the most complex business structures writ large. They can embrace risk neutrality, which may result in big or frequent losses but ex ante is the profit maximizing strategy.[139] Since managers bear bilateral relational risk, corporate law grants managers a super-shield against liability, which is the business judgment rule.[140] This rule limits the liability of risk averse managers and incentivizes their risk-taking.[141] Unlike owners in noncorporate firms whose economic livelihood are frequently tied to their firm, public shareholders can easily diversify their exposure to the unique risk of

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136 RTA § 8.07 ("An agent has a duty to act in accordance with the express and implied terms of any contract between the agent and the principal.").

137 *See supra* Section I (describing the general characteristics of noncorporate firms).

138 RUPA § 105(d)(3); ULPA (2001) § 105(d)(2); RULLCA § 105(d)(3); DEL. CODE ANN. tit. 6, § 17-1101(d) (limited partnerships); *id.* § 18-1101(c) (LLCs).

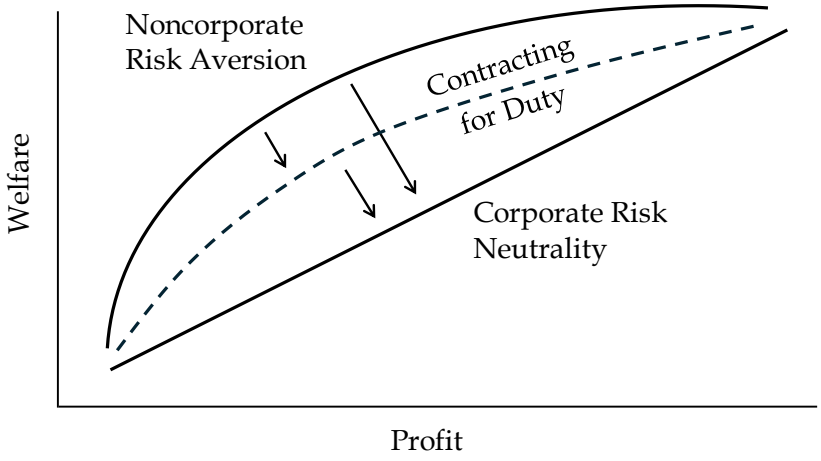
139 *See generally* Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L REV. 1951 (2018) (advancing a positive legal theory explaining why and how the law institutes shareholder profit maximation as a rule of law).

140 *See supra* note 92 (stating that business judgment rule).

141 "Risky decisions produce a social gain (and not a social loss), and the business judgment rule incentivizes risk averse directors to take risks by shielding them from unfair and disproportionate liability." Rhee, *supra* note 50, at 1180, 1181.

the corporation by holding a diversified portfolio.[142] A diversified portfolio ensures that any given unique risk of a specific firm, say Enron, is diversified away such that an investor bears only the market risk. The corporate form intermediates risk preference in favor of risk neutrality.[143]

FIGURE 2: INTERMEDIATED RISK AVERSION



In summary, the linkage between bilateral relational risk and intermediated risk preference is critical to our understanding of fiduciary duties. With profit as a constant and risk as a variable, there is no single uniform optimal state of welfare. Owners and managers in a firm are exposed to bilateral relational risk arising from their relationship. Agency cost is the risk that runs directionally to owners, and liability cost is the risk that runs directionally to managers. Firms intermediate personal risk preferences such that owners and managers choose actions that express a firm's intermediated

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142 *See* RHEE, *supra* note 125, at 71 (explaining that diversification "eliminates exposure to firm-specific risk of investing in a particular company" but "cannot eliminate the risk inherent in an investment in a market portfolio"); Johnson, *supra* note 107, at 112 ("It is important to recognize that well-diversified investors want boards to be risk neutral. . . . Since investors are presumably diversified, they want the board to be risk-neutral, so all that matters is the expected value.").

143 "The structure of corporation law is built on two grand rules limiting the liability of participants in the corporate enterprise. The first is the rule of limited liability of shareholders. The second is the rule limiting the liability of directors under the business judgment rule. Jointly these rules promote enterprise by allowing shareholders and directors to take risks without fear of catastrophic personal liability. Without them there would be no corporation as we know it." Rhee, *supra* note 50, at 1140.

risk preference. This dynamic reveals an important insight: *Given the unique characteristics of each form of firm, the state of optimal welfare must vary with intermediated risk aversion that diminishes along the line of agency, noncorporate firms, and corporations with permissive contracting that can close the gap between default risk aversion and preferred risk neutrality*.

C. Topology of Managerial Costs

The basic idea of agency cost is that agents impose costs in various ways. A developed but deeply flawed version of this idea comes from the economics literature.[144] The two forms of agency costs are particularly important: monitoring cost and residual loss.[145] Monitoring cost is cost incurred "to limit the aberrant activities of the agent" through monitoring devices, such as costs of oversight.[146] Residual loss results from "some *divergence* between the agent's decisions and those decisions which would maximize the welfare of the principal."[147] Importantly, mere *ex post* loss from a manager's action is *not*

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144 *See* Jensen & Meckling, *supra* note 10, at 308-10 (defining agency cost as the sum of monitoring costs, bonding cost, and residual loss). Jensen and Meckling's assertion of a "principal–agent" relationship. This assertion is deeply flawed because the metaphor plainly contradicts the rule of law, and since firms are creatures of law, any proffered economic model should at least be consistent with the law. Their description is doubly wrong in legal terms. Firstly, it is clear that "directors and officers are not agents of stockholders, nor are the stockholders their principals." In re Columbia Pipeline Grp., Merger Litig., 299 A.3d 393, 456 n.24 (Del. Ch. 2023). Secondly, a fundamental feature of an agency relationship is that the principal controls the agent. RTA § 1.01. It is clear that shareholders do not have this quality of control, neither in directness nor strength of control over managers. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 291 (1999) ("Because American law does not permit shareholders to command the board to action, describing directors as shareholders' 'agents' grossly misrepresents at least the legal nature of their relationship."); Robert C. Clark, *Agency Costs versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 56 (John W. Pratt & Richard J. Zeckhauser eds., 1985) ("neither officers nor directors are agents of the stockholders"); Palkon v. Maffei, 311 A.3d 255, 269 n.19 (Del. Ch. 2024) ("The principal-agent problem uses the language of economic theory, not the language of legal relationships."); Arnold v. Soc'y for Sav. Bancorp., Inc., 678 A.2d 533, 540 (Del. 1996) ("It would be an analytical anomaly, therefore, to treat corporate directors as *agents* of the corporation when they are acting as *fiduciaries* of the stockholders in managing the business and affairs of the corporation.").

145 *See* Jensen & Meckling, *supra* note 10, at 308. Bonding cost is less relevant for the analysis here. *See supra* note 130 (discussing bonding cost).

146 *Id.* at 308.

147 *Id.* (emphasis added).

a residual loss per se because have *ex ante* an owner may desired the action. Business venturing is risky, and losses are expected as part and parcel of risk-taking.[148] Residual loss results only when the manager's action diverges from the principal's ex ante preference.[149]

Aside from compensation,[150] managers impose direct cost on firms in only three ways: (1) malfeasance, (2) misfeasance, and (3) shirking. Losses may be quantitatively the same in amount but qualitatively different in character. Malfeasants are bad actors; they proverbially lie, steal, or cheat. Malfeasance is disloyalty in classic form. Misfeasants are poor managers. They are careless, incompetent, or unlucky. Shirkers are lazy managers.[151] They are derelict in fulling the minimum obligation of effort and diligence. The business world is surely populated by malfeasants, misfeasants, and shirkers, along with yeomen and stars. These three forms of bad acts reveal the topology of managerial costs.

Shirking is the source of managerial cost that is least susceptible to the law's suasion based on duty and liability. The remedy for shirking is not in the realm of legal rule–sanction but instead in the realm of best practices in managerial hiring and private contracting for incentives.[152] The fiduciary rule

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148 *See supra* note 125 and accompanying text.

149 For example, a manager's self-dealing imposes residual loss because clearly the owners would not have approved of the action.

150 Compensation schemes may affect managerial incentives, which may align the interest of managers and owners, thus potentially mitigating agency cost.

151 Economists have sought to understand how to deal with shirking, discovery of effort, and incentives. *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (discussing the problem of eliciting information regarding shirking in the context of team production).

