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Restoring Trust in Corporate Directors: The Disney Standard and the New Good Faith

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Restoring Trust in Corporate Directors: The Disney Standard and the New Good Faith

Abstract

The purpose of this Article is to explore the parameters and potential impact of the good faith standard articulated in *Disney V* and clarified in *Stone*. Part I begins with a brief review of the historical impact of the tension between entrepreneurial freedom and managerial accountability, and Part II explains why the Disney standard differs significantly from the traditional understanding of good faith as the absence of subjective bad faith. Part III points out that the court's use of the language of bad faith to articulate the new good faith may undercut the effectiveness of the standard. It urges further clarification of the difference between the absence of good faith and the presence of bad faith to ensure that the Disney standard will not be reduced to a mere semantic variation on the traditional duty of loyalty applicable only in the presence of improper—i.e., subjectively “bad”—motivation. Finally, Part IV examines the Disney standard's potential to serve as a vehicle for restoring trust in corporate directors and argues that the “new” good faith has the capacity to serve this important function, but only if the courts utilize the doctrine to require corporate directors to engage actively in oversight of the business and affairs of the entities entrusted to them. In the words of Chancellor Chandler, where corporate directors consciously disregard their duties, “the law must be strong enough to intervene against abuse of trust.”

Keywords

Disney, Good-faith standard, Fiduciary duty, Corporate directors

ARTICLES

RESTORING TRUST IN CORPORATE DIRECTORS: THE DISNEY STANDARD AND THE “NEW” GOOD FAITH

BY SARAH HELENE DUGGIN* AND STEPHEN M. GOLDMAN**

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INTRODUCTION

In its eagerly awaited June 2006 decision in *In re Walt Disney Company Derivative Litigation (Disney V)*,¹ the Delaware Supreme Court, the court at the “center of the corporate universe,”² held that the good faith required of corporate directors encompasses “not simply the duties of care and loyalty, . . . but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.”³ The *Disney* standard⁴—what we call the “new” good faith—differs from traditional notions of the concept—the “old” good faith—in that it serves as the “doctrinal vehicle” for addressing conduct that “does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence.”⁵

As courts and commentators have recognized, the fiduciary obligation to act in good faith has long been a part of Delaware’s corporate law,⁶ although it seldom has been a significant focal point in actions seeking to hold corporate directors accountable. The “new” good faith has emerged in the decade since the Chancery Court’s 1996 decision in *In re Caremark International Derivative*

1. 906 A.2d 27 (Del. 2006). For a summary of the principal decisions in the *Disney* litigation see *infra* note 14.

2. See E. Norman Veasey, Musings from the Center of the Corporate Universe, 7 Del. L. Rev. 163, 166-67 (2005) [hereinafter *Corporate Universe*] (recounting Delaware’s progression toward this central position). For discussion of the importance of the role of Delaware courts in the development of corporate jurisprudence, see generally William H. Rehnquist, The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice, 48 Bus. Law. 351 (1992).

3. *Disney V*, 906 A.2d at 67.

4. As used in this Article, the “*Disney* standard” refers to the duty of good faith articulated by the Delaware Supreme Court in its June 2006 decision. See *id.*

5. *Id.* In its November 2006 decision in *Stone v. Ritter*, the Delaware Supreme Court made clear that the “fundamental . . . fiduciary duty violated by [a failure to act in good faith] is the duty of loyalty.” No. 93, 2006 WL 3169168 at *6 (Del. Nov. 6, 2006). Pursuant to the Delaware Supreme Court’s customary practice, the court has not yet released the opinion cited in this Article “for publication in the permanent law reports[, and] until releases, it is subject to revision or withdrawal.” *Id.* at *1. *Stone* was argued on October 5, 2006, and the court handed down its decision on November 6, 2006, *id.*, after the original finalization of this Article, just as it was going to press. With the able assistance of the editors of the American University Law Review, the authors have endeavored to incorporate this very recent decision into the Article, although time pressures prohibited extensive exploration all of its ramifications.

6. See, e.g., *id.* at 67 & cases cited *id.* at n. 11; Melvin Eisenberg, The Duty of Good Faith in Corporate Law, 31 Del. J. Corp. L. 1 (2006) [hereinafter *Good Faith in Corporate Law*]; Sean J. Griffith, Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence, 55 Duke L.J. 1 (2005); E. Norman Veasey & Christine T. Di Guglielmo, What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments, 153 U. Pa. L. Rev. 1399 (2005) [hereinafter *What Happened in Delaware*].

*Litigation.*⁷ As articulated in *Disney V*, the obligation imposes an affirmative duty to act when failure to do so constitutes conscious disregard of known directorial obligations.⁸ In other words, it requires directors to make a good faith effort to do their jobs.

It is no accident that the new good faith has emerged and garnered significant attention at a time when the economic security of so many Americans depends on the financial health of major corporations.⁹ The Delaware courts' recent articulations of the duty of good faith respond to a deep need to find ways to restore trust in corporate directors. This is particularly true with respect to the directors of major corporations who wield tremendous power over the lives of investors, employees, and entire communities.¹⁰

Delaware, like all states, charges directors with the task of managing "[t]he business and affairs of every corporation organized under" its laws.¹¹ Section 102(b)(7) of Delaware's General Corporation Law permits corporations to exculpate directors from personal liability for breach of the duty of care in performing that task, but not for violations of the duty of loyalty or acts not in good faith.¹² In its June 2006 decision in *Disney V*, the Delaware Supreme

7. 698 A.2d 959 (Del. Ch. 1996).

8. See *Disney V*, 906 A.2d at 62-67. This critical distinction is discussed in Parts II and III *infra*.

9. In 1998, approximately fifty-two percent of Americans owned stock in one form or another—through individual investment, mutual funds, pension plans, etc.—in comparison with one percent in 1900 and thirteen percent in 1980. See THEODORE CAPLOW ET AL. 252-53 (2001), available at <http://www.pbs.org/fmc/book/14business6.htm>; U.S. CENSUS BUREAU, U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 2006 455 (125th ed. 2005), available at <http://www.census.gov/prod/2005pubs/06statab/income.pdf> (follow "Table Number 655" link) (detailing the composition of individuals' savings).

10. Cf. Patty M. DeGaetano, *The Shareholder Direct Access Teeter-Totter: Will Increased Shareholder Voice in the Director Nomination Process Protect Investors?*, 41 CAL. W. L. REV. 361, 364 (2005) ("Enron and its progeny . . . cause[d] an unimaginable ripple effect on the market, as tens of billions of dollars of market capital was destroyed, workers' retirement plans were devastated, shareholders' dreams were ruined, and individual investors' trust in the stock market was shattered." (citing ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS xi (Nancy B. Rapoport & Bala G. Dharan eds., 2004))). See generally TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 9-21 (Oxford Univ. Press 2006) (discussing impact of Enron and other recent corporate debacles on public confidence); CG Hintmann, Comment, *You Gotta Have Faith: Good Faith in the Context of Directorial Fiduciary Duties and the Future Impact on Corporate Culture*, 49 ST. LOUIS U. L.J. 571, 571 n.3 (2005) (citing CITIZEN WORKS, THE CORPORATE SCANDAL SHEET (2003), <http://www.citizenworks.org/corp/corp-scandal.php>) (noting large number of companies investigated for dishonesty and fraud in the 200-2005 period).

11. DEL. CODE ANN. tit. 8, § 141(a) (2006). For the relevant statutory text, see *infra* text accompanying note 153.

12. *Id.* § 102(b)(7). This controversial provision was added in 1986 in the wake of *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985). See *supra* text accompanying notes 134-149.

Court confirmed that even exculpatory provisions do not permit unbridled directorial disregard of management responsibilities.¹³ The court agreed with Chancellor Chandler, who tried the case, that good faith serves to “ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect.”¹⁴

Despite these lofty words, *Disney V* upheld the Chancery Court’s ruling in favor of the defendant directors, and the tone of the court’s subsequent decision in *Stone v. Ritter*¹⁵ suggests that it is anxious to avoid a flood of litigation alleging general breaches of the duty to act in good faith.¹⁶ Nevertheless, both decisions make clear that good faith is a distinct fiduciary obligation,¹⁷ although *Stone* defines this obligation as a component of the “fundamental” fiduciary duty of loyalty, rather than as a freestanding duty, at least in *Caremark*-type

13. *Disney V*, 906 A.2d at 65.

14. *Disney IV*, 907 A.2d 693, 760 n.487 (Del. Ch. 2005). See *Disney V*, 906 A.2d at 66-67. The shareholder derivative litigation involving The Walt Disney Company has produced six opinions, four of which are discussed in this Article. This series of decisions began with *In re The Walt Disney Co. Derivative Litig. (Disney I)*, 731 A.2d 342, 380 (Del. Ch. 1998) (dismissing the plaintiffs’ initial complaint for failing to plead facts sufficient to support their claim and excuse pre-suit demand), followed by *Brehm v. Eisner*, 746 A.2d 244, 267 (Del. 2000) (upholding the Chancellor’s grant of a motion to dismiss, but giving the plaintiffs leave to file an amended complaint). The third decision was *In re The Walt Disney Co. Derivative Litig. (Disney II)*, 825 A.2d 275, 291 (Del. Ch. 2003) (denying the defendants’ motion to dismiss the plaintiffs’ amended complaint and allowing claim for breach “of the foundational directorial obligation to act honestly and in good faith” to proceed); the fourth was *In re The Walt Disney Co. Derivative Litig. (Disney III)*, No. 15452, 2004 WL 2050138, at *8 (Del. Ch. Sept. 10, 2004) (granting defendant Michael Ovitz’s motion for partial summary judgment); the fifth was *In re The Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d at 693 (Del. Ch. 2005) (post-trial opinion, finding no waste or breach of fiduciary duties by the defendant directors). *Disney V*, 906 A.2d at 27 (upholding Chancellor’s decision in favor of the defendant directors) is the last of these decisions. This Article discusses *Brehm*, *Disney II*, *Disney IV*, and *Disney V*.

15. No. 93, 2006 WL 3169168 (Del. Nov. 6, 2006).

16. *Stone* involved a shareholders’ derivative action seeking to hold directors liable for failing to put in place monitoring systems adequate to enable them to learn of illegal employee conduct that ultimately required the corporation to pay criminal and civil fines and penalties of \$50 million. *Id.* at *1. See *infra* text accompanying notes Part II.B.3.d.

17. *Stone*, 2006 WL 3169168, at *6. In dicta, the court sought to clarify related doctrinal issues. It termed the language of *Disney V* and earlier cases referring to good faith “as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty,” as a way of describing good faith “colloquially.” *Id.* at *6. The *Stone* opinion also characterized the duty of good faith as an “indirect” basis for imposing directorial liability, noting that the *Disney V* court reserved the “issue, whether a violation of the duty to act in good faith is a basis for the direct imposition of liability, was expressly left open in *Disney [V]*.” *Id.* at n.29. See *infra* text accompanying note 30 and Part II.B.3.d.

oversight or monitoring failures.¹⁸ The operative question is what the recognition of this obligation means for corporate directors and their constituents.

Disney V is the culmination of extensive judicial exploration of the limits of section 102(b)(7).¹⁹ As a practical matter, the statute created an environment in which directors had little risk of liability for breach of fiduciary duty unless they engaged in the kind of impermissible self-dealing traditionally prohibited by the duty of loyalty.²⁰ Virtually every major corporation accepted section

18. See *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 972 (Del. Ch. 1996) (approving settlement agreement between parties). The Caremark decision is discussed *infra* Part II.A.2. The Delaware Supreme Court's location of the good faith obligation within the duty of loyalty was far from a foregone conclusion. Some Chancery Court decisions, see, e.g., *Guttman v. Huang*, 823 A.2d 492, 505-07 (Del. Ch. 2003), discussed good faith in terms of the duty of loyalty. Other opinions, however, including some Delaware Supreme Court decisions, referred to good faith as an element of the "triad[]" of . . . fiduciary duties—good faith, loyalty or due care" applicable to the conduct of corporate directors. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), or as one of directors' "three primary duties." *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001). Although Chancellor Chandler characterized an absence of good faith as "disloyal" conduct in *Disney IV*, he described the underlying allegations as either "sounding in the fiduciary duty of loyalty," or as examples of "severe violations of the fiduciary duty of care." *Disney IV*, 907 A.2d 755 n.463. Significant scholarly commentary anticipated that good faith would emerge as an independent duty. See, e.g., Eisenberg, *supra* note 5, at 5-6; Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 457, 482-83 (2004); see also sources cited *infra* note 28. Perhaps most significantly, section 102(b)(7)(i) contains a specific exclusion for disloyal acts and omissions separate and apart from acts or omissions "not in good faith." See DEL. CODE ANN. tit. 8, § 102(b)(7) (2006), set forth in pertinent part *infra* text accompanying note 156. If violations of the duty to act in good faith comprise a species of disloyalty, it is hard to understand why the Delaware legislature provided separate exclusions for each in section 102(b)(7). Cf., *Guttman*, 823 A.2d at 506 n.34 (suggesting legislature amendment of section 102(b)(7) to clarify that all of the exclusions set forth in its subsections pertain to disloyal conduct).

19. See, e.g., *Guttman*, 823 A.2d at 505-07 (discussing possible bases for Caremark-type claims); *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) (noting purpose of section 102(b)(7) to protect directors from personal liability for damages arising from violation of duty of care but not against damage liability arising from violation of duty of loyalty or bad faith claims); *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061 (Del. 1996) (finding that section 102(b)(7) amendment to corporation's certificate of incorporation protected directors from liability for monetary damages for good faith omissions); *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 914 (Del. Ch. 1999) (noting established rule that section 102(b)(7) protects directors from liability for good faith actions even if they violate the duty of care).

20. While WorldCom's twelve outside directors paid more than twenty-four million dollars to resolve claims against them as a result of the accounting fraud that led to the company's bankruptcy, and Enron's outside directors paid thirteen million, a recent article based on empirical data suggests that "out-of-pocket liability for outside directors over the last several decades has been rare" and that even now "their risk remains very low." Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1057, 1138-39 (2006); see also Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1267-68 (1999) [hereinafter *Social Norms*] (noting the reduced threat of directorial liability even in the presence of exceptions to exculpatory statutes); Lisa M. Fairfax, *Spare the Rod*,

102(b)(7)'s invitation to protect its directors from personal liability for breach of the duty of care.²¹ Consequently, for the directors of most large public corporations, the enactment of section 102(b)(7) and its counterparts in other states transformed the duty of care into an aspirational objective rather than a standard of liability.²²

The tide began to turn against directors following the corporate scandals that nearly brought down Caremark²³ and Columbia/HCA in the 1990s.²⁴ In the course of the litigation that followed, shareholders contended that the good faith exception to section 102(b)(7) provided a basis for holding directors liable for sleeping at the switch.²⁵ These cases sparked an important doctrinal development, one that the corporate world has watched with particular interest in the wake of Enron's collapse and the other major financial debacles that have occurred since 2001.²⁶ Since the Delaware Chancery Court's 1996 decision in *Caremark*,²⁷ both courts and commentators have debated whether good faith ultimately would

Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability, 42 HOUS. L. REV. 393, 394-95 (2005) [hereinafter *Spare the Rod*] (observing apparent social agreement against major directorial liability, even in light of recent corporate scandals). See generally E. Norman Veasey, *A Perspective on Liability Risks to Directors in Light of Current Events*, 19 NO. 2 INSIGHTS 9, 15-16 (2005) [hereinafter *Perspective*] (agreeing with statement attributed to Vice Chancellor Strine that "Independent directors who apply themselves to their duties in good faith have a trivial risk of legal liability").

21. *Disney IV*, 907 A.2d at 752.

22. See *Brehm*, 746 A.2d at 256 (distinguishing statutory corporate duties from "aspirational goals of ideal corporate practice"). Even the kind of inattention to directorial duties previously excepted from the protection of the business judgment rule in cases such as *Francis v. United Jersey Bank*, 432 A.2d 814, 829 (N.J. 1981) (abdication of directorial duties violates duty of care), arguably fell within the purview of the exculpatory provisions authorized by the statute prior to the courts' recognition of the significance of the good faith exception to section 102(b)(7). See discussion *infra* Part III.A.

23. See *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959, 972 (Del. Ch. 1996) (approving settlement agreement between parties). These cases are discussed *infra* Part II.A.2.

24. See *McCall v. Scott (McCall I)*, 239 F.3d 808 (6th Cir. 2001), *amended on denial of reh'g by McCall II*, 250 F.3d 997 (6th Cir. 2001).

25. See *McCall II*, 250 F.3d at 1001; *Caremark*, 698 A.2d at 968. See generally David H. Cook, *The Emergence of Delaware's Good Faith Fiduciary Duty: In re Emerging Communications, Inc. Shareholders Litigation*, 43 DUQ. L. REV. 91, 94 (2004) (noting that *Caremark* "was perhaps the first significant case to breathe life into the duty of good faith").

26. See Marleen O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1235 (2003) ("Enron 'serve[d]' as a 'perfect storm' metaphor that the checks and balances in the American system of corporate governance [were] not working . . ."). For a litany of the events that took place in 2002 in the wake of the Enron debacle, see *Year of Scandals, Shame*, CHI. TRIB., Dec. 23, 2002, at 6 (listing 2002 events related to corporate managerial misfeasance).

27. 698 A.2d at 971.

emerge as an independent fiduciary obligation.²⁸ In *Disney V*, the Delaware Supreme Court responded that, like loyalty and care, good faith is an element of “the triad of fiduciary duties” applicable to corporate directors.²⁹ While the court’s recent opinion in *Stone v. Ritter* describes this particular reference as “colloquial” and backs away from characterizing the good faith obligation as a “direct” basis for liability,³⁰ the *Stone* court stresses that a “director cannot act loyally toward a corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”³¹ Thus, a director’s “conscious disregard for [directorial] responsibilities. . . is properly treated as a nonexculpable, nonindemnifiable violation of the fiduciary duty to act in good faith.”³²

The purpose of this Article is to explore the parameters and potential impact of the good faith standard articulated in *Disney V* and clarified in *Stone*. Part I begins with a brief review of the historical impact of the tension between entrepreneurial freedom and managerial accountability, and Part II explains why the *Disney* standard differs significantly from the traditional understanding of good faith as the absence of *subjective* bad faith. Part III points out that the court’s use of the language of bad faith to articulate the new good faith may undercut the effectiveness of the standard. It urges further clarification of the difference between the absence of good faith and the presence of bad faith to ensure that the *Disney* standard will not be reduced to a mere semantic variation on the traditional duty of loyalty applicable only in the presence of improper—i.e., subjectively “bad”—motivation. Finally, Part IV examines the *Disney* standard’s potential to serve as a vehicle for restoring trust in corporate directors and argues that the “new” good faith has the capacity to serve this important function, but only if the courts utilize the doctrine to require corporate directors to engage actively in oversight of the business and affairs of the entities entrusted to them. In the words of Chancellor Chandler, where corporate directors

28. Hillary Sale wrote the first in-depth analysis of the recent emergence of the duty of good faith in 2004. See Sale, *supra* note 18, at 456. Former Delaware Chief Justice Veasey and Christine Di Guglielmo discussed the emerging duty of good faith in a 2005 article recounting developments in Delaware’s corporate law during his tenure on the court. See *What Happened in Delaware*, *supra* note 6. In addition, Melvin Eisenberg published a comprehensive analysis in 2006 shortly before the Delaware Supreme Court handed down its decision in *Disney V*. See *Good Faith in Corporate Law*, *supra* note 6. A number of other commentators also published helpful articles prior to *Disney V*. See sources cited *infra* note 229.

29. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1164 (Del. 1995).

