

THE DUTY OF GOOD FAITH IN CORPORATE LAW

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ABSTRACT

An important development in corporate law is the recent explicit recognition, in a series of Delaware cases, that corporate managers owe a fiduciary duty of good faith in addition to their traditional duties of care and loyalty. The duty of good faith was not created by those cases. On the contrary, the duty has long been explicit under the statutes—for example, in statutory provisions that require directors to act in good faith, and in provisions concerning indemnification. The duty of good faith has also long existed implicitly in the case law—for example, in the formulation of the business judgment rule and in fiduciary obligations that can only be explained by that duty, such as the duty not to knowingly cause the corporation to violate the law. Nevertheless, the explicit recognition of the duty of good faith in recent Delaware cases shines a spotlight on that duty and therefore makes it especially important to develop the contours of the duty and to examine the duty from a normative perspective.

Briefly, the duty of good faith in corporate law is comprised of a general baseline conception and specific obligations that instantiate that conception. The baseline conception consists of four elements: subjective honesty, or sincerity; nonviolation of generally accepted standards of decency applicable to the conduct of business; nonviolation of generally accepted basic corporate norms; and fidelity to office. Among the specific obligations that instantiate the baseline conception are the obligation not to knowingly cause the corporation to disobey the law and the obligation of candor even in non-self-interested contexts.

Turning to the normative issue, there are several basic reasons why the duty of good faith is desirable. To begin with, the duties of care and loyalty do not cover all types of improper conduct by managers, because

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certain kinds of managerial misconduct fall outside the spheres of those duties, and most of these types of misconduct fall within the duty of good faith. Furthermore, various rules limit a manager's accountability under the duties of care and loyalty, and these limiting rules should be and are inapplicable to conduct that violates the duty of good faith. Moreover, the duties of care and loyalty characteristically (although not invariably) function as platforms for liability rules, while the duty of good faith characteristically (although not invariably) functions as a condition to the application of rules that do not in themselves impose liability. This difference in characteristic function makes it desirable to treat good faith separately from care and loyalty. Finally, the duty of good faith provides a principled basis for the courts to articulate new specific fiduciary obligations that come to be seen as appropriate in response to changes in social and business norms, and in the general understanding of efficiency and other policy considerations, but that cannot be easily accommodated within the duties of care or loyalty.

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I. INTRODUCTION

An important development in corporate law is the explicit recognition in recent cases that corporate managers—directors and officers—owe a duty of good faith in addition to their duties of care and loyalty.¹ Because this development has been attended by a certain degree

¹The emerging recognition of the duty of good faith in Delaware case law was first fully developed by Hillary Sale in *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004). Shortly thereafter, a number of other significant articles on that issue appeared. See, e.g., 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); John L. Reed & Matt Neiderman, *Good Faith and the Ability of Directors to Assert § 102(b)(7) of the Delaware Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111 (2004); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004). For an early, more targeted, discussion, see Deborah DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 25 WAKE FOREST L. REV. 15 (1990). All

of controversy, three issues require examination: (1) Does corporate law impose a fiduciary duty of good faith? (2) If so, what should be and what are the contours of that duty? (3) Is an independent duty of good faith justified on normative grounds?

These three issues are tightly connected. For example, the legal status of the duty of good faith depends in part on whether the duty is normally justified, and whether the duty is normatively justified depends in part upon the contours of the duty. Therefore, it is difficult to resolve any one of these three issues in isolation. This article deals with the problem of interconnectedness as follows. Part II consists of an overview of the legal status of the duty of good faith in corporate law, the contours of that duty, and the normative justifications of that duty. Part III develops the legal status of the duty in greater depth. Part IV develops the contours of the duty in greater depth, by setting out the baseline conception of the duty. Part V develops the normative justifications of the duty in greater depth. Finally, Part VI considers some of the specific obligations that instantiate the general baseline conception of the duty of good faith, and some important recent cases concerning that duty.

II. OVERVIEW: THE LEGAL STATUS, CONTOURS, AND NORMATIVE JUSTIFICATIONS OF THE DUTY OF GOOD FAITH

A. *Legal Status*

The duty of good faith is well established in corporate law. To begin with, the duty has long been established in statutes. Many or most corporate statutes explicitly impose the duty of good faith on directors, officers, or both, and all or virtually all statutes implicitly impose the duty of good faith under a variety of provisions, such as those concerning indemnification. The duty of good faith also has long been implicitly recognized in case law—for example, in the formulation of the business judgment rule, and in fiduciary obligations that can only be explained by that duty, such as the duty not to knowingly cause the corporation to violate the law—and within the last fifteen years, the duty has been explicitly recognized in a number of Delaware cases.

of these articles also discuss, to varying extents, the parameters of the duty of good faith. See, e.g., Sale, *supra*, at 482-94. The present article primarily concerns that issue.

B. *Contours*

The duty of good faith in corporate law is comprised of a general baseline conception and specific obligations that instantiate that conception. The baseline conception consists of four elements: subjective honesty, or sincerity; nonviolation of generally accepted standards of decency applicable to the conduct of business; nonviolation of generally accepted basic corporate norms; and fidelity to office. Among the specific obligations that instantiate the baseline conception are the obligation not to knowingly cause the corporation to disobey the law and the obligation of candor even in non-self-interested contexts.

C. *Normative Justifications*

The duty of good faith in corporate law is supported by four normative justifications:

First, the traditional duties of care and loyalty do not cover all types of improper managerial conduct. The standard of conduct under the duty of care essentially requires a manager, when not acting in his own self-interest, to perform his duties in a manner that he reasonably believes to be in the best interests of the corporation, with a view towards maximizing corporate profit and shareholder gain. The standard of conduct under the duty of loyalty essentially requires a manager to act fairly when he acts in his own pecuniary self-interest or in the pecuniary interest of an associate or a family member. Given the ambit of these standards, certain important kinds of managerial misconduct fall outside the spheres of those duties. Most of these types of misconduct, however, fall within the duty of good faith.

Second, various rules limit a manager's accountability under the duties of care and loyalty. These include the business judgment rule; rules that make harm or unfairness to the corporation, or profit to the manager, elements of a breach of those duties; and rules that allow "disinterested" directors who are friends and colleagues of a self-interested director to insulate that director from liability for self-interested transactions. These accountability-limiting rules should be and are inapplicable to conduct that violates the duty of good faith.

Third, the duties of care and loyalty characteristically (although not invariably) function as platforms for *liability* rules. In contrast, the duty of good faith characteristically (although again, not invariably) functions as a *condition* to the application of rules that do not in themselves impose liability, such as rules concerning indemnification. This difference in

characteristic function makes it desirable to treat good faith separately from care and loyalty.

Fourth, the duty of good faith provides the courts with a principled basis for articulating new specific fiduciary obligations that come to be seen as appropriate in response to changes in social and business norms, and in the general understanding of efficiency and other policy considerations, but that cannot be easily accommodated within the duties of care and loyalty.

III. AN INTRODUCTION TO THE LEGAL STATUS OF THE DUTY OF GOOD FAITH UNDER STATUTORY AND CASE LAW

A. *Statutory Law*

There is little doubt that as a matter of positive law, corporate managers owe a duty of good faith. To begin with, that duty is explicitly imposed on directors, officers, or both, under many or most statutes. For example, section 8.30 of the Model Business Corporation Act, which has been adopted in many states, provides that "[e]ach member of the board of directors, when discharging the duties of a director, shall act . . . in good faith."² A counterpart provision, section 8.42, provides that "[a]n officer, when performing in such capacity, shall act . . . in good faith."³ Similarly, the New York statute, and many others, provide that "[a] director shall perform his duties as a director . . . in good faith."⁴

In addition, in all or virtually all states various statutory provisions make the applicability of important rules conditional on managerial good faith. For example, sections 145(a) and (b) of the Delaware General Corporation Law explicitly provide that under designated conditions a corporation has the power to indemnify a manager for the costs and outcomes of litigation and other proceedings, provided the manager acted in good faith.⁵ The strength of the good faith requirement in this context is highlighted in cases involving a manager's right to indemnification under private arrangements adopted pursuant to statutory provisions that do not by their terms require good faith as a condition to indemnification. For example, section 145(f) of the Delaware statute provides that "[t]he indemnification . . . provided by, or granted pursuant to . . . this section

²MODEL BUS. CORP. ACT § 8.30(a) (2005).

³*Id.* § 8.42.

⁴N.Y. BUS. CORP. LAW § 717(a) (McKinney 2003).

⁵DEL. CODE ANN. tit. 8, § 145(a)-(b) (2004).

shall not be deemed exclusive of any other rights to which those seeking indemnification . . . may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise."⁶

In *Waltuch v. Conticommodity Services, Inc.*,⁷ Article Ninth of the certificate of incorporation of Conticommodity (Conti), a Delaware corporation, gave Conti's managers a right to indemnification under defined circumstances, and did not require a showing of good faith. Waltuch brought suit against Conti under Article Ninth for indemnification of unreimbursed legal expenses that he had incurred in certain proceedings. Conti responded that Waltuch's claim was barred because he did not establish that he had acted in good faith. Waltuch countered that Article Ninth was authorized by section 145(f), and nothing in that section required good faith for indemnification under private arrangements. The Second Circuit held that notwithstanding the absence of an explicit requirement of good faith for indemnification under private arrangements, indemnification in the absence of good faith would exceed the scope of a Delaware corporation's power to indemnify, and a certificate provision, bylaw, or agreement that permitted such indemnification was to that extent invalid. Other cases have taken the same position, typically by subscribing to *Waltuch*.⁸

Another illuminating case concerning the role of good faith in indemnification is *In re Landmark Land Co.*⁹ Landmark Land Company (Landmark), a publicly held corporation, sat at the top of a complex corporate structure. Landmark owned all the stock in Oak Tree Savings Bank (the Bank). The Bank, in turn, indirectly owned all the stock of several real estate subsidiaries that used the Bank's funds to finance their operations. Gerald Barton was a 29% shareholder of Landmark; the CEO

⁶*Id.* § 145(f).

⁷88 F.3d 87 (2d Cir. 1996).

⁸*See* Kapoor v. Fujisawa Pharm. Co., No. 93C-06-050 SCD, 1997 Del. Super. LEXIS 386, at *11-12 (Del. Super. Ct. Aug. 22, 1997) ("I find persuasive the analysis in *Waltuch v. Conticommodity Services, Inc.*, wherein the court held that subsection (f) 'does not speak in terms of corporate power, and therefore cannot be read to free a corporation from the . . . limitations explicitly imposed in subsections (a) and (b).'" (citation omitted); Von Feldt v. Stifel Fin. Corp., No. 15,688, 1999 Del. Ch. LEXIS 131, at *8 (Del. Ch. June 11, 1999) ("It should now be clear that, as far as § 145 is concerned, Delaware corporations lack the power to indemnify a party who did not act in good faith or in the best interests of the corporation."). *See also* Owens Corning v. Nat'l Union Fire Ins. Co., 257 F.3d 484, 494-95 (6th Cir. 2001); Mayer v. Executive Telecard, Ltd., 705 A.2d 220, 225 n.6 (Del. Ch. 1997). *Cf.* Landmark Land Co. v. Cone (*In re Landmark Land Co.*), 76 F.3d 553, 562 (4th Cir. 1996) (discussing the requirement of good faith under the California and other indemnification statutes); Plate v. Sun-Diamond Growers, 225 Cal. App. 3d 1115 (Cal. Ct. App. 1970) (discussing the requirement of good faith under the California statute).

⁹76 F.3d 553 (4th Cir. 1996).

of Landmark and of the Bank; and a director and chairman of Landmark, the Bank, and the subsidiaries. William Vaughan, Barton's son-in-law, was a director and officer of the Bank and most of the subsidiaries.

In the wake of the savings-and-loan crisis, which had resulted from the use of manipulative accounting that masked the inadequate capitalization of S&Ls, Congress had created the Office of Thrift Supervision (OTS). The OTS was vested with broad regulatory powers to oversee financial institutions to ensure that they were adequately capitalized. An investigation of the Bank by the OTS in June 1990 revealed that the Bank was undercapitalized and had a pattern of consistent losses. The Bank's directors then entered into a Consent Agreement (not, apparently, a consent decree) with the OTS, in which the directors agreed that the Bank's subsidiaries would not engage in any material transaction without the OTS's prior approval. Subsequently, Barton, Vaughan, and other directors of some of the Bank's real estate subsidiaries caused the subsidiaries to file for bankruptcy. The OTS then took control of the Bank and appointed Resolution Trust Corporation as the Bank's receiver. However, the subsidiaries obtained an injunction that prevented the Bank, now controlled by Resolution Trust, from exercising its right, as the subsidiaries' shareholder, to remove and replace the subsidiaries' directors.

In response, the OTS filed administrative charges against Barton, Vaughan, and others, based in part on an allegation that the defendants had violated the Consent Agreement by causing the subsidiaries to engage in material transactions—the bankruptcy filings—without receiving the OTS's prior approval.¹⁰ The boards of the subsidiaries—which were incorporated in various states, all of which required good faith as a condition to indemnification¹¹—voted to indemnify Barton, Vaughan, and others for their expenses in connection with these proceedings. The district court, sitting as a bankruptcy court, entered an order to that effect, finding that Barton and Vaughan had acted in good faith. This finding was apparently based on the conclusion that the bankruptcy filings were in the best interests of the real estate subsidiaries, as evidenced by the fact that Resolution Trust kept the subsidiaries in bankruptcy after it eventually took them over. The Fourth Circuit reversed, on the ground that even if Barton and Vaughan had acted in the best interests of the real estate subsidiaries, and even though Burton and Vaughn had not broken any laws, they did not act in good faith, and therefore were not entitled to indemnification,

¹⁰The OTS also alleged that Barton and Vaughan had breached their fiduciary duties by causing the real estate subsidiaries to file for bankruptcy, but this allegation was hard to successfully maintain, because the RTC kept the subsidiaries in bankruptcy.

¹¹See *In re Landmark Land Co.*, 76 F.3d at 561-62.

because they had acted to circumvent the Consent Agreement and to undermine the regulatory authority of a governmental agency:

We cannot conclude that the Directors' action was taken in good faith. If the OTS charges are accurate, the [Directors'] action to place the Debtors in bankruptcy was a deliberate attempt to prevent the OTS from exercising control over the Bank's assets, thus hindering the OTS's ability to deal effectively with a failing savings and loan. Despite the district court's findings that the federal regulators had interfered with the Directors' efforts to keep the Debtors afloat, the fact remains that the Bank could not comply with the minimum capitalization requirement, and the OTS therefore had a statutory duty to force the Bank's management to comply with the capitalization requirement. . . . We cannot condone the Directors' blatant attempt to circumvent the OTS's regulatory authority by holding that they acted in good faith.

Even if the bankruptcy filings benefited the Debtors, we still could not conclude that the Directors acted in good faith. An agent who has intentionally participated in illegal activity or wrongful conduct against third persons cannot be said to have acted in good faith, even if the conduct benefits the corporation. . . . We recognize that the Directors did not break any law by filing the bankruptcy petitions, and that the OTS has not filed criminal charges against the Directors. Nonetheless, we find that a deliberate attempt to undermine the regulatory authority of a government agency cannot constitute good faith conduct, even if such actions benefit the corporation.¹²

Statutory provisions that insulate directors against liability for a self-interested transaction if the transaction is approved by disinterested directors are also normally applicable only if the disinterested directors act in good faith. So too, satisfaction of the duty of good faith is a condition to the applicability of many of the recently adopted exculpation or shield statutes. For example, the Delaware statute permits a certificate of incorporation to include:

¹²*Id.* at 564-66 (citation omitted).

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 of omissions not in good faith* or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.¹³

B. Case Law

In addition to the explicit and implicit legislative imposition of the duty of good faith under statutory law, that duty has long been implicit in

¹³DEL. GEN. CORP. LAW § 102(b)(7) (2004) (emphasis added). In *Emerald Partners v. Berlin*, No. 9700, 2003 Del. Ch. LEXIS 42, at *139 n.133 (Del. Ch. Apr. 28, 2003), reprinted in 28 DEL. J. CORP. L. 1027 (2003), the court took the position that Section 102(b)(7) does not recognize an independent duty of good faith:

The structure of Section 102(b)(7) [only] balkanizes the fiduciary duty of loyalty into various fragments [including good faith], thereby creating unnecessary conceptual confusion. For example, subsection (i) of Section 102(b)(7) excludes conduct violative of the "duty of loyalty" from exculpatory protection, but then goes on, in other subsections, to carve out conduct that amounts to different examples of quintessentially disloyal conduct. One such example of disloyal conduct is unfair self-dealing, which subsection (iv) describes as a director's receipt of "an improper personal benefit" from a transaction.

Id.

At best this position offers only one possible interpretation of section 102(b)(7)—and why adopt a convoluted and highly speculative interpretation of a statute when a straightforward reading makes complete sense?

Moreover, this position rests on the claim that intentional misconduct and the receipt of an improper personal benefit are simply fragments of the duty of loyalty. In fact, however, intentional misconduct can include malicious conduct that is not self-interested and therefore does not fall within the duty of loyalty. Similarly, not all improper personal benefits are the result of a violation of the duty of loyalty. For example, if a CEO improperly manipulates corporate earnings to increase his bonus, other director-officers who were not involved with the manipulation may receive inflated bonuses in the wake of the CEO's manipulation. The inflated component of those bonuses will constitute improper personal benefits even though these executives did not themselves violate the duty of loyalty. Furthermore, even supposing that the receipt of improper personal benefits was a special case of the duty of loyalty, that would not show that the legislature also regarded good faith as a special case of the duty of loyalty.