152 Fiduciary duty imposes a minimum level of high conduct and high culpability, and the lowest levels of culpability such as shirking lies outside of the fiduciary zone. Ordinary sloth is simply not a breach of fiduciary duty. Extraordinary dereliction may rise to misfeasance to the extent that it may result in a breach of the duty of care, or malfeasance that really is subjective bad faith, *Caremark* violation, or similar bad acts. Although shirking is not disloyalty in the classic form, it is a lighter hue of the same problem in that the manager is not the owner and has personal incentives that diverge from the interest of owners, resulting in some shirking. In the main, shirking lies outside of the fiduciary scheme, and it is best addressed in the concept of agency cost. The possibility of shirking may necessitate monitoring, and a fiduciary may agree to assume certain bonding cost to assure that he will shirk. Economic theory has helpfully shown that the solution to shirking lies in the carrot of contractual mechanisms such as compensation that align the fiduciary's interest with the owner's interests, and the stick of disciplining mechanisms such as expulsion.

works best against malfeasance and misfeasance. The difference between the two is conceptually important.[153]

1. Malfeasants.—The problem of malfeasants is much easier to understand and remedy. Their bad motive and moral delinquency mean that their actions harm *per se*. The economists' theory of agency cost best fits the malfeasant model because the worst kind of manager produces the greatest departure from the best interest of owners.[154] Bad people being who they are and temptation being what it is, such managers surely exist. Yet standard accounts of economic theory add little to our understanding of malfeasants. The law has always had a simple, powerful way to deal with bad actors, whether their actions invoke tort law, criminal law, or law of firms.

Since the inception of fiduciary relationships and their stringent legal duties tinged by moral sentiment,[155] the duty of loyalty in classic form has always proscribed all forms of conflict of interest dealings.[156] The problem of classic disloyalty does not need an economic theory for greater insight beyond what has long been obvious to the law and lawyers. A rigid requirement to be loyal in fact is a bedrock principle of fiduciary law.[157] The law has well policed such malfeasance. The duty of loyalty imposes a stringent standard.[158] Foremostly, corporate fiduciaries are not exculpated from money damages for a breach of loyalty, and thus liability for lying, stealing, and cheating will bite without mercy. The risk of liability *sans* legal defenses is a powerful disincentive.[159] Few would consider the legal duty–sanction framework an

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153 *See supra* notes 43, 66-68 and accompanying text.

154 *See supra* note 147 and accompanying text.

155 *See* Rhee, *supra* note 1, at 452 n.1 ("The concept of a fiduciary relationship and duty can be traced to *Keech v. Sanford*, (1726) 25 Eng. Rep. 223, wherein the English chancellor ordered disgorgement of profit when, after a landlord refused to renew a lease held by a child beneficiary, the trustee acquired the lease for himself."); Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

156 The law does not void *per se* such transactions. *See supra* note 118.

157 *See* RTA § 8.01 & cmt. b; *id.*, § 8.10; RESTATEMENT (THIRD) OF TRUSTS § 78 (2003).

158 A showing of a breach of the duty of loyalty rebuts the powerful presumption of the business judgment rule. *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162–64 (Del. 1995).

159 *E.g.*, Guth v. Loft, Inc., 5 A.2d 503, 515 (Del. 1939) (finding that a manager's wrongfully appropriated certain corporate opportunities); Keech v. Sanford, 25 Eng. Rep. 223 (1726)

ineffective tool. Discovery and enforcement thereafter are the only limits on perfect compliance. Discovery is facilitated by affirmative monitoring, but being a highly culpable conduct with high consequences, disloyalty tends to be noticed more as a matter of course.[160] Given unequivocal normative disvalue of malfeasance, the legal rules proscribing it, and the resulting disincentives on managers, the problem of malfeasants has largely been solved and requires little more than a clear path of discovery and legal remedy.

2. Misfeasants.—Misfeasants pose a much more difficult problem of legal and economic theory. They do not usually impose a residual loss at all, *i.e.*, a loss from the divergence of action between what a manager did and what an owner would have done. The loss from bungling and mishap is certainly a business loss, but is *not* a residual loss, a form of agency cost.[161] Why? We cannot impose on managers god-like power of omniscience and deem their failure to meet this standard as an agency cost on the firm. Without the manager, the owner would likely impose the *same or more cost* even when she acts for herself. The acts of managers would likely produce *better* net results (*i.e.*, less loss from negligence and bad judgment) because managers are more skillful and competent than owners. The entire premise of the managerial class is their net utility.[162] Managers have a positive utility writ large.

(holding that fiduciary violated his duty and ordering disgorgement "though I do not say there is a fraud in this case"); Meinhard v. Salmon, 164 N.E. 545, 548 (N.Y. 1928) (finding that a partner improperly took a business opportunity belonging to the partnership though he was not "guilty of a conscious purpose to defraud . . . [and likely acted] in all good faith"). Bad faith and disloyal actors are not subject to protection through exculpation, indemnification, or insurance. *See, e.g.*, DGCL § 102(b)(7) (no exculpation), § 145 (no insurance); Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1745 n.33 (1994) ("As a legal matter, the only personal liability costs that cannot be offset (by indemnification, insurance, or both) are those resulting from a formal adjudication of breach of duty of loyalty.").

160 Can a fiduciary lie, steal, and cheat in stealth? Of course they could, but owners will also tend to notice. Misconduct may involve larger transactions that will be scrutinized more. It may involve legal requirement of disclosure, which will trigger questions. It is harder to execute than mere bungling, mishap, or shirking. The chance of discovering malfeasance is greater when the firm is smaller, such as noncorporate firms and private corporations. In public corporations, misconduct is scrutinized by regulators, capital markets, and the masses of public shareholders.

161 *See* Johnson, *supra* note 143, at 112 (noting the difference between "a deal *actually* loses money" and "a project [] *expected* to lose money") (emphasis added).

162 *See generally* ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1993).

The economic idea of the residual loss form of agency cost is inapplicable to managers who are good-hearted but negligent, incompetent, or unlucky. Misfeasants do not impose residual loss writ large because, when the actions of managers and owners are compared, managers would come out ahead, as evinced by the fact that owners, acting in self-interest and desiring maximal profit, hire them warts and all. The real problem is how best to maximize the full potential of managers by making them less prone to bungling or mishaps. This problem invokes another aspect of agency cost—monitoring.

D. Monitoring as Joint Production

The fundamental difference between malfeasants and misfeasants raises an important question: When the maximand is the firm's optimal welfare and the minimization of agency cost, should the expression of the duty of care and the concept of good faith be framed from an assumption of addressing malfeasants or misfeasants? The legal structure of care and good faith cannot accommodate the entire topology of bad managers. We must choose two exclusive options: (1) a legal structure that monitors malfeasants for disloyalty and mitigates residual losses from its breach, or (2) a legal structure that monitors misfeasants for care and good faith and maximizes joint protection. These two options result in different rules and thus are exclusive choices.

1. Differences in Monitoring of Malfeasants and Misfeasants.— Monitoring is a basic concept in governance,[163] and all firms monitor their managers, lest fiduciaries are really unaccountable and even some saints may be tempted to sin. Monitoring, of course, discovers malfeasance and ameliorates misfeasance. Critically, the cost–benefit calculus of monitoring differs, depending on whether the assumptive purpose of monitoring is to mitigate malfeasance or misfeasance.

Like malfeasance itself, monitoring to discover malfeasance is the simpler concept. Malfeasance imposes residual loss. When a firm expends monitoring cost to discover malfeasance, it must weigh the optimal level of monitoring cost and residual loss. A marginal cost analysis applies. The tradeoff is one form of agency cost for another. This situation calls for picking one's poison.

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163 *E.g.*, Robert T. Miller, *The Board's Duty to Monitor Risk after Citigroup*, 12 U. PA. J. BUS. L. 1153 (2010); Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795 (2007); Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375 (2006).

The cost-benefit of monitoring to ameliorate misfeasance is different. It reduces business loss, which is not residual loss writ large. The firm may achieve a net gain if monitoring cost is less than expected gain from better business outcomes. Potential gains may eliminate agency cost to net zero and may impart an operational gain from the minimization of misfeasance. Simply put, monitoring may make the firm more efficient by producing a net surplus. From this perspective, managerial action and resulting business outcome cannot be solely attributed to the manager because the monitoring function is a part of *joint production* between the fiduciary and the monitor.[164]

2. Monitoring as Joint Production.—The idea that care and monitoring are aspects of joint production is revelatory. The same optimal outcome can be achieved through multiple pathways of the calculus of marginal cost–benefit analysis: increased monitoring with better expected outcomes, or decreased monitoring with worse expect outcomes.[165] Monitoring, fiduciary autonomy, and standard of care are connected in a causal knot: (1) the more monitoring and thus the lesser fiduciary autonomy, the higher the standard of care ought to be because owners and managers would expect better outcomes; or (2) the less monitoring and thus the greater fiduciary autonomy, the lower the standard of care ought to be because owners and managers would expect worse outcomes. At first blush, this reasoning strikes us counterintuitive and wrong. The more intuitive idea is that *less* monitoring should justify a *more* stringent standard of conduct so as to mitigate the temptation that may come with *more* autonomy and *less* accountability. While seemingly logical, this initial intuition is misguided for two reasons.

