

Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule

David Rosenberg¹

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1. Associate Professor of Law, Law Department, Zicklin School of Business, Baruch College, City University of New York, and Associate Director, Robert Zicklin Center for Corporate Integrity, Baruch College. Contact: 646-312-3582; david_rosenberg@baruch.cuny.edu. The author would like to thank Barry Adler, Andrew Gold, Larry Ribstein, Jonathan Rosenberg, Nathan Rosenberg and Bernard Sharfman for their helpful comments. All errors and shortcomings are mine alone.

Supplying the Adverb²: The Future of Corporate Risk-Taking and the Business Judgment Rule

I. INTRODUCTION

Risk-taking is an essential aspect of virtually any business venture. The success of most enterprises depends on the ability of their leaders to evaluate risks and to decide which, of many courses, to pursue based on the likelihood and the magnitude of gain that each risk promises. The shareholders in corporations—like investors in any commercial entity—tolerate risk-taking because they understand that competitiveness, innovation, and profitability require decision-makers to pursue paths that have uncertain outcomes. Recognizing this, American law has consistently prohibited courts from holding corporate leaders personally liable for the consequences of risky decisions that do not succeed. Indeed, a hallmark of our commercial law has been the refusal of courts to second-guess the business judgment of corporate directors.

This long-held policy of judicial abstention was sorely tested by the events of 2008. While a variety of causes undoubtedly contributed to the fall of so many financial institutions—and the loss of billions to shareholders—the most prominent among them was the mishandling of risk or, as one commentator succinctly called it, “really bad bets on mortgage securities.”³ The unprecedented events of 2008 inevitably force us to examine how the law addresses risk-taking by corporate leaders and to re-evaluate when the law should hold those leaders liable for the consequences of their bad decision-making.

The business judgment rule prevents courts from reviewing the decisions of corporate directors as long as the directors “acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”⁴ This means that aggrieved shareholders cannot hold directors legally⁵ responsible for even their most disastrous decisions unless the complaint clears a very high threshold. In justifying the broad protections provided by the business judgment rule, commentators and jurists highlight the

2. See *Gagliardi v. Trifood Int'l*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

3. Saul Hansell, NYTimes.com, Bits Blog, *How Wall Street Lied to Its Computers*, Sept. 18, 2008, <http://bits.blogs.nytimes.com/2008/09/18/how-wall-streets-quants-lied-to-their-computers>.

4. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

5. The corporate marketplace of course provides other means (of various levels of effectiveness) of sanctioning ineffective directors.

policy objective of encouraging risk-taking by corporate decision-makers.⁶ They argue that in order for a corporation to succeed in a highly competitive marketplace, it must test new ideas, pursue new markets, and create new products. Since many such inspired actions end in failure, the business judgment rule is necessary to protect directors from liability for such failures.

According to conventional wisdom, the business judgment rule allows directors to take risks freely without fearing personal liability for the potential losses resulting from those risky actions. Supporters of a strict interpretation of the rule also point out the dangers of “hindsight review” in this context. When faced with claims that corporate directors acted improperly in making a decision which later turned out to be unfavorable, courts might second-guess the reasonableness of the directors’ decision simply because something went wrong and thereby hold them legally responsible for the consequences. According to the oft-cited Delaware Court of Chancery, allowing such hindsight review would destroy “the entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation . . . with disastrous results for shareholders and society alike.”⁷

Virtually every legal decision addressing the business judgment rule emphasizes the protection of corporate risk-taking as the best justification for the rule’s broad scope. However, those decisions themselves rarely address allegations of excessive risk-taking or foolhardy speculation. Rather, most business judgment rule cases concern either the disloyalty of corporate directors (actions which clearly violate the duty of good faith) or gross negligence based on less-than-fully informed decisions or improper oversight. As the courts currently apply the rule, directors can escape liability even where there is little evidence that they exercised any business judgment at all. In justifying this kind of deference, courts claim that imposing liability in such cases would inhibit faithful directors from ever taking risks on behalf of the corporations that they oversee and lead.⁸