Finally, reading good faith out of Section 102(b)(7) would be inconsistent with the provisions of the Delaware statute that require good faith as a condition to indemnification and to the effectiveness of disinterested-director approval of a self-interested transaction, because those statutes clearly treat good faith as an independent requirement, not as a fragment of the duty of loyalty.

case law. For example, it is well established that if a manager is sued for violation of the duty of care, the manager can invoke the protective business judgment rule if, but only if, he acted in good faith. This requirement is reflected in the formulation of the business judgment rule in the American Law Institute's *Principles of Corporate Governance*:

A director or officer who makes a business judgment *in good faith* fulfills the duty [of care] . . . if the director or officer:

(1) is not interested . . . in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the corporation.¹⁴

Similarly, it is well established that corporate managers have an obligation not to knowingly cause the corporation to violate the law. This obligation has traditionally been conceived as stemming from the duty of good faith, and, as will be shown in Part VI, cannot be rationalized under either the duty of care or the duty of loyalty.¹⁵

In short, the duty of good faith has long been both explicit and implicit in corporation statutes and implicit in case law. Recently, it has become explicit in case law as well. As early as 1993, the Delaware Supreme Court stated, in *Cede II*, that a "plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* [sic] of their fiduciary duty—good faith, loyalty or due care."¹⁶ This triadic formulation was repeated two years later in *Cede III*,¹⁷ where the court stated that "to rebut the presumption [of the business judgment rule], a shareholder plaintiff assumes the burden of

¹⁴ALI, PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) (1994) (emphasis added).

¹⁵See *infra* Part VI.A.

¹⁶*Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993) (*Cede II*).

¹⁷*Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995) (*Cede III*) (emphasis omitted).

providing evidence that the board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties: good faith, loyalty, or due care."¹⁸ In 1998, the court stated, in *Malone v. Brincat*, that "[t]his Court has endeavored to provide the directors with clear signal beacons and brightly lined-channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders."¹⁹ In 2001, the Court stated, in *Emerald Partners v. Berlin*,²⁰ that "[t]he directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith. . . . [T]he shareholders of a Delaware corporation are entitled to rely upon their board of directors to discharge each of their three primary fiduciary duties at all times."²¹ The court continued:

[U]nless there is a violation of the duty of loyalty *or* the duty of good faith, a trial on the issue of entire fairness is unnecessary because a Section 102(b)(7) provision will exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care.²²

One commentator counted more than a dozen Delaware cases decided by mid-2002 that adopted the triadic formulation of the duties of corporate managers,²³ and this duty has been recognized by other Delaware and non-Delaware cases decided since that time, some of which will be considered in Part VI.²⁴

C. Vice Chancellor Strine's Opposing View

Against the view that there is a duty of good faith in corporate law, Vice Chancellor Leo Strine of the Delaware Court of Chancery has come down, in footnotes appearing in four opinions, in favor of a *dyadic* view,

¹⁸*Id.* at 1164.

¹⁹722 A.2d 5, 10 (Del. 1998).

²⁰787 A.2d 85 (Del. 2001).

²¹*Id.* at 90.

²²*Id.* at 92 (emphasis added). See also *McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000) ("The Chemical Board owe[s] fiduciary duties of care, loyalty and good faith to all Chemical shareholders in recommending a sale of the entire corporation.").

²³Charles Hansen, *Sowing the Seeds of Confusion: The Ephemeral Triad*, 73 ASPEN L. & BUS. CORP. 1, 2 (June 3, 2002) [No. 11].

²⁴See *infra* Part VI. For a comprehensive history of the development of the doctrine of good faith in explicit terms under Delaware law, see Sale, *supra* note 1.

in which the only fiduciary duties are care and loyalty, and good faith is simply a component of the duty of loyalty or a different way of describing that duty.

In 1999, in a footnote to *In re ML/EQ Real Estate Partnership Litigation*,²⁵ Vice Chancellor Strine opined that

[w]ithin [the duty of loyalty] would seem to be logically subsumed a duty to act with good rather than bad faith Bad faith conduct . . . would seem to be other than loyal conduct. *See Webster's Ninth New Collegiate Dictionary* 446 (1987) (indicating that: the primary definition of "faith" is "allegiance to duty or a person: LOYALTY"; the primary definition of "faithless" is "not true to allegiance or duty: TREACHEROUS, DISLOYAL"; "loyal" is a synonym for "faithful"; and "disloyal" is a synonym for "faithless").²⁶

The next year, in *In re Gaylord Container Corp. Shareholders Litigation*,²⁷ Vice Chancellor Strine maintained that the dyadic view was supported by two brief passages in Delaware Supreme Court cases involving the business judgment rule. The first passage is from *Barkan v. Amsted Industries, Inc.*,²⁸ where the court said, in connection with that rule, that "a board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence and in good faith. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule."²⁹ The second passage is in footnote 36 to *Cede II*. In the text of its opinion in *Cede II*, the court paraphrased *Barkan* by saying, "[W]e have also stated [in *Barkan*] that the [business judgment] rule is premised on a presumption that the directors have severally met their duties of loyalty . . . and that the directors have collectively, as a board, met their duty of care."³⁰ Following this paraphrase, the court inserted footnote 36, which quoted from *Barkan*, but added the words "care" and "loyalty" in brackets: "[A] board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence [care] and good faith [loyalty]. If no breach of duty is found, the board's actions are entitled to the protections of the

²⁵No. 15,741, 1999 Del. Ch. LEXIS 238 (Del. Ch. Dec. 20, 1999).

²⁶*Id.* at *16 n.20.

²⁷753 A.2d 462 (Del. Ch. 2000).

²⁸567 A.2d 1279 (Del. 1989).

²⁹*Id.* at 1286.

³⁰*Cede II*, 634 A.2d at 368 (citing *Barkan*, 567 A.2d at 1286).

business judgment rule."³¹ In *Gaylord*, Vice Chancellor Strine stated that "[i]t is clear [that in *Barkan*] the [Delaware] Supreme Court used the terms 'due diligence' and 'good faith' as a fresh way of referring to the 'fundamental duties of care and loyalty'"³² and that footnote 36 in *Cede* endorses that view by quoting from *Barkan* and adding the word "care" in brackets after the words "due diligence" and the word "loyalty" in brackets after the words "good faith."³³

Next, in *Nagy v. Bistricher*,³⁴ the Vice Chancellor repeated the claim he made in *ML/EQ*, but added in a footnote:

If it is useful at all as an independent concept, the good faith iteration's utility may rest in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) 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.³⁵

Finally, in *Guttman v. Huang*,³⁶ Vice Chancellor Strine maintained, in still another footnote:

It does no service to our law's clarity to continue to separate the duty of loyalty from its own essence; nor does the recognition that good faith is essential to loyalty demean or subordinate that essential requirement. There might be situations when a director acts in subjective good faith and is yet not loyal (e.g., if the director is interested in a transaction subject to the entire fairness standard and cannot prove financial fairness), but there is no case in which a director can act in subjective bad faith towards the corporation and act loyally. The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the

³¹*Id.* at 368 n.36 (quoting *Barkan*, 567 A.2d at 1286).

³²*Gaylord Container*, 753 A.2d at 476 n.41 (citing *Cede II*, 634 A.2d at 368 n.36).

³³*Id.* (citing *Barkan*, 567 A.2d at 1286).

³⁴770 A.2d 43 (Del. Ch. 2000).

³⁵*Id.* at 48-49 n.2.

³⁶823 A.2d 492 (Del. Ch. 2003).

corporation's best interest does not make it faithful, as opposed to faithless.³⁷

If we put to one side the somewhat platonic claims that the duty of good faith is "logically subsumed" within the duty of loyalty, or that the triadic view separates the duty of loyalty "from its own essence," there are two basic arguments in Vice Chancellor Strine's footnotes. One argument is semantic, based on the definition of "faith" in *Webster's Ninth New Collegiate Dictionary*. The second argument is precedential, based on the Vice Chancellor's interpretation of passages in *Barkan* and *Cede II*. Neither argument is persuasive.

1. The Semantic Argument Based on the Definition of "Faith" in *Webster's Ninth New Collegiate Dictionary*

Consider first the argument based on the definition of "faith" in *Webster's Ninth New Collegiate Dictionary*. There are two basic flaws in this argument.

First, a determination of whether there is an independent duty of good faith in corporate law is a substantive issue. Common usage, as captured in dictionaries, may certainly be helpful in resolving this issue, but dictionaries are only one source to be used for this purpose. Also important, perhaps more important, are statutes and cases in both Delaware and other jurisdictions, and normative considerations, including the reasonable expectations of shareholders and the society at large.

Second, although dictionary definitions are relevant to the meaning of good faith, Vice Chancellor Strine checked only one dictionary and then *looked up the wrong word*. There is a crucial difference between *faith*, upon whose definition the Vice Chancellor's argument rests, and *good faith*. Faith, as Vice Chancellor Strine accurately reports, means *allegiance*. Good faith does not. The difference is severe. A person can have allegiance to a bad government, a bad organization, a bad person, or a bad cause. A person who acts on the basis of such an allegiance does not act in good faith. Furthermore, good faith involves several elements, not just one. Had Vice Chancellor Strine canvassed various leading unabridged dictionaries, rather than only one abridged dictionary, and had he looked up the meaning of *good faith* rather than the meaning of *faith*, he would have found that the definition of good faith includes multiple elements, and that neither allegiance nor loyalty is one of those elements.

³⁷*Id.* at 506 n.34.

Consider the definition of good faith in four leading unabridged dictionaries. *Webster's Third New International Dictionary* defines good faith as "[a] state of mind indicating honesty and lawfulness of purpose: belief in one's legal title or right: belief that one's conduct is not unconscionable or that known circumstances do not require further investigation: absence of fraud, deceit, collusion, or gross negligence."³⁸ The *American Heritage Dictionary* defines good faith as "[c]ompliance with standards of decency and honesty."³⁹ The *Random House Dictionary* defines good faith as "accordance with standards of honesty, trust, sincerity, etc."⁴⁰ *Black's Law Dictionary* defines good faith as "[a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage."⁴¹

Furthermore, good faith is defined not only in dictionaries, but also in various bodies of law. As in the case of dictionaries, these bodies of law almost always define good faith in terms of multiple elements, none of which is either allegiance or loyalty. Both the dictionary and legal definitions of good faith will be discussed further in developing the baseline conception of the duty of good faith in corporate law.

The omission of both *allegiance* and *loyalty* from both the dictionary and the legal definitions of good faith is not surprising. Good faith is always desirable; allegiance and loyalty are not always desirable, because one can have allegiance, and be loyal, in bad faith. An actor who satisfies all the elements of good faith cannot be acting badly. An actor who satisfies all the elements of allegiance or loyalty may be acting either well or badly. A mafioso who has murdered an informer has displayed allegiance and loyalty to the mafia. An Enron mid-level executive who participated in Enron's duplicitous and rapacious culture displayed allegiance and loyalty to that culture and to his superiors. Neither has acted in good faith.

2. The Argument from Precedent Based on *Barkan* and *Cede II*

Turn now to the argument based on precedent, which turns on a passage in *Barkan* and footnote 36 in *Cede II*. "It is clear," Vice

³⁸WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH UNABRIDGED 978 (3d ed. 1993).

³⁹AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 757 (4th ed. 2000).

⁴⁰RANDOM HOUSE UNABRIDGED DICTIONARY 822 (2d ed. 1993).

⁴¹BLACK'S LAW DICTIONARY 713 (8th ed. 2004).

Chancellor Strine claims, that in *Barkan* the Delaware Supreme Court used the terms "due diligence" and "good faith" as a fresh way to refer to the duties of care and loyalty, and that footnote 36 in *Cede II* endorses that view by quoting from *Barkan* and adding the word "care" in brackets after the words "due diligence," and the word "loyalty" in brackets after the words "good faith." In fact, however, just the opposite is clear.

First, *Barkan* was not using the terms "due diligence" and "good faith" as a fresh way to refer to the duties of care and loyalty. Rather, *Barkan* was stating the business judgment rule. The business judgment rule consists of four conditions, and a special standard of review for managerial decisions—the standard of rationality—that is applicable if the four conditions are satisfied. The four conditions are: a judgment must have been made; the manager must have informed himself with respect to that judgment to the extent he reasonably believed appropriate under the circumstances; the decision must have been made in good faith; and the manager may not have a financial interest in the subject matter of the decision.⁴² All that the court did in *Barkan* was to reiterate that diligence (reasonably informing oneself) and good faith are conditions to the application of the business judgment rule. Far from equating good faith with loyalty, *Barkan* recognized that there is an independent duty of good faith, which must be satisfied as a condition to the application of the business judgment rule.

Just as *Barkan* does not stand for the proposition that good faith is a part of the duty of loyalty, neither does *Cede II*. Footnote 36 in *Cede II* is not about the duty of good faith—not even remotely. Recall that the text of *Cede II*, at the point where footnote 36 is inserted, concerns, like *Barkan*, not the duty of good faith as such, but the elements of the business judgment rule. The text says, "[W]e have . . . stated that the business judgment rule is premised on a presumption that the directors have severally met their duties of loyalty . . . and that the directors have collectively, as a board, met their duty of care." The court in *Cede II* cited *Barkan* for this proposition. Then in footnote 36, the court quoted from *Barkan*, and added bracketed words, as follows: "A board's action must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence [care] and good faith [loyalty]. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule." Here, as in *Barkan*, the court was simply attempting to state the elements of the business judgment rule—not attempting to determine whether there is a duty of good faith. Contrary to

⁴²See ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 4.01(c).

Vice Chancellor Strine's position, we can be sure that in footnote 36 the Delaware Supreme Court was not asserting that "due diligence" was a fresh way to refer to the duty of care. How could it? Due care is much more complex than due diligence. And we can be equally sure that in the next, parallel, clause, the court did not think that "good faith" was a fresh way to refer to the duty of loyalty.

How can we be so sure of this? Partly because if the court did not mean—since it could not have meant—that due diligence was the same as the duty of care, there is no reason to believe that in the next, parallel, clause, the court meant that good faith was the same as the duty of loyalty. More important, when the court got down to business in *Cede II*—that is, when the court directly considered whether there was an independent duty of good faith in the *text* of its opinion—it made its position clear. In the text of *Cede II*, the court stated, in the most explicit way, that there is such a duty. "A shareholder," the court said, "assumes the burden of providing evidence that the board of directors, in reaching their challenged decision, breached *any one of the triads* [sic] of their fiduciary duty—good faith, loyalty or due care."⁴³

A triad is a group of three things. A triad cannot consist of two things. There cannot be a triad of the law of tort, the law of contract, and the law of offer and acceptance. There cannot be a triad of the duty of care, the duty of loyalty, and the corporate-opportunity doctrine. Correspondingly, if the court in *Cede II* had treated good faith as part of loyalty, it could not possibly have said that there was a *triad* of the duties of good faith, loyalty, and care. But, of course, that is just what the court did say.

Moreover, even if, counterfactually, *Cede II* meant what Vice Chancellor Strine interprets it to mean on the basis of footnote 36, in disregard of the text of the opinion, that would be irrelevant to the Vice Chancellor's argument based on precedent, because in cases decided *after Cede II*, the Delaware Supreme Court stated unequivocally and unambiguously that good faith and loyalty were separate duties. In *Cede III*, the Delaware Supreme Court stated unequivocally and unambiguously that there is a "triad of fiduciary duties: good faith, loyalty, [and] due care."⁴⁴ In *Malone v. Brincat*, decided after Vice Chancellor Strine had staked out his position, the Delaware Supreme Court stated unequivocally and unambiguously that directors must navigate "with due care, good faith, and loyalty."⁴⁵ In a Delaware Court of Chancery decision in *Emerald*

⁴³*Cede II*, 634 A.2d at 361.

⁴⁴663 A.2d at 1164.

⁴⁵*Malone*, 722 A.2d at 10.

Partners v. Berlin, the court repeated Vice Chancellor Strine's view that good faith is only "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 fiduciary duties of loyalty and due care."⁴⁶ On appeal, the Delaware Supreme Court brought the chancery court up short: "The directors of Delaware corporations," the supreme court reminded the chancery court, "*have a triad of primary fiduciary duties: due care, loyalty, and good faith. . . .* [T]he shareholders of a Delaware corporation are entitled to rely upon their board of directors to discharge *each* of their *three* primary fiduciary duties at all times."⁴⁷

How much clearer could the court get?

Furthermore, although at one time it appeared that there might be a Delaware Court of Chancery position (rather than simply a position of Vice Chancellor Strine) in favor of the dyadic view,⁴⁸ that appearance—which, of course, would in any event be trumped by the Delaware Supreme Court's view—has eroded away over time. In *In re Emerging Communications, Inc. Shareholders Litigation*,⁴⁹ former Vice Chancellor Jacobs, now a Justice of the Delaware Supreme Court but sitting by designation in *Emerging* as a Vice Chancellor, stated that

if a loyalty breach requires that the fiduciary have a self-dealing conflict of interest in the transaction itself . . . then only [the defendant] Prosser is liable on that basis. . . . On the other hand, if a loyalty breach . . . does not require a self-dealing conflict of interest or receipt of an improper benefit, then [the defendant] Raynor would be liable for breaching his duties of loyalty *and* good faith.⁵⁰

Further, in *Disney IV*,⁵¹ Chancellor Chandler stated:

⁴⁶2001 Del. Ch. LEXIS 20, at 86 n.63.

⁴⁷*Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (emphasis added).

⁴⁸*Cf. Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 388 n.18 (Del. Ch. 1999), where Vice Chancellor Steele said, with an extra-heavy dose of skepticism, "I leave it to the [Delaware] Supreme Court and to the academic community to distinguish the fiduciary duties of loyalty and 'good faith.'"

⁴⁹No. 16,415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) (revised June 4, 2004).

⁵⁰*Id.* at 142 n.184 (emphasis added).