Firstly, a model of surveillance and accountability assumes the model of *malfeasants*. However, bad actors are adequately dealt with through the duty of loyalty in classic form. They do not escape the vice grips of fiduciary duty and liability writ large upon discovery of their bad acts. Owners generally tend to notice when fiduciaries proverbially lie, steal, and cheat with respect to important economic interests.[166] A model of surveillance and accountability does not fit well into a model of *misfeasants*.

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164 Economists and legal scholars have proposed models of firm governance focused on joint production. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Alchian & Demsetz, *supra* note 151.

165 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 10 (1991) ("It is foolish to spend $2 in monitoring to reduce by $1 the perquisites of employees.").

166 *See supra* note 160 and accompanying text.

Secondly, the intuitive link between less monitoring and higher standard of conduct is flawed because the idea is premised on the owner's perspective. An owner always wants the highest standard of conduct, which is to say that a negotiator always wants the sky. But hers is only one side of the story. Since the fiduciary must assent to the undertaking, we cannot ignore his desired terms of service because he must agree to serve as such. Bilateral relational risk governs, and the risk of liability must be a part of the mix.

Switching to the neutral perspective of a bilateral relationship, we derive the counterintuition: *If the fiduciary is monitored less, the standard of conduct ought to be less stringent, and vice versa*. The level of monitoring and the standard of conduct are not inversely correlated but are directly correlated. This idea strikes us as wrong on the first pass; but it is wrong only if we think in terms of accountability and liability in the model of malfeasants. However, the counterintuition must be correct in the model of misfeasants. We understand the logic of less monitoring necessitating lower standard if we accept that the fiduciary and the monitor engage in joint production toward a common end. *When monitoring is a part of the production function, it is a resource*. The implication of this insight is revelatory: Since less monitoring diminishes the resource available to the endeavor, we should expect worse outcomes, and vice versa. In a bilateral relationship of mutual assent, the fiduciary would not agree to a higher standard of care when the expectation of outcome is worse due to a reduction in resources. The owner would not have the better argument from the standpoint of bargaining for terms with the manager because all should and would expect worse outcomes through no fault of the manager.

To intuit this concept simply, let's assume an actor and an overseer (monitor) are working jointly toward a common end, *i.e.,* both are factors of production. Are they more likely to achieve their common end if the monitor shirks? Of course not, the answer is self-evident. Monitoring is an essential input in joint production. Monitors oversee, advise, consent, veto, and provide other resources to the fiduciary toward advancing his work, and as a result he has less autonomy and more resources.[167] Monitoring invokes suspicion and surveillance. This is the assumption underlying the economic idea of agency cost and reflects the economists' assumption that firms employ the worst people (malfeasants). However, in the model of misfeasants, monitoring is not

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167 *See* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 130 (2009) (arguing that shareholder voting corrects errors in managerial decisions).

an antagonism to the fiduciary, a device to ferret out wrongdoing, but is a complementary resource, a device to facilitate rightdoing.[168]

Like any resource, the level of monitoring affects the likelihood of success. More monitoring enhances joint production and thus increases the likelihood of satisfying a given standard of conduct. Less monitoring takes away this resource: the fiduciary finds herself on an island; the feasibility of achieving the standard of conduct diminishes; she is exposed to greater risk of liability. With more monitoring and thus decreased risk of liability, she would be more willing to assent to a higher standard of conduct. With less monitoring, she would be more insistent that the standard of care be lowered, and the owner would not have the better argument. Based on the neutral perspective of a bilateral relationship, the level of monitoring, the level of the standard of care, the owner's risk of loss, and the manager's risk of liability are logically linked by a tight causal knot.

3. Summary.—The effect of monitoring on the standard of conduct depends on whether the starting prior is the model of malfeasants or the model of misfeasants. Less monitoring should result in a higher standard of conduct only if we assume the model of malfeasants and duty of loyalty. This idea is the most apparent and intuitive to us. Yet, the reverse must be true—*less monitoring* should result in a *lower standard of conduct*—if the starting prior is duty of care and an imperfect person of ordinary moral and ethical character, *i.e.*, the kind of person that firms generally hire. When monitoring is conceptualized as a tool of joint production and managerial resource, this idea too is apparent and intuitive. The less resource available toward success, the less the standard of conduct should be in light of the lower probability of success—managers will surely negotiate this point with owners, and they will have the better of the argument. Therefore, two different priors produce diametrically opposite relational effects between the level of monitoring and the normative level of standard of conduct.

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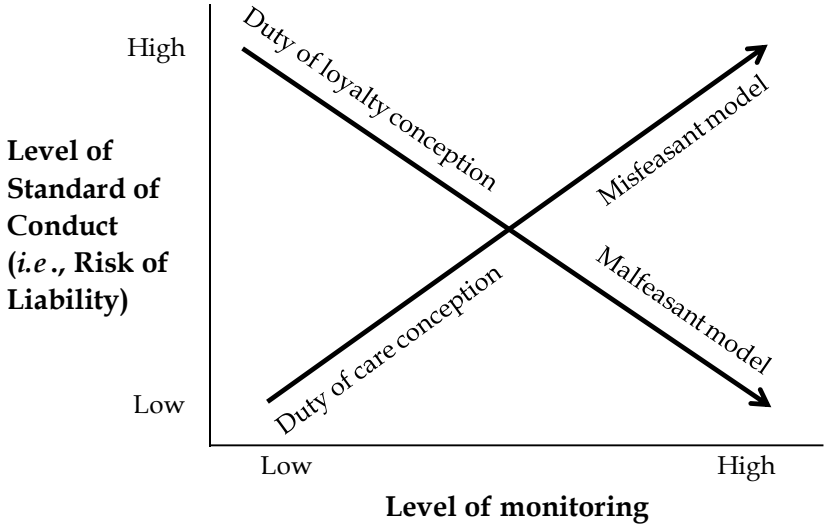
168 *See supra* note 160.

FIGURE 3: RELATIONSHIP BETWEEN STANDARD OF CONDUCT AND LEVEL OF MONITORING



Since the two models work in opposite ways and have antipodal effects, which should govern? The answer must be the *model of misfeasants* for three compelling reasons.

First, the duty of loyalty in classic form well deters and remedies malfeasance,[169] in the way that our criminal and tort laws generally deter criminal and tortious conduct, though we can always debate the matter at the margin. Monitoring provides just an ancillary benefit of assisting in the discovery and prosecution of disloyalty.

Second, misfeasants are more prevalent than malfeasants within an institutional system of laws, regulatory compliance, and monitoring: that is, reflecting society at large, most managers are more likely to be negligent than corrupt, more misfeasants than malfeasants. Given this numerosity, the cost-benefit analysis favors the model of misfeasants.

Third, so long as there is a clear path of discovery and legal remedy for disloyalty, the model of misfeasants presents a more compelling economic calculus. The model of malfeasants represents an exchange of one form of agency cost for another form. In contrast, the model of misfeasants presents the possibility of a net operational gain. The ordinary manager does not impose an agency cost in the form of residual loss, but instead imposes

169 *See supra* note 160 and accompanying text.

monitoring cost. Yet monitoring may also result in net gain from increased managerial efficiency.

E. Four Factors of Calibration

In the above sections, this Article constructed the theoretical framework of calibrated fiduciary duties based on the elements of bilateral relational risk, intermediated risk preference, role of law in mitigating cost, and monitoring in the model of misfeasants. How should the theory be implemented? Risk is the key variable in the theory, and each element of theory concerns an aspect of risk affecting owners and managers. We can now identify the four factors of calibration that, based on theory, are the instrumental determinants of the unique expressions of the duty of care and the concept of good faith. Each factor affects the owner's or manager's bilateral relational risk and thus the firm's intermediated risk preference.

1. Proximity of Monitors to Fiduciary.— The first calibrating factor is the proximity between fiduciary and monitor. Since monitoring affects joint production, it is a factor in bilateral relational risk. The most important monitors are internal constituents, who are obligee owners and other fiduciaries.[170] They constitute the front line of monitoring, and for many privately held firms they are the only monitors. Proximity between fiduciary and monitor can be in two forms: actual working proximity and legal relational proximity.

Actual working proximity refers to the monitoring that take place when a fiduciary and a monitor work together in close proximity. Such monitoring may not only detect misconduct that implicates the duty of loyalty, but may preempt or correct suboptimal or negligent conduct that implicates the duty of care. On the other hand, legal relational proximity considers the extent to which a fiduciary and a monitor are bound together in a legal relationship. The law may grant internal constituents the capacity or obligation to monitor the fiduciary. An example is partners in a general partnership, where each partner is not only a fiduciary but also per legal rule has the authority and duty to monitor other partners.[171]

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[170] Outside of the laws of firms, fiduciaries may be monitored by non-owners or institutions, such as regulators, capital markets, creditors, and courts.