Judges essentially acknowledge that even if the directors consciously neglected their duties, the courts will not impose liability because it may inhibit other more faithful directors from taking risks that ultimately will benefit the shareholders.⁹ This attitude is perhaps illustrated best in an opinion by Delaware Chancellor Allen in *Gagliardi v. Trifood International* in which he disapproves of the possibility of holding directors liable for losses arising from a risky project where “the investment was too risky (foolishly risky! stupidly

6. See *infra* notes 22-40 and accompanying text.

7. *In re Walt Disney Co. Derivative Litig.* (hereafter “Disney IV”), 907 A.2d 693, 698 (Del. Ch. 2005). I quote the phrase “disastrous results” with no intended irony or reference to the events of 2008.

8. *Gagliardi v. Trifood Int’l*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

9. See, e.g., *id.*

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risky! egregiously risky! – you supply the adverb).”¹⁰ To allow liability for such decisions, he says, “would be very destructive of shareholder welfare in the long-term.”¹¹ Reluctant to supply an adverb that would result in liability, Allen says that all the business judgment rule requires from directors is good faith and adherence to “minimalist proceduralist standards of attention.”¹² As this Article will argue, surely, the obligation of good faith requires that directors not make decisions that they know are “too risky” (in that the potential payoff is not justified by the likelihood of failure)¹³ or where they know that they are ill-informed about the nature of the risks that they are authorizing.

The corporate law of Delaware¹⁴ and of most states requires plaintiffs alleging breach of directors’ fiduciary duty to claim not only that the directors made a bad decision but also that they made that decision in “bad faith.”¹⁵ In addition to allowing recovery when directors act disloyally, this standard also allows shareholders to recover when they can show that the directors *knew* that they were making an uninformed decision, or an unreasonable decision, or an irrational decision—a high, but not unreachable threshold. Adverse decisions against directors arising, for instance, from failure to get the best price in a merger or acquisition¹⁶ might be based on directors knowingly shirking their duty to obtain the information necessary to make that decision. For the most part, however, courts seem unwilling to impose liability in such cases but not because they cannot establish conscious disregard of the directors’ duty in each particular case. Rather, courts fear that by imposing liability they will stifle the atmosphere of risk-taking that promotes innovation and increases shareholder wealth. Interestingly, this occurs even if the case in question has little to do with that particular type of risk and even if the defendants fail to present much evidence of good-faith adherence to duty by the directors.

I propose that this apparent obsession with promoting and protecting risk-taking by corporate directors has lead Delaware courts to resist applying their own standard of good faith to cases in which plaintiffs might accuse directors

10. *Id.*

11. *Id.* at 1053.

12. *Id.* at 1052.

13. Allen is plainly using the term “too risky” in this sense. Neither Allen nor this Article is suggesting that directors might be held liable for decisions in which the likelihood of success is low but the payoffs disproportionately handsome. It is not a question of how much risk is tolerable; it is a question of whether the contemplated reward justifies the degree of risk.

14. This Article focuses on the law of Delaware because of its centrality as a source of American corporate law.

15. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). Until recently, the jurisprudence regarding the definition of bad faith was quite muddled. After years of inconsistent pronouncements, the Supreme Court of Delaware finally resolved most inconsistencies in the law in its decision in *Stone*. See also *supra* notes 64-77 and accompanying text.

16. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

of taking risks in violation of that duty. Further, courts could impose liability in such cases without threatening the beneficial aspects of the culture of innovation. Just as courts do not hold directors liable because they made informed-but-bad decisions, neither should they protect directors simply because they took risks. Shareholders should be allowed to recover where it can be shown that directors took a risk knowing that they were not adequately informed about the nature of the risk or knowing that the gravity of the risk plainly outweighed the potential gains. Ultimately, the decision to take a bold risk is not different from any other type of decision except that the chances that it will succeed are lower and, presumably, that the potential gain is greater. Courts are qualified to balance the unlikelihood of success with the potential benefits that would flow to the corporation in the event that the decision does succeed.¹⁷ Further, courts should be more willing to examine the background of a risky action and conclude that the decision-makers knew that they were not adequately informed about the risks to justify a particular course of action.