30. No. 93, 2006 WL 3169168, at *6 (Del. Nov. 6, 2006).

31. *Id.* (quoting *Gutman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

32. *Disney V*, 906 A.2d at 67.

consciously disregard their duties, “the law must be strong enough to intervene against abuse of trust.”³³

I. FROM ROBBER BARONS TO THE WIDOW PRITCHARD: THE
STRUGGLE TO BALANCE MANAGERIAL ACCOUNTABILITY WITH
ENTREPRENEURIAL FREEDOM

Every jurisdiction requires directors to be loyal to the corporations they manage and to exercise care in the conduct of corporate business. These fiduciary mandates—known as the duty of loyalty and the duty of care—are set forth in judicial decisions and state corporations codes.³⁴ They do not, however, describe precise standards. On the contrary, the operation of these fiduciary duties often depends on context interpreted through the lens of the core principle that directors must act in good faith in a manner that they reasonably believe to be in the best interests of their corporations.³⁵ Until recently, however, courts seldom invoked good faith as a basis for holding directors personally liable; they certainly did not identify good faith as a fiduciary duty in its own right.³⁶ A brief review of the relevant historical background helps to explain how and why the need for a new articulation of the good faith standard arose.

A. *The Corporate Form and Its Abuses*

A corporation’s board of directors has ultimate responsibility for the management of its business.³⁷ While directors rely on officers to manage the company’s day-to-day affairs, the board itself is the highest decision-making authority, except as to those few key matters left to shareholders.³⁸ The law, however, has struggled with the question of how to hold directors, particularly outside directors, accountable for fulfilling their critical role.³⁹ The roots of this struggle date back to the emergence of the modern corporation and the quest to regulate both the external power and the internal

33. *Disney II*, 825 A.2d at 275.

34. See, e.g., DEL. CODE ANN. tit. 8, §§ 102, 141 (2006); N.Y. BUS. CORP. LAW § 717 (McKinney 2006); 15 PA. CONS. STAT. ANN. § 512 (West 2006).

35. See *Disney V*, 906 A.2d at 66; see also, e.g., MODEL BUS. CORP. ACT § 8.30 (2005).

36. See Cook, *supra* note 25, at 92-93 (describing emerging Delaware good faith obligation as an independent fiduciary duty).

37. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2006) (detailing the composition and managerial powers and functions of board of directors); MODEL BUS. CORP. ACT § 8.01 (2005).

38. See, e.g., DEL. CODE ANN. tit. 8, §§ 251, 275 (requiring shareholder vote in context of mergers and dissolutions respectively).

39. See *Spare the Rod*, *supra* note 20, at 408-09, 453-55.

management of corporate entities without unduly compromising either efficiency or innovation.⁴⁰

In the earliest period of American legal history, business corporations were publicly chartered, principally for public utility purposes; in the period from 1780 to 1801, nearly two-thirds of special state corporations charters were for inland navigation, turnpikes and toll roads, while fewer than four percent were for general business corporations.⁴¹ As Lawrence Friedman notes, in the entire eighteenth century only 335 businesses were granted corporate charters.⁴² Their purposes were circumscribed, and, unlike modern corporations, their periods of duration were fixed, rather than perpetual.⁴³ As the eighteenth century drew to a close, however, the new nation needed credit and a transportation infrastructure to facilitate growth and development.⁴⁴ The corporate form was well suited to meet these needs, and by the 1820s merchants and manufacturers, too, began to adopt the corporate form.⁴⁵ It was not until later in the nineteenth century, however, that technological advances—most notably the railroads—gave corporations “a commanding position in the economy [that t]hey never lost.”⁴⁶ The corporate form enabled business people “to expand their operations beyond what a few individuals could fund, manage, and carry out,”⁴⁷ permitting them “to elicit ongoing investment of human capital by specialized managers, along with committed financial capital from financial advisors.”⁴⁸ The corporate structure provided a legal framework ideally suited to amassing the vast sums necessary to

40. See LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 390-400 (3d ed. 2005) (outlining development of corporate law).

41. J. W. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970* 17 (1970).

42. See FRIEDMAN, *supra* note 40, at 129 (noting that most colonial corporate charters were for “churches, charities, or cities or boroughs”); see also Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, *Berkeley Bus. L.J.* 1, 4-6 (2004) (discussing the emergence of the corporate form).

43. *Id.* at 131.

44. See Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 *OHIO ST. L.J.* 1459, 1492-93 (1998) (documenting historical backdrop of the emergence of corporations in the United States).

45. *Id.*

46. FRIEDMAN, *supra* note 40, at 390.

47. Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 *U.C.L.A. L. REV.* 387, 427 (2003).

48. *Id.*; see also Douglas Arner, *Development of the American Law of Corporations to 1832*, 55 *S.M.U. L. REV.* 23, 56-57 (2002) (tracing emergence of fundamental attributes of American corporations in conjunction with industrial development); Blair, *supra* note 42, at 27 (corporate form “facilitates the locking-in of invested capital”).

develop capital-intensive industries and to facilitate accomplishment of business and financial objectives.⁴⁹

In 1795, North Carolina enacted a statute permitting incorporation without a public charter.⁵⁰ By 1850 a number of states allowed incorporation for a limited business purpose, and by 1875 permission to incorporate for “any lawful purpose” had become common.⁵¹ As legal historian Lawrence Friedman explains, “[n]o longer was the business corporation a unique, *ad hoc* creation. . . . Rather, it was becoming the general form in which to cast the organization of one’s business—legally open to all, and with few real restrictions on entry, duration, and management.”⁵²

In 1933, Justice Brandeis wrote that states long restricted freedom to incorporate because “[t]here was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations.”⁵³ During the latter part of the nineteenth century, these early concerns seemed warranted; abuses proliferated and engendered considerable disenchantment—particularly with large corporations and the infamous robber barons who ran them.⁵⁴ There were many causes for concern, but two were primary. First, across the nation many Americans protested that corporations had gained far too much power over the economy as a whole.⁵⁵ The monopolistic practices of the “trusts” became a national scandal as corporate leviathans began to undermine the competitiveness and efficiency of the very markets that gave birth to them.⁵⁶ Congress responded by passing the Sherman Act in 1890,⁵⁷ and in 1906 and 1907 President Theodore Roosevelt’s administration initiated the

49. See FRIEDMAN, *supra* note 40, at 394-95.

50. 1 William Meade Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* § 2, at 8 (Perm. Ed. 1999).

51. See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548 n.2, 555 (1933) (Brandeis, J., dissenting). Until the latter date, “the duration of corporate franchises was generally limited to a period of 20, 30, or 50 years.” *Id.* at 555. As late as 1903, almost half the states limited the duration to 20 or 50 years. *Id.* at 555 n.29.

52. FRIEDMAN, *supra* note 40, at 390-91.

53. *Louis K. Liggett Co.*, 288 U.S. at 549 (Brandeis, J., dissenting).

54. See FRIEDMAN, *supra* note 40, at 391-93 (illustrating legislative and judicial reactions to such abuses). The classic early account is MATTHEW JOSEPHSON, *THE ROBBER BARONS: THE GREAT AMERICAN CAPITALISTS* (1934).

55. See FRIEDMAN, *supra* note 40, at 392.

56. See *id.* at 399-400. See Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1452 (“The public’s anti-corporate sentiment stemmed from the very thing that made corporations successful: their ability to concentrate capital.”).

57. 15 U.S.C.A. §§ 1-7 (1997 & Supp. 2006).

antitrust actions that led to the break-up of the huge Standard Oil and American Tobacco trusts in 1911.⁵⁸

Second, financial fraud was commonplace.⁵⁹ In the words of Lawrence Friedman, “[t]he investment market was totally unregulated; no SEC kept it honest, and the level of morality among promoters was painfully low, to put it mildly. It was a generation of vultures. . . . The investing public was unmercifully fleeced.”⁶⁰ Often state legislatures seemed “supine [and] powerless.”⁶¹ Eventually, in the wake of the disastrous stock market crash of 1929, Congress enacted the Securities Act of 1933⁶² and the Securities Exchange Act of 1934⁶³ to address abuses in the issuance and trading of securities issues.

As is evident from these developments, in the latter part of the nineteenth century and the first part of the twentieth, there was considerable public distrust of large corporations and those who managed them.⁶⁴ The focus of these concerns, however, was primarily on the consequences of business power—the danger of monopolies and the unabashed exploitation of the public.⁶⁵ While the ability to accumulate capital under the corporate form facilitated these abuses, the corporate form itself was not the object of reformers’ attentions.⁶⁶ The legal responses entailed external limitations on corporate power—such as the prohibition of

58. See *Standard Oil Co. of N.J. v. United States*, 221 U.S. 1, 81-82 (1911) (upholding decision finding defendants’ actions combining their oil company stock to constitute an attempt to monopolize the oil industry and a restraint of trade); *United States v. Am. Tobacco Co.*, 221 U.S. 106, 184-85 (1911) (finding defendants in violation of antitrust laws and ordering lower court to develop a plan for dissolution of combination).

59. See FRIEDMAN, *supra* note 40, at 391.

60. *Id.*

61. *Id.* at 392.

62. 15 U.S.C.A. §§ 77a-77aa (1997 & Supp. 2006).

63. *Id.* §§ 78a-78mm.

64. What mattered to the public, however, was not necessarily the concern of businessmen. As Professor Hurst put it, “from the late 1880’s into the 1930’s, [w]e treated the corporate instrument as so useful for desired economic growth as to warrant using law to make it available on terms most responsive to businessmen’s needs or wishes.” HURST, *supra* note 41, at 62. Hurst further stated that “utility rather than the responsibility aspect of legitimacy dominated development of public policy toward the business corporation” *Id.* Although the law of corporations was responsive to the needs of business during the period, the statement is questionable from a broader perspective. While the administrations of Warren Harding and Calvin Coolidge were universally regarded as “pro-business,” the Progressive Era administrations of Theodore Roosevelt and Woodrow Wilson sponsored a number of reforms to which corporate leaders were inveterately hostile.

65. See FRIEDMAN, *supra* note 40, at 391.

66. See *id.* at 399 (noting policy focus on regulation rather than restructuring corporations).

monopoly and other abuses in the antitrust laws⁶⁷ and the issuance and trading requirements established by the Securities Act of 1933⁶⁸ and the Securities Exchange Act of 1934.⁶⁹ But these measures usually did not directly impact corporate governance structures.

Today, we are once again in the throes of a crisis in corporate trust, but the nature of the principal concerns is dramatically different.⁷⁰ Since the last decades of the twentieth century, the genesis of the dominant problem has been internal rather than external corporate power—a failure of corporate governance structures and standards to prevent flagrant abuses by insiders at many different levels.⁷¹ Today, governance, particularly the relationship between directors and shareholder-investors, is necessarily a central concern of corporate law.⁷²

B. *The Role of Directors in Corporate Governance*

The original model for defining the director-shareholder relationship emerged from the law of trusts.⁷³ This is not surprising, for the duty of a trustee is a paradigm for allocation of fiduciary responsibilities in cases where one person holds money or property on behalf of another.⁷⁴ In addition, the rules governing financial trusts were already well established by the time courts began to define the core relationships of corporate governance.⁷⁵ Consequently, the potential fit appealed to courts and commentators.⁷⁶ There was significant support for the idea that a corporate manager should be “a trustee—a guardian,” with “every shareholder . . . [as] his ward” and, at least in cases of large public enterprises, “the community [as] his *cestui qui* trust.”⁷⁷ A number of nineteenth-century judicial decisions reflect a similar propensity to invoke the law of trusts in the corporate arena.⁷⁸

67. *See id.* at 346-49.

68. 15 U.S.C.A. §§ 77a-77aa (1997 & Supp. 2006).

69. *Id.* §§ 78a-78mm.

70. *See, e.g.,* O'Connor, *supra* note 26, at 1235-36 (pointing to Enron as an illustration of control failure in corporate structure).

71. *See id.*

72. *See, e.g.,* DeGaetano, *supra* note 10, at 363 (discussing “tidal wave” of corporate governance crises and regulatory reforms engendered by recent scandals).

73. FRIEDMAN, *supra* note 40, at 393.

74. *Id.* at 393-94.

75. *Id.* at 393-95.

76. *Id.*

77. *See id.* at 394 (quoting Charles Francis Adams, Jr.).

78. *See id.* (citing *Ark. Valley Agric. Soc'y v. Eichholtz*, 25 P. 613 (Kan. 1891); *Marshall v. Farmers' & Mechanics' Sav. Bank*, 8 S.E. 586 (Va. 1889)).

The conservative rules of the trust approach, however, did not fit the entrepreneurial mold of corporate capitalism and its captains.⁷⁹ As the twentieth century dawned and the corporate form became increasingly popular, corporations began to grow and diversify.⁸⁰ It was evident that the skills that made individuals successful business directors were not necessarily the same qualities that made good trustees.⁸¹ It soon became clear that saddling corporate directors with the kinds of standards applicable to the guardians of trusts and eleemosynary institutions was counterproductive.⁸² This approach suited neither the needs of evolving business corporations nor the objectives of their investors.⁸³ Consequently, the courts began to develop a separate set of principles for corporate management.⁸⁴

As the law of corporate governance evolved, what remained of the trustee model was the idea that directors owe a fiduciary duty to the corporation, and, indirectly, to its shareholders.⁸⁵ The principal components of this fiduciary obligation emerged as the *duty of loyalty* and the *duty of care*.⁸⁶ Courts and legislatures defined and refined the parameters of these duties over time.⁸⁷ The duty of loyalty came to be epitomized in the oft-cited language of Judge Cardozo in his famous 1928 opinion in *Meinhard v. Salmon*⁸⁸—"the punctilio of an honor the most sensitive."⁸⁹ While an absolute prohibition of transactions between a corporation and its officers or directors proved undesirable for a variety of reasons,⁹⁰ the principle of transparency provided for disclosure of conflicting interests and recusal of interested directors from the decision-making process.⁹¹ Thus, the law required directors to put the well-being of the corporation before their personal interests, although in its classic application the duty of loyalty became principally associated with "a financial or other

79. *Id.*

80. *Id.* at 395-96.

81. *Id.* at 393-94.

82. *Id.* at 394.

83. *Id.* at 394-95.

84. See, e.g., *id.* at 394 (discussing early judicial attempts to rein in corporate directors and officers (citing *Ark. Valley Agric. Soc'y v. Eichholtz*, 25 P. 613 (Kan. 1891); *Marshall v. Farmers' & Mechanics' Sav. Bank*, 8 S.E. 586 (Va. 1889))).

85. See *id.* at 393.

86. See, e.g., Hintmann, *supra* note 10, at 577-79 (identifying fiduciary duties of loyalty and care).

87. See, e.g., *id.*

88. 164 N.E. 545, 548-49 (N.Y. 1928) (holding that the plaintiff was entitled to a share of the proceeds from the defendant's purchase of a leasehold estate because the opportunity arose in connection with the parties' joint "coadventure").

89. *Id.* at 546.

90. See MODEL BUS. CORP. ACT § 8F cmt. (2005); see also RESTATEMENT (THIRD) OF TRUSTS § 170(1) (2003).

91. See Hintmann, *supra* note 10, at 578.

cognizable fiduciary conflict of interest.”⁹² With respect to the duty of care, the courts struggled to strike the proper balance between entrepreneurial freedom and managerial accountability.⁹³ The solution that emerged, the fundamental rule of judicial review of corporate decisions, became known as the *business judgment rule*.⁹⁴

1. *The business judgment rule and the gutting of the duty of care*

The business judgment rule is “the foundation of our corporation law.”⁹⁵ Its practical function, however, is to limit significantly the demands imposed by the duty of care, because it “teaches that courts will not second-guess directors’ business decisions and will not interfere with the expectation of investors that directors will take honest and prudent business risks to advance the economic well-being of the enterprise.”⁹⁶ The conceptual underpinning of early iterations of the business judgment rule was virtually identical to the policy considerations invoked today: business is most likely to succeed and flourish when business managers are free to make decisions unfettered by outside interference or judicial second-guessing.⁹⁷

The famous case of *Shlensky v. Wrigley*⁹⁸ illustrates the deference courts accord management decisions pursuant to the business judgment rule. As baseball aficionados and students of corporate law

92. *Stone v. Ritter*, No. 93, 2006 WL 3169168, at *6 (Del. Nov. 6, 2006); see Hintmann, *supra* note 10, at 578 (noting that “[a]t common law a transaction involving conflicts of interest was void or voidable[, and that m]odern courts have been more lenient, but they still require the self-dealing director to act with the utmost good faith and scrupulous fairness” (citing DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 130-38 (4th ed. 1993 & Supp. 1995)).

93. See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 129 (2004).

94. See FRIEDMAN, *supra* note 40, at 396.

95. *What Happened in Delaware*, *supra* note 6, at 1442.

96. *Id.* See also Bainbridge, *supra* note 93, at 129 (“Choosing the appropriate balance between authority and accountability is the central problem of business judgment jurisprudence.”). For an analysis of the ongoing tension between authority and accountability in corporate governance, see *id.* at 107-09. The policy justifications for the business judgment rule—encouraging qualified persons to serve as directors and to take appropriate risks, judicial restraint, and preservation of the board’s role in governing corporations—arguably differ when the actions at issue are those of officers rather than directors. For a discussion of reasons why the rule should not apply to the actions of officers, see Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 455-69 (2005).

97. See generally ALAN R. PALMITER, *CORPORATIONS* § 12.2.2 at 204 (5th ed. 2006); Hintmann, *supra* note 10, at 575 (noting that “[r]eluctance toward second-guessing business decisions dates back more than 250 years in English law to *The Charitable Corp. v. Sutton* [(1742) 26 Eng. Rep. 642 (Ch.)] and the 1829 Louisiana Supreme Court decision in *Percy v. Millaudon* [8 Mart. (n.s.) 68 (La. 1829)]”).

98. 237 N.E.2d 776 (Ill. App. Ct. 1968).

are well aware, in the late 1960's the Chicago Cubs remained the only major league team that did not play home games at night.⁹⁹ Shlensky, a minority shareholder of the Chicago National League Ball Club, Inc. ("the Cubs"), challenged the refusal of the Cubs' board to outfit the stadium for night games. Shlensky attributed operating losses to inadequate attendance at home.¹⁰⁰ At the time, all nineteen other major league baseball teams played under the lights.¹⁰¹

The Cubs' directors denied Shlensky's contention that their decision was based on the idiosyncratic preferences of president and majority shareholder Philip K. Wrigley, rather than good business. The directors claimed that the potentially deleterious impact of night games on the neighborhood surrounding the Cubs' stadium justified their approach.¹⁰² The Illinois Appellate Court upheld a trial court decision in the directors' favor. The court stressed that shareholders elect directors to exercise business judgment. It emphasized that "the decision [was] one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interests in their making of that decision," and that "unless the conduct of the defendants at least borders on one of [those] elements, the courts should not interfere."¹⁰³ The court concluded by admonishing against judicial interference with board decisions in the absence of "a clear showing of dereliction of duty."¹⁰⁴

Shlensky and other decisions emphasizing the importance of entrepreneurial freedom make it clear that the business judgment rule is a process-oriented standard.¹⁰⁵ As Delaware's former Chief Justice Veasey recently explained, "the focus of the business judgment rule remains on the process that directors use in reaching their decisions."¹⁰⁶ Clearly, the latitude afforded to directors under the business judgment rule differs from the constraints the law of trusts imposes on trustees. Moreover, the business judgment rule provides corporate directors with a degree of protection unavailable to most of

99. *Id.* at 777. The Cubs eventually played the first night game at Wrigley Field on August 8, 1988. See Chicago Cubs website, <http://chicago.cubs.mlb.com/NASApp/mlb/chc/ballpark/index.jsp>.

100. 237 N.E.2d. at 777-78.

101. *Id.* at 777.

102. *Id.* at 778.

103. *Id.* at 780.

104. *Id.* at 779.

105. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. 1996) ("[T]he business judgment rule is process oriented and informed by deep respect for all *good faith* board decisions.").