[171] *See* RUPA § 401(h) ("Each partner has equal rights in the management and conduct of the partnership's business.").

Actual working and legal relational proximities vary in firms. Principals are not legally bound to monitor agents,[172] but have full power to monitor and control agents.[173] Partners in a general partnership are both fiduciaries and obligees, and thus they have both the obligation and the power to monitor each other. Corporate directors have a duty to monitor officers, and officers the same with respect to each other and subordinate employees. When owners are passive investors,[174] they are not obligated to monitor because they are not fiduciaries.[175] Even if they want to monitor managers, they have limited means to do so.[176]

Proximity of monitors calibrates the standard of conduct because it represents the quantum of monitoring resource available to fiduciaries to accomplish desired outcomes. Greater monitoring through closer proximity of monitors to managers should result in a higher standard of conduct. Conversely, a fiduciary will be less inclined to assent to a relationship if

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172 Of course, a principal suffers the consequences of an agent's actions and her failure to monitor. *E.g.,* RTA § 7.03 (establishing the rules of principal's liability).

173 Control is a key characteristic of agency. *See* RTA § 1.01.

174 Passive owners are shareholders in corporations, limited partners in limited partnerships, and members in manager-managed LLCs.

175 *See, e.g.,* ULPA § 305(b) (providing that a limited partner does not have any duty . . . solely by reason of acting as a limited partner"); RULLCA § 409(i)(6) (same as to members in a manager-managed LLC); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) ("[A] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.").

176 The most important monitoring tool for passive owners is the power to vote on certain matters. *E.g.,* DGCL §§ 211(b) (election of directors), 212 (granting shareholders the right to vote), 242(b) (amendment to charter), 251(c) (mergers); ULPA §§ 301 (admission of new partner), 801 (dissolution), 1123 (mergers); RULLCA §§ 602 (dissociation), 1023 (merger). A major reason for voting is monitoring by correcting the errors of fiduciaries. *See* Thompson & Edelman, *supra* note 167, at 130 (arguing for an information theory of voting based on error correction). Voting also necessitates disclosure of material information related to the subject of voting, which advances monitoring. *E.g.,* Appel v. Berkman, 180 A.3d 1055, 1057 (Del. 2018) (stating that informed shareholder decisionmaking requires proper disclosure); Karle v. Seder, 214 P.2d 684, 688 (Wash. 1950) (requiring "full and complete disclosure of all important information" when a partner purchases partnership property). Obligees also have information rights to inspect books and records. *E.g.,* DGCL § 220; RULLCA § 410; ULPA § 407. Bigger and complex firms hold more information, and this information tends to be specialized and compartmentalized. Noncorporate firms and public corporations differ in the amount and availability of information. The effectiveness of monitoring the inner workings of the firm is greater as the firm is smaller and simpler due to the smaller quantity and simpler quality of information. With respect to information as a component of monitoring, there is more monitoring in agency and noncorporate firms than in corporations.

proximity is remote and the standard of conduct is high because this circumstance decreases the likelihood of achieving the desired outcome and thus increases the likelihood of liability.

2. Complexity of Fiduciary's Work.—The second factor of calibration is the complexity of the fiduciary's work *qua* satisfaction of the fiduciary's obligation. The complexity of work is not related to the tasks that fiduciaries may perform in their non-fiduciary capacity. An engineering job may be quite complex, but that work has little relation to her role as an agent in negotiating contracts for her firm. Complexity of work relates to the nature of the work in management and governance. For reasons explained in *infra* Section V, the rank order of complexity of work, from simplest to most complex, follows the line of agency, noncorporate firms, and corporations.[177] We may already intuit this conclusion even without explication.

The same principle governing proximity applies to the relationship between the complexity of work and the standard of conduct. An increase in complexity calibrates the standard of conduct lower, and vice versa. Simple tasks are easier to accomplish and easier to assess the causation between the fiduciary's input and the outcome achieved; thus, the fiduciary should be subject to a higher standard of conduct, and she should assent to such. When the task is complex, the fiduciary will demand a lower standard. Again, the arrangement between fiduciary and obligee is characterized by mutual assent and bilateral relational risk.

3. Fiduciary's Exposure to Excessive Liability.—The third calibrating factor is the fiduciary's exposure to excessive liability to the firm and its owners.[178] Excessive liability is not a judgment about some absolute value. Harms from negligence may be slight or catastrophic, but high amount of liability is not the same as excessive liability. The slip of a surgeon's scalpel can result in minor injuries or death, but the doctor must pay the damage, be it $1,000 or $1 million; when he is negligent, $1 million is not disproportionate to his conduct. We are not troubled by the high absolute value of liability here because we accept that the harm was within the scope of foreseeability.[179]

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177 *See infra* Section III.D. (applying the four factors of calibration to the forms of firms).

178 To be clear, this liability is not liability that runs to external parties for any wrongs attributable to managers, but liability that specifically runs internally to the firm and its owners for breaching the standard of conduct. In this respect, the concept of limited liability is irrelevant and is not a factor of excessive liability. *See supra* note 28 and accompanying text.

179 *See* RTT § 6 & cmt. b (stating that physical harms may create liability "within the scope of liability" which has been historically called "proximate cause"); *id. Chapter 6, Scope of Liability (Proximate Cause)*.

Excessive liability is a relative concept. The idea is that liability is grossly disproportionate to the conduct. Excessive liability is disfavored in Anglo-American law on the principle that "the law abhors disproportionate liability or penalty."[180] We see this principle in constitutional and criminal laws, tort law, and even contract law.[181] It is also seen in the laws of firms.[182] Excessive liability is a policy judgment that weighs the fiduciary's conduct, her gain from the conduct, and the scope of liability. This relative assessment answers whether the liability was disproportionate to the nature of the underlying conduct.[183]

To understand further this principle, we contemplate the nature of duty. In a prior article, I analyzed the tort foundation of the corporate duty of care and the business judgment rule.[184] The essential idea there is that, for the purpose of thinking about liability, we must consider the nature and legal theory of the "wrong." Tort and criminal laws are easier to understand because wrongs are based on the substantive merits of the action defined by the reasonableness of the action and the foreseeability of harms therefrom. In business, foreseeability is not a limiting concept as it is in other laws. The

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180 Rhee, *supra* note 50, at 1172. *See* Robert L. Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 STAN. L. REV. 1513, 1534 (1985) ("The Anglo-American judicial tradition maintains a deep abhorrence to the notion of disproportionate penalties for wrongful behavior.").

181 *See* U.S. CONST., AMEND. VIII (prohibition against cruel and unusual punishment). *E.g.*, Coker v. Georgia, 433 U.S. 584, 592 (1977) (concluding that "a sentence of death is grossly disproportionate and excessive punishment for the crime of rape"); Rabin, *supra* note 180, at 1534 ("In tort law, the proximate cause limitation on negligence liability illustrates a similar concern about proportionality between act and responsibility."); Barber Lines A/S v. M/V Donau Maru, 764 F.2d 50, 55 (1st Cir. 1985) (Breyer, J.) ("These considerations of administrability and disproportionality, offer plausible, though highly abstract, 'policy' support for the reluctance of the courts to impose tort liability for purely financial harm."); RESTATEMENT (SECOND) OF CONTRACTS § 351(3) (1981) ("A court may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation.").

182 *See* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects.").

183 *See* Rhee, *supra* note 50, at 1180 n.240 (noting that without the liability protection of the business judgment rule corporate fiduciaries would bear the full costs of any economic harm inflicted, but receive only a minute fraction of the gain from risky decisions they make on behalf of the firm).

184 *See* Rhee, *supra* note 50.

theory of the legal "wrong" may not include substantive "errors" or "mistakes" because the agreed undertaking requires risk-taking and bad outcomes are simply unavoidable and accepted as such.[185] Losses are foreseeable, but are not wrong because they are part and parcel of the nature of the agreed venturing. The implication is that liability based on economic harms inflicted through error or mistake may not be theorized as legal "wrongs." Otherwise, a factor exogenous to underlying conduct would act as a liability multiplier. For the same substantively bad conduct—for example, a decision that can fairly be characterized as egregious, foolish, or irrational[186]—damages would be directly proportional to the firm's size. A noncorporate firm may lose $1 million, but a corporation may lose $1 billion. The implication is clear. A breach of the duty of care would result in larger liability for managers of larger firms than those of smaller firms, *ceteris paribus*.[187] Foreseeability would not connect a person's action to amount of harm, but instead a firm's size to amount of harm. A manager's exposure to excessive liability increases as the firm size increases.