⁵¹The recent *Disney* derivative litigation involved four principal opinions, which will be referred to in this article as *Disney I*, *II*, *III*, and *IV*. In *In re Walt Disney Co. Derivative Litig. (Disney I)*, 731 A.2d 342 (Del. Ch. 1998), the chancery court dismissed the plaintiff's complaint against Disney's directors and Michael Ovitz. In *Brehm v. Eisner (Disney II)*, 746 A.2d 244 (Del. 2000), the Delaware Supreme Court held that the plaintiffs should be allowed to plead their

The good faith required of a corporate fiduciary includes *not simply the duties of care and loyalty*, in the narrow sense that I have discussed them above, but all actions 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 a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.⁵²

Vice Chancellor Strine's dyadic view is also inconsistent with American statutory law generally, and with Delaware statutory law in particular. As discussed above, many or most American corporate law statutes explicitly impose a duty of good faith on directors, officers, or both; and all, or virtually all, statutes implicitly impose that duty by making good faith a condition to the applicability of one or more important statutory provisions, such as indemnification provisions, provisions concerning approval of a self-interested transaction by disinterested directors, and exculpatory or shield provisions. For example, in *Disney IV*, Chancellor Chandler pointed out that treating good faith as part of the duty of loyalty (or for that matter, the duty of care) would be inconsistent with Section 144 of the Delaware General Corporation Law: That section provides that a transaction between a corporation and its directors or officers will be deemed valid if approved by a majority of the independent directors, assuming three criteria are met: (1) the approving directors were aware of the conflict inherent in the transaction, (2) the approving directors were aware of all the facts material to the transaction, and (3) the approving directors acted in good faith.⁵³ As Chancellor Chandler tellingly observed:

complaint. In *In re the Walt Disney Co. Derivative Action (Disney III)*, 825 A.2d 275 (Del. Ch. 2003), the chancery court denied a motion to dismiss the revised complaint on the pleadings. In *In re the Walt Disney Co. Derivative Action (Disney IV)*, No. 15,452, 2005 Del. Ch. LEXIS 28 (Del. Ch. Feb. 4, 2005); judgment entered 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005) [*Disney IV*], *reprinted* in 31 DEL. J. CORP. L. 349 (2006), the chancery court held for the defendants after a trial.

⁵²*Disney IV*, 2005 Del. Ch. LEXIS 113, at *176-77 (footnotes omitted), *reprinted* in 31 DEL. J. CORP. L. at 425 (emphasis added).

⁵³DEL. CODE ANN. tit. 8, § 144(a)(1) (2004).

In other words, the inside transaction is valid where the independent and disinterested (loyal) directors understood that the transaction would benefit a colleague (factor 1), but they considered the transaction in light of the material facts (factor 2—due care) mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies (factor 3—good faith).⁵⁴

IV. THE BASELINE CONCEPTION OF THE DUTY OF GOOD FAITH

In 1968, Robert Summers published an influential article arguing that in contract law, good faith was best understood as an excluder—that is, "a phrase which has no general meaning . . . of its own, but which serves to exclude many heterogeneous forms of bad faith."⁵⁵ "[I]n cases of doubt," Summers suggested, "a lawyer will determine more accurately what the judge means by . . . 'good faith' if [the lawyer] does not ask what good faith itself means, but rather asks: What . . . does the judge intend to rule out by his use of this phrase?"⁵⁶

Certainly, Summers made an important point.⁵⁷ It is easier to characterize a given action as lacking good faith than to provide a general definition of good faith.⁵⁸ Nevertheless, as Deborah DeMott has observed, "[In a] contractual context, good faith has suppletory and protective functions whose scope is defined by the express terms of the parties' contract. In contrast, as applied to the decisions of corporate directors, good faith focuses on directors' position as fiduciaries obliged to serve the interests of others."⁵⁹ Accordingly, in corporate law the duty of good faith must be given a positive meaning.

It is neither necessary nor appropriate, however, to delineate that meaning by a single phrase. The duty of good faith is a general principle,

⁵⁴*Disney IV*, 2005 Del. Ch. LEXIS 113, at *178 n.464, reprinted in 31 DEL. J. CORP. L. at 425 n.464.

⁵⁵Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968).

⁵⁶*Id.* at 200 (footnote omitted).

⁵⁷In fact, Summers's analysis made its way into the commentary to the good faith provision in the *Restatement (Second) of Contracts*. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981).

⁵⁸For ease of exposition, unless the context indicates otherwise, in the balance of this article the terms *action* and *conduct* will be used interchangeably, and the term *lacks good faith* will be used synonymously with the term *in bad faith*.

⁵⁹DeMott, *supra* note 1, at 24.

and general principles often are delineated by baseline conceptions consisting of a cluster of elements. For example, the general principle of care is delineated by a baseline conception consisting of elements such as diligence and rationality. The general principle of loyalty is also delineated by a baseline conception consisting of elements such as fairness and disclosure. The general principle of good faith is also delineated by a baseline conception consisting of a cluster of elements.

To begin with, good faith requires subjective honesty. Subjective honesty, in turn, requires several types of sincerity. A corporate manager must sincerely believe that his conduct is in the best interests of the corporation, that any statements he makes in his managerial capacity are truthful, and that his conduct is within the realm of decent behavior.

It is not enough, however, that a manager acts honestly in the sense that he acts sincerely. Many persons adopt belief systems that allow them to sincerely conclude that their morally outrageous conduct is proper. This point is well made in a review by Mick LaSalle of the film *Downfall*, which concerns Adolph Hitler's final days.⁶⁰ As LaSalle noted, the fact that "Hitler is portrayed as human made the film mildly controversial in America, as though that were the same as making him likeable." This, LaSalle pointed out, missed the value of the film, which is to "remind us of a lesson that simply can't be repeated enough—that absolute faith in one's own virtue is not a commitment to virtuous behavior but a commitment to one's own will."⁶¹ Or, as Deborah De Mott puts it:

Wholly apart from these practical issues of proof, a standard for good faith that looks solely to directors' motives ignores the function to be served by the standard. As applied to directors' decisions, a standard of good faith tests directors' fidelity to the interests they may appropriately consider or serve. Subjective motivation and sincere belief are, at best, imprecise surrogates to measure fidelity. Directors, like other people, are capable of deceiving themselves about the point and effect of their actions. Sincere self-deception is not responsive to the obligation to which directors, as fiduciaries, are subject. Fiduciary norms are stringent: they prohibit the fiduciary from creating interests in conflict with interests of the beneficiary protected by the relationship, and they deny a fiduciary the profit derived from a breach of duty even when

⁶⁰Mick LaSalle, *Downfall*, SAN FRANCISCO CHRONICLE DATEBOOK, Aug. 7, 2005, at 28, available at <http://sfgate.com/cgi-bin/article.cgi?file=c/a/2005/08/07> (last visited Oct. 7, 2005).

⁶¹*Id.*

the breach caused no demonstrable injury to the beneficiary. One explanation for this stringency is the persistent capacity of decisionmakers for sincere self-deception when self-interest is at stake.⁶²

Accordingly, good faith in law includes objective as well as subjective elements. So, for example, in *First National Bank v. F.C. Trebein Co.*,⁶³ the court said, "[G]ood faith in law . . . is not to be measured always by a man's own standard of right, but by that which [the law] has adopted and prescribed as a standard for the observance of all men in their dealings with each other." Indeed, in law generally, the objective elements of good faith dominate the subjective element. For example, in *Landmark Land* the court held that the defendants' deliberate action to circumvent the authority of a governmental agency constituted bad faith even if the defendants intended to and did act in the best interests of the corporation.⁶⁴ In *T.S. Kaung v. Cole National Corp.*,⁶⁵ a Delaware decision, Kaung had been an employee of Cole National. Based on his conduct in that capacity, Kaung had been made a party to a class action and was also a target of an SEC investigation. Kaung hired Kelso as a consultant in connection with these proceedings, and retained the law firm of O'Rourke & Cundra to represent him in the proceedings. Cole at first advanced Kaung's expenses, but later began to question Kelso's qualifications (Kelso was not a lawyer), his role, and the reasonableness of his fees, and pending an investigation into these issues, suspended its advances. Kaung then brought suit against Cole for continued advancement of his expenses.

The Delaware Court of Chancery not only ruled against Kaung on the merits (on the ground that the time billed by Kelso was not reasonable), but also ordered Kaung to pay the attorneys' fees that Cole had incurred in connection with defending against the suit. Although the winning party in litigation is usually not entitled to recover its fees from the losing party, there is an exception where the losing party has acted in bad faith. The chancery court held that Kaung's actions in the course of the litigation fell within the bad faith exception. The Delaware Supreme Court affirmed, in large part on the basis of the objective actions of Kaung's representatives, and without an inquiry into whether Kaung or his representatives subjectively believed those actions were morally defensible:

⁶²DeMott, *supra* note 1, at 22-23.

⁶³52 N.E. 834, 837 (Ohio 1898).

⁶⁴See *supra* text accompanying note 9.

⁶⁵No. 163-N, 2004 Del. Ch. LEXIS 126 (Del. Ch. Aug. 27, 2004), *aff'd in part and rev'd in part*, 884 A.2d 500 (Del. 2005).

[T]he record shows that throughout the litigation Kaung's representatives made excessive and duplicative deposition requests while ignoring their own discovery obligations. They refused to facilitate the schedule of Kelso's deposition, and when he finally appeared for deposition, he refused to answer questions and instead peppered Cole's attorneys with questions and accusations. [Kaung's lawyer,] Cundra, who accompanied Kelso to the deposition, aggravated the situation by supporting Kelso's behavior and failing to provide any substantive answers to Cole's discovery requests regarding Kelso.⁶⁶

In corporate law, as in law generally, the objective elements of good faith are far more important in practice than the subjective elements. There are three objective baseline elements of good faith in corporate law, which are founded on the meaning of good faith in common usage, as reflected in dictionaries; on the meaning of good faith developed in various bodies of law, including corporate law; and on the basis of the reasonable expectations of shareholders and of the society at large.

First, the duty of good faith in corporate law requires a manager not to violate generally accepted standards of decency applicable to the conduct of business.⁶⁷ This element reflects the reasonable expectations of society and conforms to a standard meaning of good faith in common usage: "[c]ompliance with standards of decency."⁶⁸

Second, the duty of good faith in corporate law requires a manager not to violate generally accepted basic corporate norms.⁶⁹ This element reflects the constitution of the corporation, which includes such norms, and is analogous to the meaning of good faith in Article 2 of the Uniform Commercial Code, which provides that in the case of a merchant, good faith means honesty in fact and the observance of reasonable commercial standards of fair dealing.⁷⁰

Third, the duty of good faith in corporate law requires a manager to have fidelity to his office. This element reflects the reasonable expectations of shareholders and conforms to standard usage, which

⁶⁶Kaung, 884 A.2d at 507.

⁶⁷See DeMott, *supra* note 1.

⁶⁸See AMERICAN HERITAGE DICTIONARY, *supra* note 39, at 757.

⁶⁹Cf. E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, 38 WAKE FOREST L. REV. 839, 850 (2003) ("Today, the 'utter failure' to follow the minimum expectations of the evolving standards of director conduct . . . might . . . raise a good-faith issue.").

⁷⁰See, e.g., CAL. COM. CODE § 2103(b) (West/Deering 2002).

includes faithfulness to one's duty or obligation.⁷¹ *Office* in this context means a position of duty, trust, or authority in an organization. *Fidelity* to one's office means an attempt to execute an office, and the role that the office implicates, in the manner in which execution of the office is reasonably to be expected, given the constitution of the office and of the organization in which the office is embedded.

The role of the baseline conception of the duty of good faith must be understood against a distinction between standards of conduct and standards of liability.⁷² A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test that a court should apply when it reviews an actor's conduct to determine whether to impose liability on the actor. In many or most areas of law, these two kinds of standards tend to be conflated. For example, the standard of conduct that governs automobile drivers is that they should drive carefully, and the standard of review in a liability claim against a driver is whether he drove carefully. The conflation of standards of conduct and standards of review is so common that it is easy to overlook the fact that whether the two kinds of standards are or should be identical in any given area is a matter of prudential judgment.

For a variety of reasons, in corporate law the standards of review and the standards of conduct pervasively diverge.⁷³ For example, in the area of loyalty the general standard of conduct is that a manager who acts in his own financial self-interest, or the financial interest of an associate or a family member, should act fairly. However, if a self-interested transaction has been approved by disinterested directors, a standard of review that is much easier for the manager to satisfy may be applied. Similarly, in the area of care the general standard of conduct is that a manager should act reasonably. If the manager's conduct satisfies the conditions of the business judgment rule, however, the standard of review is whether the manager's judgment was rational, which is also a much easier standard for the managers to satisfy.

⁷¹See BLACK'S LAW DICTIONARY, *supra* note 41, at 713. See also, e.g., *In re Hicks*, 79 B.R. 45, 47 n.5 (Bankr. N.D. Ala. 1987).

⁷²See Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 52 FORDHAM L. REV. 437 (1993). That article touched on the duty of good faith, but did so only briefly.

⁷³This divergence between standards of conduct and standards of review in corporate law was long implicit. The Model Business Corporation Act has now made this divergence explicit. Section 8.30 of the Model Act sets forth "Standards of Conduct" for directors, while section 8.31 sets forth "Standards of Liability" for directors. MODEL BUS. CORP. ACT §§ 8.30, 8.31 (2005) (emphasis added).

Similarly, while the baseline conception of the duty of good faith is a standard of conduct, noncompliance with that conception does not in and of itself give rise to liability. Liability will arise only under specific obligations that instantiate the duty of good faith. In this respect, the duty of good faith operates like the duties of care and loyalty. Courts normally do not impose liability on a corporate manager simply on the ground that the manager acted without due care. Instead, they impose liability only on the ground that the manager violated a specific obligation that is based on the duty of care, such as the obligation to become properly informed before making a decision. Correspondingly, courts normally do not impose liability on a manager simply on the ground that the manager acted disloyally. Instead, they impose liability only on the ground that the manager violated a specific obligation that is based on the duty of loyalty, such as the obligation not to engage in a self-interested transaction at an unfair price.

The fact that the baseline conception of the duty of good faith is not itself a liability rule does not mean that the conception lacks legal significance. On the contrary, the baseline conception has three important roles in corporate law.

First, the baseline conception is a legal standard of conduct.

Second, where good faith is a condition to the application of a legal rule that would benefit a manager, such as the business judgment rule or a statutory provision concerning indemnification or exculpation, the condition will not be satisfied if there has been a failure to comply with one or more of the elements of the baseline conception.

Third, the general baseline conception serves as a platform for more specific obligations that instantiate that conception, whose violation may give rise to liability.

To summarize, the elements of the baseline conception of the duty of good faith in corporate law are subjective honesty or sincerity, nonviolation of generally accepted standards of decency applicable to the conduct of business, nonviolation of generally accepted basic corporate norms, and fidelity to office. This baseline conception serves three functions. (1) The baseline conception is a standard of conduct. (2) The elements of the baseline conception figure in determining whether a manager has satisfied a condition of good faith. (3) The general baseline conception provides a platform for more-specific obligations. These more specific obligations, some of which will be discussed in Part VI, serve to give further texture to the duty of good faith in cases where good faith operates as a condition and may also serve as liability rules.

To put this differently, when good faith operates as a *condition*, the courts should ask whether the manager has violated either an element of the

baseline conception of the duty of good faith or a specific obligation that is based on that conception. When *liability* is at issue, however, the court should ask the narrower question, whether the manager has violated a specific obligation that instantiates the baseline conception.

V. NORMATIVE CONSIDERATIONS

Part II of this article briefly described four reasons why the duty of good faith not only is but should be part of American corporate law. In this Part, those reasons will be developed in greater depth.

A. *The Duty of Good Faith Covers Managerial Conduct That Is Improper but Falls Outside the Spheres of the Duties of Care and Loyalty*

The duties of care and loyalty, as traditionally understood, have well-defined ambits. The duty of care (although not the standard of review for liability under that duty) requires a manager who is not self-interested to perform his duties in a manner that he reasonably believes to be in the best interests of the corporation, with a view to enhancing corporate profit and shareholder gain. In that connection, the standard of *conduct* under the duty of care (although not the standard of review) requires a manager to act reasonably—with due care—in informing himself concerning a proposed decision, and in making the decision itself. The duty of loyalty requires a manager to act fairly when he is interested in a transaction or a course of conduct. A manager is interested, for purposes of the duty of loyalty, when he, an associate, or a family member has a financial interest in the transaction or the conduct. For example, section 1.23(a) of the ALI's *Principles of Corporate Governance* defines "interested," for purposes of the duty of loyalty, as follows:

A director . . . or officer . . . is "interested" in a transaction or conduct if either:

- (1) The director or officer . . . is a party to the transaction or conduct;
- (2) The director or officer has a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director's or officer's judgment with respect to the transaction or conduct in a manner adverse to the corporation;

(3) The director or officer has a material pecuniary interest in the transaction or conduct . . . and that interest . . . would reasonably be expected to affect the director's or officer's judgment in a manner adverse to the corporation⁷⁴

Similarly, section 8.60 of the Model Business Corporation Act defines a "director's conflicting interest transaction" as follows:

[A] transaction effected or proposed to be effected by the corporation

(i) to which . . . the director is a party; or

(ii) respecting which . . . the director had knowledge and a material financial interest known to the director; or

(iii) respecting which . . . the director knew that a related person was a party or had a material financial interest.⁷⁵

In various important kinds of cases, however, a manager's conduct is improper, but falls outside the spheres of the duties of care and loyalty. An example is provided by Chancellor Chandler in *Disney IV*:

[In the context of] an imperial CEO or controlling shareholder with a supine or passive board . . . the concept of good faith may prove highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of

⁷⁴ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 1.23.

⁷⁵MODEL BUS. CORP. ACT § 8.60 (2005).

purpose and with an understanding of whose interests they are there to protect.⁷⁶

Other examples, which will be discussed in Part VI, include cases in which a manager knowingly causes the corporation to violate the law, lacks candor in a non-self-interested context, or acts out of improper nonfinancial motives. An important reason for the duty of good faith, therefore, is that this duty covers most of the important types of cases in which a manager's action, although improper, does not violate the duties of care or loyalty.

*B. Certain Rules That Limit the Duties of Care and Loyalty
Should Not and Do Not Apply to Conduct That Lacks Good Faith*

Various rules limit a manager's accountability under the duties of care and loyalty. For example, a manager will not be liable for breach of the duty of care, even if he is negligent, if his conduct is protected by the business judgment rule or a gross negligence standard. In the case of the duty of loyalty, self-interested transactions may be insulated from effective judicial review if they are approved by a director's friends and colleagues on the board. Furthermore, injury to the corporation, or gain to the manager, are normally elements of a breach of those duties. So, for example, even if a manager employs a grossly negligent decision making process, he will not have violated the duty of care if the outcome is no worse than it would have been if he had been careful. Similarly, a director who sells a building that he owns to the corporation at a price that is at the very high end of the range of market prices will not be liable for violating the duty of loyalty.