106. See *What Happened in Delaware*, *supra* note 6, at 1421.

those who receive compensation for their services in other fields.¹⁰⁷ The rationale for applying the business judgment rule, however, breaks down when directors fail to fulfill their basic obligation to pay attention to the affairs of the entities they manage.

2. *The problem of dereliction of directorial duty*

As corporate law developed, another species of disputes about fiduciary responsibilities emerged involving allegations of disregard or dereliction of directorial duties. In *Barnes v. Andrews*,¹⁰⁸ for example, Judge Learned Hand, ruled that a director could be liable for “general inattention to his duties as a director.”¹⁰⁹ Judge Hand reached this conclusion even though the integrity of the defendant director was “unquestioned.”¹¹⁰ Although “[n]o men of sense would take the office [of director], if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence,”¹¹¹ the defendant director “had allowed himself to be carried along as a figurehead”¹¹² without adequately informing himself of the corporation’s business affairs.¹¹³ The director escaped liability, even though the court could not “acquit [him] of misprision in his office,”¹¹⁴ because it concluded that there was no evidence that the director’s inattention had *caused* the mortal harm suffered by the company.¹¹⁵

More than fifty years later, the issue of directorial inattention arose in another well known case, *Francis v. United Jersey Bank*.¹¹⁶ In an

107. As the United States Court of Appeals for the Second Circuit noted in *Joy v. North*:

Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation. Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.

Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982). See also *infra* text accompanying notes 341-345.

108. 298 F. 614 (S.D.N.Y. 1924).

109. *Id.* at 615.

110. *Id.* at 616.

111. *Id.* at 617.

112. *Id.* at 616.

113. *Id.* at 615-16.

114. *Id.* at 616.

115. *Id.* at 617-18.

116. 432 A.2d 814 (N.J. 1981). Although the company was incorporated in New York, the court applied New Jersey law because “New Jersey had more significant relationships to the parties and the transactions than New York.” *Id.* at 820. This

unusual state of affairs, the proverbial poor widow was the defendant rather than the plaintiff. Following her husband's death, Mrs. Lillian Pritchard and her two sons served as directors of the family reinsurance brokerage business; the two sons were also officers of the company.¹¹⁷ Although her late husband had warned Mrs. Pritchard that their son Charles, Jr. "would take the shirt off my back,"¹¹⁸ she neglected her directorial duties, preferring instead to focus her attention on her gin. While their mother was asleep at the switch, the boys misappropriated large sums of money and soon drove the company into bankruptcy.¹¹⁹

The trustees in bankruptcy sued Mrs. Pritchard for breach of fiduciary duty and continued the action against her estate following her death.¹²⁰ Remarking that "[t]he sentinel asleep at his post contributes nothing to the enterprise he is charged to protect,"¹²¹ the New Jersey Supreme Court held Mrs. Pritchard's estate liable for her breach of the duty of care because of a complete failure to perform her duties as a director.¹²² In so doing, the court upheld the trial court's rejection of the argument that Mrs. Pritchard should be excused because she was simply a poor widow, overwhelmed by grief and exploited by wicked children.¹²³ The high court held that, as a director, Mrs. Pritchard was obligated to "discharge [her] duties in good faith and act as ordinarily prudent person would under similar circumstances in like positions."¹²⁴ Unlike Judge Hand in *Barnes v. Andrews*,¹²⁵ the *Francis* court found that the plaintiffs had established causation for their losses.¹²⁶ In so doing the court warned: "A director is not an ornament, but an essential component of corporate governance. Consequently, a director cannot protect himself behind a paper shield bearing the motto, 'dummy director.'"¹²⁷

Barnes and *Francis* illustrate a judicial reluctance to interpret the business judgment rule to bar actions against directors who fail to

choice of law was contrary to the internal affairs doctrine, under which the law of the state of incorporation governs the internal affairs of a corporation.

117. *Id.* at 818.

118. *Id.* at 819.

119. *Id.* at 818-19.

120. *Id.* at 816.

121. *Id.* at 822.

122. *Id.* at 819.

123. Mrs. Pritchard had never paid attention to the business; her husband ran the company until his death. After he died, she apparently suffered from a form of acute depression, became bedridden, and began to drink heavily. *Id.* at 819-20.

124. *Id.* at 819.

125. 298 F. 614 (S.D.N.Y. 1924).

126. 432 A.2d at 826-29 (explaining that determining causation is a matter of both law and common sense).

127. *Id.* at 823 (citing *Campbell*, 62 N.J. Eq. at 443).

exercise their managerial authority. By the latter part of the twentieth century the courts had also begun to limit the application of the business judgment rule in other important respects. For example, in *Joy v. North*¹²⁸ the United States Court of Appeals for the Second Circuit expounded at length on the rule in the context of a duty of care action against the directors of Citytrust Bank. On the recommendation of Citytrust's chief executive officer ("CEO"), the bank's board had repeatedly approved extensions of significant amounts of credit to a real estate developer with whom the CEO had a personal relationship.¹²⁹ When the developer defaulted, thereby inflicting a major loss on the bank, a group of shareholders filed a derivative action claiming that the directors had breached their duty of care by approving the loans.¹³⁰ The court rejected the defendant directors' argument that their actions were protected by the business judgment rule, explaining that:

the business judgment rule extends only as far as the reasons which justify its existence. Thus, it does not apply in cases, *e.g.*, in which the corporation lacks a business purpose, is tainted by a conflict of interest, is so egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision.¹³¹

In ruling that Citytrust's directors could be liable for breach of fiduciary duty, the *Joy* Court rebuffed the outside directors' protest that "they had neither information nor reasonable notice of the problems raised by the [loan] transactions."¹³² The court admonished:

[L]ack of knowledge is not necessarily a defense, if it is the result of an abdication of directional responsibility. Directors who willingly allow others to make major decisions affecting the future of the corporation wholly without supervision or oversight may not defend on their lack of knowledge, for that ignorance itself is a breach of fiduciary duty.¹³³

Joy v. North is significant because it is one of the few cases in which a court upheld a challenge to a board decision for reasons grounded more in substantive irrationality than procedural shortcomings. Although the law of Connecticut, rather than that of Delaware, governed the decision, *Joy v. North* offered an inkling of major issues

128. 692 F.2d 880 (2d Cir. 1982).

129. *Id.* at 894-95.

130. *Id.* at 882.

131. *Id.* at 886 (citations omitted).

132. *Id.* at 896.

133. *Id.* (citations omitted).

about to surface in corporate fiduciary law—outside directors’ ignorance, inattention, or undue deference to insiders. The court’s willingness to wade into these waters also presaged the course the Delaware Supreme Court would soon take in trying to prevent the business judgment rule from wholly swallowing the duty of care. Appropriately, the real storm over the parameters of the modern duty of care broke in Delaware.

3. *Smith v. Van Gorkom: the judicial earthquake and its aftermath*

In *Smith v. Van Gorkom*,¹³⁴ the Delaware Supreme Court halted the progressive advance of the business judgment rule and attempted to breathe new life into the duty of care. In September of 1980, Jerome Van Gorkom, Trans Union’s chairman and CEO, asked the board to consider an offer from Pritzker Corp. to purchase Trans Union stock at a price of \$55 per share.¹³⁵ The offer ostensibly came with a very tight time limitation that required prompt action by Trans Union’s board.¹³⁶ The directors approved the cash-out merger proposal on the basis of Van Gorkom’s twenty-minute account of his negotiations with Pritzker representatives.¹³⁷ The directors did not review any documentation of the proposed terms and underlying financial data or consult the company’s investment advisers.¹³⁸ Trans Union’s directors were well qualified and highly accomplished business people.¹³⁹ Nevertheless, when a shareholder derivative action challenging the board’s decision reached the Delaware Supreme Court, the majority decided to put some bite back into the duty of care. The court held Trans Union’s directors personally liable for gross negligence in breach of the duty of care on the ground that they had failed to inform themselves properly before voting to proceed with the merger.¹⁴⁰

The analytical portion of the majority’s opinion in *Van Gorkom* begins with a standard obeisance to the business judgment rule. The

134. 488 A.2d 858 (Del. 1985).

135. *Id.* at 867.

136. *Id.*

137. *Id.* at 868.

138. *Id.* at 868-69 (observing that such documents were not even available for review prior to the meeting).

139. *Id.* at 894 (McNeilly, J., dissenting) (noting that the Trans Union directors “had collectively been employed by the Company for 116 years and had 68 years of combined experience as directors”).

140. *Id.* at 881. The directors were also held liable for gross negligence in approving amendments to the merger proposal and for relinquishing their freedom to recommend to the stockholders that the merger offer be turned down. *Id.* at 883-84, 887-88.

court cited *Zapata Corp. v. Maldonado*¹⁴¹ as a reminder that “[t]he business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.”¹⁴² Subsequently, however, in a decided twist on the Illinois Appellate Court’s deferential language in *Shlensky*, Delaware’s highest court admonished that “fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud.”¹⁴³ The court continued: “[r]epresentation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.”¹⁴⁴ After clarifying that a failure to make an informed business judgment violated the duty of care rather than the duty of loyalty, the court confirmed that “gross negligence” was the relevant standard in determining whether the directors breached that duty.¹⁴⁵ It then proceeded to analyze the facts and circumstances of the Trans Union merger, concluding that “the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of [Pritzker’s offer] for sale of the Company.”¹⁴⁶

The court’s decision shook the foundations of the corporate world.¹⁴⁷ As the decision’s aftershocks rippled through boardrooms across the country, Delaware’s legislature reacted quickly to this perceived judicial invasion of the realm of business professionals.¹⁴⁸ Within months, both chambers of the General Assembly passed, and the governor signed, legislation amending Delaware’s corporate code in an effort to undo the damage wrought by what a dissenting justice called the *Van Gorkom* majority’s “comedy of errors.”¹⁴⁹

C. Protecting Directors from the Courts: Delaware’s Exculpation Statute

Delaware’s new statute, codified as section 102(b)(7) of the state’s General Corporation Law, eviscerated *Van Gorkom* by permitting corporations to limit, or even eliminate, the personal liability of directors for almost all breaches of the duty of care.¹⁵⁰ The legislative history of the statute is sparse, but it is clear that the legislature’s

141. 430 A.2d 779 (Del. 1981).

142. 488 A.2d at 872 (citing *Zapata*, 430 A.2d at 782).

143. *Id.*

144. *Id.*

145. *Id.* at 872-73 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

146. *Id.* at 878.

147. See, e.g., Sale, *supra* note 18, at 466 n.58.

148. *Id.* at 466-67.

149. 488 A.2d at 894 (McNeilly, J., dissenting).

150. For the text of section 102(b)(7), see *infra* text accompanying note 153.

objective was to undo a decision that many believed would discourage qualified people from serving as corporate directors.¹⁵¹ There was also concern that *Van Gorkom* would result in a prohibitive increase in the cost of directors' and officers' insurance. The new statute responded to these anxieties.¹⁵² Section 102(b)(7) provides in pertinent part that a Delaware corporation's certificate of incorporation may contain:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this Title [unlawful distributions]; or (iv) for any transaction from which the director derived an improper personal benefit.¹⁵³

The structure of the provision is significant. In keeping with Delaware's traditional approach to corporate law, section 102(b)(7) is essentially an enabling statute that permits corporations to add provisions to their charters protecting directors from personal liability for failure to fulfill their fiduciary duties.¹⁵⁴ The statute, however, precludes limitation of liability for breach of the duty of loyalty, intentional misconduct or knowing violation of law, reaping improper personal benefit from transactions (presumably a subset of

151. See, e.g., Hintmann, *supra* note 10, at 586-88; E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U. L. & POL'Y 1, 11 (2003) (commenting on the obvious relationship between *Van Gorkom* and the enactment of the Delaware statute).

152. See RODMAN WARD, JR., EDWARD P. WELCH & ANDREW J. TUREZYUN, *FOLK ON DELAWARE GENERAL CORPORATION LAW § 102*, n.55 and accompanying text (2001); see also Bruner, Christopher M., "Good Faith," *State of Mind, and the Outer Boundaries of Director Liability in Corporate Law* (Boston Univ. School of Law, Working Paper No. 05-19, 2005), available at <http://ssrn.com/abstract=832944>.

153. DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).

154. For a discussion of Delaware's corporation law as an enabling statute, see *What Happened in Delaware*, *supra* note 5, at 1411. See also E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179, 2179-80 (2001) (positing that the flexibility of the Delaware enabling model makes it superior to mandatory corporate law rules); E. Norman Veasey, Essay, *Policy and Legal Overview of Best Corporate Principles*, 56 S.M.U. L. REV. 2135, 2139-40 (2003) (explaining that Delaware's statute is based upon trust that executives will act rationally and with integrity in pursuing the best interests of stockholders); E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, 38 WAKE FOREST L. REV. 839, 843 (2003) (arguing that the most effective way to protect stockholders is to ensure directors' independence). In addition, as former Chief Justice Veasey observes, Delaware's corporate code "create[s] only a skeletal framework. . . . The 'flesh and blood' of corporate law is judge-made." *Id.*

disloyal actions), or making unlawful distributions of corporate assets.¹⁵⁵ These exclusions are fairly straightforward. The exception “for acts or omissions not in good faith” set forth in the first part of subsection (ii), however, is less so, because the concept of “good faith” has always been somewhat amorphous in corporate law.¹⁵⁶ It is this language, rather than the disloyalty exclusion in subsection (i), that provided the impetus for the evolution of the “new” good faith and its recognition by the Delaware Supreme Court in *Disney V*. While section 102(b)(7) does not bar injunctive relief,¹⁵⁷ the exculpatory provisions it authorizes create an effective release from personal liability for monetary damages as a result of directorial carelessness—both negligence and gross negligence.¹⁵⁸ Consequently, section 102(b)(7) sounded the death knell of the duty of care as an effective fiduciary standard constraining the conduct of corporate directors.¹⁵⁹

Other jurisdictions were quick to follow Delaware’s lead. In the course of the succeeding year, more than thirty states enacted similar provisions, and all fifty states eventually did so.¹⁶⁰ In the blink of an eye, virtually every major corporation accepted the invitation to include an exculpatory provision in its certificate of incorporation.¹⁶¹ The corporate world heaved a collective sigh of relief—at least until the Caremark and Columbia/HCA fiascos made front-page news across the country in the mid 1990s.¹⁶² These corporate scandals

155. See DEL. CODE ANN. tit. 8, § 102(b)(7)(i), (iii)-(iv) (2006).

156. See Griffith, *supra* note 5 (pre-*Disney* description of the concept of good faith as a rhetorical device rather than a substantive standard). In its decision in *Emerald Partners v. Berlin*, No. 9700, 2003 WL 21003437 (Del. Ch. 2003), *aff’d*, 840 A.2d 641 (Del. 2003), the court noted the difficulty of interpreting section 102(b)(7) because it “creat[es] unnecessary conceptual confusion.” *Id.* at *39 n.133.

157. See DEL. CODE ANN. tit. 8, § 102(b)(7) (permitting exculpation of directors from personal liability without limitation of injunctive relief).

158. *Id.*

159. See Sale, *supra* note 18, at 458, 482-94 (suggesting that Delaware’s legislature “abdicat[ed] part of its role in regulating corporate governance. . . . [by] allow[ing] companies, at the directors’ initiative, to exempt [directors] from damages for failing to adhere to their duty of care . . .”). For a discussion of the general decline of the potency of the duty of care in Delaware, see Stephen J. Lubbin & Alana J. Darnell, *Delaware’s Duty of Care*, 31 DEL. J. CORP. L. 589, 591 (2006) (describing the duty of care as “a rule that now requires little more of a director than a ritualistic consideration of relevant data”).

160. See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 332 n.93 (2004); see also *Spare the Rod*, *supra* note 20, at 405 (highlighting trends in state law to limit director liability and suggesting that the SEC proved unable to address fully the shortcomings of state corporation law).

161. *Disney IV*, 907 A.2d 693, 752 (Del. Ch. 2005).

162. As a result of its criminal conviction and associated civil liability, Caremark paid more than \$160 million to the U.S. Government and other third parties. See *infra* Part II.A.2.a.

focused attention on the exceptions to the exculpatory language of section 102(b)(7), particularly the good faith proviso. Subsequently, Enron and the spectacular corporate debacles that followed¹⁶³ intensified pressure to hold outside directors accountable for fiduciary lapses, and the brouhaha over Michael Ovitz's exit from Disney provided an admirable vehicle for exploring the limits of the good faith exception.

The culmination of the Disney litigation—the Delaware Supreme Court's June 2006 decision—offers hope that the “new” good faith will evolve to fill a significant gap in contemporary corporate law. If the courts choose to confine its application as an enforceable legal standard quite narrowly, the promise of the new good faith will soon evaporate. But, if the courts utilize the *Disney* standard to hold directors accountable for actually fulfilling the responsibilities they knowingly accept in return for the payment, prestige and perquisites that accompany seats on major corporate boards,¹⁶⁴ the new good faith has the potential to become a landmark in the evolution of standards defining the conduct of corporate directors in Delaware and—because of Delaware's importance in American corporate law—throughout the entire United States.

II. THE “NEW” GOOD FAITH

The *Disney* standard is the product of twenty years of development, beginning with the Delaware Supreme Court's decision in *Smith v. Van Gorkom*¹⁶⁵ and the Delaware General Assembly's enactment of section 102(b)(7) in reaction to that decision.¹⁶⁶ The importance of *Disney V* in this context¹⁶⁷ lies in its recognition that directors of a Delaware corporation have a fiduciary obligation to act in good faith that does not conflate good faith with the duty of care, yet goes beyond the mere obligation not to act with subjectively improper motivation.¹⁶⁸ This richer obligation imposes upon directors an

163. See Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579 (2002) (discussing the impact of the Enron collapse in the aftermath of the September 11, 2001 terrorist attacks).

164. As Professor Johnson points out, the fiduciary duty of loyalty has the potential to function across a broad spectrum “ranging from a minimalist aspect of nonbetrayal to the more full-bodied dimension of affirmative devotion.” See Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 30 (2004) [hereinafter *Loyalty Discourse*].

165. 488 A.2d 858 (Del. 1985).

166. DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).

167. *Disney V*, 906 A.2d 27 (Del. 2006). For a complete list of the key decisions in the *Disney* litigation, see *supra* note 14.

168. *Disney V*, 906 A.2d at 66-67.

affirmative duty to act where they have a known duty to do so.¹⁶⁹ Unfortunately, while it has noted this distinction, the Delaware Supreme Court, like the Chancery Court, has at least troubled the waters by using “bad faith” to define “good faith” within the meaning of section 102(b)(7)(ii). Consequently, there is a significant risk that the “failure-to-act test” could be equated with an older, different test, namely a motivational inquiry. This Part argues that it would be clearer to focus on an absence of *good* faith than to require a finding of the presence of *bad* faith, given the baggage the latter term brings with it. In any event, it is essential to articulate the required finding clearly if the new good faith is to realize its full potential.

A. *Closing the Accountability Gap*

1. *Van Gorkom and section 102(b)(7)*

In *Van Gorkom*, the Delaware Supreme Court made clear that there was no suggestion that the actions of Trans Union’s directors constituted self-dealing or that they had not made their decision in good faith.¹⁷⁰ The court understood the case to implicate the duty of care, not the duty of loyalty.¹⁷¹ The primary importance of the case for the new good faith arises not from the decision itself, but from the Legislature’s response—section 102(b)(7)’s grant of permission to Delaware corporations to shield their directors from liability for money damages for breach of the duty of care, except for “acts or omissions not in good faith.”¹⁷² The practical effect of the statute was to protect directors and officers from liability for both negligent and grossly negligent conduct.¹⁷³ This legal regime effectively neutralized

169. *Id.*; *Stone v. Ritter*, No. 93, 2006 WL 3169168, at *6-*7 (Del. Nov. 6, 2006).

170. 488 A.2d at 873.