The prospect of excessive liability is a calibrating factor because it affects the calculus of bilateral relational risk, which in turn affects the firm's intermediated risk preference. When the expected harm from undesirable conduct is lower, the standard of conduct can be set higher, and conversely when the expected harm tends toward excessive liability, the standard of conduct should be set lower.

4. Owner's Diversification of Risk of Loss.—The last calibrating factor is the equity owner's diversification of risk. Agency and noncorporate firms differ markedly from public corporations with respect to the ability of principals and owners to mitigate exposure to the risks posed by the fiduciary's work. The financial idea of diversification of risk requires little explication. It is well-settled that diversification of investment risk is a good thing and can eliminate the exposure to the unique risk of any specific

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185 *See id.* at 1168-72.

186 *See supra* note 92 and accompanying text.

187 *E.g.,* In re Boeing Co. Deriv. Litig., 2021 WL 4059934, at *1 (Del. Ch. 2021) ("The crashes caused the Company and its investors to lose billions of dollars in value. Stockholders have come to this Court claiming Boeing's directors and officers failed them in overseeing mission-critical airplane safety to protect enterprise and stockholder value."); In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 112-15 (Del. Ch. 2009) (describing massive billion dollar losses due to bad decisions by corporate managers).

investment.[188] Diversification of business risk means that an equity owner would want the manager to make decisions under a risk neutral framework. It is textbook that ex ante risk neutral decisionmaking is more profitable than decisionmaking under a risk adverse perspective.[189] Clearly, a lower standard of care would incentivize risk-taking because it would shield risk-taking managers from liability for bad outcomes, and vice versa.

Equally clearly, when one's investment is not diversified, one would be more inclined to be risk adverse. This is the rationale of the insurance market. One's life, home, and health are not diversifiable risk factors. To mitigate these risks, the insured pays an insurance premium that is greater than the actuarial expected loss.[190] Similarly, if an equity owner's investment is concentrated in a single firm, which is typical for owners of noncorporate and private firms, that investment is not diversified. The undiversified risk justifies a policy of some risk aversion and thus a higher standard of care.

IV. POSITIVE THEORY OF CALIBRATION

A. Agency

So much for normative theory. Does the positive theory of calibration explain the divergence of fiduciary duties and standards of conduct in the forms of firms? Yes, quite perfectly. When considered in the context of the normative theory, the four calibrating factors of calibration reveal the fundamental logic of divergent laws and a single fiduciary rule.

Let's first consider the law of agency. In addition to the universal duty of loyalty in classic form, an agent is subject to the negligence standard of care. If an agent deviates from this high standard of conduct, she will be liable.[191] Substantive negligence covers not just ordinary bungling, mishap, and much of shirking, but also the corporate conception of good faith: An agent would surely be negligent, if not more, if she acts in subjective bad faith, knowingly

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188 *See* Markowitz, *supra* note 126, at 77, 79 (stating that ""the investor does (or should) consider expected return a desirable thing and variance of return an undesirable thing" and that diversification can reduce certain unique risks).

189 *See* RHEE, *supra* note 125, at 45-46; *supra* notes 133 & 142 and accompanying text.

190 *See supra* notes 132-133 and accompanying text (explaining risk aversion).

191 *See* RTA § 8.01 cmt. b ("An agent's breach of the agent's fiduciary obligation subjects the agent to liability to the principal.").

violates positive law, abjures oversight on delegated matters, or wastes the principal's assets.[192] The unique configuration of the four calibrating factors explains agency law's highest standard of conduct.

The dominant factor in agency is the proximity of the monitor. The basic conception of a principal–agent relationship is person-to-person dealing.[193] An agency relationship does not presume intermediation by a firm structure,[194] which may impose legal or contractual artifices on relationships and thus structural barriers to monitoring.[195] The principal has direct, unhindered actual working and legal proximities to the agent. Agent and principal are presumed to work closely together as evinced by the fundamental requirement that the agent assents to the principal's control.[196] The principal fully controls his proximity to his agent.

With respect to the complexity of the fiduciary's work, the principal–agent relationship is the simplest work. The nature of agency is simple. There is a direct hierarchy, and the agent's work is generally guided by the principal's control. The core of satisfying duty is the agent's compliance with the principal's instructions and intent.

The agent is not exposed to excessive liability. The scope of liability is most tort-like in agency. The relationship is person-to-person, without the complicating intermediation of a firm structure and a larger, complex managerial function. An agency may inflict ordinary liabilities, akin to any other outcomes of negligence. An agent's negligent may result in high liability, but not excessive liability. In entering into the agency relationship, the agent understands the potential stakes. The principal controls the agent and thus both their risks. Their joint production mitigates the principal's risk and the agent's liability exposure.

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192 *See supra* notes 98-109 and accompanying text; RTA § 8.10 ("An agent has a duty . . . to refrain from conduct that is likely to damage the principal's enterprise.").

193 Certainly, agents work in a firm, but the law does not presuppose a firm structure. The law of agency must cover all facets of commercial relationships, and not just those within a firm. *See supra* note 134 and accompanying text.

194 *See supra* note 144.

195 For example, officers are not generally conceived as monitors of directors, though both are fiduciaries; shareholders do not have ready access to directors and officers, though they are monitors; information available to directors, officers, and shareholders may be limited by law or the structure of their relationship with the firm.

196 *See* RTA § 1.01.

Lastly, the principal's diversification of risk is self-evident. Control over the relationship gives the principal the power to control his own risk.[197] However, the principal has no way to diversify away the risk of an agent's conduct. If the agent bungles, she will likely be responsible for the loss.[198]

B. Noncorporate Firms

The standard of conduct in noncorporate firms is lower than that in agency. The threshold for breaching the duty of care is set at gross negligence, not simple negligence. The four factors of calibration explain this lower standard.

In the prototypical general partnership, partners work closely together as both fiduciaries and obligees.[199] The actual working and legal proximities to monitors are not as close as the direct legal and actual working relationship in agency. A two-partner partnership can resemble the closeness of an agency relationship, but we cannot assume that the two-partner partnership is the template partnership. A twenty-partner firm is just as prototypical. In larger firms, the legal proximity of partners is direct,[200] but the actual working proximity may be more remote. As a firm increases in size, the actual working proximity would naturally become more remote as complex firms tend to compartmentalize information and work function more, and the amount of monitoring to do would increase. A partner in Paris may be more limited in her capacity to monitor a partner in New York due to their actual working remoteness despite legal proximity that is the same as a two-partner partnership in the same office. The degree of monitoring in noncorporate firms is less than in agency, thus justifying a lower standard of conduct.

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197 The retention of control is the rationale for vicarious liability of employers, the rule of respondeat superior. *See* RTA § 7.07; Nat. Convenience Stores, Inc. v. Fantauzzi, 584 P.2d 689, 691 (Nev. 1978); Appiah v. Hall, 7 A.3d 536, 554 (Md. 2010); Zimprich v. Broekel, 519 N.W.2d 588, 591 (N.D. 1994).

198 *See* RTA §§ 6.01–6.03 (principal's liability for contracts), 7.03 (principal's liability for torts).

199 *See* RUPA § 409(a) ("A partner owes to the partnership and the other partners the duties of loyalty and care . . . .").

200 *See id.* § 401(h) ("Each partner has equal rights in the management and conduct of the partnership's business."); *id*. § 409(a) ("A partner owes to the partnership and the other partners the duties of loyalty and care").

The second calibrating factor is the complexity of the fiduciary's work. Compared to an agency, the management of firms is a more complex task. An agent's work may be a part of operating a venture, but is not equivalent to managing the firm's business and affairs. The management of firms requires undertaking of business risk. More judgment and complexities are involved. If an agent is unsure of a matter, he always has the option to consult the principal and take appropriate direction. Managers generally do not have this option because the nature of the managerial function is the exercise of discretionary authority under uncertainty. Greater complexity of work justifies a standard of conduct that is lower than in agency.

The third factor of calibration is the manager's exposure to excessive liability. The larger the venture generally, the greater is the scale of risk of liability. When a person operates in a firm, as opposed to a principal–agent relationship or a sole proprietorship, the scale of the risk of liability would be generally higher. An increase in the risk of excessive liability justifies a lower standard of conduct in noncorporate firms.

The last calibrating factor is the owner's diversification of risk. Like a principal, partners and members of noncorporate firms cannot diversify away their risk exposure to bad fiduciaries. Virtually all interests in noncorporate firms are privately held and thus illiquid. Owners of noncorporate firms are generally more attached to the firm's business. Ownership is not just limited to an equity investment, but often encompasses the partner's or member's economic livelihood. Partners and members often work in their firms. The owner's inability to diversify the exposure to the firm's risk militates a higher standard of conduct as in agency.