These limiting rules should be and are inapplicable to conduct that violates the duty of good faith, because of the high degree of wrongfulness that such conduct involves. Conduct that lacks good faith, such as knowingly causing the corporation to violate the law, should not be protected by the business judgment rule or a gross negligence standard, and should not be insulated from effective judicial review by the approval of a director's friends and colleagues. Furthermore, injury to the corporation or gain to the manager should not be an element of a breach of the duty of good faith. For example, a manager who knowingly causes the corporation to break the law violates the duty of good faith even if breaking the law maximizes profits, and a manager who acts on the basis of an improper

⁷⁶*Disney IV*, 2005 Del. Ch. LEXIS 113, at *191 n.487, reprinted in 31 DEL. J. CORP. L. at 431 n.487.

nonpecuniary motive violates the duty of good faith even if his action fortuitously does not injure the corporation.

C. The Duty of Good Faith Characteristically Functions Differently From the Duties of Care and Loyalty

The duty of good faith characteristically functions differently from the duties of care and loyalty. To understand this difference, it is useful to analogize to contracts. Contracts are constructed on the basis of two very different types of provisions—promises and express conditions. A promise is a commitment to perform in a designated manner. An express condition provides that a contracting party does not come under a duty to perform a promise unless and until some designated state of events occurs or fails to occur. Breach of a promise gives rise to liability. Nonfulfillment of a condition does not. Instead, nonfulfillment of a condition by one party relieves the other party of his duty to perform.

The duties of care and loyalty for the most part function as promises do; that is, they characteristically serve as bases of liability. In contrast, although the duty of good faith serves as a platform for certain liability rules, good faith much more commonly serves as a condition to the application of a rule that does not in itself impose liability, such as an indemnification provision or the business judgment rule. Where the duty of good faith serves as a condition, failure to fulfill that duty does not in and of itself lead to liability. For example, a manager who is deprived of the benefit of a shield provision is not liable simply for that reason: he is only liable if he would be liable but for the shield. Just as conditions and promises are treated differently in contract law because they serve different functions, so the duty of good faith should be treated differently from the duties of care and loyalty because for the most part it serves a different function than the latter duties do.

D. The Duty of Good Faith Provides the Courts with a Principled Basis for Articulating New Specific Fiduciary Obligations in Response to Social Changes

The life of the law, including the life of corporate law, is in a constant state of change in response to social changes. 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. Sometimes, social changes indicate that an existing fiduciary obligation should be modified or cut back. An example is the widespread legislative adoption of exculpatory or shield

provisions. Other times, social changes indicate that a new specific fiduciary obligation should be articulated because a type of conduct that was once regarded as proper is no longer so regarded. 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.⁷⁷ An example is the emerging obligation of candor in non-self-interested contexts, which will be discussed in Part VI.

VI. SOME SPECIFIC OBLIGATIONS UNDER THE DUTY OF GOOD FAITH

A. *The Obligation Not to Knowingly Cause the Corporation to Violate the Law*

A well established principle under the duty of good faith is that a manager may not knowingly cause the corporation to violate the law, even when it is rational to believe that the violation would maximize corporate profits and shareholder gain because the cost of the violation, consisting of the legal penalty and damage to reputation discounted by the likelihood of detection and enforcement, is less than the expected profit from the violation. Like other obligations that fall under the duty of good faith, fulfillment of this obligation will often operate as a condition, as illustrated by *Landmark Land*, which held that a deliberate attempt to undermine the regulatory authority of a government agency, although short of an actual violation of law, constituted a lack of good faith that precluded indemnification. However, violation of this obligation also gives rise to liability.

The reason for the obligation not to knowingly cause the corporation to violate the law is as follows: A complex society in which individuals obeyed the law only because they feared prosecution could not thrive. For a complex society to thrive, the bulk of its members must internalize the moral obligation to obey the law. Similarly, given the dominance of

⁷⁷As Summers points out in connection with the duty of good faith in contract law: [The function that good faith doctrines] perform further[s] the most fundamental policy objectives of any legal system—justice, and justice according to law. By invoking good faith, . . . it may be possible for a judge to do justice *and* do it according to law. Without legal resources of this general nature he might, in a particular case, be unable to do justice at all, or he might be able to do it only at the cost of fictionalizing existing legal concepts and rules, thereby snarling up the law for future cases. In begetting snarl, fiction may introduce inequity, unclarity or unpredictability. In addition, fiction can divert analytical focus Summers, *supra* note 55, at 198-99.

organizations in complex societies, such a society could not thrive if individuals believed themselves free of a moral obligation to obey the law when they acted in an organizational rather than personal capacity.

Therefore, there is a strong social interest in prohibiting managers from knowingly causing the corporation to disobey the law in search of profits. This objective cannot be achieved solely by criminal and regulatory actions against the corporation. Corporate violations of law will often go undetected or unprosecuted simply because government resources are very limited. Furthermore, the principle that corporations must obey the law is most likely to be internalized by the corporation and its managers if the principle is part of corporation law itself. Moreover, because the corporation is the primary wrongdoer, the probability that a manager who knowingly causes the corporation to violate the law will be made subject to criminal or regulatory sanctions for the corporation's act is very low. Thus, an additional sanction is required as a disincentive to managers to engage in such conduct.

Accordingly, a corporation is obliged to obey the law, not only as a matter of criminal and regulatory law, but as a matter of corporate law. This obligation is reflected in section 2.01 of the ALI's *Principles of Corporate Governance*. Section 2.01(a) of the *Principles* provides that, with certain exceptions, "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."⁷⁸ Under section 2.01(b)(1), however, "[e]ven if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . [is] obliged, to the same extent as a natural person, to act within the boundaries set by law."⁷⁹

I will call the principle embodied in section 2.01(a) the *profit-maximization principle* and the principle embodied in section 2.01(b)(1) the *legal-conduct principle*. The legal-conduct principle is exemplified in Illustration 7 to section 2.01(b)(1):

F Corporation is a publicly held corporation with annual earnings in the range of \$3-5 million. F hopes to be awarded a supply contract by P, a large publicly held corporation. The anticipated profits on the contract are \$5 million over a two-year period. A vice-president of P has approached Brown, the relevant corporate decisionmaker of F, with the suggestion that if F pays the vice-president \$20,000, F will be awarded the contract. Brown knows such

⁷⁸ALI, *PRINCIPLES OF CORPORATE GOVERNANCE*, *supra* note 14, § 2.01(a).

⁷⁹*Id.* § 2.01(b)(1).

a payment would be illegal, but correctly regards the risk of detection as extremely small. After carefully weighing that risk and the consequences of detection, Brown causes F to pay the \$20,000. F's action involves a departure from the principle stated in § 2.01(b)(1).⁸⁰

Assume that the payment demanded by the vice-president of P, plus the present value of a fine and all other financial and reputational costs that might flow from the illegal payment, discounted by the likelihood of detection and enforcement, is less than the present value of the supply contract. On a profit-maximization analysis, A should pay the bribe. Under the legal-conduct principle, however, the bribe should not be paid. Instead, A should cause F to obey the legal rule that prohibits bribery. Cost-benefit analysis may very well factor into an authoritative determination whether a given type of conduct should be deemed legally wrongful. Once that determination has been made, however, the resulting legal rule normally represents a community decision that such conduct is wrongful. Violations of the rule cannot then be morally or socially justified on the ground that in a particular case the violator's financial gains would outweigh its financial losses or even social financial losses (except in those relatively rare cases where either the sanction under the relevant legal rule is properly regarded as a price, such as the fine for parking overtime at a meter, or where the norm of obedience to law is conventionally deemed inapplicable or counterbalanced by another norm, such as necessity). So, for example, Milton Friedman, in a well-known essay, denied that corporations have any social responsibility other than to increase profits, but also made clear that the pursuit of profits had to be conducted while conforming to the basic rules of society, including legal rules.⁸¹

Indeed, the legal-conduct principle is consistent with the profit-maximization principle. The profit-maximization principle states what the

⁸⁰*Id.* § 2.01(b)(1), illus. 7. Here is another illustration:

8. G Corporation owns and operates 15 plants that were traditionally non-union. For the last several years, Union U has been attempting to organize G's workers, and has won elections at three of G's plants. Although G does not have a good faith belief that the elections were invalid, it adopts a strategy of refusing to bargain at these three plants and harassing members, adherents, and supporters of U at G's other 12 plants. The relevant corporate decisionmaker knows that the conduct violates the National Labor Relations Act, but believes that a long time will elapse before sanctions are imposed, and that the profit from this conduct will far exceed the cost of possible sanctions. G's action involves a departure from the principle stated in § 2.01(b)(1).

⁸¹Milton Friedman, *The Social Responsibility of Business Is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 33.

objective of the corporation should be. The legal-conduct principle does not modify that objective, but rather lays down the channels within which that objective may properly be realized. An analogy may be drawn to the rules of a game. An objective of playing a game is to win. Obeying the rules of a game is consistent with that objective, even when breaking the rules would make winning more likely. If a player asserted that she was justified in breaking the rules of a game because doing so maximized her chances of winning, we would say that she does not understand what it means to play a game. As with the rules of a game, so with the rules of law. A corporate actor who said that profit-maximization justifies causing the corporation to break the law would not understand what law means and would not understand what profit-maximization means.

Section 2.01 of the *Principles of Corporate Governance* concerns the objectives of the corporation rather than the duties and liabilities of corporate managers. However, the principle reflected in that section also applies to corporate managers, for the same reasons. Accordingly, section 4.01(a) of the *Principles* states that "[a] director or officer has a duty to the corporation to perform the director's or officer's functions in good faith," and the comment to this section makes clear that a manager who knowingly causes the corporation to violate the law is in breach of the duty of good faith: "The duty of a director or officer to 'perform the director's or officer's functions in good faith' includes the obligation to act consistently with § 2.01."⁸² The comment continues: "[A] director or officer violates the duty to perform his or her functions in good faith if he or she knowingly causes the corporation to disobey the law."⁸³ Similarly, the comment to Model Business Corporation Act § 8.31 states: "Conduct involving knowingly illegal conduct that exposes the corporation to harm will constitute action not in good faith, and belief that decisions made (in connection with such conduct) were in the best interests of the corporation will be subject to challenge as well."⁸⁴

The rule embodied in the comments to the *Principles of Corporate Governance* and the Model Business Corporation Act is well supported by case law. For example, in *Roth v. Robertson*,⁸⁵ the managing director of a corporation that owned an amusement park caused the corporation to pay off persons who had threatened to complain to authorities that the park was unlawfully operating on Sundays. Undoubtedly, the director made these payments to maximize corporate profits. Moreover, the director could have

⁸²ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 4.01(a).

⁸³*Id.* § 4.01(a) cmt.

⁸⁴MODEL BUS. CORP. ACT § 8.31(a) cmt. a (2005).

⁸⁵118 N.Y.S. 351 (N.Y. Sup. Ct. 1909).

rationally believed that the expected corporate profits from operating the amusement park on Sundays would exceed the possible cost of punishment to the corporation, discounted by the likelihood of detection and enforcement. Nevertheless, the court held that the director was liable to the corporation for the amount of the payoffs:

For reasons of public policy, we are clearly of the opinion that payments of corporate funds for such purposes as those disclosed in this case must be condemned, and officers of a corporation making them held to a strict accountability, and be compelled to refund the amounts so wasted for the benefit of stockholders To hold any other rule would be establishing a dangerous precedent, tacitly countenancing the wasting of corporate funds for purposes of corrupting public morals.⁸⁶

In *Abrams v. Allen*,⁸⁷ plaintiffs brought a derivative action against the directors of Remington Rand, alleging that the directors had illegally closed and relocated corporate plants and curtailed production in order to intimidate and punish employees for their involvement in a labor dispute, in violation of the New York Labor Law and the National Labor Relations Act.⁸⁸ Undoubtedly, the directors engaged in this conduct to maximize corporate profits. Moreover, the directors could have rationally believed that the expected corporate profits from fighting unionization would exceed the possible cost of punishment to the corporation, discounted by the likelihood of detection and enforcement. Nevertheless, the court held that proof of the plaintiff's allegation could sustain recovery against the directors.⁸⁹

In *Miller v. American Telegraph & Telephone Co.*,⁹⁰ AT&T had failed to collect an outstanding debt of \$1.5 million owed by the Democratic National Committee for communications services that AT&T had provided during the 1968 Democratic National Convention. Plaintiffs brought a derivative action against AT&T's directors, on the ground that the failure to collect the debt was a corporate contribution to the Democratic Party, in violation of the Federal Election Campaign Act of 1971.⁹¹

⁸⁶*Id.* at 353.

⁸⁷74 N.E.2d 305 (N.Y. 1947).

⁸⁸*Id.* at 306-07.

⁸⁹*Id.* at 306.

⁹⁰507 F.2d 759 (3d Cir. 1974).

⁹¹*Id.* at 761.

Undoubtedly, the board took this action to maximize corporate profits. Moreover, the board could have rationally believed that the expected corporate profits from making a contribution to the Democratic Party would exceed the possible cost of punishment, discounted by the likelihood of detection and enforcement. Nevertheless, the court held that on the facts stated in the complaint the directors would be liable:

Had plaintiffs' complaint alleged only failure to pursue a corporate claim, application of the sound business judgment rule would support the district court's ruling that a shareholder could not attack the directors' decision. . . . Where, however, the decision not to collect a debt owed the corporation is itself alleged to have been an illegal act, different rules apply. When New York law regarding such acts by directors is considered in conjunction with the underlying purposes of the particular statute involved here, we are convinced that the business judgment rule cannot insulate the defendant directors from liability if they did in fact breach [the Federal Election Campaign Act], as plaintiffs have charged.⁹²

Similarly, in *Metro Communications Corp. BVI v. Advanced Mobilecomm Technologies Inc.*,⁹³ the Delaware Court of Chancery held that "[u]nder Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity."⁹⁴ In *Guttman v. Jen-Hsuan Huang*,⁹⁵ another Delaware Court of Chancery case, the court also held that causing the corporation to violate the law violates a manager's fiduciary duty.⁹⁶

⁹²*Id.* at 762.

⁹³854 A.2d 121 (Del. Ch. 2004).

⁹⁴*Id.* at 131.

⁹⁵823 A.2d 492 (Del. Ch. 2003).

⁹⁶*See also*, e.g., *Wilshire Oil Co. v. Riffe*, 409 F.2d 1277, 1283-86 (10th Cir. 1969) (holding that suit could be brought by corporation against employees whose antitrust violations subjected the corporation to civil and criminal liability); *H.R. Plate v. Sun-Diamond Growers*, 275 Cal. Rptr. 667, 672 (Cal. Ct. App. 1990) ("For example, corporate executives who participate in a deliberate price-fixing conspiracy with competing firms could not be found to have acted in good faith, even though they may have reasonably believed that a deliberate flouting of the antitrust laws would increase the profits of the corporation.") (quoting *HAROLD MARSH, JR. ET AL., CALIFORNIA CORPORATION LAW* § 9.42 (2d ed. 1981)); *Di Tomasso v. Loverro*, 293 N.Y.S. 912, 916-17 (N.Y. App. Div. 1937), *aff'd mem.*, 276 N.Y. 551 (N.Y. 1937) (holding that it was proper to grant injunction and impose liability on directors for damages, in derivative action, where they knew, or should have known, the contract was in restraint of trade); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 129-30 (1979) ("Bad faith may preclude the application of the business judgment defense where directors knowingly violate a

A manager who knowingly causes the corporation to violate the law is liable to the corporation for any losses, such as fines, that the corporation incurs as a result of the legal violation. Furthermore, the amount of the manager's liability should not be offset by profits that the corporation made as a result of the violation, because such an offset would be contrary to the purpose of imposing liability. This position is embodied in section 7.18(c) of the *Principles of Corporate Governance*, which provides that a manager's liability arising out of a wrongful transaction may not be offset by gains to the corporation that arose out of the same transaction if the offset would be contrary to public policy. This rule is exemplified as follows:

A derivative action is brought to require a corporate official of XYZ Corporation to account to the corporation for \$200,000 in legally questionable overseas political contributions. The defendant admits the payments, but seeks to defend on the basis that in prior years other such payments had produced profitable contracts. . . . Even if the offsets arise out of the same transaction, the court should decline to permit offsets that it determines are contrary to an established public policy.⁹⁷

statute or comparable expression of public policy, even if such a violation is undertaken in the corporation's best interests.").

⁹⁷ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 7.18 illus. 4. Several New York cases decided between 1941 and 1963 held that a derivative action based on directors' illegal conduct would be dismissed even if the plaintiff alleged that the corporation had to pay criminal fines, unless the plaintiff also alleged that the corporation suffered a net loss. *See Smiles v. Elfred*, N.Y.L.J., Feb. 20, 1963, at 14, col. 6 (Sup. Ct.); *Borden v. Cohen*, 231 N.Y.S.2d 902 (N.Y. 1962); *Spinella v. Heights Ice Corp.*, 62 N.Y.S.2d 263 (N.Y. 1946); *cf. Diamond v. Davis*, 31 N.Y.S.2d 582 (N.Y. App. Div. 1941). These cases were incorrectly decided, for the reasons given in the text. In any event, New York law is not completely clear on this issue. In *Premseelaar v. Chenery*, No. 6151, N.Y. Sup. Ct., N.Y. County, Feb. 13, 1963, the court held a complaint sufficient despite the absence of allegations that the corporation had suffered a net loss. Plaintiff alleged that the defendant had caused Airco to engage in conduct that violated an antitrust decree, and that as a result Airco suffered damages consisting of a \$60,000 fine, expenses of litigation, potential triple-damage liability, loss of goodwill, and loss of time of corporate executives. The court said that "[t]he contention that the complaint fails to allege damages sufficient to sustain the causes of action is without merit." (The opinion in *Premseelaar* was apparently unpublished, and seems to be no longer available. I take the facts from descriptions of the case in several contemporaneous law review articles and notes. *See Wesley E. Forte, Liabilities of Corporate Officers for Violations of Fiduciary Duties Concerning the Antitrust Laws*, 40 IND. L.J. 313, 334-35, 338-39 (1965); Joel B. Harris, *Derivative Actions Based upon Alleged Antitrust Violations: Trap for the Unwary*, 37 BROOK. L. REV. 337, 350 (1971); *Recent Developments—Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions*, 64 COLUM. L. REV. 174, 177 (1964).) *Knopfler v. Bohen*, 225 N.Y.S.2d 609 (App. Div. 1962), seems to take the same position as *Premseelaar*.