171. *Id.* at 872-73. More particularly, the court held that the duty of care imposes on directors the obligation “to act in an informed and deliberate manner,” and the duty is breached where directors are found to have acted in a grossly negligent fashion. *Id.* at 873.

172. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2006). Delaware has a similar exclusion with respect to indemnification. *See* DEL. GEN. CORP. LAW tit. 8, § 145 (2006).

173. Professor Eisenberg has argued that standards of conduct and standards of judicial review diverge in the law of corporate governance. He suggests that the duty of care sets forth a standard of conduct for directors, but that the business judgment rule provides a (much less-stringent) standard of review. *See* Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 52 *FORDHAM L. REV.* 437, 439-49 (1993). A section 102(b)(7) provision operates in a manner analogous to the business judgment rule: it does not affect a director’s duty to act with care, but it denies courts the ability to impose personal monetary liability as a consequence of careless conduct. While it is certainly true that business men and women have moral duties not encompassed by legal requirements, standards of review that are less stringent than standards of conduct make the standards of

the duty of care as a check on directorial negligence. It was inherently unstable because it went too far.¹⁷⁴

2. *The rise of the new good faith*

a. Caremark

Although it is easy to view the rise of the new good faith as a response to the corporate scandals of the Enron-WorldCom era,¹⁷⁵ the first major development was the Delaware Chancery Court's landmark 1996 decision in *In re Caremark International Inc. Derivative Litigation*.¹⁷⁶ In *Caremark*, the parties asked the court to approve the settlement of a shareholders' derivative suit that arose after the company had been indicted in connection with health care fraud. Caremark agreed to settle with the government by pleading guilty to one count and paying criminal fines and civil claims in an amount totaling approximately \$165 million.¹⁷⁷ The directors had not known about, and hence had not been in a position to stop, the wrongdoing.¹⁷⁸ The question was whether they should have known.

On the application to approve the settlement, the court's responsibility was to assess the strengths and weaknesses of the plaintiffs' claims.¹⁷⁹ The complaint did "not charge either director self-dealing or the more difficult loyalty-type problems arising from cases of suspect director motivation, such as entrenchment or sale of

conduct legally irrelevant. See also Gregory Scott Crespi, *Standards of Conduct and Standards of Review in Corporate Law: The Need for Closer Alignment*, 82 NEB. L. REV. 671 (2004) (criticizing the standard of conduct/standard of review distinction).

174. See *supra* text accompanying note 150.

175. See Griffith, *supra* note 6, at 7-8 ("The duty of good faith emerged in an environment of *sturm und drang* in corporate governance, when a series of scandals—including frauds and failures at Enron, WorldCom, Tyco, and Adelphia, celebrity insider trading, and corruption in the IPO market—drew American corporate governance into question and plunged previously settled questions into heated debate.").

176. 698 A.2d 959 (Del. Ch. 1996). Soon after the enactment of section 102(b)(7), in *Barkan v. Amsted Indust., Inc.*, 567 A.2d 1279 (Del. 1989), the Delaware Supreme Court approved the settlement of litigation involving a management-sponsored leveraged buyout. In discussing the directors' good faith belief that the shareholders were getting the best price, even in the absence of a market test, the court stated that "the crucial element supporting a finding of good faith is knowledge." *Id.* at 1288. Because *Barkan* is an acquisition case, the reference to good faith could point to what this Article calls the old good faith, namely, that the directors' action did not violate the duty of loyalty for being self-interested. Yet, it also contains a hint, upon which later cases would build, that "good faith is more closely associated with diligence, or the duty of care." Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 881 (1996).

177. 698 A.2d at 965 n.10.

178. *Id.* at 971-72.

179. *Id.* at 961, 966-67.

control contexts.”¹⁸⁰ The court was not asked to rule directly on the question whether the plaintiffs’ case was fatally weak because of the presence of a section 102(b)(7) provision in the corporate certificate, but it is clear that the Chancellor understood that this issue was potentially present.¹⁸¹ Nevertheless, the court discussed the directors’ duties, in part, in light of good faith. Chancellor Allen distinguished between two kinds of breach-of-duty-of-care cases—liability arising either from a board decision that was ill-advised or negligent, or from a board’s unconsidered failure to act where action would have prevented the loss.¹⁸² In the first category, the business judgment rule protected decisions that were the product of a process that was either rational or “employed in a *good faith* effort to advance corporate interests.”¹⁸³

In the second category, the Chancellor determined that the board had a duty to “exercise a *good faith* judgment that the corporation’s information and reporting system [was] in concept and design adequate to assure the board that appropriate information [would] come to its attention in a timely manner as a matter of ordinary operations, so that it [could] satisfy its responsibility.”¹⁸⁴ Without deciding the impact of the presence of a section 102(b)(7) exemption in the certificate, the Chancellor opined that failure to attempt in good faith to assure that such a system was in place “under some circumstances may . . . render a director liable for losses. . . .”¹⁸⁵ In the Caremark matter, however, the Chancellor noted that “the corporation’s information systems appear[ed] to have represented a good faith attempt to be informed of relevant facts,”¹⁸⁶ and there was no significant evidence “of a sustained failure to exercise their oversight function.”¹⁸⁷ Consequently, the Chancellor approved the proposed settlement, even though it “provide[d] very modest benefits.”¹⁸⁸

180. *Id.* at 967.

181. *Caremark’s* predecessor, *Baxter International, Inc.*, had amended its certificate of incorporation to include the liability exclusion authorized by section 102(b)(7). As a result, the Chancellor opined that the claims asserted in the case “likely were susceptible to a motion to dismiss in all events.” *Id.* at 971.

182. *Id.* at 967.

183. *Id.*

184. *Id.* at 970 (emphasis added).

185. *Id.* The court addressed the potential issue under section 102(b)(7), see *id.* at 970 n.27.

186. *Id.* at 971.

187. *Id.*

188. *Id.* at 972.

b. McCall

*McCall v. Scott*¹⁸⁹ took the *Caremark* analysis a step further. *McCall* was a shareholder derivative action in which the plaintiffs sought damages from current and former directors for a number of transgressions, including failing to prevent, and establishing policies that sometimes promoted, widespread health care fraud.¹⁹⁰ The plaintiffs alleged breach of the duty of care in connection with this claim.¹⁹¹ Consistent with then-existing Delaware case law, they necessarily alleged that the directors' conduct was grossly negligent.¹⁹² Columbia/HCA Healthcare Corporation, a Delaware company, countered by citing its inclusion of the exculpatory provision authorized by section 102(b)(7) in its certificate of incorporation.¹⁹³

In *McCall*, the United States Court of Appeals for the Sixth Circuit, applying Delaware law, had to resolve the question that Chancellor Allen identified, but did not decide in *Caremark*: the legal effect of the good faith exception for directors of a corporation that had placed a section 102(b)(7) liability shield in its certificate.¹⁹⁴ The *McCall* court ruled that the good faith exception contained in section 102(b)(7)(ii) was not merely a hortatory cry for ethically appropriate conduct, but a provision with real bite. The court, therefore, allowed the plaintiffs to maintain an action alleging reckless misconduct on the part of directors and officers of Columbia/HCA.¹⁹⁵

Section 102(b)(7)(ii) prohibits corporations from exempting directors from personal liability for acts or omissions *either* "not in good faith *or* which involve intentional misconduct or a knowing violation of the law."¹⁹⁶ Because the facts alleged in *McCall* suggested that the directors might have acted recklessly, but not intentionally, the plaintiffs argued that the statutory phrase "intentional misconduct" should be interpreted as encompassing recklessness.¹⁹⁷ The court rejected this contention, but it accepted the argument that allegations of reckless misconduct brought the case within the statute's good faith exception "[t]o the extent that recklessness

189. 239 F.3d 808 (6th Cir. 2001) ("*McCall I*"), *amended on denial of reh'g* by *McCall v. Scott*, 250 F.3d 997 (6th Cir. 2001) ("*McCall II*").

190. *McCall I*, 239 F.3d at 813-14.

191. *Id.* at 813, 817-19, 824-26. They also accused directors and officers of illegal insider trading in violation of the duty of loyalty. *Id.* at 813.

192. *Id.* at 817 n.9; *see* *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

193. *McCall I*, 239 F.3d at 818.

194. *Id.* at 818-19.

195. *Id.*

196. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2006) (emphasis added).

197. *McCall I*, 239 F.3d at 818.

involves a conscious disregard of a known risk.”¹⁹⁸ As the court stated in its amended opinion, “while it is true that duty of care claims alleging only grossly negligent conduct are precluded by a § 102(b)(7) waiver provision, it appears that duty of care claims based on reckless or intentional misconduct are not.”¹⁹⁹ The federal court relied on a treatise on Delaware corporate law that stated: “To the extent that recklessness involves a conscious disregard of a known risk, it could be argued that such an approach is not one taken in good faith and thus could not be liability exempted under the new statute.”²⁰⁰ On this basis, the court refused to dismiss the action against the defendant directors despite the exculpatory provision in the corporation’s certificate.²⁰¹

The court held that “[u]nder Delaware law, the duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer.”²⁰² The court did not have to decide whether the statute protected directors from liability for unconsidered inaction. It found the allegations of recklessness sufficient to fall within the statute. By embracing recklessness as a basis for a breach of good faith capable of eliminating section 102(b)(7) protection, the court opened the door to a question quite different from the motivational inquiry required by earlier ideas of good faith.²⁰³

B. *Disney, the Old Good Faith and the New Good Faith*

During the late 1990s and the first years of the new century, a number of Delaware Chancery Court decisions explored the limits of the good faith exception to section 102(b)(7). From time to time, the Delaware Supreme Court weighed in on related matters, but it did not have occasion to determine the nature or parameters of the

198. *Id.* The court’s reason was its belief that the Delaware Supreme Court would not interpret section 102(b)(7) in this way.

199. *McCall II*, 250 F.3d 997, 1000 (6th Cir. 2001).

200. *Id.* at 1000-01 (quoting 1 BALLOTTI & FINKLESTEIN, *DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.29, at 4-116 to 4-116.1 (3d ed., Supp. 2000)).

201. *Id.* at 1001.

202. *Id.*, citing *Nagy v. Bistricher*, No. Civ.A. 18017, 2000 WL 1759860, at *3 n.2 (Del. Ch. Nov. 22, 2000).

203. See *id.* at 1001 (“[W]e find that [plaintiffs] have alleged a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith.”); see also *In re Abbott Laboratories Derivative Shareholders Litig.*, 325 F.3d 795 (7th Cir. 2003) (applying an Illinois statute modeled on section 102(b)(7) in shareholders’ derivative suit and following *McCall*’s interpretation of good faith in a case determining a question of failure to plead demand futility).

obligation.²⁰⁴ It was in the *Disney* litigation that the new good faith took center stage.

All of the events relevant to the Disney dispute took place within a single year, although the litigation they generated spanned nearly ten. The driving force behind the hiring and then the firing of Michael Ovitz was his long-time friend, Disney CEO Michael Eisner.²⁰⁵ Ovitz's performance at Disney was abysmal.²⁰⁶ Yet the compensation Ovitz received for this unsatisfactory service, including his termination payout, amounted to approximately \$140 million.²⁰⁷ As Chancellor Chandler, who tried the case, saw it, this was an instance of "an imperial CEO" operating with a "supine or passive board."²⁰⁸ Shareholders sought to recover against the directors—Eisner for orchestrating and the others, including the outside directors, for permitting—this chain of events to occur. The gravamen of the allegations against the directors, other than Eisner, was that they had entirely neglected their duties. The trial court found that the plaintiffs failed to prove their allegations. The Delaware Supreme Court affirmed.²⁰⁹

It is crucial to note that the plaintiffs did not allege that the defendant directors acted on the basis of improper motivation. The key issue at trial was about dereliction of duty.²¹⁰ This distinction is important. Improper motivation traditionally falls within the rubric of subjective bad faith; dereliction of duty does not. The two concepts differ sharply. The *old* good faith addresses improper motivation; the *new* good faith addresses dereliction of duty, specifically, an "intentional failure to act in the face of a known duty to act."²¹¹ In the words of the *Disney V* court, such disregard of duty constitutes "a nonexculpable, nonindemnifiable violation of the fiduciary duty to act in good faith."²¹² To understand the new good faith and the role it can play in the evolving law of corporate governance requires a clear understanding of the difference between the two. The following discussion examines *Disney V*'s new standard in the context of discussions of good faith generally and then

204. See cases cited *supra* note 19.

205. *Disney V*, 906 A.2d 27, 35-42 (Del. 2006).

206. *Id.* at 42-46.

207. *Disney IV*, 907 A.2d 693 (Del. Ch. 2005). Ovitz's severance payout alone was approximately \$130 million. *Disney V*, 906 A.2d 27, 27.

208. *Disney IV*, 907 A.2d at 761 n.487.

209. *Id.* at 778-79.

210. *Id.* at 753-56.

211. *Id.* at 755.

212. 906 A.2d at 66.

explores in greater detail the doctrine referred to as the “old” good faith.

1. *Good faith: one doctrine or two?*

In *Disney V*, the Delaware Supreme Court began its discussion of good faith by stating that “at least three different categories of fiduciary behavior are candidates for the ‘bad faith’ pejorative label.”²¹³ One of these categories—the second in the court’s list—is “lack of due care—that is, fiduciary action taken by reason of gross negligence and without any malevolent intent.”²¹⁴ The court easily rejected an approach that would read section 102(b)(7) to permit holding directors liable for grossly negligent violations of the duty of care. Although the court did not cite *Van Gorkom* in its discussion, the court stated that allowing the statutory “good faith” exception to permit directors to be held personally liable for gross negligence “would eviscerate the protections accorded to directors by the General Assembly’s adoption of Section 102(b)(7).”²¹⁵

The other two categories the court discussed, as well as the differences between them, are central to the analysis here. Both are viable ideas in corporate law. The first is “subjective bad faith,” that is, fiduciary misconduct based on improper motivation. The second encompasses “fiduciary conduct . . . which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, [and therefore] should be proscribed.”²¹⁶ Before studying the difference between these two different formulations of good faith, it is helpful to examine certain other bedrock difficulties with the concept.

Despite its well-developed status in both contract²¹⁷ and insurance law,²¹⁸ good faith has bred confusion in corporate law in two different ways. First, in the view of one commentator, “the meaning of good faith in 102(b)(7) remains a mystery.”²¹⁹ Far from being a coherent concept that usefully provides a remedy for directorial dereliction of duty, from this perspective good faith has been “used as a loose rhetorical device that courts can wield to find viability or enjoin actions that do not quite fit within established doctrinal categories.”²²⁰

213. *Disney V*, 906 A.2d at 64.

214. *Id.*

215. *Id.* at 65.

216. *Id.*

217. *Disney IV*, 907 A.2d 693, 753 n.449.

218. See generally STEPHEN S. ASHLEY, BAD FAITH ACTIONS LIABILITY AND DAMAGES (1977).

219. Griffith, *supra* note 5, at 14.

220. *Id.* at 34.

Second, prior to *Disney V*, Delaware courts and commentators disagreed about whether good faith constituted a third, independent fiduciary duty,²²¹ or whether it should be understood as “a subset or ‘subsidiary’ requirement that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock duties of loyalty and due care.”²²² As Chancellor Chandler put it in *Disney IV*, “[t]he fiduciary duties owed by directors of a Delaware corporation are the duties of care and loyalty. Of late, much discussion among the bench, bar, and academics alike, has surrounded a so-called third fiduciary duty, that of good faith.”²²³

At one level, *Disney V* settled this latter dispute by recognizing good faith as a fiduciary obligation qualitatively different from the duty of care and the traditional interpretation of the duty of loyalty.²²⁴ Nevertheless, despite its admonition that “[t]he good faith required of a corporate fiduciary includes not simply the duties of care and loyalty,”²²⁵ the *Disney V* court left open the question whether the duty it recognized could serve as an independent basis for “direct” imposition of liability.²²⁶ The court’s subsequent opinion in *Stone* has now described the duty of good faith, at least in the context of allegations of claims of *Caremark*-type oversight failure, as a component of the “fundamental duty of loyalty.”²²⁷ While the doctrinal location of the new good faith has significance,²²⁸ the key point for purposes of this discussion is that there are two ways in which good faith operates in Delaware corporate law. The first, the obligation we refer to as the *old* good faith, functions generally as an ethical evaluation of the subjective motivation frequently at issue in traditional duty of loyalty cases. The second, the duty we call the *new* good faith applies where directors consciously fail to comply with known duties, and it can be identified through the application of

221. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (referring to “triads” of fiduciary duty—good faith, loyalty and care”). See also sources cited *supra* note 29 and *infra* note 236.

222. *Emerald Partners v. Berlin*, No. 9700, 2001 WL 115340, at *25 n.63 (Del. Ch. Feb. 7, 2001), *vacated by* 787 A.2d 85 (2001), *remanded to* No. 9700, 2003 WL 21003437 (Del. Ch. Apr. 28, 2003).

223. *Disney IV*, 907 A.2d at 745. See sources cited *infra* note 229.

224. *Disney V*, 906 A.2d 27, 63-66 (Del. 2006).

225. *Id.* (quoting *Disney IV*, 907 A.2d at 755).

226. *Id.* at 67, n.112.

227. *Stone v. Ritter*, No. 93, 2006 WL 3169168 at *6 (Del. Nov. 6, 2006).

228. *Id.*; *Disney V*, 906 A.2d at 66 n.109.

objective criteria. Doctrinal confusion arises because the term “good faith” functions differently in the two contexts.²²⁹

2. *The old good faith: good faith as the opposite of subjective bad faith*

Before turning to the claim before it, the *Disney V* court first discussed the category of conduct “involv[ing] so-called ‘subjective bad faith,’ that is, fiduciary conduct motivated by an actual intent to do harm.”²³⁰ This conduct, the court explained, “constitutes classic, quintessential bad faith. . . .”²³¹ in that it entails “‘the conscious doing of a wrong because of dishonest purpose or moral obliquity . . . a state of mind affirmatively operating with a furtive design or ill will.’”²³² The *Disney V* court included within this category instances in which a fiduciary prefers his or her own interests, or the interests of related persons, over the best interests of the corporation, terming this conduct as “disloyalty in the classic sense.”²³³

The opposite of such improperly motivated conduct is good faith, but it is the *old* good faith. There are two critical characteristics of

229. Even within a single legal discipline, sometimes the same term may have different meanings. For example, in constitutional law, due process means something quite different when it is substantive rather than procedural. The starting place for an analysis of the Delaware courts’ recent iterations of corporate directors’ duty to act in good faith is Hillary Sale’s 2004 article. See Sale, *supra* note 18. After a meticulous examination of the cases, Professor Sale argues that good faith constitutes a third, independent fiduciary duty. *Id.* In a very recent article, Professor Eisenberg likewise concludes that good faith constitutes a fiduciary duty distinct from the duties of care and loyalty. Eisenberg, *supra* note 5, at 74-75. For other discussions of good faith predating *Disney V*, see Griffith, *supra* note 6, at 6 (suggesting that good faith functions less as a substantive standard and more as a rhetorical device used to increase judicial review of corporate board decisions); Robert Baker, In Re Walt Disney: *What it Means to the Definition of Good Faith, Exculpatory Clauses, and the Nature of Executive Compensation*, 4 FLA. ST. U. BUS. REV. 261 (2004-2005) (arguing that *Disney II* aligns the duty of good faith with the traditional duty of care, thereby diminishing the usefulness of exculpatory provisions); Matthew R. Berry, *Does Delaware’s Section 102(b)(7) Protect Reckless Directors From Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L. REV. 1125 (2004) (noting that section 102(b)(7) of the Delaware Corporate Code protects directors from personal liability for gross negligence and reckless behavior); Jaclyn J. Janssen, Note, In re Walt Disney Company Derivative Litigation: *Why Stockholders Should Not Put Too Much Faith in the Duty of Good Faith*, 2004 WIS. L. REV. 1573; Tara L. Dunn, *The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket After Disney IV?*, 83 DENV. U. L. REV. 531 (2005) (chronicling the Delaware courts’ progression toward imposing personal liability on directors through the duty of good faith); John L. Reed & Matt Niederman, “Good Faith” and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporate Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 DEL. J. CORP. L. 111 (2004) (analyzing the meaning of “not in good faith” with regard to Delaware’s exculpation statute).