The widely accepted notion that the business judgment rule should protect virtually all risk-taking by corporate directors goes too far. Under Delaware law, a director should be liable for risky decisions that go wrong if the plaintiffs can show that the director knew that the decision was, to use Chancellor Allen's phrase, "too risky"¹⁸ or if the director did not even care to find out what the risks were. The burden that the law places on the plaintiff is to supply the adverb that brings the director's failing beyond the threshold of bad faith.

Focusing on the current law in Delaware—in light of the 2006 Delaware Supreme Court decision in *Stone v. Ritter*¹⁹ that refined the definition of "good faith,"—I propose that courts are perfectly well-equipped to hear cases in which aggrieved shareholders claim that directors took improper risks in ways that ought to result in liability.²⁰ I attempt to show that such review—even if the courts have, for the most part, refused to engage in it—would neither fall outside the prevailing boundaries of the business judgment rule nor damage the ability of corporations to take the kind of bold risks that have resulted in years of innovation and growth in the American corporate sector.

Further, and perhaps most vitally, if the doctrine of good faith is to have any teeth at all, it must address all areas of director decision-making, including risk-taking. It is well within the ability of courts to decide whether or not a board intentionally made a risky decision, as *Stone* puts it, "with a purpose

17. See Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion*, 67 S. CAL. L. REV. 287, 305 (1994); D. A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 841-42 (2007).

18. *Gagliardi v. Trifood Int'l*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

19. 911 A.2d 362 (Del. 2006).

20. This article does not address whether the directors' D & O insurance covers or ought to cover such misconduct.

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other than that of advancing the best interests of the corporation.”²¹ Although *Stone* and its most important predecessor, *Caremark*, involved the *oversight* function of the board, the good faith obligation imposed by those decisions should apply equally to directors’ states of mind when they approve or make affirmative decisions to take actions, including risky ones. By seeming to exclude review of decisions to take risks, the Delaware courts currently disregard their own definition of the duty of good faith and limit the scope of the fiduciary duties of corporate directors to nothing more than the obligation not to self-deal. If consistency and clarity are to remain a hallmark of Delaware corporate law, the business judgment rule and the duty of good faith should apply to risky decisions in the same way that they apply to other actions and inactions taken by corporate directors.

II. THE PRIMACY OF RISK-TAKING

Arguments in favor of the risk-taking justification for the business judgment rule rely on four key notions: the role of risk-taking in wealth creation, the ability of shareholders to diversify their portfolios, the dangers of hindsight review, and the disproportionality of directors’ potential payoff and potential liability. Taken together, these do indeed make a compelling case for the proposition that courts should not review the decisions of America’s business leaders except in extraordinary circumstances. Not surprisingly, the great body of cases applying the business judgment rule and scholarship commenting on the nuances of the rule emphasize the importance of these elements in justifying application of the rule’s protections even where corporate directors did not engage in “best practices.”²²

First, students of American law and economic history agree that much of our nation’s technological progress and resulting economic growth arose not just through the inspired tinkering of a few great inventors but through the bold risk-taking of our great corporate innovators.²³ When a corporation embarks on a risky venture, its leaders will likely justify the action on the grounds that, although the likelihood of failure is high, the venture will greatly benefit the corporation and its shareholders if it is successful. Often such risky projects

21. *Stone*, 911 A.2d at 369.

22. See, e.g., *Disney IV*, 907 A.2d at 697 (“This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices.”). It is important to note that advocates of near absolute business judgment rule protection for risk-taking acknowledge the distinction between the standard the law imposes and the standard of conduct that most of us would expect from reasonable and prudent directors. See, e.g., William T. Allen, Jack B. Jacobs & Leo Strine, Jr., *Realigning the Standard of Review of Director Due Care With Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 450 (2002).