A manager's obligation not to knowingly cause the corporation to violate the law has traditionally and properly been founded on the duty of good faith.⁹⁸ A corporate manager who knowingly causes the corporation to violate the law lacks honesty, because he knows that he is acting improperly and is violating generally accepted standards of decency applicable to the conduct of business. In addition, such a manager lacks fidelity to his office, because the organization in which his office is embedded is obliged to act within the boundaries set by the law and can reasonably expect its managers to act accordingly. In contrast, the obligation not to knowingly cause the corporation to violate the law cannot be founded on the duties of care and loyalty. A manager who knowingly causes the corporation to violate the law will seldom violate the duty of loyalty, because typically the manager does not engage in self-interested conduct, and will seldom violate the duty of care, because typically the manager rationally believes that the illegal conduct will serve the end of profit maximization.

To maintain his dyadic view, Vice Chancellor Strine asserted in *Guttman v. Jen-Hsun Huang*⁹⁹ that the obligation not to knowingly cause the corporation to violate the law was justified by, and fell within, the duty to act loyally. "[O]ne cannot," he said, "act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey." This argument, however, conflicts with both conventional legal usage and clear analysis. Why, and to whom, is a director or officer being disloyal if he causes the corporation to take an action that violates the law, when he is not self-interested in the action and the action is rationally calculated to increase corporate profit and shareholder gain? Trying to squeeze such conduct into the duty of loyalty is like trying to squeeze the foot of Cinderella's stepsister into Cinderella's glass slipper—an enterprise equally painful and fruitless.

B. *The Obligation of Candor*

Another set of obligations that are based on the duty of good faith consist of obligations of candor in various contexts not involving self-interest.¹⁰⁰ (I use the term *candor* in its broadest sense to mean the "state or quality of being frank, open, and sincere in speech or expression."¹⁰¹) For present purposes, the obligation of candor has two aspects. First,

⁹⁸See *supra* Part VI.A.

⁹⁹823 A.2d 492, 506 n.34 (Del. Ch. 2003).

¹⁰⁰See Sale, *supra* note 1, at 487-88.

¹⁰¹RANDOM HOUSE UNABRIDGED DICTIONARY, *supra* note 40, at 305.

managers have an obligation not to make intentionally or recklessly false or misleading statements in their managerial capacity. I will refer to this aspect of candor as the *obligation not to mislead*. Second, managers have an obligation not to intentionally or recklessly fail to inform other managers or corporate organs (including the body of shareholders) of information that is known by the manager to be material to those managers or corporate organs in making decisions or discharging their duties. I will refer to this aspect of candor as the *obligation to duly inform*. Although the obligations not to mislead and to duly inform shade into each other, they differ in an important way. The obligation not to mislead only addresses the issue of how a manager should act *if* he makes a statement. In contrast, the obligation to duly inform imposes a positive duty on managers to make certain statements. A manager's obligation of candor is not limited to ensuring that what he chooses to say is true. Rather, in appropriate cases a manager must step forward and say what ought to be said.

The obligation of candor even where self-interest is not involved will be discussed in three contexts: communication between the board and the shareholders, communication among members of the board, and communication by officers to the board and to other officers.

1. The Board's Obligation of Candor

a. *The Obligation Not to Mislead*

It has long been the law that when directors request shareholder action they may not knowingly make misleading statements concerning the action.¹⁰² Suppose, however, that the directors knowingly make misleading statements to the shareholders without requesting shareholder action.

If the corporation is subject to reporting requirements under the Securities Exchange Act, and the statements are made by directors in an

¹⁰²See, e.g., *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998) ("This Court has held that a board of directors is under a fiduciary duty to disclose material information when seeking shareholder action."); *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 137 (Del. 1997) ("Delaware law of the fiduciary duties of directors . . . establishes a general duty . . . to disclose to stockholders all material information reasonably available when seeking stockholder action."); *Arnold v. Soc'y for Sav. Bancorp., Inc.*, 650 A.2d 1270, 1277 (Del. 1994) (holding that a fiduciary disclosure "obligation attaches to proxy statements and any other disclosures in contemplation of shareholder action"); *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992) (stating that "directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action"). See also, e.g., *Alessi v. Beracha*, 849 A.2d 939 (Del. Ch. 2004) (sustaining a complaint of a shareholder who sold her shares in a buy-sell program for small shareholders and later brought a breach-of-fiduciary duty action against the directors for failing to disclose negotiations to sell the corporation).

SEC filing, the directors will have violated federal law.¹⁰³ Even if those conditions are not satisfied, a knowingly misleading statement may give rise to liability under Rule 10b-5, which makes it unlawful to make any untrue statement of a material fact, or to omit a material fact necessary to make statements not misleading, in connection with the purchase or sale of securities.¹⁰⁴ But Rule 10b-5 is hedged in a variety of ways, one of which is that only a purchaser or a seller may bring a private action under that Rule. The issue therefore arises whether shareholders who are not purchasers or sellers can bring suit under corporation law against directors who have knowingly made misleading statements to the shareholders, on the ground that the directors have thereby violated their fiduciary duty.

That issue was addressed in *Malone v. Brincat*,¹⁰⁵ decided by the Delaware Supreme Court in 1999. Mercury Finance was a publicly traded corporation. Plaintiffs, who had been Mercury shareholders since 1993, brought a class action against Mercury's directors on the ground that the directors had knowingly disseminated false information by overstating Mercury's earnings, financial performance, and shareholders' equity. For example, according to the complaint, in 1995, Mercury reported earnings of \$99 million, when in fact earnings were only \$78 million. In 1996, Mercury reported earnings of \$121 million, when in fact earnings were only \$57 million.¹⁰⁶ At year-end 1996, Mercury reported that shareholders' equity was \$353 million, when in fact it was not more than \$263 million. All of this inaccurate information was included in communications that Mercury's directors made to the shareholders.¹⁰⁷

The directors moved to dismiss the complaint, arguing that under the circumstances alleged, they had not violated Delaware corporate law. Applying chancery court precedent, the Vice Chancellor granted the motion and dismissed the complaint with prejudice, on the ground that directors had no duty of candor under Delaware law except when they were requesting shareholder action. The Delaware Supreme Court, however, held that directors do have a duty to communicate honestly with shareholders even outside the context of a request for shareholder action:

The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That tripartite fiduciary

¹⁰³See 15 U.S.C. § 77x (2005).

¹⁰⁴*Id.* § 240.10b-5.

¹⁰⁵722 A.2d 5 (Del. 1998).

¹⁰⁶All figures are rounded off.

¹⁰⁷*Malone v. Brincat*, 722 A.2d 5 (Del. 1998).

duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided. . . .

. . . . Whenever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows *a fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors' fiduciary duty to shareholders is honesty.

The issue in this case is not whether Mercury's directors breached their duty of disclosure. It is whether they breached their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information about the financial condition of the company. The directors' fiduciary duties include the duty to deal with their stockholders honestly.¹⁰⁸

Although the court in *Malone v. Brincat* referred to both loyalty and good faith—and earlier in its opinion referred to care—the board's obligation not to mislead shareholders through communications that do not involve a request for shareholder action is best explained by the duty of good faith. The duty of loyalty is not a satisfactory basis for the obligation because the board may violate the obligation not to mislead even if it is not self-interested. The duty of care is not a satisfactory basis for the obligation because under given circumstances the board may make a rational decision that lack of candor is profit-maximizing and best protects the wealth of existing shareholders. In contrast, the duty of good faith does provide a basis for the obligation. First, a board that knowingly makes false statements to the shareholders acts dishonestly. Second, in knowingly making false statements to the shareholders, directors lack fidelity to their office because shareholders have a reasonable expectation of truthful communication by the board.

This leaves the issue of remedy. In some cases, a board's misleading statements may cause injury to the corporation—for example, as the result of repercussions when the truth comes out. This would be especially true

¹⁰⁸*Id.* at 10 (footnotes omitted).

if the corporation transacts business in markets, such as credit markets, in which reputation is especially important. In *Malone v. Brincat*, the plaintiffs alleged that as a result of the board's misleading statements the corporation had lost \$2 billion, comprising most or all of its value. The Delaware Supreme Court pointed out that such a loss would constitute an injury to the corporation. Therefore, a suit based on the loss would have to be brought as a derivative action, preceded by a demand on the board, and the plaintiffs had neither made a pre-suit demand nor shown why a demand should be excused. Accordingly, the court agreed that the complaint should be dismissed. However, the court held that the plaintiffs should be permitted to replead a derivative claim, together with a request for any damage or equitable remedy sought on behalf of the corporation. The court also held that the plaintiffs should have the opportunity to assert any individual cause of action and to articulate a remedy that was appropriate on behalf of either the named plaintiffs individually or a properly recognizable class. In this connection, the court referred to the possible remedies of injunctive relief, judicial removal of directors, or the disqualification of directors.¹⁰⁹ This range of remedies dramatically illustrates that violation of the duty of good faith can have significant consequences apart from the possibility of liability for damages.

b. *The Obligation to Duly Inform*

There is evidence of a recurring lack of candor by managers to investors. In particular, recent research strongly suggests that managers systematically withhold bad news from investors.¹¹⁰ If a corporation's securities are registered under section 12 of the Securities Exchange Act, the corporation is required to make extensive periodic disclosure, and the Proxy Rules require the corporation to provide the shareholders with extensive information concerning major transactions that require shareholder approval.¹¹¹ However, the periodic-disclosure rules often will not require prompt disclosure of various kinds of bad news. Furthermore, the overwhelming bulk of corporations, including many publicly held corporations, are not registered under section 12 and not subject to the

¹⁰⁹The court stated that it was expressing no opinion whether these remedies could be asserted in *Malone* itself, because that relief had not been sought in the complaint. At least prior to *Malone v. Brincat*, the issue whether courts have the equitable power to remove directors in the absence of statutory authority was unclear and in conflict.

¹¹⁰See S.P. Kothari et al., *Do Managers Withhold Bad News?* (MIT School of Management Working Paper No. 4556-05, 2005), available at <http://ssrn.com/abstract=803865> (last visited Feb. 20, 2006).

¹¹¹15 U.S.C. § 78f; 240 C.F.R. § 14a-3 (2005).

Proxy Rules. Additionally, few, if any, state statutes require boards to provide investors with either material information, in general, or information concerning major transactions requiring shareholder approval, in particular.

The Delaware courts, at least, have filled part of the gap by making clear that the board has an obligation to duly inform the shareholders when the board requests a shareholder vote in such cases. Then Vice Chancellor (now Delaware Supreme Court Justice) Jacobs addressed this issue in *Turner v. Bernstein*,¹¹² which involved an arm's-length merger of unaffiliated corporations in which the shareholders of one corporation were provided with virtually no information. Drawing on a large number of decisions, Vice Chancellor Jacobs stated:

The fiduciary duty of disclosure flows from the broader fiduciary duties of care and loyalty. That disclosure duty is triggered (*inter alia*) where directors . . . present to stockholders for their consideration a transaction that requires them to cast a vote and/or make an investment decision, such as whether or not to accept a merger or demand appraisal. Stockholders confronted with that choice are entitled to disclosure of the available material facts needed to make such an informed decision. Specifically in the merger context, the directors of a constituent corporation whose shareholders are to vote on a proposed merger, have a fiduciary duty to disclose to the shareholders the available material facts that would enable them to make an informed decision, pre-merger, whether to accept the merger consideration or demand appraisal.¹¹³

In a later decision in the case,¹¹⁴ Vice Chancellor Strine said, "In his earlier opinion . . . , Vice Chancellor Jacobs succinctly stated the pertinent principles of law relevant to whether the defendant directors breached their fiduciary duties by providing the GenDerm stockholders with deficient disclosures."¹¹⁵ Vice Chancellor Strine added:

¹¹²No. 16,190, 1999 Del. Ch. LEXIS 18 (Del. Ch. Feb. 9, 1999), *reprinted in* 24 DEL. J. CORP. L. 1276 (1999).

¹¹³*Id.* at *19-20, *reprinted in* 24 DEL. J. CORP. L. at 1290 (footnotes omitted, emphasis added).

¹¹⁴*Turner v. Bernstein*, 776 A.2d 530 (Del. Ch. 2000).

¹¹⁵*Id.* at 541.

In *Skeen v. Jo-Ann Stores, Inc.*, the Supreme Court recently confirmed Vice Chancellor Jacobs's view of the applicable standard, stating:

In this appeal we consider the adequacy of corporate disclosures to minority stockholders who were "cashed out" in a merger approved by the majority stockholder. The minority stockholders complain that they were not given enough financial information to decide whether to accept the merger consideration or seek appraisal. They say, in essence, that the settled law governing disclosure requirements for mergers does not apply, and that far more valuation data must be disclosed where, as here, the merger decision has been made and the only decision for the minority is whether so seek appraisal. *We hold that there is no different standard for appraisal decisions. Directors must disclose all material facts within their control that a reasonable stockholder would consider important in deciding how to respond to the pending transaction.*¹¹⁶

Although Vice Chancellor Jacobs rested the board's obligation to duly inform in such cases on the duties of care and loyalty, those duties do not adequately explain that obligation, at least as they are traditionally understood. The duty of loyalty does not explain the obligation to duly inform, because that obligation applies even if the directors are not self-interested in the proposed transaction. The duty of care does not explain the obligation, because a failure to duly inform the shareholders does not necessarily run counter to the idea of profit-maximization. (It is true that when an obligation exists, a failure to duly perform the obligation may be a breach of the duty of care, but the existence of an obligation must precede

¹¹⁶*Id.* at 542 (emphasis added by Vice Chancellor Strine) (citing *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170 (Del. 2000)). *See also, e.g.*, *Frank v. Arnelle*, 725 A.2d 441 (Del. 1999) (noting the obligation of directors to disclose material information to stockholders regarding a decision to sell). Although the Delaware cases concerning transactional disclosure to the shareholders are sometimes framed in terms of the exercise of appraisal rights, for present purposes there is no reason in principle to distinguish between the exercise of appraisal rights and voting rights, and in *Turner*, Vice Chancellor Jacobs explicitly stated that disclosure was required in connection with both voting and appraisal rights.

the duty to perform it carefully.) The duty of good faith, on the other hand, does explain the board's obligation to duly inform, because fidelity to office requires the board to satisfy the shareholders' reasonable expectations that the board will provide them with information that is known by the board to be material to a decision that the board requests the shareholders to make.

Of course, not every failure to duly inform violates the duty of good faith, just as not every noncompliance with law violates the duty of good faith.¹¹⁷ A failure to inform, like noncompliance with law, will violate the duty of good faith only if it is intentional or reckless.¹¹⁸

2. Communication among Directors

Another context in which candor is required concerns communication by an individual director to the whole board. In this section, I will take it as a premise that individual directors, when communicating to the board, have an obligation not to mislead, and will focus instead on an individual director's obligation to duly inform.

In the case of individual directors, the rule that should—and almost certainly would—be applied is that a director must duly inform the board of all material facts that he knows are relevant to the board's decision-making and monitoring responsibilities, even when he is not self-interested. This rule has now been explicitly embodied in section 8.31(c) of the Model Business Corporation Act: "In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions"

Again, the obligation to duly inform in this context is not explained by the duty of loyalty, because a director who withholds information may

¹¹⁷*See, e.g.,* *Arnold v. Soc'y for Sav. Bancorp., Inc.*, 650 A.2d 1270, 1288 (Del. 1994) (directors did not lose protection of a shield provision on the ground of faulty disclosure where the single disclosure violation "was consistent only with a good faith omission").

¹¹⁸*See* *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061-62 (Del. 1996) ("The record reveals that any misstatements or omissions that occurred were made in good faith. . . . A good faith erroneous judgment as to the proper scope or content of required disclosure implicates the duty of care rather than the duty of loyalty."); *Johnson v. Wagner*, No. 17,651, 2003 Del. Ch. LEXIS 45, at *34 (Del. Ch. Apr. 10, 2003), *reprinted in* 28 DEL. J. CORP. L. 1109, 1125 (2003) ("If [Wagner had knowledge of the buyout proposal] and intentionally or recklessly failed to disclose such information Wagner would have breached his fiduciary duties."); *Johnson v. Shapiro*, No. 17,651, 2002 Del. Ch. LEXIS 122, at *30-31 (Del. Ch. Oct. 18, 2002), *reprinted in* 28 DEL. J. CORP. L. 361, 374 (2003) ("If Wagner intentionally failed to disclose, or was reckless in his failure not to disclose, material information known on or before September 28, 1999 about the buyout proposal to Garden Ridge stockholders, then § 102(b)(7) does not save him as a matter of law.").

not act for reasons of self-interest. It is also not explained by the duty of care, because a director may withhold information in the reasonable belief that if he provides the information it might lead the board to make a decision that is not profit-maximizing. In contrast, the obligation to duly inform in this context *is* explained by the duty of good faith, because it springs from the requirement of fidelity to the director's office. The board is a collegial body, and the office of director entails an obligation to promote the board's decision making and monitoring functions by duly informing the director's colleagues of facts that the director knows are relevant to the discharge of those functions.

3. Communication by Officers

A particularly important aspect of the obligation of candor concerns communication by officers. One context in which officers have an obligation of candor involves the provision, by officers to the board, of information that bears on a proposed corporate action. When board approval is needed for a corporate action, the nonmanagement directors will be almost wholly dependent on the corporation's officers for the information on which their decision should be based. The officers, however, may spin the information they provide, to push the board toward a decision that the officers believe to be best for the corporation.

Essentially, this is a special case of the more general problem presented by asymmetric information within a hierarchal organization. The problem is well described by Milgrom and Roberts:

We take it as given that some of the information that is important for the organization to make good decisions is not directly available to those charged with making the decisions. Instead, it is lodged with or producible only by other individuals or groups that are not empowered to make the decisions but may have a direct interest in the resulting outcomes. . . .