230. *Disney V*, 906 A.2d at 64.

231. *Id.*

232. *Disney V*, 906 A.2d at 64 n.102 (quoting *McGowan v. Ferro*, 859 A.2d 1012, 1036 (Del. Ch. 2004)).

233. *Id.* at 65. See *infra* note 239.

the old good faith. First, good faith in this sense is most typically understood in terms of its opposite, subjective bad faith. As the court noted in *Disney IV*, “at least in the corporate fiduciary context, it is probably easier to define bad faith rather than good faith.”²³⁴ This understanding echoes Professor Summers’ venerable observation in the context of contract law that good faith is “a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith.”²³⁵ Second, as the *Disney V* court’s language makes clear, the terms good faith and bad faith in this sense function as a description of an actor’s motivations, rather than an objective account of his or her actions. Their character, therefore, is “subjective.”²³⁶ Thus, the old good faith was not at issue in *Disney V* with respect to the conduct of the outside directors.

The old good faith is a concept fundamentally defined by the negation of its negation—that is, good faith is an absence of subjective bad faith. A director, therefore, is said to act in good faith, in this sense, if his or her motivations are neither dishonest, deceptive nor otherwise improper. Because the old good faith is principally a concept related to motivation, it is not surprising that good faith “is not a well-developed area of our corporate fiduciary law.”²³⁷ The old good faith has not bred “a carefully delineated mode of analysis,”²³⁸ because it has not had to do so.²³⁹

The new articulation of good faith that began to attract attention following *Caremark* is quite different. Far from commanding an absence of improper motivation, it should be understood to require positive conduct measured by objective criteria. In *Disney V*, the Delaware Supreme Court, like the Chancery Court decision it upheld, defined this concept in terms of bad faith. Nevertheless, the

234. *Disney IV*, 907 A.2d 693, 753.

235. Robert S. Summers, “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968). The court then contrasts this state of affairs with the abundance of jurisprudence regarding good faith in contractual contexts. *Disney IV*, 907 A.2d 693, 754 n.449. The inapplicability of bad faith to the duty at issue in the *Disney* trial is discussed *infra* Part III.

236. *Disney V*, 906 A.2d at 64. In *Desert Equities v. Morgan Stanley Leveraged Equity Fund, II, LP*, 624 A.2d 1199, 1208 n.16 (Del. 1993), the court quoted *Black’s Law Dictionary* (5th ed. 1983) to define bad faith as “not simply bad judgment or negligence, but rather [as] impl[ying] the conscious doing of a wrong because of dishonest purpose or moral obliquity. . . .”

237. *Disney V*, 906 A.2d at 63.

238. Griffith, *supra* note 5, at 7.

239. Bad faith motivation in corporate law generally has been discussed in connection with cases alleging a breach of the fiduciary duty of loyalty. While the word “loyalty” carries a broad range of positive normative connotations in ordinary speech, in the law of corporate governance it generally has played a more narrowly-focused role. See generally *Loyalty Discourse*, *supra* note 164.

required showing of bad faith conduct associated with the new good faith encompasses a failure to act in accordance with known directorial duties rather than the presence of subjectively bad motives. In a passage in *Disney V* reiterated in *Stone*, the court also left open the possibility that “[t]here may be other examples of bad faith yet to be proved or alleged” in connection with the new formulation of good faith.²⁴⁰ How the doctrine will unfold in the courts is impossible to predict, but it seems possible that corporate law is on the threshold of the development of a new doctrine that could have a real cutting edge in terms of what officers and directors must do to avoid liability. The following sections discuss the role of the good faith standard in the Disney litigation.

3. *The Disney opinions—the core of the new good faith*

a. *Disney II—allegations that state a good faith claim*

*Disney II*²⁴¹ took an important step beyond *McCall* in establishing the existence of a positive new good faith duty, and not just because it was the decision of a Delaware court. The Court of Chancery held that allegations of directors’ sustained inattention to duty—i.e., “knowing or intentional lack of due care . . . suggest[ing] that the Disney directors failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders—were sufficient to permit the plaintiffs’ action to go forward.”²⁴²

Procedurally, the Disney matter came before the Chancellor on the defendant directors’ motion to dismiss the amended complaint that the Supreme Court permitted the plaintiffs to file in its decision in *Brehm v. Eisner*.²⁴³ Initially, the plaintiffs had pled their case on the basis of alleged breaches of the duties of loyalty and care.²⁴⁴ The *Brehm* court dismissed the duty of loyalty claims after finding that the pertinent allegations were “not supported by well-pleaded facts” and

240. *Stone v. Ritter*, No. 93, 2006 WL 3169168, at *5 (Del. Nov. 6, 2006) (citing *Disney V*, 906 A.2d at 67).

241. 825 A.2d 275 (Del. Ch. 2003).

242. *Id.* at 278.

243. 746 A.2d 244, 267 (Del. 2000).

244. “[I]t appears from the [initial] Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz’ value to the Company; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory.” *Brehm*, 746 A.2d at 249. As such, “[t]his is a case about whether there should be personal liability of the directors of a Delaware corporation to the corporation for lack of due care in the decision-making process and for [the] waste of corporate assets.” *Id.* at 255.

“were illogical and counterintuitive.”²⁴⁵ The court also dismissed the plaintiffs’ duty of care claims. On appeal, the Delaware Supreme Court instructed the Chancellor to provide the plaintiffs with an opportunity to file an amended complaint repleading their allegations pertaining to conscious disregard of duty.²⁴⁶ It was in the plaintiffs’ interest to characterize the defendant directors’ behavior in terms of failures to act in good faith, thereby bringing their conduct outside the protective shield of the section 102(b)(7) exculpatory provision included in the company’s certificate of incorporation. The result, in the apt words of former Delaware Chief Justice Veasey, was that a due care action “morphed into a ‘good faith’ case.”²⁴⁷

In refusing to dismiss the amended complaint in *Disney II*, Chancellor Chandler described the new complaint as charging the directors with an “ostrich-like” approach.²⁴⁸ The Chancellor read the amended complaint to claim that the defendants “*consciously and intentionally disregarded their responsibilities*, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.”²⁴⁹ Emphasizing that the plaintiffs alleged that the “directors *knew* that they were making material decisions without adequate information and without adequate deliberation,” the court held that such allegations sufficed to state a claim for a “breach of the directors’ obligation to act honestly and in good faith in the corporation’s best interests”²⁵⁰ The directors were neither shielded from substantive liability by the business judgment rule nor entitled to the protection of section 102(b)(7).²⁵¹ Accordingly, the Chancellor ruled in favor of the plaintiffs when the defendants moved to dismiss the amended complaint.²⁵² The Chancellor’s decision calls to mind Judge Hand’s famous words:²⁵³ “[Directors] have an individual duty to keep themselves informed in some detail” about the affairs of the corporation, instead of allowing themselves “to be carried along as . . . figurehead[s].”²⁵⁴

245. See *id.* at 257; *Disney I*, 731 A.2d at 355-56.

246. *Brehm*, 746 A.2d at 267.

247. *What Happened in Delaware*, *supra* note 6, at 1441. “Curiously,” as Chief Justice Veasey notes, “potential exoneration of directors under section 102(b)(7) was not discussed in that phase of the case.” *Id.* at 1440 n.155.

248. *Disney II*, 825 A.2d 275, 288 (Del. Ch. 2003).

249. *Id.* at 289.

250. *Id.*

251. *Id.* at 289-90.

252. *Id.*

253. *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924).

254. *Id.* at 615.

b. Disney IV—plaintiffs’ failure to prove the directors’ conscious disregard of duty

The lengthy trial of the claims against the Disney directors was probably the most celebrated, and widely-reported, corporate governance trial in American history—at least since the Dodge boys challenged Henry Ford in *Dodge v. Ford Motor Company*²⁵⁵ nearly a century ago. *Disney IV* is the painstaking analysis supporting the Chancellor’s decision in favor of the defendants. Given the context, most of the opinion details “who did what” in the hiring and firing of Michael Ovitz. What matters for purposes of the long run development of doctrine is the standard of conduct to which the court held the outside directors. The question the court decided was whether the quantity and quality of the outside directors’ actions sufficed to constitute good faith performance of their duties. The facts did not present a question of the ethical assessment of the directors’ motivations, connoted by the traditional use of the expression “bad faith.” Rather, the court described the standard under which it was assessing the conduct of the various defendant directors as follows: “Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty*, a *conscious disregard for one’s responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith.”²⁵⁶

While evaluation of the court’s decision on the merits of the case is beyond the scope of this Article, Chancellor Chandler’s discussion of why two Disney directors, actor Sidney Poitier and publisher and former U.S. ambassador to El Salvador, Monica Lozano, were not liable is illustrative. There was no dispute that both became involved in the matter late in the process of hiring Ovitz.²⁵⁷ The court assessed their liability by comparing their actions to those of the Trans Union

255. 170 N.W. 668 (Mich. 1919).

256. *Disney IV*, 907 A.2d 693, 755 (Del. Ch. 2005). The court then described such a dereliction of duty as conduct “disloyal to the corporation.” *Id.* Chancellor Chandler, however, cited *Van Gorkom* in a footnote appended to the discussion. *Id.* at n.460 (citing 488 A.2d 873). Although *Van Gorkom* focused on the duty of care, see 488 A.2d at 872-73 (“a director’s duty to exercise informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty.”), the Chancellor’s point was to hone in on the somewhat elusive aspects of fiduciary duty that he characterized as beyond the narrow parameters of either care or loyalty. *Id.* at 755 & n.460. At a later point in the opinion, the Chancellor also cited an article by Lyman Johnson suggesting that the duty of loyalty has the capacity to command a higher degree of faithfulness than generally required of corporate directors under prevailing legal standards. *Id.* at 761, n.487. See *infra* note 262.

257. *Disney IV*, 907 A.2d at 766.

directors in *Van Gorkom*.²⁵⁸ The question the court was deciding, in other words, was whether Poitier and Lozano had fulfilled their affirmative duties as directors. The court concluded that they were not liable because they “did not intentionally disregard a duty to act, nor did they bury their heads in the sand knowing a decision had to be made.”²⁵⁹

c. *Disney V—confirmation of the new good faith*

Disney V marks not only the last word in this protracted litigation, but also the seminal word in the development of the new good faith. Given the procedural posture, the Chancellor’s lengthy opinion, and its decision to affirm, the Delaware Supreme Court could have avoided providing much insight on the meaning of good faith. Fortunately, in *Disney V* the court had the wisdom to provide guidance to the bar, and to the corporate world by shining a light on a duty “shrouded in the fog of . . . hazy jurisprudence.”²⁶⁰ *Stone* clarifies the *Disney* standard, but it does not change its essential character.

In its decision, the *Disney V* court confirmed that corporate directors can be held accountable when they consciously disregard their responsibilities. The court stated that “the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or a related person to the interest of the corporation) or gross negligence.”²⁶¹ The “vehicle . . . needed to address [conscious disregard of directorial duty] doctrinally . . . is the duty to act in good faith.”²⁶² In working out the scope of the duty, the decision identified the difference between the old good faith and the new good faith. In so doing, it recognized the difference between what it called “‘subjective bad faith,’ that is, fiduciary conduct motivated by an actual intent to do harm,”²⁶³ and the “good faith . . . [of] all actions required by a true faithfulness and devotion to the interests of a corporation and its shareholders.”²⁶⁴

258. *Id.* at 767-70.

259. *Id.* at 771.

260. *Id.* at 754 (quoted in *Disney V*, 906 A.2d at 63 n.98).

261. *Disney V*, 906 A.2d 27, 66 (Del. 2006).

262. *Id.*

263. *Id.* at 64.

264. *Id.* at 67 (quoting *Disney IV*, 907 A.2d at 755). For discussion of the court’s three-fold analysis on this point, see text accompanying notes 214-215, *supra*. The court also interpreted the use of good faith in the indemnification statute, DEL. CODE ANN. tit. 8, § 145 (2001)—the only other use of the phrase in the General Corporation Law—consistently with the distinction between negligent or grossly

The “new” good faith applies in cases “where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision.”²⁶⁵ The is true regardless of the directors’ motives. The Supreme Court quoted Chancellor Chandler in defining the duty:

The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty . . . discussed . . . above, but all action required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating conscious disregard for his duties.²⁶⁶

Significantly, like Chancellor Chandler, the Delaware Supreme Court made it clear that this was an open-ended list. It noted: “There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.”²⁶⁷ The invitation to further doctrinal development is plain and entirely salutary. It reflects the tradition developed in the corporate jurisprudence of Delaware and many other states of establishing a general approach to doctrine to be developed in subsequent case-by-case adjudication.²⁶⁸ In a matter of months, the high court availed itself of its own invitation.

negligent violation of the duty of care and conduct that is not in good faith: “[u]nder Delaware statutory law a director or officer may be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith.” *Id.* at 66.

265. *Disney V*, 906 A.2d at 66.

266. *Id.* at 67 (quoting *Disney IV*, 907 A.2d at 755). Interestingly, although the court does not cite the language, this passage echoes the observation in *Van Gorkom* that a director’s “obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information. . . .” *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

267. *Disney V*, 906 A.2d at 67 (quoting *Disney IV*, 907 A.2d at 756).

268. See, e.g., *Corporate Universe*, *supra* note 2, at 168-73 (asserting that corporate jurisprudence evolves as a “function of the development of the common law reflecting changing business morés and sharper pleading in corporate litigation”).

d. The Stone clarification

In November 2006, the Delaware Supreme Court handed down its decision in *Stone v. Ritter*.²⁶⁹ *Stone* involved a shareholders' derivative action against present and former directors of the AmSouth Bancorporation. The plaintiffs filed a *Caremark* action alleging that AmSouth's directors breached their duty to act in good faith by failing to put in place monitoring systems adequate to enable them to learn of illegal conduct on the part of branch bank employees that ultimately required the corporation to pay fines and penalties of \$50 million.²⁷⁰ Finding that the plaintiffs had conceded the absence of any basis for concluding that the directors knew or should have known of the misconduct, the Delaware Supreme Court upheld the Chancellor's dismissal of the complaint "for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities."²⁷¹

In reaching its decision, the court noted that "the *Caremark* standard for so-called 'oversight' liability draws heavily upon the concept of director failure to act in good faith . . . consistent with the definition(s) of bad faith recently approved by this court in its recent *Disney* decision."²⁷² After holding that the Chancery Court had utilized the proper standard in evaluating the plaintiffs' complaint against the AmSouth directors, the high court proceeded to clarify the operation of good faith in *Caremark* oversight actions. Noting the *Disney V* court's reservation of the specific question whether good faith is an independent duty, the court explained that "a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability . . . [but] 'is a subsidiary element[,] i.e., a condition, 'of the fundamental duty of loyalty.'"²⁷³ The court continued: "It follows that because a showing of bad faith conduct, in the sense described in *Disney [V]* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty."²⁷⁴

The court derived two doctrinal consequences from its analysis. "First, although good faith may be described colloquially as part of a

269. No. 93, 2006 WL 3169168 (Del. Nov. 6, 2006).

270. *Id.* at *1.

271. *Id.* at *9. The court admonished that "good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both. . . ." *Id.*

272. *Id.* at *5 (citing *Disney V*, 906 A.2d 27).

273. *Id.* at *6. (citing *Disney V*, 906 A.2d at 67 & n.112).

274. *Id.*

triad of fiduciary duties that includes the duties of care and loyalty,” it is not “an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”²⁷⁵ Second, however, the court emphasized that the 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.”²⁷⁶ The court explicitly admonished that “[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.”²⁷⁷

The outcome in *Stone* is consistent with this analysis. There was nothing to support a sustained oversight failure or conscious disregard of duty on the part of AmSouth’s directors. In fact, they had implemented significant compliance and monitoring procedures. As the court noted, the plaintiffs appeared to rest their claims on the failure of the monitoring system to prevent the illegal conduct rather than on directorial inattention, let alone conscious disregard, of this important responsibility.²⁷⁸

A potential problem with *Stone* is that, like the *Disney V* opinion it clarifies, it poses a risk that in requiring bad faith conduct to take directorial misconduct beyond the reach of section 102(b)(7) exculpatory provisions, it will be read, or misread, to require more than the absence of good faith specified by the statute—i.e., bad faith understood as subjectively bad motivation.²⁷⁹

275. *Id.*

276. *Id.*

277. *Id.* (citing *Disney V*, 906 A.2d at 67).

278. *Id.* at *9.

279. The court’s characterization of the “traditional” duty of loyalty in *Stone* and *Disney V* does not mitigate this problem, nor does its apparent association of bad faith as a necessary element in loyalty cases. See *id.* at *6. Duty of loyalty cases most often concern some form of deliberate self-dealing or other type of self-aggrandizement, but even traditional duty of loyalty actions do not always turn on a showing of subjectively improper motivation. Courts frequently find the operative disloyalty in the objective, self-aggrandizing conduct of the defendant, rather than in the “bad faith” motivation that may have prompted it. Indeed, the action of a director or officer could be entirely motivated by subjective good faith and yet objectively constitute self-dealing, for which the court would impose liability. As Professor Eisenberg notes, “[i]t is not enough . . . that a manager acts honestly in the sense that he acts sincerely. Many persons adopt belief systems that allow them to sincerely conclude that that morally outrageous conduct is proper.” Eisenberg, *supra* note 5, at 22; see also O’Connor, *supra* note 26, at 1238 (explaining the potential impact of group pressures on directorial decision-making). As the testimony of a number of the key defendants in the mega-scandals of the first years of this century shows (if we believe they were testifying honestly), the capacity of human beings to deceive themselves about their motivations where their acts objectively benefit themselves is

Consequently, it is important for the Delaware courts to make the requirements of the new good faith standard clear, especially because in both *Disney V* and *Stone*, the high court upheld decisions in favor of corporate directors. The following discussion suggests that clarification of the applicable good faith/bad faith calculus could have a major effect on the long term impact of the standard.

III. THE IMPORTANCE OF CLARIFYING THE DIFFERENCE BETWEEN THE PRESENCE OF SUBJECTIVE BAD FAITH AND THE ABSENCE OF GOOD FAITH

A. *Did Mrs. Pritchard Act in Bad Faith?—A Question of Apples and Oranges*

For the purpose of restoring trust in corporate governance, the new good faith is full of promise. Few would quarrel with the goal of instilling “true faithfulness and devotion to the interests of the corporation and its shareholders.”²⁸⁰ However, if the new good faith is to be significant, it must offer more than rhetoric and encompass tasks neither rendered irrelevant by section 102(b)(7) exculpatory provisions nor already addressed by the classic duty of loyalty.

A good way to demonstrate the difference between the absence of good faith—failing to act where one has a fiduciary duty to act—and the traditional understanding of bad faith—acting with improper motivation—is to return to the Widow Pritchard and *Francis v. United Jersey Bank*.²⁸¹ To understand why it is risky to define the absence of good faith in terms of bad faith, suppose that *Francis* were to arise today under Delaware law, and that the corporation had availed itself of the opportunity to include the kind of exculpatory provision authorized by section 102(b)(7) in its certificate of incorporation. If the duty to act where one has a known duty to act were breached only by bad faith in the sense of subjectively improper motivation, then the Widow Pritchard undoubtedly would escape liability. There was no evidence that she intended to harm the corporation, or that she preferred another’s interests to those of the entity she undertook to serve. Nevertheless, her inaction is a paradigm of conscious disregard of directorial duties.