23. For a discussion of the role of big firms in innovation, see WILLIAM J. BAUMOL, *THE FREE-MARKET INNOVATION MACHINE* 55-72 (2002).

fail, but there is little dispute that by taking risks, corporate decision-makers consciously attempt to maximize the present value of the corporation's expected income and, thereby, benefit shareholders.²⁴ Anyone with an interest in the future profitability of a corporation would likely want that corporation to take risks and insist that governance mechanisms allow its leaders to do so.²⁵ Any fair summary of American corporate legal history would show that this model has been followed for at least the last one hundred years.

While individual corporations maximize the wealth of their shareholders by embarking on risky ventures, many of the arguments in favor of the business judgment rule also rely on a second notion—the ability of shareholders to diversify their holdings across many corporations and therefore diversify their risk as well.²⁶ In *Gagliardi*, for example, Chancellor Allen justifies the broad protections of the business judgment rule on the ground that shareholders should not rationally want directors to be risk averse: “[s]hareholders’ investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm’s cost of capital.”²⁷ Similarly, Stephen Bainbridge invokes portfolio theory to argue that, since shareholders can diversify their portfolios, they should be indifferent to decisions by directors that affect the risks faced by an individual corporation as long as those decisions are designed to increase the rate of return of that specific

24. Allen et al. explain how a very risky decision might be in the best interest of the corporation: “Because the expected value of a risky business decision may be greater than that of a less risky decision, directors may be acting in the best interest of the shareholders when they choose the riskier alternative.” Allen et al. *supra* note 22, at 455.

25. As Bainbridge explains, we can view the business judgment rule as an “off-the-rack rule” that essentially imposes by default a rule that the shareholders would willingly agree to by contract – a promise on their part “to refrain from challenging the reasonableness of managerial business decisions.” Stephen Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 114-116 (2004).

26. This argument seems to disregard the contractarian view of the corporation, a theory which many of the business judgment rule’s strongest proponents embrace. To a contractarian, a director owes fiduciary duties to the shareholders in a way that is similar to the duties a party assumes under an ordinary contract. David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law*, 29 DEL. J. CORP. LAW 491 (2004). Surely in defining those duties, the parties do not assume that the shareholders must hold shares in other corporations. The duties owed by a director, whatever they might be, ought to be defined within the confines of the conglomeration of relationships within that specific corporation. To define the duties owed by a director to a shareholder with reference to the fact that the shareholder likely owns stock in other corporations seems akin to mitigating the liability of a negligent babysitter on the grounds that, well, the parent probably has other children who will not have been harmed by that babysitter’s lack of care.

27. *Gagliardi v. Trifood Int’l*, 683 A.2d 1049, 1052 (Del. Ch. 1996). This assumption may well have played a crucial role in the meltdown of 2008. In advocating for greater regulation in the wake of the events of the Fall of 2008, Martin Wolf of the Financial Times writes, “In particular, far more attention must be paid to behaviour that may appear rational for each institution, but cannot be rational if all institutions are engaged in it at the same time.” Martin Wolf, *The end of lightly regulated finance has come far closer*, Financial Times, Sept. 16, 2008.

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corporation.²⁸ Indeed, the holder of shares in a publicly traded corporation likely owns shares in other publicly traded corporations as well.²⁹ Plainly, to maximize the overall value of a diversified portfolio of holdings, the broad protections of the business judgment rule serve the shareholder well by encouraging directors to take risks without fear of liability even if those specific risks do not ultimately add value to the corporation that they oversee.

A third notion supporting the broad application of the business judgment rule is the notorious complication that inevitably accompanies judicial review of business decisions. The problem with allowing courts to review the decisions of corporate directors is not that sometimes the directors get it wrong; no one seriously suggests that investors should be able to recover from directors any time a decision ends up hurting the corporation.³⁰ This understanding is implicit in any discussion of the workings of a market economy that recognizes the corporate form.³¹ The real problem with reviewing bad decisions by corporate directors, as many commentators have pointed out, is that courts will sometimes error in their determination of how and why the directors made a mistake. Both common sense³² and empirical studies³³ tell us that any attempt to judge or analyze a decision after the results of the decision are already known may be tainted by “hindsight bias.”³⁴ Whatever the standard a court might use in evaluating a claim regarding a decision made in the past, it will be difficult for the court to ignore the known consequences of the decision. As Bainbridge puts it: “[d]ecision makers tend to assign an erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring.”³⁵ Hence, many fear that absent the strong protections of the