In such situations, the members of the organization may have an incentive to try to manipulate the information they develop and provide in order to influence decisions to their benefits. Such manipulation can take many forms, . . . [including] presenting the information in a way that accentuates the points supporting the interested party's preferred decision and then insisting on these points at every

opportunity.¹¹⁹

The concern here is not necessarily, nor even usually, that officers will exploit informational asymmetry to benefit themselves by lining their own pockets in self-dealing transactions. Rather, the concern is that officers will attempt to herd the board toward action that the officers believe is in the corporation's best interests. As Milgrom and Roberts point out, "The directors of a firm may have the final say on whether a new plant will be built, but only the division whose products will be made in the plant can generate important parts of the relevant information on the likely profitability of the new facility."¹²⁰

An officer who provides some information while knowingly holding back other information, or who spins information, violates the obligation not to mislead. An officer also has an obligation to duly inform. Officers are a special class of agents, and the rule has long been established in agency law that agents have a duty to duly inform their principals. *Restatement (Second) of Agency* § 381 provides that an agent must "give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have."¹²¹ Similarly, *Restatement (Third) of Agency* § 8.11 provides that "[a]n agent has a duty to use reasonable effort to provide the principal with facts that the agent know[s] . . . when . . . the agent knows or has reason to know that the principal would wish to have the facts."¹²² The corporate law counterpart of this rule has now been explicitly adopted in section 8.42(b)(1) of the Model Business Corporation Act:

(b) The duty of an officer includes the obligation:

(1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the

¹¹⁹Paul Milgrom & John Roberts, *An Economic Approach to Influence Activities in Organizations*, 94 AM. J. SOC. S154, S156-57 (Supp. 1988) (footnote omitted).

¹²⁰*Id.* at S156.

¹²¹RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

¹²²RESTATEMENT (THIRD) OF AGENCY § 8.11 (Tent. Draft No. 6, 2005). *Restatement Third* was approved at the ALI's 2005 annual meeting, but has not yet been published.

For a leading analysis of the duty of candor in corporate law, see Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187 (2003).

scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee

This rule should—and undoubtedly would—be applied to corporate officers even by courts in non-Model Act jurisdictions. Indeed, one explanation of the result in *Smith v. Van Gorkom*¹²³—or more accurately, one explanation of the imposition of liability on Van Gorkom, the CEO of Trans Union, the corporation in that case—is that Van Gorkom violated his obligation of candor by withholding important information from the board in connection with a cash-out merger. For example, Van Gorkom did not disclose to the board the shaky methodology by which he had arrived at a price of \$55 per share for the corporation or the fact that Trans Union's CFO had concluded that in a leveraged buyout the price range for Trans Union's stock would be \$55-\$65 per share.

There are other important contexts, besides board decision making, in which officers owe an obligation to duly inform—for example, providing the board with material information that is relevant to the board's duty to monitor. A related context, emphasized by Donald Langevoort, concerns providing the board with material information about important risk factors in the corporation's business:

Extraordinary forms of risk-taking are, by black-letter corporate law doctrine, for the board in any event. But even to carry out its monitoring function, the board must gain a fair sense of the aggregate level of risk assumed by the firm. Especially in today's business environment, where sophisticated tools for both hedging and assuming risk abound, there is a temptation to assume greater risk in order to satisfy perceived pressures—whether from the marketplace or the board itself—to generate high returns. Thus it is risk-related information that is the underdeveloped substance of the duty of candor we are describing. When risk is hidden, CEOs can play out "last period" strategies—taking more aggressive steps as the company's performance lags (or more likely, as the CEO fears that it is about to lag) because he or she fears that termination is a real possibility once that subpar performance becomes clear to the board. Risk-related information is also important to the board because it allows

¹²³488 A.2d 858 (Del. 1985).

board members to second-guess the CEO's risk perceptions, which are likely to be colored by an optimistic bias.¹²⁴

An officer's obligation to duly inform the board of material information that he knows or has reason to know the board would desire to have is paralleled by an obligation to duly inform his superiors of such information. An officer also has an obligation to duly inform appropriate superior officers or corporate organs of material violations of law or breaches of duty by other officers, or by employees or agents of the corporation, which the officer believes have occurred or are likely to occur. The obligation to duly inform in this context is explicitly imposed by the Model Business Corporation Act:

(b) The duty of an officer includes the obligation

....

(2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, or any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes had occurred or is likely to occur.¹²⁵

In agency law, the agent's obligation of candor is not categorized as part of either the agent's duty of care or duty of loyalty.¹²⁶ Neither can it be so characterized in corporate law. An officer's obligation of candor is not based on the duty of loyalty, because an officer typically will have no pecuniary self-interest in providing or withholding information. The duty of care also does not provide a basis for this obligation, because an officer who violates this obligation typically does so because he reasonably believes that doing so is in the corporation's best interest. For example, in the Milgrom & Roberts new-plant hypothetical, the officers may reasonably believe that building the new plant is the best decision, but that if all the material information was given to the board, the board might erroneously

¹²⁴Langevoort, *supra* note 122, at 1201 (footnotes omitted).

¹²⁵MODEL BUS. CORP. ACT § 8.42(b)(2) (2004).

¹²⁶See RESTATEMENT (SECOND) OF AGENCY § 378 (2005); RESTATEMENT (THIRD) OF AGENCY § 8.12 (2005).

decide not to build the plant. Similarly, in the case of risk elements, an officer might withhold information from the board because he reasonably believes that the board is unduly risk-averse. In the case of a failure to report violations of law and breaches of duty, an officer might withhold information because he reasonably believes that the wrongdoer was motivated by his perception of the corporation's best interests and did not harm the corporation, and that disciplining the wrongdoer would itself harm the corporation.

The duty of good faith does explain an officer's obligation of candor.¹²⁷ An officer who makes misleading or skewed statements is insincere, dishonest, and lacks fidelity to his office. The board is entitled to have all material information that is relevant to its monitoring obligation and to any decisions that the board is either required or chooses to make. The role of officers in such cases is to present the material facts and to present them fairly, not to spin the facts with the objective of leading the board in a certain direction that the officers believe is in the corporation's best interest. The officers may properly seek to achieve that objective only by reasoned persuasion. The board has the right to make decisions that the officers believe are wrong. This is also true of an officer's superiors.

An officer who fails to duly inform also violates the duty of good faith. Generally accepted basic corporate norms require officers to duly inform others within the corporation of information that is known to be material to the discharge of the others' duties and responsibilities. Fidelity to office requires an officer to be forthcoming with facts that come to his knowledge and that his office obliges him to pass on. Failure to duly inform may also be viewed as a lack of sincerity, because an actor who is charged with a duty to speak, and does not do so, acts insincerely.

Again, this leaves the issue of remedy. If the board is led to make a bad decision by an officer's breach of the obligation of candor, in principle the officer could be made liable for any losses resulting from the decision. In practice, however, causation in such cases would often, perhaps invariably, be difficult to prove. Alternative remedies are suggested by the comment to section 8.42 of the Model Business Corporation Act, which

¹²⁷Cf. Langevoort, *supra* note 122, at 1203:

[W]hat is the categorical basis for the duty of candor? Clearly, it is not part of the duty of care, which deals with negligent or unintentional misconduct. Nor is it really the duty of loyalty. . . . The intracorporate duty of candor is a separate and distinct kind of obligation, and ought to be recognized as such. At the same time, however, those wanting to stay within convention could make a good argument that it is an integral part of the duty of good faith, which is often mentioned as one of the three kinds of fiduciary obligations officers and directors owe under Delaware law.

points out that "deficient performance of duties by an officer, depending on the facts and circumstances, will normally be dealt with through intracorporate disciplinary procedures, such as reprimand, adjustment of compensation, delayed promotion, demotion, or discharge."¹²⁸

*C. Obtaining Action by a Corporate Organ Through the Use
of a Manipulative Process that Violates
Generally Accepted Basic Corporate Norms*

A manager also violates the duty of good faith if he obtains action by a corporate organ through the use of a manipulative process that violates generally accepted basic corporate norms. Usually, this principle operates as a condition, rather than as a liability rule, because where this principle is applicable, its main effect is to render an action of the corporate organ ineffective. If the action is ineffective, a manager's violation of the principle will usually not cause damage to the corporation, and therefore will not result in liability.

This principle is well exemplified by three Delaware cases: *Koch v. Stearn (Koch)*,¹²⁹ *VGS, Inc. v. Castiel (VGS)*,¹³⁰ and *Adlerstein v. Wertheimer (Adlerstein)*.¹³¹ In each of these cases, an enterprise was in serious business difficulty, and the managers caused the board to take action that seemed to be in the best interests of the enterprise. Nevertheless, the board's action was held to be ineffective because the managers obtained the action by using a manipulative process that violated generally accepted basic corporate norms.

In *Koch*, the board of Showcase Communications Network consisted of four directors: Stearn, Koch, Ginsberg, and Bunn. Stearn was the founder and CEO; Koch was a major investor; Ginsberg was Stearn's designee; and Bunn was Koch's designee. By late March 1992, Showcase was running out of funds and approaching insolvency. Koch offered to invest an additional \$2 million, subject to several conditions, including Stearn's resignation as CEO. A third party, Shapiro, had offered to provide \$250,000 in interim financing, but the directors other than Stearn believed that Koch's offer was the most attractive possibility available to Showcase,

¹²⁸MODEL BUS. CORP. ACT § 8.42 cmt. (2005).

¹²⁹No. 12,515, 1992 Del. Ch. LEXIS 163 (Del. Ch. July 28, 1992), *reprinted in* 18 DEL. J. CORP. L. 730 (1993).

¹³⁰No. 17,995, 2000 Del. Ch. LEXIS 122 (Del. Ch. Aug. 31, 2000), *reprinted in* 27 DEL. J. CORP. L. 454 (2002), *aff'd*, 781 A.2d 696 (Del. 2001) (table), No. 564, 2000 (Del. May 23, 2001).

¹³¹No. 19,101, 2002 Del. Ch. LEXIS 13 (Del. Ch. Jan. 25, 2002).

and that Stearn should be removed as CEO if he would not resign.¹³²

Koch's offer was open until April 2. That day passed without the offer having been accepted. The next day, Koch and Bunn discussed holding a board meeting at which Stearn would be removed from office. On April 6, Bunn faxed a letter to Showcase's counsel, Levy, requesting that Stearn and Levy attend a board meeting the following morning. The letter stated:

In view of the pending offer from Shapiro, and the dire financial condition of Showcase, David [Koch], Jerry [Ginsberg] and I hope that you and Leathem [Stearn] can attend a meeting at David's office at 9:00 a.m. tomorrow morning to review the situation. David has asked Mr. Shapiro to extend his offer until we have had a chance to discuss the situation. Since there is no time for formal notice, the four directors would waive notice at the 9:00 a.m. meeting tomorrow. Please advise immediately.¹³³

Later that day, Bunn sent Koch and Ginsberg drafts of board resolutions to remove Stearn as CEO. These resolutions were not circulated to either Stearn or Levy. On April 7, Showcase's board held a meeting at which Stearn was removed as CEO and replaced by Ginsberg, his own designee. The Court set aside the action of the board because Stearn had been tricked into attending the meeting:

The letter to Levy suggested that the board would be considering the revised Shapiro offer. It was silent as to any possible consideration of the Koch offer, which had technically expired. Moreover, the outside directors had an agenda, which included removing Stearn from office if he did not cooperate and step down voluntarily. I cannot help but conclude that Bunn's failure to inform Stearn of this agenda item was intentional.¹³⁴

VGS concerned an action by the board of managers of an LLC, rather than by a corporation's board of directors, but the applicable principles were the same. The LLC, Virtual Geosatellite, had been formed by David Castiel. It had three members: Holdings and Ellipso, which were

¹³²Koch, 1992 Del. Ch. LEXIS 163, at *7.

¹³³*Id.* at *8.

¹³⁴*Id.* at *13.

corporations controlled by Castiel, and Sahagen Satellite, an LLC controlled by Peter Sahagen. Castiel, through Holdings and Ellipso, owned 75% of Virtual's equity. Sahagen, through Sahagen Satellite, owned 25%. The management of Virtual was vested in a board of managers. As the majority owner, Castiel had the power to appoint, remove, and replace two of the three members of the board of managers, and therefore had the power to prevent any board decision with which he disagreed. Castiel named himself and Tom Quinn to the board of managers. Sahagen named himself as the third member of the board.¹³⁵

Not long after the formation of Virtual, Castiel and Sahagen fell out.¹³⁶ Sahagen ultimately convinced Quinn—Castiel's nominee—that for Virtual to prosper, Castiel had to be ousted from leadership. Many of Virtual's employees, and even some of Castiel's lieutenants, believed that such an action was in Virtual's best interest.¹³⁷

Virtual's LLC Agreement allowed Virtual to merge by a majority vote of the board of managers. Quinn covertly defected from Castiel to Sahagen's camp, and Sahagen and Quinn decided to wrest control of Virtual from Castiel. Under the Delaware LLC statute, on any matter that is to be voted on by managers, the managers may take action without prior notice, a vote, or a meeting, through means of a written consent signed by managers having the number of votes that would be necessary to authorize the action at a meeting. Sahagen and Quinn, acting by written consent, without notice to Castiel, merged Virtual into a new corporation, VGS. VGS's board of directors was comprised of Sahagen, Quinn, and Neel Howard. On the day of the merger, Sahagen executed a \$10 million promissory note to VGS in exchange for two million shares of VGS preferred stock. Upon consummation of the merger, Sahagen's interest in the Virtual enterprise went from 25% to 62.5% and Castiel's interest went from 75% to 37.5%.¹³⁸

The Delaware Court of Chancery,¹³⁹ in an opinion affirmed by the Delaware Supreme Court,¹⁴⁰ set these actions aside on the ground that they involved improper manipulative conduct:

There can be no doubt why Sahagen and Quinn, acting

¹³⁵VGS, 2000 Del. Ch. LEXIS 122, at *4, *reprinted in* 27 DEL. J. CORP. L. at 456.

¹³⁶*Id.*

¹³⁷*Id.* at *5, *reprinted in* 27 DEL. J. CORP. L. at 456.

¹³⁸*Id.* at *5-6, *reprinted in* 27 DEL. J. CORP. L. at 457.

¹³⁹VGS, Inc. v. Castiel, No. 17,995, 2000 Del. Ch. LEXIS 122 (Del. Ch. Aug. 31, 2000), *reprinted in* 27 DEL. J. CORP. L. 454 (2002).

¹⁴⁰VGS, Inc. v. Castiel, 781 A.2d 696 (Del. 2001).

as a majority of the LLC's board of managers did not notify Castiel of the merger plan. Notice to Castiel would have immediately resulted in Quinn's removal from the board and a newly constituted majority which would thwart the effort to strip Castiel of control. Had he known in advance, Castiel surely would have attempted to replace Quinn with someone loyal to Castiel who would agree with his views. Clandestine machinations were, therefore, essential to the success of Quinn and Sahagen's plan. . . .

. . . . [T]he LLC Act, read literally, does not require notice to Castiel before Sahagen and Quinn could act by written consent. The LLC Agreement does not purport to modify the statute in this regard.

Those observations can not complete the analysis of Sahagen and Quinn's actions, however. Sahagen and Quinn knew what would happen if they notified Castiel of their intention to act by written consent to merge the LLC into VGS, Inc. Castiel would have attempted to remove Quinn, and block the planned action. . . .

. . . . Nothing in the statute suggests that this court of equity should blind its eyes to a shallow, too clever by half, manipulative attempt to restructure an enterprise through an action taken by a "majority" that existed only so long as it could act in secrecy.

. . . . The majority investor [in Virtual] protected his equity interest in the LLC through the mechanism of appointment to the board rather than by the statutorily sanctioned mechanism of approval by members owning a majority of the LLC's equity interests. . . . Instead the drafters [of the LLC Agreement] made the critical assumption, known to all the players here, that the holder of the majority equity interest has the right to appoint and remove two managers, ostensibly guaranteeing control over a three member board. When Sahagen and Quinn, fully recognizing that this was Castiel's protection against actions adverse to his majority interest, acted in secret, without notice, they failed to discharge their duty of loyalty to him in good faith. They owed Castiel a duty to give him prior notice even if he would

have interfered with a plan that they conscientiously believed to be in the best interest of the LLC.¹⁴¹

In *Adlerstein*, Joseph Adlerstein was the founder and CEO of SpectruMedix and owned a majority of the corporation's voting power. In early 2000, Adlerstein elected Steven Wertheimer and Judy Mencher to join him on the SpectruMedix board. By late 2000, SpectruMedix's cash position had become perilous. A business consultant recommended various restructuring measures. These measures were supported by most of the corporation's department heads, and put into place, but Adlerstein tried to undo them. The consultant also concluded that Adlerstein was the central problem at SpectruMedix, because he was totally lacking in managerial and business competence, and that for SpectruMedix to have any chance to succeed, Adlerstein had to be removed from any operating influence.

At the beginning of July 2001, if not earlier, SpectruMedix was either insolvent or operating on the brink of insolvency; Adlerstein was not communicating with creditors; key vendors were refusing to make deliveries unless paid in cash; SpectruMedix did not have sufficient cash to make its next payroll; and a complaint of sexual harassment had been filed against Adlerstein.¹⁴² Against the background of these actual and impending conditions, Wertheimer had contacted Ilan Reich to invest in and help manage SpectruMedix. Reich was willing to invest, but only if he was put in charge. Wertheimer and Mencher concluded that it was essential to bring Reich on board, and concomitantly to remove Adlerstein. Without Adlerstein's knowledge, they negotiated with Reich to that end. The deal they negotiated with Reich provided that subject to board approval, Reich would invest \$1 million in SpectruMedix and would assume active management of the corporation, and SpectruMedix would issue to Reich preferred stock carrying voting control of the corporation. The documents necessary for a transaction with Reich were in draft form by July 6, 2001. They were sent to Wertheimer, Mencher, and Reich, but not to Adlerstein, who was deliberately kept unaware that Reich had made a proposal.