Francis held Mrs. Pritchard personally liable for paying so little attention to corporate affairs that her feckless sons were able to

huge. Fiduciaries also may act disloyally for other than pecuniary reasons, see Hintmann, *supra* note 10, at 580.

280. *Disney V*, 906 A.2d at 67.

281. 432 A.2d 814 (N.J. 1981).

misappropriate virtually all of the funds the company held in trust for its insureds.²⁸² Under *Van Gorkom*'s gross negligence standard, in the absence of the kind of exculpatory provision authorized by section 102(b)(7), Mrs. Pritchard would surely be liable for breach of the duty of care because of her radical inattention to her directorial responsibilities. The business judgment rule would not help her, because that rule requires at least *some* directorial action.²⁸³ If, on the other hand, the corporation had taken advantage of the right to exculpate directors to the extent permitted by section 102(b)(7), the provision arguably would immunize Mrs. Pritchard from liability for her clear violation of the duty of care. The only way around the provision would be to invoke the statute's exceptions.²⁸⁴ But, as described above, good faith in its traditional formulation—i.e., the absence of subjective bad faith motivation—would not help. Thus, equating dereliction of duty with acting on the basis of subjectively improper motivation is like mixing apples and oranges.

One cannot help but feel empathy for Mrs. Pritchard. Her inaction merits criticism, but it is not the type of criticism that would be directed at her sons who, to enrich themselves personally, stole from the corporation and its clients.²⁸⁵ Nothing in the case suggests that her inaction was in any respect malicious or otherwise *motivated* in an ethically improper way.²⁸⁶ Mrs. Pritchard surely did not act in bad faith; her sons did. Yet, it should be clear that Mrs. Pritchard breached the good faith standard articulated in *Disney V*. This standard imposes liability "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious

282. *Id.* at 819-20, 829 (noting that Mrs. Pritchard's husband had even warned that one of their sons would "take the shirt off [his] back"); see *supra* text accompanying note 118.

283. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) (stating that, because it "operates only in the context of director action," the business judgment rule is inapplicable "where directors have[,] . . . absent a conscious decision, failed to act."); see also American Law Institute, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 4.01(c) cmt. C (American Law Institute Publishers, 1994).

284. Three of the exceptions set forth in section 102(b)(7) plainly are inapplicable to a claim against Mrs. Pritchard. There is no self-dealing that would constitute a breach of the duty of loyalty (subsection (i)), no suggestion that Mrs. Pritchard could be charged with the corporation's unlawful acquisition of stock or payment of dividends (subsection (iii)), and no allegation that she derived improper benefit from a transaction (subsection (iv)).

285. See *Francis*, 432 A.2d at 818 ("Starting in 1970, . . . Charles, Jr. and William begin [sic] to siphon ever-increasing sums from the corporation under the guise of loans.").

286. See *id.* at 819 (noting both that Mrs. Pritchard was unfamiliar with the rudiments of the business and that she became incapacitated after her husband's death).

disregard for his duties.”²⁸⁷ Mrs. Pritchard’s subjective motivation, from an ethical point of view, is quite irrelevant. Her inattention to her responsibilities breached her duty of good faith, not because she acted in bad faith, but because she *failed to act in good faith*. The motivation-laden language of bad faith used in *Disney V* and *Stone* threatens to obscure this important distinction.²⁸⁸

B. A Different Kind of Bad Faith

This consideration of *Francis* illustrates the confusion that may arise if the Delaware courts fail to make the distinction between the absence of good faith and the presence of bad faith crystal clear. In *Disney V*, Delaware’s high court left the door open to additional examples of bad faith that may lead to further development of the good faith duty,²⁸⁹ but optimal doctrinal development will occur only if the courts avoid the trap of conflating the absence of good faith—i.e., conscious disregard of directorial responsibilities—with the presence of bad faith in the form of improper subjective motivation. In light of the language of *Disney V*, whenever a lawsuit alleges a conscious disregard of duty by a defendant director, the defense undoubtedly will argue that the challenged conduct bears none of the hallmarks traditionally associated with bad faith. However, as the Delaware Supreme Court first pointed out in *Van Gorkom* and reiterated in *Disney V*, “fulfillment of the fiduciary function requires more than the mere absence of [traditional] bad faith or fraud.”²⁹⁰

Nevertheless, the Delaware Supreme Court has defined the duty of good faith in the context of failure to attend to directorial duties as “bad faith,” expanding the meaning of “bad faith” beyond its traditional connotation as an ethical assessment of motivation. The court did not need to take this tack. Good faith, shorn of connotations of improper motivation, could have done the job by

287. *Disney V*, 906 A.2d 27, 67 (Del. 2006).

288. *Compare Francis*, 432 A.2d 814, *with Joy v. North*, 692 F.2d 880 (2d Cir. 1982). As discussed *supra* Part I.B.1, *Joy v. North* involved director quiescence in the face of loans potentially risking ten percent of shareholders’ equity. *Joy*, 692 F.2d at 895. Applying Connecticut law, in an era before the passage of statutes such as section 102(b)(7), the Second Circuit held that directors could be liable for violating the duty of care, saying, “[d]irectors who willingly allow others to make major decisions affecting the future of the corporation wholly without supervision or oversight may not defend on their lack of knowledge, for that ignorance itself is a breach of fiduciary duty.” *Id.* at 896. The outside directors were *inattentive* to their duties. They did not act in bad faith. Under the new good faith, they could be held liable, as could Mrs. Pritchard, without proof that they possessed an improper motive.

289. *Disney V*, 906 A.2d at 67 (concluding it was “unwise” to curtail development of fiduciary duty by offering a categorical definition).

290. 488 A.2d 858, 872 (Del. 1985).

requiring plaintiffs to plead an absence of good faith with appropriate specificity in conjunction with the standard procedural requirements for shareholder derivative actions pursuant to Delaware corporate law.²⁹¹ It is riskier to redefine “bad faith.” The term is so laden with the accumulated baggage of improper motivation that efforts to hold directors liable for serious inattention to duty in the absence of improper motive could be thwarted. Nor was it necessary to define good faith in this manner to fashion a loyalty exception to section 102(b)(7). Subsection (i) of the statute forbids exculpation of acts or omissions that violate the duty of loyalty.²⁹²

Whatever course the courts follow, it is essential to recognize the substantive difference between a conscious failure to act and improperly motivated action. Ultimately, “the good faith iteration’s utility may rest in its [capacity to serve as a] constant reminder . . . that, *regardless of his motive*, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.”²⁹³ Bearing in mind this caveat, properly applied the *Disney* standard offers real potential as a means of helping to restore trust in corporate directors to do their jobs.

IV. THE NEW GOOD FAITH AS AN ANTIDOTE FOR THE CORPORATE TRUST CRISIS

The value of any legal standard depends on its effectiveness in promoting societal objectives. While the ultimate impact of legal rules turns on the interplay of a variety of factors, including cultural morés, social expectations, and enforcement capability, there are many different routes to accomplishing societal goals through law.²⁹⁴

291. See *Brehm*, 746 A.2d at 254 (discussing Delaware pleading requirements).

292. See *supra* text accompanying note 154.

293. *Nagy v. Bistricher*, 770 A.2d 43, 48 n.2 (Del. Ch. 2000) (quoted in *Disney V*, 906 A.2d at 67 n.111) (emphasis added).

294. As Lisa Fairfax points out, “some scholars argue that legal sanctions may be neither necessary (because of extra-legal factors [e.g., management pressures and fear of reputational damage] that shape director conduct) nor effective in constraining director behavior.” *Spare the Rod*, *supra* note 20, at 427. Others, particularly contractarians, oppose legal strictures on directorial conduct because of the transaction costs these kinds of laws generate. As Margaret Blair and Lynn Stout observe, however, neither the market nor the law alone does a particularly effective job of keeping directors faithful to their fiduciary responsibilities. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1737-38 (2000-2001) [hereinafter *Blair and Stout*]. Both Professor Fairfax and Professors Blair and Stout offer analyses of the operation of legal and extra-legal forces. Professor Fairfax emphasizes her disagreement with those who eschew directorial liability and focuses on the need for sanctions to hold directors accountable for adherence to fiduciary duties. See *Spare the Rod*, *supra* note

In Sarbanes-Oxley,²⁹⁵ Congress chose to address the need to restore trust in the corporate sector by enacting prescriptive measures that focus principally on constraining the behavior of critical actors. Delaware's new good faith embodies a complementary but quite different approach. To the extent the courts prove willing to enforce it, the *Disney* standard promises to promote general trustworthiness instead of requiring actors to act, or refrain from acting, in specified ways. After a brief look at trust in the corporate fiduciary context, the following discussion focuses on the potential effectiveness of the new good faith as a vehicle to promote trust in corporate directors by encouraging trustworthy conduct.

A. The Nature of Trust in the Context of Corporate Fiduciary Relationships

Trust is a critical aspect of life. The very act of living requires a basic level of faith in our ability to perceive the physical world and to understand both intellectual concepts and the complex interactions that comprise our social environment.²⁹⁶ Trust is integral to social well-being,²⁹⁷ and it is "at the root of any economic system based on mutually beneficial exchange."²⁹⁸ Without some level of trust in

20, at 395. Professors Blair and Stout focus on the operation of trust within the firm. See Blair & Stout, *supra*.

295. Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201-7266 (Supp. 2003).

296. Consequently, as Mark Hall points out, "[w]hether trust is regarded as an end in itself, or as a means to some other end, trust is too important and pervasive for the law to neglect in any realm." Mark A. Hall, *Law, Medicine, and Trust*, 55 STAN. L. REV. 463, 525 (2002). Professor Hall draws on the metaphor of trust as a kind of social adhesive. See *id.* at 464. In a similar vein, in the corporate arena, Lawrence Mitchell describes trust as "the glue that binds corporate relationships," suggesting that: No matter how strong the legal rules requiring fiduciary loyalty are, no matter how successfully the market aligns a fiduciary's self-interest with corporate interest, trust is essential for corporate survival. In the absence of some measure of trust between those who invest their money and those who manage it, the corporation cannot succeed as an efficient business entity.

Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 425 (1993) [hereinafter *Fairness and Trust*]; see also, e.g., Bruce Chapman, *Trust, Economic Rationality and the Fiduciary Obligation*, 43 U. TORONTO L.J. 547 (1993); Russell Hardin, *Trustworthiness*, 107 ETHICS 26, 41-42 (1996); Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591 (2001) [hereinafter *Importance of Being Trusted*].

297. See FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 7-8 (1995), referenced by Lisa M. Fairfax, *Trust, The Federal Sentencing Guidelines, and Lessons from Fiduciary Law*, 51 CATH. U. L. REV. 1025, 1025 (2002) [hereinafter *Lessons*]; see also, e.g., *Perspective*, *supra* note 20, at 16 ("The corporate governance system depends on trust in people—especially the directors, regulators and courts."). From a marketing perspective, trust sells products. Consequently, for decades companies have spent a great deal of money to advertise slogans such as "you can trust your car to the man who wears the star," or that theirs is "a name you can trust."

298. Alan Greenspan's commencement address given at Harvard University in June of 1999 (quoted in FRANKEL, *supra* note 10, at 49 (quoting COLLEGE

corporations and those who manage their affairs, hiding money under the mattress would be more attractive than investing in stocks and bonds. While legal scholars and social scientists debate the extent to which legal sanctions, market signals, and other factors generate trust,²⁹⁹ both proponents of an economic understanding of law and those who challenge the validity of the *homo economicus* model agree that trust is valuable—as a means of increasing efficiency by reducing transaction costs³⁰⁰ and/or as a social good in and of itself.³⁰¹

As Professors Blair and Stout observe, “[t]he essence of a fiduciary relationship is the legal expectation that the fiduciary will adopt the other-regarding preference function that is the hallmark of trustworthy behavior.”³⁰² Corporate directors have a direct fiduciary relationship with the entities they serve and an indirect fiduciary relationship with the shareholders. Shareholders *entrust* control of their property to directors who are charged with overall management of the corporation.³⁰³ They expect those who manage the companies

ADMINISTRATION PUBLICATIONS, ETHICS AND THE PROFESSIONS: A MESSAGE FROM ALAN GREENSPAN, CAP ELECTRONIC BULL. (Oct. 19, 1999), *available at* <http://www.collegepubs.com/elecbulletin.shtml#EB99.4>); *see also* FRANKEL, *supra* note 10, at 49. (“Trust has a crucial role in promoting prosperity.”).

299. For a discussion of the role of legal and market sanctions, social and economic context, and internalized learning in promoting trust within the firm, *see* Blair & Stout, *supra* note 294, at 1747-53.

300. *See, e.g.*, NICHOLAS LUHMAN, TRUST AND POWER 79, 93-94 (1979); Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 STRATEGIC MGMT. J. (SPECIAL ISSUE) 175 (1994); Frank H. Easterbrook & David R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); Nicholas L. Georgakopoulos, *Meinhard v. Salmon and the Economics of Honor*, 1999 COLUM. BUS. L. REV. 137, 146 (1999) (“Broad fiduciary obligations facilitate the financing of ventures, mitigate the effects of managers’ risk-aversion, align the financing decisions of investors with the true economic desirability of projects, and align the incentives of managers with the benefit to the economy and the desire of investors”); Larry Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 555 (2001) (Trust “refers to the willingness to make oneself vulnerable to another without costly external constraints. Trust is socially valuable, and thus society should encourage it.”).

301. *See, e.g.*, FRANKEL, *supra* note 10, at 206 (“The one thing on which we need not compromise is the ambition to become an honest society and to have our society reap the rich rewards of honesty.”).

302. Blair & Stout, *supra* note 294, at 1743.

303. *Fairness and Trust*, *supra* note 296, at 430, *citing* Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1684-87 (1990) (“[T]he power holder has complete freedom to conduct that segment of the dependent’s life over which she has been given responsibility.”) (citation omitted); *see also, e.g.*, Ribstein, *supra* note 300, at 556 (“Trust can be seen simply as a decision by one person to give power over his person or property to another in exchange for a return promise.”). Mitchell notes that in the corporate context, “[t]he power and control that are present in all fiduciary relationships are exaggerated . . . because the indeterminate length of the enterprise and the practically infinite array of investment opportunities for the corporation make any possibility of specified limitations on directors’ power or ongoing control by the stockholders unrealistic.” *Fairness and Trust*, *supra* note 296, at 430.

they invest in to produce value, and they anticipate a share in the benefit derived from their capital. Shareholders are entitled to directors who act in a trustworthy fashion.

Today, more Americans own stock than at any other time in history. The number of shareholders has grown exponentially over the last several decades, increasing from one percent of the population in 1900 to thirteen percent in 1980, to more than fifty percent by the turn of the twenty-first century.³⁰⁴ Large corporations employ tens of millions of workers,³⁰⁵ and a number of major corporations wield more global economic power than many of the world's countries.³⁰⁶ Americans therefore have a compelling interest in the trustworthiness of those who manage major corporations. One of the most important purposes of corporate fiduciary law is to encourage directors to merit this trust, for the benefit of the public generally and shareholders in particular.

While trust is critical in the corporate fiduciary context, as Professor Mitchell has observed, this recognition "does not necessarily lead to the conclusion that the result of that trust will in some sense be the 'true' or 'right' result or the result that one would have chosen for herself. In other words, one can be mistaken yet trustworthy."³⁰⁷ The notion that it is better to allow directors to make mistakes than to curtail entrepreneurial freedom is the operative principle of the business judgment rule, and it is consistent with the emergence of the new good faith.³⁰⁸ The *Disney* standard does not require directors to act correctly; in keeping with the exclusion set

304. See CAPLOW ET AL., *supra* note 9. As David Skeel observes, "for the first time in history, the stock market is the investment of choice of many Americans' ordinary, 'safe' savings, not just their savings at risk." DAVID SKEEL, *ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM* 212 (2005).

305. See U.S. CENSUS BUREAU, *supra* note 9, at 382.

306. For example, in a 2002 comparison of countries' national gross domestic products with the sales of major corporations Wal-Mart placed nineteenth—between Belgium and Sweden, General Motors followed Poland in twenty-fourth place, and Exxon Mobil was in twenty-sixth place—between Saudi Arabia and Turkey. Sales figures for many other large corporations exceeded the GDP of most of the world's countries. SARAH ANDERSON, THEA LEE AND JOHN CAVANAUGH, *FIELD GUIDE TO THE GLOBAL ECONOMY* (2005). More recent data is available by comparing statistics compiled by Forbes and by the World Bank. See Special Report: The Forbes Global 2000, available at <http://www.forbes.com/2005/03/30/05f2000land.html>; World Bank Development Report 2007: Development and the Next Generation at 294 (table 4. Economic Activity), available at <http://www-wds.worldbank.org>.

307. *Fairness and Trust*, *supra* note 296, at 433. This is parallel to the philosophical insight that a decision may be rational but ultimately wrong.

308. See *What Happened in Delaware*, *supra* note 6, at 1436 ("[T]hese evolving expectations may be largely aspirational standards of conduct."); see also, e.g., Eisenberg, *supra* note 6, at 62; Harvey L. Pitt, *The Changing Standards by which Directors Will Be Judged*, 79 ST. JOHN'S L. REV. 1 (2005).

forth in section 102(b)(7)(ii), the new good faith standard prohibits conscious disregard of directorial responsibilities, particularly a failure to act in the face of a known duty to act.³⁰⁹ It does not limit the protection the business judgment rule affords to directors and the decisions they make. Nor does it put directors at risk for acting negligently, or even grossly negligently, so long as they actually fulfill their duty to act when they are required to do so. The thrust of the *Disney* standard is much more modest, but it is nevertheless important. A brief review of what many have called the corporate governance crisis—particularly the aspects we refer to as the *corporate trust crisis*—helps explain why.

B. *The Corporate Trust Crisis*

The 1990s began with a mild recession. During the remainder of the decade, however, the Dow Jones average and NASDAQ index climbed to previously unprecedented levels.³¹⁰ This was a period when many people leapt at the chance to become members of the boards of major corporations. Corporate directorships offered significant compensation along with enviable prestige and attractive perquisites.³¹¹ During the same time, however, the number of federal criminal prosecutions and associated civil proceedings against corporations and corporate managers steadily increased.³¹² Unfortunately, with a few notable exceptions such as the high-profile prosecutions of Caremark and Columbia/HCA and the associated shareholders' derivative actions,³¹³ these developments received relatively little attention. They did not deter investors from continuing to put their money into corporate securities. Nor did they

309. *Disney V*, 906 A.2d 27, 67 (Del. June 8, 2006).

310. The Dow Jones average peaked in January 2000, and the Nasdaq reached its record closing high in March 2000. Jonathan Fuerbringer, *The Markets: Market Place; Stocks Surge, Bonds Fall, and Some See a New Bull Run*, N.Y. TIMES, Dec. 6, 2000, at C1. "The decade of the 90s . . . represented the halcyon days of the boom." E. Norman Veasey, *Policy and Legal Overview of Best Corporate Governance Principles*, 56 SMU L. REV. 2135, 2135 (2003).

311. See Abigail Aims, *2005 Trends in the Corporate Governance Practices of the 100 Largest U.S. Public Companies*, 1523 PLI/Corp 233, 240 (2006) (noting that the majority of the largest 100 U.S. companies pay directors retainers of \$40,000 or more in cash, along with meeting fees, travel reimbursement, benefits such as life and health insurance, and free products and services); see also, e.g., *Inside the Boardroom—Board Profiles: A Seattle Times Special Report*, THE SEATTLE TIMES, at E1, Oct. 5, 2003 (reporting on retainers and other perquisites provided to leading companies in the state of Washington, such as \$95,000 per year in annual fees for Weyerhaeuser board members and \$45,000 for Nordstrom directors).