C. Corporations

The corporate duty of care contains no substantive standard as to the merit of the decision, but concerns only decisionmaking process and even in this limited scope finds liability only when fiduciaries are grossly negligent.[201] The four factors of calibration explain why the standard of conduct in corporations seems so lax, but is theoretically justified.

Corporations pose particular challenges with respect to the first factor of calibration, the proximity of monitors to the fiduciary. The corporation's hierarchical structure is unique among forms of firms because it most

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201 *See supra* Section I.C.

separates ownership and control. General partnerships presume coequals and thus partners can and do monitor each other.[202] While limited partnerships and manager-managed LLCs also have hierarchical structures that more resembles corporations, they differ as well in that their owners have close proximity to managers by virtue of smaller size.[203] In these kinds of firms, it is not unheard of that members and partners, even if they are passive owners, can call a meeting with managers. Ordinary shareholders, on the other hand, do not call up the director or CEO of Microsoft.

Monitoring is less circular and more hierarchical. The board is the ultimate manager; the CEO reports to the board; inferior officers report to superior officers, and so forth. Officers can be monitored effectively, as effectively as any employer–employee arrangement can be if governance is done well. On the other hand, directors do not usually monitor each other in the formal context of governance because a director *qua* director does not have independent managerial authority.[204] Corporate law makes clear that the board, a single organ, is the decisionmaking body.[205] The point is: Who monitors the board?

A corporate board is *sui generis*. It does not formally (legally) report to anyone. What about reporting to shareholders? Of course, the board makes necessary disclosures to them and facilitates required participation such as mandated voting on certain matters,[206] but disclosure and voting on a limited menu of items is not the same as reporting for the purpose of feedback and accountability in the broader context of joint production. Shareholders are kept at arm's length. They generally do not nominate directors, but only vote on nominees whom the board nominates and vets in a kabuki ritual in which the outcome is predetermined. Corporate law, related rules, and governance

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202 *See* RUPA § 401(a) ("Each partner is entitled to an equal share of the partnership distribution . . . ."); *id.* § 401(h) ("Each partner has equal rights in the management and conduct of the partnership's business.").

203 *See supra* note 176.

204 In individual cases, a director may be granted transactional authority as an agent or as a committee of the board. *See* DGCL § 141(a) (providing that the corporation "shall be managed by or *under the direction* of a board of directors") (emphasis added); *id.* § 141(c) (permitting committees of a board comprising of at least one director).

205 *See* DGCL § 141(a) (providing managerial authority lies in "a board of directors").

206 *See supra* note 176.

practices weaken the legal mechanisms of shareholder monitoring.[207] Shareholder monitoring is deemphasized in favor of financial market mechanisms. Shareholders can exercise the Wall Street rule by selling shares that disappoint and thus the capital market can send a price signal to corporate managers.[208] Shareholders watch from afar and have limited insight into the internal decisionmaking process within corporations in real time that is most helpful in effective monitoring as a form of joint production.

Shareholders could be monitors, except that high numerosity engenders difficult problems of coordination, freeriding, rational apathy, and expedient option of the Wall Street rule. Corporate fiduciaries and obligee shareholders are legally connected, but the connection is more tenuous and formalistic than the relationship among partners.[209] Partners can literally pick up the phone and talk to each other, Paris to New York even. Shareholders do not directly monitor fiduciaries, neither close legal nor actual working proximity. While officers *qua* employees are certainly monitored, directors are not in any meaningful sense. These prosaic observations are not meant to criticize the corporate scheme, but simply to highlight the salient features of shareholder monitoring. The problems of corporate hierarchy and shareholder remoteness are obvious.

The second calibrating factor is the complexity of the fiduciary's work. As between noncorporate firms and corporations, the work of corporate managers is obviously more complex. The corporate form is particularly suited for the aggregation of large amount of capital, management by professional managers, and the engagement of large business ventures. The management of public corporations represents the pinnacle of complexity of the work function.

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207 *See, e.g.*, DGCL § 141(a) (providing that the corporation shall be managed by a board); 17 C.F.R. § 240.14a-8(i)(1) & note (providing that shareholder proposals should be put as a recommendation and not binding); *id.* § 240.14a-8(i)(8) (prohibiting proposals that would affect the outcome of election for directors); Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) (striking down SEC Rule 11a-11, which would have provided proxy access to director nomination).

208 *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970) (describing how "exit" is an option when constituents such as shareholders and employees are dissatisfied with firms).

209 This comment applies even to partners in a limited partnership and members in a manager-managed LLC, where the general partner and manager have managerial authority and limited partners and members are presumed to be passive investors. The prototypical noncorporate firm is presumed to be smaller, closely held, and tightly connected. *See supra* Section I. The proximity in these relations is closer even if managerial authority is centralized.

The third calibrating factor is the manager's exposure to excessive liability. This factor is especially pertinent to corporations. The size of the venture, from smallest to biggest, follows the line of agency, noncorporate firms, and corporations. Size is the liability multiplier. Like other fields of law,[210] corporate law rejects excessive liability.[211] One bad decision should not result in a billion-dollar personal liability. Principle side, the practical consideration is that if personal liability results from massive losses, defendants will be judgment proof. Few corporate managers, other than Elon Musk and his ilk, would be able to pay foreseeable harms in the hundreds of millions or billions of dollars.

The last calibrating factor is the owner's diversification of risk. This factor too is especially pertinent to corporations. Public shareholders can diversify their risk of loss by owning a diversified portfolio of investments, and their investment in the corporation is typically separate from their economic livelihood. Shareholders are presumed to be and are in fact diversified. Seldom would any equity investor be invested in substantial amounts in a single stock, or even several stocks. The benefits of diversification have long been recognized.[212]

D. Synthesis and Summary

The laws of firms fundamentally diverge on the duty of care. In decreasing order, the standards of conduct follow the line of agency, noncorporate firms, and corporations. The theory of calibrated fiduciary duties explains this phenomenon and argues for its correctness. This ordering of the standards of conduct is not random, but is a function of the four factors of calibration. Let's synthesize the reasons.

The law of agency states the highest standard of conduct. Agency is characterized by high degree of monitoring due to the close legal and working proximities between the principal and agent, the relative simplicity of the agent's work, low risk of excessive liability for the agent, and the principal's inability to diversify away the errors of the agent. Under these conditions, the

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210 *See supra* notes 180-181 and accompanying text.

211 *See supra* notes 182-183 and accompanying text; Rhee, *supra* note 50, at 1180 ("Risky decisions produce a social gain (and not a social loss), and the business judgment rule incentivizes risk averse directors to take risks by shielding them from unfair and disproportionate liability.").

212 *See* Markowitz, *supra* note 126.

principal can rationally demand a high standard of care. The agent will assent because she will likely meet the high standard due to high monitoring and low complexity, and even if she fails, her risk of excessive liability is low.

The law of noncorporate firms states an intermediate standard of conduct. Three factors of calibration weigh in favor of a lower of standard of conduct. Compared to agency, noncorporate firms exhibit more remote legal and working proximities among partners, more complex form of partners' work in managing a firm, and a higher exposure to excessive liability in light of the fact that they manage a business venture. Like a principal in agency, a partner cannot diversify away the errors of other partners. An assessment of the four factors militates a lower standard of care.

Corporate law states the lowest standard of conduct. The legal and working proximities of monitors are most remote. The complexity of a manager's work is the highest. Managers are exposed to the highest risk of excessive liability. Unlike principals in agency and owners in noncorporate firms, shareholders can diversify away the errors of fiduciaries in the public stock market. The fiduciary can rationally demand the lowest standard of care, and the obligee will assent. Policy can induce intermediated risk neutrality to maximize profit, achieved only when managers are incentivized through the lowest standard of conduct such that the risk of liability is the lowest.

Fiduciary law is the principal prophylactic against malfeasants and misfeasants. The duty of loyalty concerns mostly malfeasants, and it is uniform across all forms of firms because the nature of bad acts is the same. With respect to the duty of care, the standard of conduct is founded on a model of misfeasants. If the starting prior is that corporate managers are malfeasants, we would expect to see a higher standard of care in light of lesser monitoring. But the opposite is true. A model of misfeasants necessitates a lower standard of conduct when monitoring is lower.[213] Thus, the theory of agency cost, a preoccupation of corporate governance for the past half century in economic and legal literature, plays only an ancillary role when we theorize the link between the fiduciary rule and corporate governance. An important insight is revealed: *Variations in the fiduciary rule, seen in the duty of care, are not intended to minimize managerial agency cost as defined in economic and legal literature, but instead to enhance managerial efficiency and operational surplus*.