Wertheimer and Mencher then asked Adlerstein to convene a board meeting on July 9, without telling him that they intended to effectuate their plan at that meeting. The SpectruMedix bylaws had no requirement of prior notice of agenda items for meetings of the board of directors, nor was there a hard-and-fast legal rule that directors be given advance notice of all

¹⁴¹VGS, 2000 Del. Ch. LEXIS 122, at *6, 10-11, 13, *reprinted in* 27 DEL. J. CORP. L. at 457, 459-60.

¹⁴²*Adlerstein*, 2002 Del. Ch. LEXIS 13, at *3-11.

matters to be considered at a meeting.¹⁴³ Adlerstein convened the meeting. The deal with Reich, including the discharge of Adlerstein, was adopted by majority vote, over Adlerstein's objection.

The court set aside the board's action. It pointed out that the decision to keep Adlerstein in the dark about the Reich proposal was significant, because Adlerstein possessed power to prevent the issuance of the preferred stock by executing a written consent removing Wertheimer and Mencher from the board. Had Adlerstein known beforehand that Wertheimer and Mencher intended to approve the Reich deal and to remove Adlerstein from office at the July 9 meeting, Adlerstein could have exercised his legal right to remove one or both of them. The court concluded:

[I]n the context of the set of legal rights that existed within SpectruMedix at the time of the July 9 meeting, Adlerstein was entitled to know ahead of time of the plan to issue new Series C Preferred Stock with the purposeful effect of destroying his voting control over the Company. This right to advance notice derives from a basic requirement of our corporation law that boards of directors conduct their affairs in a manner that satisfies minimum standards of fairness.¹⁴⁴

The results in these cases are best explained by the duty of good faith. The duty of care does not explain these results, because the managers in all three cases could have rationally—indeed, reasonably—believed that they were acting in the best interests of the enterprise. It is true that in *VGS* the court referred to the duty of loyalty, but that reference is ambiguous because the court stated that the directors had "failed to discharge their duty of loyalty . . . *in good faith*,"¹⁴⁵ so that the reference to loyalty seems to be surplusage. Furthermore, the elements of wrongfulness that all three cases refer to—elements such as trickery, being "too clever by half,"¹⁴⁶ and failure to conduct the board's affairs in a manner that meets minimum standards of fairness—all sound in good faith, rather than loyalty.

Even apart from the language of the opinions, there are two reasons why the obligation not to achieve results through the use of manipulative processes that fail to satisfy generally accepted basic corporate norms is better understood as part of the duty of good faith than as part of the duties

¹⁴³*Id.* at *28.

¹⁴⁴*Id.* at *28-29.

¹⁴⁵*VGS*, 2000 Del. Ch. LEXIS 122, at *13, *reprinted in* 27 DEL. J. CORP. L. at 460 (emphasis added).

¹⁴⁶*Id.* at *11, *reprinted in* 27 DEL. J. CORP. L. at 460.

of care or loyalty. First, this obligation applies even when, as in *Adlerstein*, the result that is achieved does not involve self-interest. Second, conduct that results in a benefit to the enterprise might not be deemed to violate the duty of loyalty, just for that reason. In contrast, the obligation not to achieve action by a corporate organ through the use of a manipulative process that violates generally accepted basic corporate norms applies even when the result benefits the enterprise, as seems to have been the case in *Koch*, *VGS*, and *Adlerstein*. It is never proper—never in good faith—to achieve desirable objectives through improper methods.

D. Impermissible Nonpecuniary Motives

Occasionally, a corporate manager engages in conduct in his managerial capacity that is based on a motive that, although not pecuniary, is self-regarding (hereinafter an "impermissible motive"). Conduct based on such a motive violates the duty of good faith. As Chancellor Allen stated in *In re RJR Nabisco, Inc. Shareholders Litigation*,¹⁴⁷ a manager does not act in good faith if he is motivated by "hatred, lust, envy, revenge, or . . . shame or pride."¹⁴⁸ Hatred, envy, and revenge may not often figure as managerial motives in publicly held corporations, but may frequently figure in closely held corporations. Lust or love may occasionally figure even in publicly held corporations, as where an executive hires or promotes a lover.

The prohibition against acting on the basis of impermissible motives provides still another way to explain the liability of Van Gorkom in *Smith v. Van Gorkom*.¹⁴⁹ Some of Van Gorkom's conduct seems best explained by the premise that he did not want to jeopardize his social position in Chicago generally, and with his negotiating counterparty, Jay Pritzker, in particular, by failing to deliver on a transaction that he had negotiated with Pritzker, who was one of the most prominent figures in Chicago. This could explain, for example, Van Gorkom's apparent lack of candor, which was likely aimed at getting the board to approve the transaction that Van Gorkom had arranged with Pritzker, rather than to negotiate that transaction more aggressively or explore alternative transactions.

A manager's obligation not to act on the basis of impermissible motives differs from the obligations considered in the first three sections of this Part. Because the conduct is self-regarding, the obligation might be explained, even without the duty of good faith, by the duty of loyalty.

¹⁴⁷No. 10,389, 1989 Del. Ch. LEXIS 9, at *46 (Del. Ch. Jan. 31, 1989), reprinted in 14 DEL. J. CORP. L. 1132, 1159 (1989).

¹⁴⁸*Id.*

¹⁴⁹See *supra* text accompanying note 123.

However, there are several reasons why it is important to place, or also place, the prohibition on such conduct within the duty of good faith.

To begin with, although such conduct *could* fall within the duty of loyalty, because it is self-regarding, it is not clear as a matter of positive law that it *does* fall within that duty because, as shown in Part V, traditionally that duty applied only to conduct that is motivated by direct or indirect *financial* self-interest. Locating the prohibition against conduct based on an impermissible, although non-pecuniary, motive under the duty of good faith makes clear that such conduct is improper even though it may not violate the duty of loyalty as traditionally conceived.¹⁵⁰

Another reason for locating this prohibition under the duty of good faith concerns the nature of the prohibition. Over a wide range of cases, the duty of loyalty does not prohibit self-interested transactions, but only requires that such transactions be fair.¹⁵¹ In contrast, the duty of good faith involves absolute prohibitions. So, for example, a manager may not properly take an action based on spite even though the same action would be unobjectionable if engaged in for proper reasons. Locating the prohibition on conduct based on impermissible motives under the duty of good faith underlines that such conduct is prohibited without regard to the outcome, although the outcome may affect the extent of liability, if any. Finally, locating this prohibition under the duty of good faith has the consequence that a manager cannot be shielded from accountability for such conduct.

An important and recurring case in which the possibility of impermissible motivation plays a central role concerns actions by directors to effectively preclude the liability of a colleague. Such actions occur in two contexts. First, some states, such as Delaware, have statutes that are interpreted to allow "disinterested" directors to approve a colleague's self-interested transaction and thereby preclude the normal judicial review of the fairness of such a transaction.¹⁵² Second, many states allow the board to form a special litigation committee composed of "disinterested" directors, which has the effective power to preclude a judicial determination whether a derivative action against one or more colleagues of the directors is meritorious.

I put the term "disinterested" in quotes, because it is highly unlikely

¹⁵⁰Cf. E. Norman Veasey with Christine T. Di Guglielmo, *What Happened to Delaware Corporate Law and Governance from 1992-2004?*, 153 U. PA. L. REV. 1399, 1451 (2005) ("Arguably, it is analytically preferable to treat good faith and loyalty as separate duties, in part because self-dealing is not required for a good faith violation.").

¹⁵¹See, e.g., DEL. CODE ANN. tit. 8, § 144(a)(3) (2004).

¹⁵²*Id.* § 144.

that directors are impartial when deciding whether to preclude the liability of a friend and colleague. This is yet another case where "interestedness" is narrowly defined to mean only financial self-interest. Lately, the Delaware courts have expanded the test of disinterestedness, both by adding a test of independence and by determining financial disinterestedness and independence in a more expansive manner.¹⁵³ Nevertheless, even the Delaware courts have stopped well short of requiring impartiality. For example, in *Beam v. Stewart*,¹⁵⁴ the Delaware Supreme Court held that allegations that Martha Stewart and directors who took action to insulate her from suit "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' even when coupled with Stewart's 94% voting power, are insufficient, without more, to rebut the presumption of independence."¹⁵⁵ Would not a Delaware judge who had those same kinds of relationships with Martha Stewart believe that he was obliged to recuse himself from deciding a case in which Martha Stewart was a party? If those kinds of relationships would render a judge not impartial, how could they fail to render a director not impartial?

It is true, of course, that the action of the "disinterested" directors, like any other directorial action, is potentially subject to judicial review. However, the duty of loyalty is typically inapplicable to these directors, because by hypothesis they have no material financial ties to either the director whose transaction or conduct is at issue or to the transaction or conduct itself. And as a result of the business judgment rule, typically it is also very difficult to prove that the directors have violated the duty of care.

The best way to address these problems would be to adopt a special rule of review in these contexts. Many states do just that, either by providing that a self-interested transaction is subject to judicial review for fairness even if approved by "disinterested" directors, or by adopting rules that require a much higher level of scrutiny of the recommendations of special litigation committees than would be normally applied under the business judgment rule. The next-best alternative is to apply the duty of good faith to determine whether the approving directors have acted with the impermissible motive of favoring their colleague. As Chancellor Chandler pointed out in *Disney IV*:

Another example of how the concept of good faith may
operate in a situation where ensuring director compliance with

¹⁵³*In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

¹⁵⁴845 A.2d 1040 (Del. 2004).

¹⁵⁵*Id.* at 1051.

the fiduciary duties of care and loyalty (as we have traditionally defined those duties) may be insufficient to protect shareholders' interests, is found in . . . § 144(a). Under § 144(a), a transaction between a corporation and its directors or officers will be deemed valid if approved by a majority of the independent directors, assuming three criteria are met: 1) the approving directors were aware of the conflict inherent in the transaction; 2) the approving directors were aware of all the facts material to the transaction; and 3) the approving directors acted in good faith. In other words, the inside transaction is valid where the independent and disinterested (loyal) directors understood that the transaction would benefit a colleague (factor 1), but they considered the transaction in light of the material facts (factor 2—due care) mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies (factor 3—good faith). On the other hand, where the evidence shows that a majority of the independent directors were aware of the conflict and all material facts, in satisfaction of factors 1 and 2 (as well as the duties of care and loyalty), but acted to reward a colleague rather than for the benefit of the shareholder, the Court will find that the directors failed to act in good faith and, thus, that the transaction is voidable. In such a case, the duties of care and loyalty, as traditionally defined, might be insufficient to protect the equitable interests of the shareholders, and the matter would turn on the good faith of the directors.¹⁵⁶

A similar position was taken in *Desaigoudar v. Meyercord*.¹⁵⁷ Here the court stated:

[T]he business judgment rule . . . does not apply in the case of bad faith. . . . "The policy reasons for keeping a court from evaluating after the fact the wisdom of a particular business decision do not apply when the issue is whether a party to that decision acted fraudulently or in bad faith. . . ."¹⁵⁸

¹⁵⁶*Disney IV*, 2005 Del. Ch. LEXIS 113, at *177 n.464, reprinted in 31 DEL. J. CORP. L. at 425 n.464 (citing DEL. CODE ANN. tit. 8, § 144(a) (2004)).

¹⁵⁷133 Cal. Rptr. 2d 408 (Cal. Ct. App. 2003).

¹⁵⁸*Id.* at 419 (quoting *Will v. Engbretson*, 261 Cal. Rptr. 868, 874 (Cal. Ct. App. 1989)).

A court's review to uncover bad faith . . . is not a perfunctory one. . . . [W]hether a committee employed proper procedures before rejecting the claim-involves an analysis of the committee's good faith. This means that the court must look into the procedures employed and determine whether they were adequate or whether they were so inadequate as to suggest fraud or bad faith. That is, "[p]roof . . . that the investigation has been so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham, consistent with the principles underlying the application of the business judgment doctrine, would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine." . . . "[I]t [is] necessary for the court to consider whether, on the facts alleged, the refusal of the directors to prosecute the claims was so clearly against the interests of the corporation that it must be concluded that the decision of the directors did not represent their honest and independent judgment."¹⁵⁹

Similarly, the comment to Model Business Corporation Act § 8.31(a) states:

If a director's conflicting interest transaction is determined to be manifestly unfavorable to the corporation, giving rise to an inference of bad faith tainting the directors' action approving the transaction under section 8.62, the safe harbor protection afforded by section 8.61 for both the transaction and the conflicted director would be in jeopardy.

In these and like cases, the duty of good faith functions as a condition—specifically, as a condition to the effectiveness of the approving directors' action. Seldom, if ever, would violation of the duty of good faith in this context give rise to liability, because if the approving directors violate the duty of good faith, so that their action is ineffective, the director whose conduct is at issue is left unprotected against suit, and the corporation therefore normally will suffer no damage as a result of the directors' approval.

¹⁵⁹*Desaigoudar*, 133 Cal. Rptr. 2d at 419-20 (quoting *Auerbach v. Bennett*, 47 N.Y. 2d 619, 634-35 (N.Y. 1979) (quoting *Findley v. Garrett*, 109 Cal. App. 2d 166, 177 (Cal. Ct. App. 1952)).

E. Substantial Disregard of Responsibilities

Managers sometimes disregard their responsibilities. Such disregard will almost always constitute a violation of the duty of care (although the manager may be insulated against liability for the violation by the business judgment rule, a gross negligence standard of review, or a shield provision in the corporation's certificate of incorporation). In some cases, however, the magnitude of the disregard rises to so high a level that the manager also violates the duty of good faith, because disregard of responsibilities at that level constitutes a lack of fidelity to one's office, violates generally accepted basic corporate norms, and usually is dishonest in the sense that the manager does not sincerely believe that he is acting properly. A number of important recent cases have so held: in particular, *In re Caremark International Inc. Derivative Litigation* (Caremark),¹⁶⁰ *McCall v. Scott* (McCall),¹⁶¹ *In re Abbott Laboratories Derivative Shareholders Litigation* (Abbott Laboratories),¹⁶² *In re Emerging Communications, Inc. Shareholders Litigation* (Emerging Communications),¹⁶³ *Disney III*,¹⁶⁴ and *Disney IV*.¹⁶⁵

Caremark, decided by Chancellor Allen in 1996, concerned disregard of the board's duty to install monitoring and information systems. Caremark Corporation was a health care provider. A substantial portion of its revenues was derived from payments by Medicare and Medicaid. These payments were subject to the federal Anti-Referral Payments Law, which prohibited health care providers from making payments to third parties—primarily physicians—to induce referrals of Medicare or Medicaid patients.¹⁶⁶

From its inception, Caremark entered into "consultation agreements" with, and made research grants to, physicians who then prescribed or recommended Caremark to their Medicare patients. Based on these agreements and grants, Caremark was indicted for violating the Anti-Referral Payments Law. Caremark pleaded guilty, agreed to pay civil and criminal fines, and reimbursed various private and public parties. In all,

¹⁶⁰698 A.2d 959 (Del. Ch. 1996).

¹⁶¹239 F.3d 808 (6th Cir. 2001), *amended by* 250 F.3d 997 (6th Cir. 2001).

¹⁶²325 F.3d 795 (7th Cir. 2003).

¹⁶³No. 16,415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) (revised June 4, 2004).

¹⁶⁴825 A.2d 275 (Del. Ch. 2003).

¹⁶⁵No. 15,452, 2005 Del. Ch. LEXIS 28 (Del. Ch. Feb. 4, 2005), judgment entered 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005), *reprinted in* 31 DEL. J. CORP. L. 349 (2006).

¹⁶⁶*Caremark*, 698 A.2d at 961-62.

Caremark was required to make payments of approximately \$250 million as a result of its illegal conduct.¹⁶⁷

Derivative actions based on these payments were brought against Caremark's directors, and settled. The issue in *Caremark* itself was whether the settlements should be judicially approved. That issue, in turn, depended in part on the nature of the board's duty, if any, to install information and reporting systems. Chancellor Allen stated that it would

be a mistake to conclude that . . . corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.¹⁶⁸

Rather, he said, "[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists" ¹⁶⁹

As to when a failure of directors to assure themselves that appropriate information and reporting systems are in place constitutes a lack of good faith, Chancellor Allen opined that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."¹⁷⁰ The *test* laid down by Chancellor Allen—a sustained or systematic failure of the board to exercise oversight—seems appropriate. The *illustration*—an "utter failure"—is certainly an example of a sustained or systematic failure, but it would be inappropriate if it were a test rather than an illustration.

McCall,¹⁷¹ decided by the Sixth Circuit in 2001 under Delaware law, was a derivative action against former directors of another health care provider, Columbia/HCA Healthcare Corporation. The claims arose out of widespread and systematic fraudulent schemes engaged in by Columbia,

¹⁶⁷*Id.* at 960-62.

¹⁶⁸*Id.* at 970.

¹⁶⁹*Id.*

¹⁷⁰*Caremark*, 698 A.2d at 971.