28. Bainbridge, *supra* note 25, at 112-14.

29. Still it is unclear why this should at all affect the culpability of the directors. Although the misconduct in the Enron debacle was far worse than the kind of borderline bad faith contemplated here, the fact that the retirement plans of many Enron employees were made up almost entirely of stock in Enron itself made the impact far more devastating. Michael W. Lynch, *Enron's 401(k) Calamity*, Reason Magazine, Dec. 27, 2001. The failure of the Enron employees to diversify was a bad investment decision for them. But even if they had diversified, that should not have mitigated the culpability of the Enron leadership.

30. Indeed, it might be said that the business judgment rule (which to a degree prohibits recovery even when the actor made a bad decision) is the polar opposite of strict liability (which imposes liability even where the plaintiff cannot prove that the actor made a bad decision).

31. Judge Winter described this assumption nicely in his oft-cited opinion in the well known case of *Joy v. North*: “First, shareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers . . . [t]he business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.” 692 F.2d 880, 885-886 (2d Cir. 1982).

32. For a non-legal example of hindsight bias, listen to a random five-minute segment of any sports-related, radio call-in show anywhere in the world on a Monday morning.

33. Allen et al., *supra* note 22, at 454-55. See also Bainbridge, *supra* note 25, at 114.

34. See Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD L REV 398, 443 (2007).

35. Bainbridge, *supra* note 25, at 114.

business judgment rule, courts would be tempted to hold directors liable for good-faith decisions that did not end up benefiting the corporation.³⁶

Finally, a fourth notion that informs the rationale of the business judgment rule is what Chancellor Allen in *Gagliardi* called “this stupefying disjunction between risk and reward for corporate directors.”³⁷ As he explains, corporate directors generally do not own a large percentage of the stock in the corporations that they oversee.³⁸ When directors take a risk that succeeds in producing wealth for the corporation, they benefit by perhaps a decent gain in their equity share of the corporation and certainly a gain for their reputation as good leaders and decision-makers. Similarly, if they take a risk that produces losses for the corporation, the directors will take a small equity hit and a concomitant dent in their reputations as good leaders. However, as Allen emphasizes, if courts were to hold directors personally liable for the damages arising from their unsuccessful risky decisions, the law would minimize directors’ incentives to take the kind of risks that shareholders would want them to take.³⁹ The current business judgment rule, then, simply puts the potential for personal damages in line with the potential personal payoff that might result from the authorization of a risky venture by corporate directors.⁴⁰ Since the potential financial payoff for most directors is very low (because they possess little equity in the corporation), their potential liability should be very low as well.

36. As other commentators have pointed out, however, this does not stop our legal system from allowing judges and juries to determine the reasonableness of an actor’s actions in a variety of areas of professional endeavor or everyday life after something goes wrong. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 94 (Harvard Univ. Press 1991) (pointing out that judges routinely “decide whether engineers have designed the compressors on jet engines properly” and “whether the farmer delivered pomegranates conforming to the industry’s specifications”); Gevurtz, *supra* note 17, at 305. But see Telman, *supra* note 17 at 841-42.

37. *Gagliardi v. Trifood Int’l*, 683 A.2d 1049, 1052 (Del. Ch. 1996). See also, Allen et al., *supra* note 22, at 456 (“But directors will tend to deviate from this rational acceptance of corporate risk if, in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss”).

38. *Gagliardi*, 683 A.2d at 1052. Stephen Bainbridge, however, notes that corporations sometimes require directors to buy stock in corporations in which they serve. Bainbridge, *supra* note 23, at 117. This would work to align the interests of directors and shareholders and lessen, to a degree, the disproportion between the reward for successful risks and the penalty for those that fail.