The following table summarizes the four factors of calibration as they are applied to the laws of firms. The arrow in each box indicates the relative effect

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213 *See supra* Section III.D.

of the factor on the standard of conduct, consistent with the analysis above:[214] indications noting ↑ for higher standard of conduct, ↓ for lower standard, and ↔ for intermediate (medium) standard.

TABLE 3: FOUR FACTORS AND THEIR EFFECTS ON STANDARD OF CONDUCT

	Remoteness of Monitors to Fiduciary	Complexity of Fiduciary's Work	Fiduciary's Risk of Excessive Liability	Owner's Diversification of Risk of Loss		Standard of Conduct
Agency	Low ↑	Low ↑	Low ↑	Low ↑	→	High
Noncorporate	Medium ↔	Medium ↔	Medium ↔	Low ↑	→	Medium
Corporate	High ↓	High ↓	High ↓	High ↓	→	Low

This Article also theorizes the connection between risk (*i.e.*, bilateral relational risk and risk preferences) and the unique calibration of fiduciary duty.[215] In agency, risk preference is not intermediated by a firm structure. Natural risk preferences govern, which we presume to be risk aversion. The dynamic of bilateral relational risk is this: The principal cannot diversify away her risk from the agent's errors, and the agent is not subject to excessive liability. Under these conditions, the principal and agent would assent to a high standard of conduct. Based on these combined factors, the standard of conduct should be the highest.

In noncorporate firms, the firm structure intermediates personal risk preference, resulting in less risk aversion. The dynamic of bilateral relational risk is this: Owners cannot diversify away his risk from the manager's errors, and the manager is subject to greater risk of excessive liability since he is tasked with managing a firm. Based on these combined factors, the standard of conduct should be lower than that in agency.

In corporations, the intermediated risk preference is risk neutrality. The dynamic of bilateral relational risk is this: Owners can fully diversify the risk of managerial errors, and managers are subject to excessive liability. Based on

214 *See supra* Section III.E.

215 *See supra* Section III.A.

the combined effect of these factors, the standard of conduct should be the lowest among the forms of firms.

The table below summarizes how the dynamic between bilateral relational risk and intermediated risk preference works to produce the standard of conduct.

TABLE 4: INTERMEDIATED RISK PREFERENCE AND STANDARD OF CONDUCT

	Fiduciary's Risk of Excessive Liability	Owner's Diversification of Risk of Loss		Firm Intermediated Risk Preference		Standard of Conduct
Agency	Low	Low	→	More Risk Averse	→	High
Noncorporate	Medium	Low	→	Less Risk Averse	→	Medium
Corporate	High	High	→	Risk Neutral	→	Low

The theory of calibration must explain the role of contracting for fiduciary duty and standard of conduct. This task is easy. Although the standard of conduct in noncorporate firms is higher, it is not fixed (unlike in corporations). Since noncorporate firms are contract-based, managers and owners can contract for fiduciary duties and good faith.[216] If owners prefer more profit by moving toward risk neutrality in decisionmaking, they can contract for a lower standard of conduct that is required to intermediate risk preference.[217] Given bilateral relational risk, managers will always be pleased with a lower standard of conduct that reduces their risk of liability.

We must also explain the concept of good faith in the laws of firms. Certain kinds of bad acts should be proscribed in all forms of firms. The duty of loyalty in classic form serves this role. Corporate law also shows that at least four kinds of other bad acts should likewise be proscribed: subjective bad faith, knowing violation of law, failure of oversight, and irrational waste of firm assets.[218] These bad acts should inform the conduct of *all managers* irrespective of the form of firm. In fact, they do. However, while corporate law

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216 *See supra* notes 69-73 and accompanying text.

217 *See supra* notes 71 and accompanying text.

218 *See supra* notes 98-116 and accompanying text.

characterizes these forms of malfeasance as a component of the duty of *loyalty*, the law of noncorporate firms fits them in the duty of *care*.

What accounts for the reclassification and relocation of these bad acts in the law of noncorporate firms? The answer is simple. The classification and location are irrelevant in the law of noncorporate firms because a fiduciary who violates the duty of care or the duty of loyalty will be assessed liability. The laws of noncorporate firms do not contain an equivalent of Section 102(b)(7).[219] Clearly, they permit such exculpation per contract, but by not containing a Section 102(b)(7)–equivalent the laws do not mandate a nonwaivable distinction between a breach of the duty of care and the duty of loyalty including corporate good faith. With this in mind, they define the duty of loyalty in classic form to address conflict of interest dealings, and they fit all other malfeasance into the duty of care as *misconduct* based on intentional, willful, or knowing bad acts.[220] From the perspective of the laws of noncorporate firms, this taxonomy serves legal clarity by providing a certain logical aesthetic, avoiding a confusing asymmetry of fitting a square peg in a round hole. Corporate law does not have the luxury of fretting about this aspect of aesthetics. A more pragmatic consideration is at the fore. An important device in inducing intermediated risk neutrality is the exculpation of money damages for a breach of the duty of care, which in addition to the business judgment rule insulates corporate managers from the risk of liability such that they can implement a policy preference for risk neutrality. Because corporate bad faith is fundamentally malfeasance, we should not select a policy that exculpates bad faith.[221] Accordingly, such bad acts must be attached to the duty of loyalty.

This Article notes a final theoretical point: Why calibrate fiduciary duty in the forms of firms as opposed to the unique circumstance of each firm? Since some or many noncorporate firms share the characteristics of corporations, and vice versa, would it be better to uniquely calibrate fiduciary duty in individual firms as opposed to the forms of firms? No, it would not for several compelling reasons. The default standards of conduct establish baselines as determined by policy experts and expectations of constituents. The laws of agency and noncorporate firms permit customization per contracting around

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219 *See supra notes* 116 & 159; *infra* note 221.

220 *See supra* notes 66-67 and accompanying text. This standard captures the corporate doctrine of bad faith. *See supra* Section I.D.; *supra* notes 122-123 and accompanying text.

221 *See* DGCL § 102(b)(7) (prohibiting exculpation for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law").

default rules.[222] Permitted contracting provides the benefit of both worlds. With respect to corporations, we do not want any deviations in fiduciary duty and standard of conduct for the simple reason that the corporate form involves much greater stakes, the possibility of great abuse of passive shareholders, and the structural separation of ownership and control.[223] For over a century, public corporations have been the goose that laid the golden egg for society. In light of these considerations, if a corporation is not a public company, the LLC can provide a superior alterative form of firm precisely because it permits much greater contracting and modification of default rules, which explain why the LLC is the fastest growing form of firm.[224]

V. THE CASE OF GOLDMAN SACHS

So much for positive theory that explains the laws as they are expressed. Is there any other evidence that supports the ideas advanced here? This Article provides an important datum that corroborates the theory of calibrated fiduciary duties. It is an episode from the history of Goldman Sachs, which is its conversion from a private partnership to a public corporation. Goldman Sachs is the most storied and powerful investment bank on Wall Street.[225] While its conversion is only a single datum, the event is a milestone in the history of Wall Street and has larger significance on global finance.[226] Goldman Sachs is not just a random factoid. The theory of calibrated fiduciary duties contextualizes this history of Wall Street. It shows that Goldman Sachs's

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222 *See supra* notes 54 & 71 and accompanying text.

223 *See supra* notes 93-97 and accompanying text.

224 *See supra* notes 30, 36-37 and accompanying text (describing the rise of LLCs); JEFFREY D. BAUMAN, RUSSELL B. STEVENSON, JR. & ROBERT J. RHEE, BUSINESS ORGANIZATIONS LAW AND POLICY 18 (10th ed. 2022) (showing the rapid rise of LLC and relative decline of corporations and partnerships).

225 *See generally* STEVEN G. MANDIS, WHAT HAPPENED TO GOLDMAN SACHS: AN INSIDER'S STORY OF ORGANIZATIONAL DRIFT AND ITS UNINTENDED CONSEQUENCES (2013); WILLIAM D. COHAN, MONEY AND POWER: HOW GOLDMAN SACHS CAME TO RULE THE WORLD (2012); CHARLES D. ELLIS, THE PARTNERSHIP: THE MAKING OF GOLDMAN SACHS (2009); LISA ENDLICH, GOLDMAN SACHS: THE CULTURE OF SUCCESS (2000). In recent history, three Secretaries of Treasury were Goldman Sachs investment bankers: Robert Rubin (1995–1999), Henry Paulson (2006–2009), and Steven Mnuchin (2017–2021).

226 *See* Robert J. Rhee, *The Decline of Investment Banking: Preliminary Thoughts on the Evolution of the Industry 1996–2008*, 5 J. BUS. & TECH. L. 75, 81 (2010) (identifying Goldman Sachs's conversion and the merger of Citicorp and Travelers as major events in recent history).

conversion affected bilateral relational risk, intermediated risk preferences, and optimal welfare, which are then actuated through managerial actions.