¹⁷¹239 F.3d 808 (6th Cir. 2001), *amended by* 250 F.3d 997 (6th Cir. 2001).

such as systematic overbilling. The complaint alleged that with the board's knowledge, Columbia's senior management devised these fraudulent schemes to improperly increase Columbia's revenue and profits and, to that end, perpetuated a management philosophy that provided strong incentives for employees to engage in such schemes. The directors argued that the complaint should be dismissed because it alleged only a violation of the duty of care, and Columbia's certificate of incorporation included a shield provision, adopted pursuant to Delaware General Corporation Law § 102(b)(7), which insulated the directors from liability for violation of the duty of care.¹⁷² The court rejected this argument because the basis of the complaint was the director's conscious disregard of known risks, and such conduct violates the duty of good faith and is therefore ineligible for protection under the shield. "[D]uty of care claims alleging only grossly negligent conduct are precluded by a § 102(b)(7) . . . provision, [but] it appears that duty of care claims based on reckless or intentional misconduct are not. . . . [A] conscious disregard of known risks, . . . if proven, cannot have been undertaken in good faith."¹⁷³

Abbott Laboratories, decided by the Seventh Circuit in 2002 under Delaware law, was a derivative action against directors of Abbott, a pharmaceutical company. Plaintiffs alleged that the directors had, over a seven-year period, ignored both strong warnings from the Food and Drug Administration (FDA) and reports in the *Wall Street Journal* that two of Abbott's production facilities were seriously and persistently deficient under the FDA's published standards. As a result of the deficiencies and the lack of board action, the plants had to be closed down, and Abbott suffered substantial losses. The court held that the complaint stated a claim that the directors had violated the duty of good faith:

Delaware law imposes three primary fiduciary duties on the directors of corporations; the duty of care, the duty of loyalty, and the duty of good faith

¹⁷²*Id.* at 813-18. More accurately, the precise issue was whether the allegations in the complaint, if true, created a reasonable doubt that a majority of the board was disinterested, so that a derivative action could be brought without first making demand on the board. The governing rule was that "[w]hile the mere threat of personal liability is not sufficient, reasonable doubt as to the disinterestedness of a director is created when the particularized allegations in the complaint present 'a substantial likelihood' of liability on the part of the director." *Id.* at 817 (citations omitted). The directors argued that the allegations in the complaint did not create a substantial likelihood of liability because the complaint essentially alleged that the board had violated the duty of care, and the directors were exculpated from duty-of-care liability under Columbia's shield provision. *Id.*

¹⁷³*McCall*, 250 F.3d at 1000-01.

. . . . Given the extensive paper trail in *Abbott* concerning the violations and the inferred awareness of the problems, the facts support a reasonable assumption that there was a "sustained and systematic failure of the board to exercise oversight," in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses, establishing a lack of good faith. We find that six years of noncompliance, inspections, . . . Warning Letters, and notice in the press, all of which then resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately \$ 250 million in corporate assets, indicate that the directors' decision to not act was not made in good faith and was contrary to the best interests of the company. . . .

The Sixth Circuit followed Delaware law in *McCall* in finding that the directors' fiduciary duties include not only the duty of care, but also the duties of loyalty and good faith, stating that although "duty of care claims alleging only grossly negligent conduct are precluded by § 102(b)(7) waiver provision, it appears that duty of care claims based on reckless or intentional misconduct are not." . . . The *McCall* court . . . further stated, "Under 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." . . . Plaintiffs in *Abbott* accused the directors not only of gross negligence, but of intentional conduct in failing to address the federal violation problems, alleging "a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith."¹⁷⁴

*Emerging Communications*¹⁷⁵ was decided in 2004 by Justice Jacobs of the Delaware Supreme Court, sitting by designation as Vice Chancellor. Innovative Communications owned a majority of the stock of Emerging

¹⁷⁴*Abbott Labs.*, 325 F.3d at 808-09, 811.

¹⁷⁵*In re Emerging Commc'ns S'holders Litig.*, No. 16,415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) (revised June 4, 2004).

Communications (Emerging). All of Innovative's stock, in turn, was indirectly owned by Jeffrey Prosser, Emerging's CEO. Innovative and Emerging had engaged in a going-private transaction, which was effectuated through a combined tender offer and cashout merger. The transaction had been recommended by a special committee of Emerging and approved by Emerging's board. Under the transaction, Innovative acquired the minority stock in Emerging at a price of \$10.25 per share. There were two issues in the case: whether the transaction was fair to Emerging's minority shareholders and, if it was unfair, whether any Emerging directors were personally liable for breaching their fiduciary duties to those shareholders. The court concluded that the merger price was unfair, and then turned to "the nature of the fiduciary duty violation—whether of care, loyalty, or good faith—that resulted in the unfair transaction."¹⁷⁶

As to one of the defendant-directors, Raynor, the court concluded that although Raynor did not directly benefit from the transaction, his loyalties ran solely to Prosser because his economic interests were tied solely to Prosser and he acted to further those interests. Accordingly, the court held that Raynor was liable to the minority shareholders for breaching "his fiduciary duty of loyalty and/or good faith."¹⁷⁷ The court explained its use of the "and/or" phraseology as follows:

The Court employs the "and/or" phraseology because the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and of good faith. If a loyalty breach requires that the fiduciary have a self-dealing conflict of interest in the transaction itself, as at least one commentator has suggested, then only Prosser is liable on that basis. Raynor would be liable for violating his duty of good faith for consciously disregarding his duty to the minority stockholders. On the other hand, if a loyalty breach, does not require a self-dealing conflict of interest or receipt of an improper benefit, then Raynor would be liable for breaching his duties of loyalty *and* good faith. The Court need not decide that definitional issue, because under either definition, Raynor's conduct amounted to a non-exculpated breach of fiduciary duty.¹⁷⁸

¹⁷⁶*Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *137-38.

¹⁷⁷*Id.* at *142.

¹⁷⁸*Id.* at *142 n.184 (citations omitted).

The court then turned to another defendant-director, Muoio, and concluded that Muoio was also liable. Even though Muoio's conduct was less egregious than that of Raynor, he was culpable because he voted to approve the transaction although he knew, or at the very least had strong reason to believe, that the merger price was unfair. Muoio was in a special position to know the price was unfair because he "possessed specialized financial expertise and an ability to understand [Emerging's] intrinsic value, that was unique to"¹⁷⁹ the members of Emerging's board, except for perhaps Prosser:

Informed by his specialized expertise and knowledge, Muoio conceded that the \$ 10.25 price was "at the low end of any kind of fair value you would put," and expressed to [another director] his view that the Special Committee might be able to get up to \$ 20 per share from Prosser. In these circumstances, it was incumbent upon Muoio, as a fiduciary, to advocate that the board reject the \$ 10.25 price that the Special Committee was recommending. As a fiduciary knowledgeable of ECM's intrinsic value, Muoio should also have gone on record as voting against the proposed transaction at the \$ 10.25 per share merger price. Muoio did neither. Instead he joined the other directors in voting, without objection, to approve the transaction.¹⁸⁰

On this basis, the court continued:

The credible evidence persuades the Court that Muoio's conduct is explainable in terms of only one of two possible mindsets. The first is that Muoio made a deliberate judgment that to further his personal business interests, it was of paramount importance for him to exhibit his primary loyalty to Prosser. The second was that Muoio, for whatever reason, "consciously and intentionally disregarded" his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair. If motivated by either of those mindsets, Muoio's conduct would have amounted to a violation of his duty of loyalty and/or good faith. . . . Muoio has not established to the satisfaction

¹⁷⁹*Id.* at *144.

¹⁸⁰*Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *144 (footnotes omitted).

of the Court, after careful scrutiny of the record, that his motivation was of a benign character¹⁸¹

The court amplified its reasoning on Muoio's violation of the standard of good faith as follows:

Although the Supreme Court has yet to define the precise conduct that would actionably violate that duty, this Court has recently held that directors can be found to have violated their duty of good faith if they "*consciously and intentionally disregard . . . their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."¹⁸²

*Disney III*¹⁸³ involved a motion to dismiss on the pleadings. Accordingly, the court assumed that the facts alleged in the complaint were true. These facts were essentially as follows: Michael Eisner was Disney's chief executive officer. Disney needed a president to be Eisner's second-in-command. Eisner chose Michael Ovitz, who had been Eisner's close friend for over twenty-five years. In September 1995, Disney prepared a draft five-year employment agreement for Ovitz. At a meeting of the board's compensation committee on September 26, the committee members were provided with a rough summary of the agreement, but not the draft agreement itself, and even the summary was incomplete. The summary stated that Ovitz was to receive options to purchase five million shares of stock, but did not state the exercise price. Furthermore, no analytical document that showed the potential payout to Ovitz, or the possible cost of his severance package, was either created or presented to the committee. The committee neither requested nor received any information concerning how the agreement compared with agreements in the entertainment industry involving similarly situated executives. The committee nevertheless approved the general terms and conditions of the agreement. Disney's board met immediately after the compensation committee meeting. Again, no documents were produced for the board to review before the meeting, and the board did not consider the various payout scenarios if a termination should occur.¹⁸⁴

¹⁸¹*Id.* at *146-47 (footnotes omitted).

¹⁸²*Id.* at *153 (quoting *Disney III*, 825 A.2d at 289).

¹⁸³825 A.2d 275 (Del. Ch. 2003).

¹⁸⁴*Id.*

Final negotiation of the employment agreement was left to Eisner, Ovitz's close friend. Neither the board nor the compensation committee reviewed or approved the final agreement. The final agreement differed significantly from the summary presented to the compensation committee. One major difference concerned the circumstances surrounding Ovitz's severance benefits. The draft provided that in the case of a "non-fault" termination, Ovitz would receive very substantial benefits, but that a non-fault termination would occur only if Disney wrongfully terminated Ovitz or Ovitz died or became disabled. In contrast, the final agreement stated that Ovitz would receive non-fault termination benefits if he was terminated by Disney and had not acted with gross negligence or malfeasance. Therefore, under the final agreement, Ovitz would receive "non-fault" termination benefits even if he was terminated by Disney because he acted negligently, as long as his behavior did not reach the level of gross negligence or malfeasance.¹⁸⁵

Ovitz's tenure as Disney's president was extremely unsuccessful. Although Ovitz admittedly did not know his job, he studiously avoided attempts to be educated.¹⁸⁶ Instead of working to learn his duties as Disney's president, Ovitz began seeking alternative employment. Under his contract, Ovitz could properly terminate his employment only if one of four designated events occurred. None of these events ever occurred. However, Eisner rewrote Ovitz's contract so that in the event of Ovitz's voluntary departure for *any* reason, Disney would pay him the benefits provided for in the event of a non-fault termination. As a result, Ovitz received termination benefits of \$140 million for doing a terrible job for one year.¹⁸⁷

If the alleged facts were true, Disney's directors would have violated their duty of care, but the directors would have been insulated from liability for violation of that duty by Disney's shield provision. However, violations of the duty of good faith are not protected under the Delaware shield provision and on the basis of "the foundational directoral obligation to act honestly and in good faith to advance corporate interests,"¹⁸⁸ the court held that if the alleged facts were true, the directors' conduct also violated the duty of good faith:

These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of

¹⁸⁵*Id.*

¹⁸⁶*Id.* at 283.

¹⁸⁷*Disney III*, 825 A.2d 275 (Del. Ch. 2003).

¹⁸⁸*Id.* at 291.

material importance to their corporation. Instead, the facts alleged in the . . . complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs' . . . complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests¹⁸⁹

After the denial of the motion to dismiss on the pleadings, the case went to trial. The evidence at trial diverged from the allegations in the complaint, and on the basis of that evidence, in *Disney IV* Chancellor Chandler held for the defendants. In the course of his opinion, the Chancellor elaborated on the duty of good faith as follows:

Bad faith has been defined as authorizing a transaction "for some purpose *other than* a genuine attempt to advance corporate welfare or [when the transaction] is *known to constitute* a violation of applicable positive law." In other words, an action taken with the intent to harm the corporation is a disloyal act in bad faith. A similar definition was used seven years earlier, when Chancellor Allen wrote that bad faith (or lack of good faith) is when a director acts in a manner "unrelated to a pursuit of the corporation's best interests." It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation.

. . . .

¹⁸⁹*Id.* at 289.

Bad faith can be the result of "any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation," including greed, "hatred, lust, envy, revenge, . . . shame or pride." Sloth could certainly be an appropriate addition to that incomplete list if it constitutes a systematic or sustained shirking of duty. . . .

. . . . [T]he defendants' motion to dismiss this action was denied because I concluded that the complaint . . . alleged that Disney's directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."

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. . . .

. . . . The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions 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 a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.¹⁹⁰

The cases use various formulations as tests for determining when the magnitude of disregard of responsibilities rises to so high a level that a manager has violated not only the duty of care, but also the duty of good faith. These tests include "a sustained or systematic failure of the board to

¹⁹⁰*Disney IV*, 2005 Del. Ch. LEXIS 113, at *169-70, 173-77 (footnotes omitted), reprinted in 31 DEL. J. CORP. L. at 422-25.

exercise oversight,"¹⁹¹ "reckless or intentional misconduct,"¹⁹² "a conscious disregard of known risks,"¹⁹³ "consciously and intentionally disregard[ing] their responsibilities,"¹⁹⁴ "adopting a 'we don't care about the risks' attitude concerning a material corporate decision,"¹⁹⁵ "intentional dereliction of duty,"¹⁹⁶ "conscious disregard for one's responsibilities,"¹⁹⁷ "[s]oth . . . if it constitutes a systematic or sustained shirking of duty,"¹⁹⁸ and "[k]nowing or deliberate indifference . . . [to one's] duty to act faithfully and with appropriate care."¹⁹⁹

These tests are not conflicting. Rather, they are various ways to indicate the magnitude and type of disregard required to establish a breach of the duty of good faith on the basis of disregard of one's responsibilities. Chancellor Chandler said as much in *Disney IV*: "[T]he concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (*although not the only*) standard for determining when fiduciaries have acted in good faith."²⁰⁰

The terms "intentional" and "conscious," as used in that and some other tests, need interpretation. The formulations that employ these terms would make little or no sense unless they mean either that the manager was conscious that he was disregarding his duties or that a reasonable person in the manager's position would have known that he was disregarding his duties—not that the actual manager was subjectively conscious that he was disregarding his duties. Surely it would be no defense in such a case that the manager on being asked, "Were you consciously disregarding your duties?" truthfully replied, "No," or, "I didn't think about it one way or the other."

Once that is understood, it is not necessary to choose a single formulation of when disregard of responsibilities rises to a magnitude that constitutes a violation of the duty of good faith, because there is more than one way for disregard to rise to that level. For simplicity, I will use the

¹⁹¹*Caremark*, 698 A.2d at 971.

¹⁹²*Abbott Labs.*, 325 F.3d at 811; *McCall*, 250 F.3d at 1000-01.

¹⁹³*Abbott Labs.*, 325 F.3d at 811; *McCall*, 250 F.3d at 1000-01.

¹⁹⁴*Disney II*, 825 A.2d at 289; *Disney IV*, 2005 Del. Ch. LEXIS 113, at *174, *reprinted in* 31 DEL. J. CORP. L. at 424; *Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *153 (emphasis omitted).

¹⁹⁵*Disney III*, 825 A.2d at 289; *Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *153.

¹⁹⁶*Disney IV*, 2005 Del. Ch. LEXIS 113, at *175, *reprinted in* 31 DEL. J. CORP. L. at 424.

¹⁹⁷*Id.*

¹⁹⁸*Id.* at *173, *reprinted in* 31 DEL. J. CORP. L. at 423.

¹⁹⁹*Disney III*, 825 A.2d at 289.

²⁰⁰*Disney IV*, 2005 Del. Ch. LEXIS 113, at *175, *reprinted in* 31 DEL. J. CORP. L. at 424 (emphasis added; emphasis by the court omitted).

term *substantial disregard of responsibilities* to embody that level, on the understanding that (1) this term is intended to capture any unjustifiable or inexplicable disregard of responsibilities that is either persistent or concerns a very important event, and (2) this term is intended to embrace, rather than supplant, the various formulations that have been used in the cases.

Two important observations need to be made about *Disney III* and *IV* in particular, and a substantial disregard of responsibilities (however formulated) in general.

The first observation is that a substantial disregard of responsibilities effectively operates only as a condition, not as a basis of liability. The reason is that a manager who substantially disregards his responsibilities violates the duty of care, and that violation is a sufficient basis for liability in all cases. Since the manager is liable for breach of the duty of care, his breach of the duty of good faith does not add a new liability. The only operational effect of the fact that the disregard is substantial, and therefore a violation of the duty of good faith, is that the manager cannot avail himself of a shield provision that does not exculpate violations of the duty of good faith.

The second observation is that although at the beginning of his discussion of good faith in *Disney IV* Chancellor Chandler states that "[d]ecisions from the Delaware Supreme Court and the Court of Chancery are far from clear with respect to whether there is a separate fiduciary duty of good faith," the entire balance of the Chancellor's discussion endorses that duty:

To create a definitive and categorical definition of the universe of acts that would constitute bad faith would be difficult, if not impossible. And it would misconceive how, in my judgment, the concept of good faith operates in our common law of corporations. Fundamentally, the duties traditionally analyzed as belonging to corporate fiduciaries, loyalty and care, are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary. The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions 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 a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient. As evidenced by previous rulings in this case both from this Court and the Delaware Supreme Court, issues of the Disney directors' good faith (or lack thereof) are central to the outcome of this action.²⁰¹

Although the Chancellor took the view that the duty of good faith embraces the duties of care and loyalty, rather than the view that good faith stands alongside care and loyalty, there is little or no functional difference between those two views. Under either view, good faith is an independent duty that gives rise to specific obligations not comprehended within the duties of care and loyalty.

VII. CONCLUSION

An important development in corporate law is the recent explicit recognition, in a series of Delaware cases, that managers have a fiduciary duty of good faith. That duty was not created by those cases. On the contrary, the duty has long been explicit or implicit under the statutes—for example, in statutory provisions that require directors to act in good faith and in provisions concerning indemnification. The duty of good faith has also long existed implicitly in the case law—for example, in the formulation of the business judgment rule, and in fiduciary obligations that can only be explained by that duty, such as the rule that a manager acts improperly if he knowingly causes the corporation to take an illegal action. Nevertheless, the explicit recognition of the duty of good faith in recent Delaware cases shines a spotlight on that duty and therefore makes it especially important to develop the contours of the duty and to examine the duty from a normative perspective. It is these two issues with which this article has been primarily concerned.

The duty of good faith has a Janus-like quality, looking both backward and forward. Looking backward, the duty of good faith rationalizes and explains a variety of specific obligations that are already established, although they do not fit comfortably or at all within the duties

²⁰¹*Id.* at *176-77, reprinted in 31 DEL. J. CORP. L. at 424-25 (footnote omitted).

of care and loyalty, such as the obligation not to knowingly cause the corporation to disobey the law and the obligation of candor, even when law violation and lack of candor are not self-interested and are reasonably designed to maximize corporate profits and shareholder gain. Looking forward, the general duty of good faith may give rise to the articulation of new specific fiduciary obligations that come to be seen as appropriate in response to social changes, but cannot be accommodated within the duties of care or loyalty.