39. See Allen et al., *supra* note 22, at 455 (“A standard of review that imposes liability on a board of directors for making an ‘unreasonable’ (as opposed to an ‘irrational’) decision could result in discouraging riskier yet socially desirable economic decisions, because an ordinary negligence standard of care will tend to make directors unduly risk averse”).

40. In *Gagliardi*, Allen writes, “Given this disjunction, only a very small probability of director liability based on ‘negligence,’ ‘inattention,’ ‘waste,’ etc., could induce a board to avoid authorizing risky investment projects to any extent!” *Gagliardi*, 683 A.2d at 1052. It appears that Allen means that even a small probability of liability would cause a director to avoid risks because the rewards for success are disproportionately small compared to the damages resulting from failure. Effectively, the business judgment rule allows directors to take risks without fear of that liability.

III. THE LEGAL FRAMEWORK FOR EVALUATING CORPORATE RISK-TAKING

The bottom line for supporters of a strong business judgment rule is the *bottom line*—the financial gain accomplished via risky decisions. For many, its justification lies in the overall value it creates.⁴¹ Much of Delaware's jurisprudence on the rule and scholarly commentary⁴² dwell heavily on the policy justifications for shielding directors from liability for risk-taking through the protections of the business judgment rule. And yet in the courts' embrace of the centrality of risk-taking, they appear to ignore the legal structure of fiduciary obligations under which corporate directors function. When used to evaluate a claim of actionable risk-taking, Delaware law is confusing and inconsistent at least partly because, until recently, the Delaware Supreme Court had not yet devised a workable definition of the fiduciary obligations owed by corporate directors.⁴³

Although the justifications for the business judgment rule seem to prohibit it, cases involving allegations of director misconduct through excessive risk-taking often address the directors' states of mind in deciding to take the risk. For example, in *Trenwick v. Ernst & Young*, a case better known for its discussion of the directors' duties to creditors, Chancellor Strine quotes *Gagliardi* for the proposition discussed here earlier that plaintiffs cannot hold directors liable for decisions to invest, "no matter how foolish the investment may appear in retrospect."⁴⁴ Strine again references directors' states of mind as he addresses the role of the business judgment rule in both encouraging risk-taking by directors and protecting those directors when the risks end in failure. He says:

But business failure is an ever-present risk. The business judgment rule exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that *seem to promise great profit*. If the mere fact that a strategy turned out poorly is in itself sufficient to create an inference that the directors who approved it breached their fiduciary duties, the business judgment rule will have been denuded of much of its utility.⁴⁵

Strine states the conventional rule that a court must nearly always avoid evaluating a director's decision based on its eventual outcome. He explains

41. And indeed many judges do not seem to insist that the rule has moral or ethical justifications. They often point out, for example, that directors who receive the rule's protection *should have* behaved differently. See, e.g., *Disney IV*, 907 A.2d 693, 697 (Del. Ch. 2005). This is not to say, however, that moral failings on the part of directors are irrelevant to application of the business judgment rule. It is often a moral failing (e.g. greed) that gives rise to a violation of fiduciary duty and a resulting substantial loss to the corporation.

42. See, e.g., EASTERBROOK & FISCHER, *supra* note 36, at 93 ("Behind the business judgment rule lies recognition that investors' wealth would be lower if managers' decisions were routinely subjected to strict judicial review").

43. See *infra* Section IV on good faith.

44. *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168, 193 (Del. Ch. 2006) (citing *Gagliardi*, 683 A.2d at 1052).

45. *Id.* (emphasis added).

that, whatever the actual consequences of the director's action, the director will receive the rule's protection where he acted in good faith and where his state of mind was such that the risk "seem[ed]" like a decent idea.