Goldman Sachs was founded in 1869, and for most of its history it operated as a private partnership.[227] In 1998, the partners decide to take the firm public.[228] This necessitated a conversion from a partnership to a corporation.[229] It was the last partnership among independent "bulge bracket" investment banking firms.[230] In May 1999, it went public and listed its stock on the New York Stock Exchange.[231] Why did Goldman Sachs become a public corporation? What were the effects of its conversion?

While these questions merit standalone, sustained academic scrutiny, the theory advanced in this Article answers them this way: A conversion from a partnership to a corporation would intermediate risk preference from some degree of risk aversion in a partnership toward risk neutrality in a corporation, and the resulting legal structure would institute a lower standard of conduct to incentivize greater risk-taking and profit maximization. In fact, this is what actually happened to Goldman Sachs. Commentators have over the years made observations that corroborate the ideas advanced in this Article and the predictions that the theory makes.

Commentators have observed that when Goldman Sachs converted from a private partnership to a public corporation, its intermediated risk preference changed in favor of greater risk-taking in line with the trend in financial services more generally.[232] In an earlier article, I examined the financial

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227 *A Brief History of Goldman Sachs*, GOLDMAN SACHS (Mar. 2022), available at https://www.goldmansachs.com/our-firm/history.

228 *Id.*

229 *See* MANDIS, *supra* note 225, at 93-116 (describing the conversion, first from partnership to LLC, then to corporation).

230 "Bulge bracket" status identified large investment banks that provided a diverse array of products and services. At the time, independent bulge bracket firms were the leading global investment banking firms. *See* Rhee, *supra* note 226, at 75 (identifying "bulge bracket" firms as Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns).

231 *A Brief History of Goldman Sachs*, *supra* note 227.

232 *See* Rhee, *supra* note 226, at 85-87 (explaining that when Goldman Sachs was a private partnership before 1999 the business mix was diversified but after its IPO it increased its risk profile by leveraging its balance sheet and relying more on trading); Erik F. Gerding, *Remutualization*, 105 CORNELL L. REV. 797 815 (2020) ("After the IPO, the investment bank moved toward businesses such as proprietary trading that were less client-centered compared to traditional business lines (such as securities underwriting) and involved a higher degree of

performance and metrics of Goldman Sachs and empirically showed the connection between the firm's conversion to a public company and the change in its business strategy that relied much more on increasing leverage for the purpose of proprietary trading.[233] This strategy is a much riskier activity compared to traditional functions such as capital raisings for clients, mergers and acquisitions advisory, and asset management.

To be clear, the suggestion is not that when investment bankers are working in partnerships, and thereby risking partner capital and personal liability for debts of the partnership,[234] they become financial poltroons afraid of the shadow of their own deals. Investment banking has always been the purest form of financial risk-taking, and investment bankers are premier practitioners of financial poker. Rather, the suggestion is that the risk-taking in partnerships was more judicious and marked by some degree of risk aversion in business strategy precisely because investment bankers were owner partners whose personal net worths were substantially tied to the capital in the firm and thus could be decimated in any single bad deal or trade. The partner managers were not employees without an equity stake; they were owners with their own capital on the line in a pure risk-taking venture. The conversion from a private partnership to a public corporation fundamentally

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risk to the firm and its customers."); Will Bunting, *The Trouble with Investment Banking: Cluelessness, Not Greed*, 48 SAN DIEGO L. REV. 993, 1031 (2011) ("[I]t likely remains true that the opportunity cost of capital implicit in the partnership form will generally be higher than that for a similarly situated public corporation."); MERVYN KING, THE END OF ALCHEMY: MONEY, BANKING, AND THE FUTURE OF THE GLOBAL ECONOMY 109 (2016) ("[F]or a century Goldman Sachs had been a partnership and so every partner had an incentive to help monitor and manage the risks of the firm, a culture that had survived its transition to limited liability company status in 1999. In investment banking, the partnership form of the business has much to be said for it. Those who manage other people's money are more careless than when managing their own."); ENDLICH, *supra* note 225, at 9 (noting that the limit of partnership capital was "a restraint" that put limits on risky activities like sponsoring leveraged buyouts and engaging in risk arbitrage trades); MANDIS, *supra* note 225, at 160-61 ("Although the partners' stake in the firm now had liquidity and the risk to their personal assets had been eliminated, the loss of ownership and the elimination of personal liability for losses suffered by the firm eventually had unintended and far-reaching consequences to the organizational culture.").

233 *See* Rhee, *supra* note 226, at 78, 82, 85-87 (stating that proprietary trading and leverage puts equity capital at risk, and showing that after its conversion and IPO, Goldman Sachs greatly increased its reliance on leverage and trading, thus increasing its risk profile). *See also* ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 292 (2007) (stating conversion to public companies allowed investment banks "to raise the capital they needed to expand their operations").

234 General partnerships are not endowed with limited liability. *See* RUPA § 306(a).

altered this economic calculus. Partner owners became shareholders who are protected by limited liability. They also became employees who do not fully bear residual loss. The time horizon of wealth realization also changed, from a longterm career as partners or partner-aspirants to the short-term cycle of annual bonuses and the beguiling winds of the investment banking industry's labor market.[235]

When Goldman Sachs was a private partnership, it staked its reputation on judicious risk-taking because it was risking partner capital, and the specter of personal liability for the debts of the partnership always loomed. When it converted to a public corporation, its appetite for risk-taking increased and managers were more willing to risk the capital of public shareholders.[236] This important historical datapoint supports the theory of calibrated fiduciary duty and its ideas of bilateral relational risk and intermediated risk preference. The variable of risk determines legal policy that is actuated as the expression of fiduciary duties and standards of conduct unique to each form of firm.

CONCLUSION

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[235] *See* MANDIS, *supra* note 225, at 160 ("Risk slowly shifted from partners to public shareholders."); Frank Dobbin & Jiwook Jung, *The Misapplication of Mr. Michael Jensen: How Agency Theory Brought Down the Economy and Why It Might Again*, 30B RESEARCH IN SOCIOLOGY OF ORGS. 29, 57 (2010) ("Investment banks had been organized as partnerships, but now they listed themselves on the stock market, making their partners wealthy through initial public offerings and ensuring that executives no longer faced the downside risk they had faced as partners.").

[236] None other than Adam Smith observed in 1776 that the management of a broadly owned company by professional managers was different than that of a partnership.

> In a private copartnery, each partner is bound for the debts contracted by the company to the whole extent of his fortune. In a joint stock company, on the contrary, each partner is bound only to the extent of his share. The trade of a joint stock company is always managed by a court of directors. . . . This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private copartnery. Such companies, therefore, commonly draw to themselves much greater stocks than any private copartnery can boast of. . . . The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.

ADAM SMITH, THE WEALTH OF NATIONS 799-800 (Edwin Cannan, ed., 1994) (1776).

The law does not assign random rules of fiduciary duty for each form of firm. It uniquely formulates standards of conduct for good reason. It has in mind specific needs. Initial intuition suggests that if maximal profit is a constant, and if fiduciary rules affect managerial actions toward the venture's end, a unitary fiduciary rule and standard of conduct should govern. The law contradicts this easy intuition. It shuffles, reclassifies, and relocates elements of the duty of care and the concept of good faith. In doing this, it applies a rigorous logic. It uniquely calibrates each set of fiduciary duties and standards of conduct to fit the prototypical need of each form of firm.

The profit motive is a constant in all forms of business firms, and risk is the critical variable. The underlying principles of calibration are bilateral relational risk and intermediated risk preference. Bilateral relational risk encapsulates the concept that when owners and managers venture together, each bears a form of risk that is intrinsic in the relationship: owners bear the risk of agency cost; managers bear the risk of liability. Owners and managers must assent to an optimal arrangement that advances not maximal profit but maximal welfare under the specter of risk. Since fiduciary rules and standards of conduct affect the manager's risk of liability and personal incentives, they intermediate risk preference that is expressed through managerial actions.

Based on this theoretical framework, this Article identifies four factors of calibration that determine how the law shuffles, reclassifies, and relocates elements of the duty of care and the concept of good faith. They are the proximity of monitors to managers, complexity of the fiduciary's work, the manager's exposure to excessive liability, and the owner's ability to diversify the risk of loss from managerial actions. When these factors are applied to the prototype and unique conditions of each form of firm, they fully explain why the standard of care decreases along the line of agency, noncorporate firms, and corporations. The theory of calibration is both positive and normative. It explains why the laws of firms exist in discrete legal states, and it argues that this legal framework of unique calibration is normatively correct.