312. See Sarah Helene Duggin, *Internal Corporate Investigations: Legal Ethics, Professionalism and the Employee Interview*, 2003 COLUM. BUS. L. REV. 859, 875-77 (2003) [hereinafter *Internal Investigations*].

313. See *supra* Part II.A.2.a. & b.

discourage service on corporate boards to any great extent; some noted individuals served on five or more corporate boards during the same time period.³¹⁴

The raucous activity of the bull market drowned out voices calling for reform.³¹⁵ The question whether corporate boards could be trusted to oversee the operations and finances of large companies began to garner significant national attention only after Caremark and other leading health care providers were caught in the sweeping federal anti-health-fraud campaigns initiated during the Clinton Administration.³¹⁶ In combination with the advent of the Organizational Sentencing Guidelines a few years earlier³¹⁷ and a concomitant increase in federal prosecutorial activity in the business sector,³¹⁸ the *Caremark* decision engendered a rapidly expanding industry in corporate compliance programs.³¹⁹ These measures offered hope for resolution of the kinds of monitoring problems at issue in *Caremark*. As Enron's celebrated code of ethics illustrates, however, compliance measures are of little use without diligent oversight.³²⁰

314. See, e.g., Judith H. Dobrzynski, *When Directors Play Musical Chairs; Seats on Too Many Boards Spell Problems for Investors*, N.Y. TIMES, Nov. 17, 1996, at § 3 page 1 (reporting that in 1995 "68 directors of Fortune 100 companies sat on nine or more corporate boards, up from 36 . . . in 1991"); Judith H. Dobrzynski, *Market Place, Report Calls for Recasting Corporate Boards*, N.Y. TIMES, Nov. 12, 1996, at D1 (reporting that among 7,200 Fortune 1,000 company directors, 207 held seats on seven or more boards and many more sat on four or five); Patricia Sabatini, *WE [Westinghouse] Board Represented Well on List of Laggards*, PITTS. POST GAZETTE, Nov. 4, 1995, at B9 (noting that one Westinghouse director served on eleven boards and discussing multiple board memberships as a possible source of some of the problems faced by troubled companies); Aims, *supra* note 311, at 239-40 (reporting on multiple board memberships among directors of 100 largest U.S. companies). See also note 388 *infra*.

315. Despite the bull market of the 1990s institutional investors such as CALPERS were calling for corporate governance reforms. See N.Y. TIMES articles, *supra* note 314. In fact, a number of significant reform movements began in the 1990s. See E. Norman Veasey, *Counseling Directors in the New Corporate Culture*, 59 BUS. L. 1447 (2004).

316. See Sarah Helene Duggin, *The Impact of the War Over the Corporate Attorney-Client Privilege on the Business of American Health Care*, 22 J. CONTEMP. HEALTH L. & POL'Y 301 (2006) [hereinafter *Corporate Attorney-Client Privilege*].

317. See *Internal Investigations*, *supra* note 312, at 875-77.

318. See *id.* at 876-77.

319. See *id.* at 881-84.

320. Enron had a comprehensive, beautifully drafted corporate ethics code that provided: "[w]e are dedicated to conducting business according to all applicable local and international laws and regulations . . . and with the highest professional and ethical standards." ENRON CORP., ENRON CODE OF ETHICS 5 (2000), available at <http://www.thesmokinggun.com/graphics/packageart/enron/enron.pdf>. All Enron employees were required to sign a certificate of compliance confirming that they had read the corporate ethics code and agreed to comply with it. *Id.* at 3. In addition to providing information on legal compliance, Enron's Code of Ethics contained inspiring language on honesty and integrity. *Id.* It even stated: "Ruthlessness, callousness and arrogance don't belong here." *Id.* at 4.

Corporate governance reform became a national priority following the financial disasters that ravaged Enron, WorldCom, and other corporate giants beginning in the fall of 2001. Many Americans lost jobs, pensions, health care and other benefits in these debacles.³²¹ These events badly damaged confidence in the integrity of corporate executives and undermined faith in the ability of directors to keep officers honest and companies financially sound.³²² The Disney litigation involved very different issues, but it similarly undermined faith in directors as effective corporate overseers. At least in the short run, Michael Ovitz made more money by failing to work out as president than if he had actually done a good job for the company. As both Chancellor Chandler and the Delaware Supreme Court recognized, the conduct of Disney's directors was scarcely a model of best practices;³²³ it certainly did not engender trust.

The Disney plaintiffs claimed that Chairman Michael Eisner had engaged in misconduct.³²⁴ A number of senior executives of Enron and other companies involved in spectacular financial debacles were charged with fraud and other crimes.³²⁵ Outside directors, however, were rarely accused of dishonesty or bad faith. Their principal shortcomings arose from an inability to discern what was happening to the companies entrusted to their care. The shenanigans of senior executives in combination with the oversight failures of directors generated a *crisis in corporate trust*.

The corporate trust crisis has provoked many different reactions. The most notable legislative response was, of course, Sarbanes-Oxley,³²⁶ the most significant expansion of the scope of federal securities law since the 1930s. In many respects, Sarbanes-Oxley entered a realm of law previously reserved to the states.³²⁷ In contrast

321. See sources cited *supra* note 10.

322. See *supra* text accompanying notes 24-26. As Faith Stevelman Kahn has observed, "[l]ike that of the Twin Towers, Enron's collapse was sudden, devastating, and horribly unjust in its effect." Kahn, *supra* note 163, at 1584.

323. *Disney V*, 906 A.2d 27, 58-59 (Del. June 8, 2006); *Disney IV*, 907 A.2d 693, 697 (Del. Ch. 2005).

324. See *supra* Part II.

325. See, e.g., *Year of Scandals, Shame*, CHI. TRIB., Dec. 23, 2002, at 6.

326. Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201-7266 (Supp. 2003).

327. See James H. Cheek, III, *The Legislative and Judicial Response to Recent Corporate Governance Failures—Will It Be Effective—Part II?*, 5 TRANSACTIONS: TENN. J. BUS. L. 311, 312 (2004); Harvey L. Pitt, *The Changing Standards by Which Directors Will Be Judged*, 79 ST. JOHN'S L. REV. 1, 2-3 (2005). Many authorities describe the Sarbanes-Oxley legislation as the "federalization" of corporate law, suggesting that unless Delaware and other states act decisively, Congress will continue to expand federal control over corporate governance and other aspects of business regulation traditionally reserved to the states. See, e.g., E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 443 (2003) [hereinafter *State-Federal Tension*]. For discussion of the nature and impact of

to Delaware's enabling approach,³²⁸ Sarbanes-Oxley sets forth a number of specific, self-executing mandates, such as verification of financial statements by CEOs and CFOs and prohibitions on loans to senior officers and directors,³²⁹ and it directs the SEC and other federal agencies to promulgate additional rules and regulations.³³⁰ Congress enacted the statute in an effort to restore confidence in securities markets.³³¹ It seeks to constrain the behavior of corporate actors by establishing positive requirements and negative prohibitions. These kinds of constraints work well with respect to the specific areas they address. However, they also may encourage actors to find ways around them. Tax "loopholes" provide the classic example. At best, this approach places reliable limits only on the

"federalization," see *Spare the Rod*, *supra* note 20, at 396-408. Some commentators contend that Congress has gone too far into a realm traditionally reserved to the states. Jill Fisch, for example, argues that "[t]he increasing intrusion of federal law into how corporations go about their business threatens to sacrifice the prime objective of corporate productivity." Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39, 49 (2004); see also, Florence Shu-Acquaye, *Smith v. Van Gorkom Revisited: Lessons Learned in Light of the Sarbanes-Oxley Act of 2002*, 3 DEPAUL BUS. & COM. L. J. 19, 49 (2004). At least one commentator attributes the need for Congressional action to the inaction of state officials, specifically blaming state legislators for the fiduciary lapses that contributed to the collapse of Enron and other problems. See Brown, *supra* note 160, at 317-18 ("The scandals arose in large part out of a failure of managerial oversight. . . . Not so much a matter of director indolence, the lack of oversight occurred in large part because state laws did not impose meaningful obligations on the board of directors in supervising the activities of the company."). Former Delaware Chief Justice Norman Veasey, however, characterizes Sarbanes-Oxley as an ill-conceived measure "cobbled together by Congress . . . [with] little regard for collateral damage—both in terms of principles of federalism and in terms of shrinking the universe of qualified and willing directors." E. Norman Veasey, *Counseling Directors in the New Corporate Culture*, 59 BUS. LAW. 1447, 1451 (2003-2004). For a general discussion of issues pertaining to federalism and Sarbanes-Oxley, see E. Norman Veasey, *Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics, and Federalism*, 152 U. PA. L. REV. 1007 (2003). But see Andrew A. Lundgren, *Sarbanes-Oxley Then Disney: The Post-Scandal Corporate Governance Plot Thickens*, 8 DEL. L. REV. 195 (2006) (suggesting that the risk of federalization is likely to diminish as the crises that prompted enactment of Sarbanes-Oxley recede in time).

328. See *supra* note 154.

329. See, e.g., 15 U.S.C. § 7241; 15 U.S.C. § 78m. See generally Lyman P. Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1209 (2004) (describing Sarbanes-Oxley as a collection of "piecemeal [mandates] on a wide variety of subjects, sometimes aiming at the board of director level and sometimes centering on senior officers").

330. See, e.g., 15 U.S.C. § 7233 (directing the SEC to issue regulations pertaining to audit procedures and auditor independence); 15 U.S.C. § 7245 (instructing SEC to issue rules pertaining to professional responsibility of attorneys practicing before the Commission).

331. See, e.g., Adriain M. Morse, Jr., *Breaking the Circle: The Problem of Independent Directors Policing Public Company Financial Disclosure Under the SEC's New Rules Governing Public Company Audit Committees*, 23 ANN. REV. BANKING & FIN. L. 673, 675 (2004) (quoting remarks by SEC Chairman William Donaldson and former SEC Chairman Harvey Pitt on the need to reassure investors and restore trust in the wake of corporate scandals).

target conduct that is spelled out in the applicable statutory provisions and concomitant regulations. It does not promote trust.³³²

Delaware's recognition of good faith as a significant fiduciary obligation reflects a complementary, but very different, response to the corporate trust crisis.³³³ Its promise lies not in its constraints in targeting specific misconduct, but in its capacity to encourage directors to take their responsibility to do their jobs as least as seriously as they take their perquisites. Before exploring the potential of this new fiduciary standard, however, it is useful to look briefly at the ways in which the longstanding duties of loyalty and care function and where they fall short as a means of promoting trustworthy action on the part of outside directors.

C. *Trust and the Fiduciary Duties Owed by Corporate Directors*

The duties of loyalty and care developed in response to well-founded doubts about the trustworthiness of corporate managers. As discussed in Part I, for more than a century legislators and courts have struggled with the tension between entrepreneurial freedom and managerial accountability.³³⁴ The classic duties of loyalty and care impose obligations designed to ensure that corporate fiduciaries merit trust.³³⁵ While both duties make strong exhortative demands on directors, as a result of the operation of the business judgment rule, enforcement of the duty of care historically has been weak, and the

332. See, e.g., Ribstein, *supra* note 300, at 555-56 ("[M]andatory rules to increase trust, in any form, may have precisely the opposite effect. . . . In particular, regulation gives parties a weapon that they might use opportunistically, thereby increasing the risk of distrust."). A clear example of this effect is found in *qui tam* actions. Whatever its positive effects, the Civil False Claims Act, 31 U.S.C. §§ 3729-33 (2000), undermines trust within organizations by giving constituents an incentive to turn in employees and colleagues for pecuniary gain. See generally *Corporate Attorney-Client Privilege*, *supra* note 316.

333. As Andrew Lundgren points out in a recent article, "SOX and Disney are both products of the post-Enron world and reactions to perceived corporate governance failures, but they differ significantly at their core." See Lundgren, *supra* note 327, at 195.

334. See *supra* Part I.B. Courts also often find it difficult to define a fiduciary relationship. See *Lessons*, *supra* note 297; see also Blair & Stout, *supra* note 294, at 1780-89 (discussing the nature of trust in fiduciary relationships); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879 (noting that "[f]iduciary obligation is one of the most elusive concepts in Anglo-American law").

335. See *Lessons*, *supra* note 297, at 1026 ("[B]y imposing special duties on participants in special trust relationships, the law of fiduciary obligations 'permit[s] and encourage[s] the reposing of trust.'" (quoting Theresa A. Gabaldon, *Love and Money: An Affinity-Based Model for the Regulation of Capital Formation by Small Businesses*, 2 J. SMALL & EMERGING BUS. L. 259, 280 (1988))).

duty of loyalty most often comes into play only when adverse financial interests arise.³³⁶

1. *Trust and the duty of loyalty*

Although the precise parameters vary, all states impose on corporate directors an obligation to put the interests of the entities they serve before their personal objectives in matters pertaining to their directorial duties. When issues relating to breach of the duty of loyalty arise, they almost always do so in the context of conflicting pecuniary interests. Consequently, the jurisprudence of loyalty focuses principally on prohibitions against self-dealing.³³⁷ While some question the magnitude of the transaction costs it imposes,³³⁸ by encouraging fidelity on the part of corporate directors, the duty of loyalty fosters trust on the part of shareholders and other corporate constituents.³³⁹ The problem with relying too much on the classic duty of loyalty is, as earlier discussed, that it generally involves conflicting financial interests. Instances in which the disputed conduct involves dereliction of duty rather than subjectively bad motives for culpable acts or omissions does not fit so readily within the duty.³⁴⁰

2. *Trust and the duty of care*

As noted in Part I, the desire to preserve entrepreneurial freedom has sometimes proved an obstacle to ensuring greater managerial accountability. This conflict has been particularly apparent in efforts to define the scope of the duty of care, principally because the

336. See *Disney V*, 906 A.2d at 66 (discussing traditional reach of duty of loyalty); see also *supra* Part I.B.

337. See *supra* text accompanying notes 86-92. Statutory safe harbor provisions applicable to conflicting interest transactions seek to permit interested-director transactions that may benefit corporations by providing for transparency and independent review—i.e., disclosure of actual or potential conflicts of interest and approval by directors who are neither interested in a proposed opportunity or transaction nor dependent upon a director involved in it. In Delaware and other states, directors may be excused from liability for conflicting interest transactions, as well as other forms of self-dealing in certain situations, but only when it is clear that the corporation has suffered no harm as a result of the fiduciary breach and that the challenged transaction was entirely fair to the corporation. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). Lawrence Mitchell, however, argues persuasively that “the fairness test in corporate law enhances fiduciaries’ power to self-deal with the practical ability and legal right to do so. The fairness test is neither fair nor much of a test.” *Fairness and Trust*, *supra* note 296, at 491.

338. See Frank H. Easterbrook & David R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) (asserting that the duty of loyalty comes at the high price of specification and monitoring).

339. See *id.* at 425.

340. See *Disney V*, 906 A.2d at 66 (“[C]onduct of this kind does not involve disloyalty (as traditionally defined).”). See generally *supra* Parts II.B and III.

business judgment rule limits the scope of the duty as an enforceable standard of liability. In so doing, the business judgment rule provides corporate directors with unique protection against personal liability for negligence, and, since the enactment of section 102(b)(7), even gross negligence. Comparison of the application of the business judgment rule in corporate legal disputes with the operation of the standard of care in medical malpractice litigation provides a practical example.³⁴¹

Medical malpractice actions most often sound in negligence. To prevail, a plaintiff must establish the applicable standard of care and prove that the defendant health care provider violated that standard.³⁴² The standard of care is usually quite specific. It serves as a measure of what a prudent provider would do in the same or similar circumstances.³⁴³ Consequently, it involves both procedural and substantive criteria. Suppose, for example, that a patient consults a physician for treatment of a skin lesion. The applicable standard of care would require the physician to follow certain procedures—e.g., examine the lesion carefully and possibly biopsy it, question the patient about its onset and any concurrent symptoms, review the patient's medical history and the environments in which he lives and works, etc. If the physician follows proper procedures, she can take some comfort that she is not only treating her patient properly but that she is protecting herself against liability for medical malpractice. Proper procedures alone are not enough, however. The physician must also draw reasonable conclusions and take appropriate actions in response to her findings.³⁴⁴ If the physician does not do so, she may be held liable for malpractice—e.g., if, despite following proper procedures, she fails to diagnose and treat malignant melanoma.³⁴⁵ The principal limitation on judicial review of

341. See also, e.g., *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982) (noting that while an automobile driver would likely be held liable for a mistake in judgment that resulted in harm to a pedestrian, a corporate officer would rarely be found liable for a judgment error that caused injury to a corporation).

342. See BARRY R. FURROW ET AL., 264-78 (2d ed., West Group 2000). Medical malpractice actions, like corporate fiduciary challenges, traditionally are governed primarily by state law. See *Corporate Attorney-Client Privilege*, *supra* note 316.

343. See FURROW ET AL., *supra* note 342, at 264-66.

344. See *id.* at 264 (quoting the two-pronged standard of care set forth by *Hall v. Hillburn*, 466 So. 2d 856, 873 (Miss. 1985)).

345. Lawyers are in a similar position. In *Williams v. Ely*, 668 N.E.2d 799, 806 (Mass. 1996), a law firm was held liable when it gave estate planning clients advice that, although reasonable at the time, "proved to be wrong." Liability was based on the fact that the firm rendered its opinion with an "apparent certainty . . . at a time when the issue was not conclusively resolved, den[ying] the plaintiffs the opportunity to assess the risk and to elect to follow alternative estate planning options." *Id.* See

the physician's actions is the general requirement of expert testimony to establish the applicable standard of care. Once evidence is offered to establish the appropriate standard, the trier of fact determines whether the physician has committed negligence and is therefore subject to personal liability.

In contrast, the business judgment rule operates solely at the procedural level.³⁴⁶ The recognition that business people often must make decisions on the basis of imperfect information underlies the rule.³⁴⁷ Health care providers, too, must act without optimal information. However, the standard of care applicable in medical malpractice actions, unlike the business judgment rule, does not protect them from substantive judicial review of their actions. As Professor Mitchell notes, "the business judgment rule suggests that as long as decisions are made in [good faith, with due care, and with regard to the best interests of the corporation], those decisions are justified in the context of the fiduciary relationship. Put simply, they are deserving of trust."³⁴⁸ No matter how ill-advised their actions, directors are not legally accountable for the substance of their decisions unless their judgment is compromised by conflicting pecuniary interests or, at least in theory, a failure to follow appropriate procedures in the decision-making process. Thus, directors need not reach the "true" or "right" result to avoid liability or to merit trust; they can be "mistaken yet trustworthy."³⁴⁹

As the historical discussion in Part I notes, courts originally adopted the business judgment rule because it fit well with the objectives of investors and their willingness to accept risk as a quid pro quo for the promise of significant returns on their investments.³⁵⁰ Section 102(b)(7), however, created a shield that went far beyond the protection afforded by the business judgment rule. In permitting corporations to exempt directors from personal liability for all instances of negligence and gross negligence, section 102(b)(7) appeared to excuse even the kinds of malfeasance at issue in *Francis* and *Joy*.³⁵¹ While it may not have altered social norms overnight, this

generally R. E. MALLIN & J. M. SMITH, LEGAL MALPRACTICE, Chs. 18-19 (5th ed., West Group 2000).

346. See *supra* text accompanying notes 97-107; see also Bainbridge, *supra* note 93 (suggesting that the business judgment rule operates as an abstention doctrine rather than as a standard of review).

347. See *Fairness and Trust*, *supra* note 296, at 434.

348. *Id.* at 435.

349. *Id.* at 433.

350. See *supra* Part I.B.

351. See *id.*

change in the law certainly freed directors from concerns over legal liability for negligent performance of their responsibilities.