Importantly, however, the business judgment rule is not merely an application of the duty of care in the corporate context.⁴⁶ Instead, the rule as generally described goes further than necessary—it protects even strategies that do not "seem to promise great profit"—so that directors will still be willing to take the kind of calculated chances that we want them to take. The problem here is that, under current Delaware law, one could argue that it constitutes bad faith for a director to pursue a strategy that does not *seem* to him calculated to promise great profit. Such a decision would therefore fall outside the protections of the business judgment rule. Of course, in such cases, courts still must determine whether the corporate leaders who authorized risky investments—in, for example, sub-prime mortgages—really believed that these risks "seemed to promise great profit" or if the directors simply did not care to inquire into their potential for profit because they felt that the business judgment rule did not require them to. Under *Trenwick*, it appears that the business judgment rule would protect actions that courts might consider "bad faith" under the current definition of that term.

The Disney litigation arose after the company's board approved CEO Michael Eisner's decision to hire his good friend Michael Ovitz as President of the company in 1995.⁴⁷ This decision made big news because Ovitz was quite close to Eisner and because Ovitz lacked any kind of experience leading a major media conglomerate.⁴⁸ But the real controversy began a little over a year later when Ovitz was fired and Disney's shareholders learned that he was entitled to approximately \$130 million upon leaving the company. In early 1997, several plaintiffs brought a shareholder derivative lawsuit against Ovitz and the Disney board of directors alleging, among other things, that the board had breached its fiduciary duty when it approved Ovitz's original employment agreement.⁴⁹ Nearly a decade of litigation in the Delaware Court of Chancery and the Delaware Supreme Court followed.⁵⁰

The ensuing court battles were fun to watch over the years because they allowed us to see Hollywood big shots (such as Eisner, Ovitz, and Sidney Poitier) squirming in the wake of a very bad business decision. But it was also fun to watch because it allowed students of corporate governance to engage in

46. *Gagliardi*, 683 A.2d at 1052.

47. *In re Walt Disney Co. Derivative Litig.* (hereafter "Disney V"), 906 A.2d 27, 35 (Del. 2006).

48. *Id.* at 39. He had however been extraordinarily successful as the founder of one of Hollywood's leading talent agencies. *Id.* at 36.

49. *Id.* at 35.

50. This Article will refer to the several decisions (notably Disney II, IV and V) in the case using the convention that has taken hold in both the courts' opinions and the scholarly literature.

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our own hindsight analysis regarding a risky decision made by corporate directors who did not adhere to what one court referred to as “best practices.”⁵¹ An underlying theme of the Disney opinions was the apparent failure of directors to recognize and evaluate risk. Specifically, the risks arose from approving the hiring of an untested, new president at a high price and with an extraordinarily generous severance package. The courts’ discussions of the directors’ approach in approving the new president suggest that the business judgment rule does not necessarily preclude review of risky forward-looking decisions and ultimately the imposition of liability.

In *Disney II*, Chancellor Chandler held that “a ‘we don’t care about the risks’ attitude” concerning directors’ material corporate decisions could constitute a breach of the duty of good faith.⁵² Relying in part on *Gagliardi*, the Court of Chancery found that the plaintiffs had indeed pled facts sufficient to support a claim for breach of the directors’ fiduciary duty.⁵³ Under *Disney II*, evidence of a risky decision coupled with evidence that directors did not care whether that decision helps the corporation and its shareholders together can constitute evidence of bad faith.⁵⁴

Two years later, in an opinion known as “*Disney IV*,” Chandler revisited his earlier decision and delved more deeply into the issue of risk. In the first few pages of a seventy-plus-page opinion, he jumped into a *Gagliardi*-like discussion of the centrality of risk-taking in the business world.⁵⁵ Like so many other judges faced with evaluating the culpability of directors in the wake of an unsuccessful decision, Chancellor Chandler points out that any kind of business involves risk and that courts will not apportion liability simply on the grounds that a director took a risk that did not turn out to benefit the company.⁵⁶ Though conscious of the primacy of risk-taking, Chandler also displays a clear willingness to hold directors liable when they take risks knowing that they have not been sufficiently informed:

But the essence of business is risk—the application of informed belief to contingencies whose outcomes can sometimes be predicted, but never known. The decision-makers entrusted by shareholders must act out of loyalty to those shareholders. They must in good faith act to make informed decisions on behalf of the shareholders untainted by self-interest. Where they fail to do so, this Court stands ready to remedy breaches of fiduciary duty.⁵⁷

51. *Disney IV*, 907 A.2d 693, 697.