There are undoubtedly a variety of reasons why directors who should know better sometimes consciously disregard their fiduciary obligations even when the duty to act is clear. First, as Congress recognized in requiring members of the audit committees of publicly held corporations to possess certain basic qualifications, a lack of financial independence may cloud directors' judgment.³⁵² Similarly, a lack of suitable expertise may discourage outside directors from paying adequate attention to corporate finances. As Chancellor Chandler noted in *Disney IV*, problems often arise in companies presided over by "an imperial CEO or controlling shareholder with a supine or passive board."³⁵³ Overcommitment on the part of directors who sit on multiple boards raises other kinds of issues.³⁵⁴ An aggressive "whatever it takes" management culture may intimidate outside directors from inquiring about questionable management practices even when they know they should do so,³⁵⁵ or the failure of lawyers and other "gatekeepers" properly to advise directors as to their responsibilities may lull directors into inaction.³⁵⁶ Finally, perhaps some directors, like the Widow Pritchard,³⁵⁷ just don't care.

The growing realization that the boards of a number of major corporations were unable to prevent serious misconduct on the part of officers and employees led to the focus on the good faith exception to section 102(b)(7) that first generated significant attention following the *Caremark* decision.³⁵⁸ Although the Delaware courts continue to refine its parameters, the fiduciary duty to act in good faith could become a significant tool in efforts to restore trust in corporate directors to do their jobs. If the courts, however, evidence reluctance to hold directors accountable for significant

352. See Sarbanes-Oxley Act of 2002, § 301, codified at 15 U.S.C. § 78j-1(m)(3). (Supp. 2003).

353. *Disney IV*, 907 A.2d 693, 761 n.487 (Del. Ch. 2005).

354. See *supra* note 314.

355. See, e.g., O'Connor, *supra* note 26, at 1251-55 (suggesting that an aggressive corporate culture can create pressure on individuals to engage in unethical behavior).

356. See John C. Coffee, Jr., *Understanding Enron: It's About the Gatekeepers, Stupid*, 57 BUS. L. 1403 (2002).

357. See *supra* text accompanying notes 116-127.

358. See *supra* Part II.A.2.a. For discussion of the Enron and WorldCom situations, see WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 148-77 (Feb. 1, 2002), available at <http://news.findlaw.com/hdocs/docs/enron/sicreport>; DICK THORNBURGH, FIRST INTERIM REPORT OF DICK THORNBURGH, BANKRUPTCY COURT EXAMINER 6-7 (Nov. 4, 2002), available at <http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/thornburgh1strpt.pdf>.

derelictions of known duties, then the new good faith will become little more than a rhetorical exhortation replete with good form but utterly lacking in substance.³⁵⁹ As Chancellor Chandler observed in *Disney II*, “the law must be strong enough to intervene against the abuse of trust.”³⁶⁰

D. The New Good Faith as a Means of Promoting Trust

As the New Jersey Supreme Court observed in *Francis*, “[t]he sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.”³⁶¹ Unless directors are willing to act conscientiously in overseeing the affairs of the corporations they manage, no matter how talented or accomplished they may be,³⁶² they are not worthy of trust, and they should not be entitled to participate in managing the business entities so vital to the economic well-being of their constituents. Whether the new good faith will contribute meaningfully to the task of restoring corporate trust depends to a large extent on whether it motivates outside directors to engage actively in their oversight function, and, just as importantly, whether it offers a means of holding them accountable if they fail to do so. Unless subsequent judicial decisions so dull its edge that, like the proverbial knife incapable of cutting butter, it becomes functionally useless, we believe that the *Disney* standard is capable of achieving these objectives for four key reasons.

1. The new good faith as an enforceable legal standard

Unless the defense bar succeeds in turning the *Disney* standard into an examination of directors’ subjective motivations, the standard offers the hope of closing at least part of the accountability gap created by section 102(b)(7) by holding out the threat of personal liability for conscious disregard of known duties. As discussed in Part I.B, the business judgment rule cut deep inroads into the duty of care as a standard of liability, and the exculpatory provisions authorized by section 102(b)(7) gutted the duty, relegating it to the status of an aspirational objective for directors of corporations with such provisions in their certificates of incorporation.³⁶³ The advent of the new duty of good faith, even as a distinct component of the duty of

359. See Griffith, *supra* note 6, at 1.

360. *Disney II*, 825 A.2d at 291.

361. *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (N.J. 1981) (citation omitted).

362. See *supra* note 139 and accompanying text.

363. See *supra* Part I.C and Part II.A.

loyalty, does not alter the protections afforded to directors and their decisions by the business judgment rule, nor does it undercut the liability shield available to directors pursuant to section 102(b)(7), for negligent, or even grossly negligent, decisions. It does, however, provide a means of holding those who accept the prestige and perquisites of corporate directorships accountable to act when their duty to do so is clear. While shareholders theoretically have the power to vote directors out of office, this authority is too seldom exercised with respect to the boards of major corporations. By providing a cause of action against directors who evidence a “we don’t care about the risks attitude,”³⁶⁴ however, the new good faith requires directors to exercise their power.³⁶⁵ At least where directors have a known duty to act, the *Disney* standard promises to place much needed limitations on the legal license not to care created by section 102(b)(7).³⁶⁶ Thus, the new good faith is a modest step, but it is an important one.³⁶⁷

364. *Disney II*, 825 A.2d 275, 289 (Del. Ch. 2003); see *Disney V*, 906 A.2d at 63.

365. See Sale, *supra* note 18, at 495 (“Strong enforcement of the duty of good faith creates an incentive to prompt fiduciaries to better behavior, even if we cannot change their character.”).

366. For various perspectives on the effectiveness of legal sanctions as a means of promoting fiduciary fidelity, see, e.g., Blair and Stout, *supra* note 294, at 1750-53 (offering an anti-contractarian view of the advantages of “internalized trust” over prescriptive legal rules as a means of generating trust and trustworthy behavior within the firm); Ribstein, *supra* note 300, at 590 (“[M]andatory regulation may actually decrease . . . trust by creating opportunities for distrust and inhibiting trust-creation.”). Discussion of contractarian and anti-contractarian views on the desirability of legal sanctions in corporate fiduciary law is fascinating but beyond the scope of this Article. However, the passage of Sarbanes-Oxley testifies to a widespread desire for legal sanctions capable of reining in business executives—both officers and directors. Similarly, a number of scholars have called for more comprehensive legal regulation of directorial conduct. Professor Fairfax, for example, advocates this position in a recent article: “[A]lthough legal liability has some costs, and hence its rod should not be used without an appreciation of those costs and an attempt to minimize them, sparing directors that rod altogether may encourage them to engage in lax behavior to the detriment of shareholders and the public alike.” *Spare the Rod*, *supra* note 20, at 456. Cf., FRANKEL, *supra* note 10, at 119 (during the past three decades “[w]e have emasculated the regulation of trusted persons—fiduciaries . . . [and] changed legal doctrine to reduce the burdens and stigma on embezzling fiduciaries and converted them to salespersons and contracting parties in the markets.”).

367. The new good faith may also serve an important role from a federalism perspective. As former Delaware Chief Justice Veasey notes, “[T]he Delaware franchise is fragile largely because of encroaching federalization.” *Corporate Universe*, *supra* note 2, at 163. In enacting Sarbanes-Oxley, Congress entered into the realm of corporate governance law previously reserved to the states. See *State-Federal Tension*, *supra* note 327. Chief Justice Veasey and others have argued that this intrusion amounts to an unwise “federalization” of corporate fiduciary law. See *id.* See generally sources cited *supra* note 327; cf. Johnson & Sides, *supra* note 329, at 1225 (suggesting that while some provisions of Sarbanes-Oxley preempt state fiduciary law, these are targeted sections that will neither preempt state fiduciary law generally nor preclude state law from providing a “conceptual framework”). While it is certainly possible for

2. *The Disney standard as a means of incorporating emerging business and social morés into corporate fiduciary law*

Delaware's former Chief Justice has observed that incorporating good faith into fiduciary law permits the law to embrace "evolving expectations"—the morés of the business community itself, as well as broader societal demands.³⁶⁸ As Professor Eisenberg has explained:

Circumstances change, the social norms applicable to the conduct of business change, business practices change, concepts of efficiency and other issues of policy applicable to corporate law change. . . . In some cases, the articulation of such an obligation can be justified by the duties of care or loyalty. In other cases, it cannot. In those cases, the duty of good faith often provides a principle that supports the articulation of the new obligation.³⁶⁹

If the courts resist the temptation to eviscerate the flexibility inherent in the new good faith standard, the doctrine promises to fulfill a critical function in a changing legal environment, particularly in the corporate area.³⁷⁰ As former Delaware Chief Justice Veasey points out, the relevant standards are those that develop within the business sector itself and within the broader community in which it operates.³⁷¹ The new good faith provides an important incentive for directors to keep up with business and societal expectations and reminds them that they cannot ignore their responsibility to act in accordance with these standards without facing legal consequences.

While courts should be concerned about fairness in embracing any liability standard that has flexible parameters, the very development of the common law itself rests on the adaptability of judge-made law.³⁷² This is particularly true in Delaware corporate law where both the legislature and the courts have embraced an "enabling approach."³⁷³ Moreover, if Delaware and other states do not hold directors accountable for flouting their duties while greedily embracing the privileges and perquisites of office, the increasingly fragile franchise that states hold over corporate governance matters

federal and state law to operate in a complementary fashion in this important area, if the states are to maintain preeminence in general corporate law, lawmakers and courts need to take measures to hold corporate decision-makers more accountable. The new good faith is a step in this direction.

368. *What Happened in Delaware*, *supra* note 6, at 1439.

369. *Good Faith in Corporate Law*, *supra* note 6, at 30-31.

370. For discussion of the importance of Delaware's corporate law jurisprudence see sources cited *supra* note 2.

371. See *What Happened in Delaware*, *supra* note 5, at 1436 (pointing out that expectations of corporate directors are rooted in "business realities and morés").

372. It is an oft-stated maxim that the genius of the common law arises from its adaptability.

373. See *supra* note 154.

may well be forced to give way to the increasing federalization of corporate law so many have lamented.³⁷⁴ Of course, the Delaware General Assembly could readily resolve at least some of the dilemmas facing the courts with respect to this issue, but it has not yet elected to do so.³⁷⁵

3. *The language of the new good faith as a tool to help shape expectations of directors and perceptions of their fiduciary obligations*

While it is a mistake to expect empty rhetoric to effect change, language does matter. As Professor O'Connor notes, the "the way we talk about fiduciary obligation is crucial because the most distinguishing characteristic of fiduciary law is its operation as a system of moral education that promotes and reinforces trust and honesty in commercial transactions."³⁷⁶ Similarly, as Professor Johnson points out, "a moral vocabulary has been, and should remain, central to corporate law discourse."³⁷⁷ It is also true that legal standards exert influence far beyond the courtroom because they serve as the basis for the advice that counsel provide to their clients.³⁷⁸ They can also create a kind of legal lore that influences actors in a positive way, just as a lawless "tone at the top" creates the kind of atmosphere that Congress sought to discourage in Sarbanes-Oxley.

The language of the new good faith—e.g., "honesty of purpose"³⁷⁹ and "a true faithfulness and devotion to the interests of the corporation and its shareholders"³⁸⁰—implicitly recognizes that what people say influences what they do. It calls directors to fidelity to the interests they are charged to protect in sharp contrast with the

374. See *supra* note 327 and accompanying text.

375. See *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) (noting potential benefit of legislative action to correct "balkanization of duty of loyalty" by revising section 102(b)(7)).

376. O'Connor, *supra* note 26, at 1318-19.

377. *Loyalty Discourse*, *supra* note 164, at 72; see also, e.g., Lyman P.Q. Johnson, *Reclaiming an Ethic of Corporate Responsibility*, 70 GEO. WASH. L. REV. 957, 965-66 (2002); Lyman P.Q. Johnson, *The Social Responsibility of Corporate Law Professors*, 76 TUL. L. REV. 1483, 1490-98 (2002). Cf. Lyman P.Q. Johnson, *Faith and Faithfulness in Corporate Theory*, 56 CATH. UNIV. L. REV. 1 (forthcoming Dec. 2006) (suggesting that the highly secular nature of corporate discourse may inhibit understanding of many concepts, particularly the notion of faithfulness, and that allowing some of the language of faith to enter into the vocabulary could offer significant benefits).

378. See *Sale*, *supra* note 18, at 494 (describing "real value" of duty of good faith as arising from "the ex ante role it can play in changing the behavior and incentives of corporate fiduciaries and thereby changing corporate governance"). As the United States Supreme Court noted in *Upjohn Co. v. United States*, "corporations, unlike most individuals, 'constantly go to lawyers to find out how to obey the law.'" 449 U.S. 383, 392 (quoting Bryson P. Birnbaum, *The Attorney-Client Privilege in the Corporate Arena*, 24 BUS. LAW. 901, 913 (1969)).

379. *Disney IV*, 907 A.2d 693, 755 (Del. Ch. 2005).

380. *Disney V*, 906 A.2d 27, 67 (Del. June 8, 2006).

“cynical model of the corporate actor [that] has dominated the thinking about the nature of the fiduciary duties owed by corporate actors over the last twenty years.”³⁸¹ The latter is the view lauded by Gordon Gecko in his rhapsody on the merits of greed in the movie *Wall Street*; it is also the view decried by famed former Federal Reserve Chairman Alan Greenspan in his denunciation of a corporate culture “blighted by ‘infectious greed’” following the Enron debacle.³⁸²

In addition to the threat of legal sanctions it holds out, the *Disney* standard promises to encourage adherence to fiduciary duty by reminding directors of the meaning of “true faithfulness.”³⁸³ As Professor Sale observes, when directors ignore problems they “contribute to an atmosphere of permissiveness, recklessness, or deliberate indifference that can result in bad governance and business decisions, or worse, illegal activity.”³⁸⁴ To the extent that it voices a countervailing call, the new good faith promises to have an impact far beyond the boardroom.

4. *The new good faith as an alternative to prescriptive measures that create the risk of perverse incentives*

“Trust comes in many different forms and contexts, and it can be unpredictable and paradoxical in how it responds to different influences.”³⁸⁵ Moreover, “[m]istaken assumptions about the role and importance of external incentives in furthering cooperative behavior can lead not only to mistaken descriptions but also to mistaken prescriptions.”³⁸⁶ The effectiveness of Sarbanes-Oxley and other prescriptive approaches to the corporate trust crisis remains to be seen, but the new good faith does not pose the risk of perverse incentives. Instead, it calls on directors to do their jobs.

A strong, readily enforceable good faith obligation could well cause individuals—even those with excellent credentials—to think twice

381. O'Connor, *supra* note 26, at 1317. Professor O'Connor suggests that this model “presents a rather sterile view of fiduciary duty because it supports the idea [of] ‘honesty is the best policy’ as an appeal to self-interest.” *Id.*

382. Richard W. Stevenson & Richard A. Oppel, Jr., *Corporate Conduct: The Overview; Fed Chief Blames Corporate Greed; House Revises Bill*, N.Y. TIMES, July 17, 2002, at A1 (quoting July 16, 2002 Cong. Testimony of Alan Greenspan); *see also* Daniel Altman, *Parties Trade Lobs Over Issue of Lax Oversight*, N.Y. TIMES, July 12, 2002, at C4 (quoting U.S. Rep. Bernard Sanders of Vermont regarding “incredible culture of corporate greed”).

383. *Disney V*, 906 A.2d 27, 67 (Del. June 8, 2006). *See* Blair & Stout, *supra* note 294, at 1743 (one way law advances trust is “by framing the relationship between the fiduciary and her beneficiary as one that calls for a psychological commitment to trustworthy, other-regarding behavior”).

384. Sale, *supra* note 18, at 494-95.

385. Hall, *supra* note 296, at 525.

386. Blair & Stout, *supra* note 294, at 1808.

about serving as corporate directors. Its demands, however, would be unlikely to deter persons who are truly willing to do the job. As two noted Delaware jurists recently emphasized, “[i]ndependent directors who apply themselves to their duties in good faith have a trivial risk of legal liability.”³⁸⁷ If anything, the Delaware Supreme Court’s recognition of the new good faith as a distinct fiduciary obligation is likely to help inspire directors to stand up to domineering CEOs, insist on receiving appropriate information, and overcome a variety of structural obstacles to active engagement in the business and affairs of their corporations. Consequently, the new good faith is most likely to deter only those who do not belong on corporate boards—those who are unable or unwilling to commit to doing the job—from becoming directors.³⁸⁸ That is precisely what it ought to do.

CONCLUSION

The new good faith has emerged at a critical time in the history of American corporate governance. It is unclear whether corporate directors can reclaim the high ground, but it is certain that they will not succeed unless they actively engage in their oversight responsibilities. In accord with this reality, while remaining faithful to the spirit of the exculpatory provision of Delaware’s General Corporation Law, the *Disney* standard holds out the promise that a new, more comprehensive concept of good faith will become a recognized principal fiduciary responsibility of corporate directors. This new good faith focuses on “true faithfulness and devotion to the interests of the corporation and its shareholders”³⁸⁹ as its measure, and holds that conscious disregard of duty exposes directors to personal liability.

387. *Corporate Universe*, *supra* note 2, at 170 (quoting Leo E. Strine, Jr., *Director Liability Warnings*, BUS. & SEC. LITIGATOR (2003)); *see also, e.g.*, E. Norman Veasey, *Annual Audit Committee Issues Conference Keynote Speech: “A Perspective on Liability Risks to Directors in Light of Current Events”*, 1486 PLI/CORP. 1227 (2005).

388. As Delaware’s Vice Chancellor Strine has observed, “If an overly busy person serves on the boards of five public companies . . . [and] finds himself in a situation where one of his companies is accused of serious wrongdoing that the board arguably should have prevented, he should not be surprised if his good faith comes under severe attack. . . .” Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW 1371, 1373 (2002) (quoted in Lyman P.Q. Johnson, *The Audit Committee’s Ethical and Legal Responsibilities: The State Law Perspective*, 47 S. TEX. L. REV. 27, 38 (2005)). According to a posting on the Shearman & Sterling LLP website, cited in Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129, 162 (2006), “[a]t least one director of forty-five of the top 100 companies serves on five or more public company boards.” *See also supra* note 314.

389. *Disney V*, 906 A.2d 27, 67 (Del. 2006) (quoting *Disney IV*, 907 A.2d at 755.).

In exploring the parameters of the new good faith, we have argued three principal points. First, we have suggested that the most important legal innovation of the new good faith is its recognition of the substantive difference between the traditional standard and conscious disregard of a known duty to act. We have emphasized that if the *Disney* standard is to function as a meaningful norm for holding corporate directors accountable, it is critical to clarify that the new good faith does not require the presence of subjectively improper motivation.

Second, we have maintained that it is analytically cleaner to articulate the *Disney* standard in terms of an absence of *good* faith rather than the presence of *bad* faith. The Delaware Supreme Court, however, has defined the hallmark of the new *good* faith—conscious disregard of duty—as evidence of *bad* faith. Consequently, it is incumbent on the courts to ensure that the criteria applied in this context clearly define a *new* bad faith, one that clearly embraces conscious disregard of known duties, regardless of intention, and focuses on what directors have done or failed to do. Otherwise, there is a real risk that references to “bad faith conduct” set forth in both *Disney V* and the *Disney IV* decision it upholds, as well as in *Stone*, will reduce the new fiduciary duty to little more than a minor, and perhaps meaningless, variation on the classic duty of loyalty.

Finally, we have suggested that, if reasonably interpreted and enforced, the *Disney* standard is capable of playing a significant role in restoring corporate trust. While the scope of the new good faith obligation is modest, its objectives are important. Unless outside directors take their responsibility to engage actively in corporate affairs very seriously, they have little if any chance of functioning effectively to oversee the operations and finances of these highly sophisticated, increasingly complex organizations. Society has a great deal at stake in their success. Ensuring that those who direct the business and affairs of corporations have effective incentives and the structural support necessary to perform their function responsibly is a critical task of corporate law.