52. *In re Walt Disney Co. Derivative Litig.* (hereafter “*Disney II*”), 825 A.2d 275, 289 (Del. Ch. 2003).

53. *Id.*

54. *Id.*

55. *Disney IV*, 907 A.2d at 698.

56. *Id.* (“...under our corporate law, corporate decision-makers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and abilities dictate, free of *post hoc* penalties from a reviewing court using perfect hindsight.”).

57. *Id.*

By insisting that directors be *informed* when making a risky decision, Chandler equates the kind of risk-taking at issue in *Disney* with the oversight function at issue in the many Delaware cases in which the duty of good faith evolved. As in director-oversight cases, the business judgment rule protects directors for risks that they take only when they have consciously informed themselves of the extent of the risks.

Later in the opinion, Chandler revisits his statement in *Disney II* that bad faith could exist where directors “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.”⁵⁸ Affirming himself, Chandler announces that he will evaluate the behavior of the Disney directors based on the standard that “[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.”⁵⁹ His ruling establishes that bad faith may exist where a director takes a risk without consciously believing that the risk is in the best interests of the corporation.⁶⁰ Not caring about the risks is not merely negligence nor even gross negligence; rather, it rises to the level of bad faith, and is therefore not protected by the business judgment rule.

In applying this standard, Chandler ultimately found that, while the directors’ conduct “fell significantly short of the best practices of ideal corporate governance,”⁶¹ their conduct did not amount to bad faith, as the duty was then understood. In the absence of bad faith, the business judgment rule protected the *Disney* directors. Chandler’s dismissal of the allegations against each defendant director has been discussed at length elsewhere,⁶² but it is worth focusing briefly on the language he uses regarding the conduct of Raymond L. Watson, then a director and formerly Chairman of Disney’s board. Finding insufficient evidence that Watson breached his fiduciary duties, Chandler said, “[n]othing in his conduct leads me to believe that he took an ‘ostrich-like’ approach to considering and approving [Ovitz’s compensation package].”⁶³ That is to say, if directors do not bother to look at the consequences of their actions, such behavior can be bad faith even if the directors’ actions (or inactions) do not seem to benefit them in any way.

Disney IV’s broad sense of the duty of good faith presages the formulation in *Stone*. For the first time, *Stone*’s description of the duty drew the line

58. *Id.* at 754-55 (emphasis omitted).

59. *Id.* at 755.

60. The Supreme Court of the State of Delaware explicitly upheld this definition in *Disney V*, 906 A.2d 27, 63 (Del. Supr. 2006). That not caring is bad faith is made plain in *Stone*. 911 A.2d 362, 369 (Del. 2006).

61. *Disney IV*, 907 A.2d at 697.

62. See, e.g., David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. LAW 301 (2007).

63. *Disney IV*, 907 A.2d at 765.

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indicating where a breach of the duty of care might also constitute bad faith. *Stone* more explicitly held what Chandler and others were hinting at (and what *Gagliardi* shied away from): conscious breaches of the duty of care are bad faith and can therefore constitute disloyalty even if those actions did not benefit the directors themselves.

IV. *STONE V. RITTER*, GOOD FAITH, AND THE BUSINESS JUDGMENT RULE

For years, the Delaware courts and academic commentators could not agree on the meaning of “good faith” in the context of the business judgment rule.⁶⁴ Much of the confusion regarding the definition of good faith and its relationship to the duties of care and loyalty arises from the 1986 passage of Section 102(b)(7) of the Delaware General Corporations Law. The Delaware legislature passed the law in the wake of the Delaware Supreme Court’s decision in *Smith v. Van Gorkom*, a case in which corporate directors were held personally liable for acts which the court found amounted to gross negligence.⁶⁵ Intended to provide assurance to would-be directors that they would not risk their personal fortunes by agreeing to serve on the boards of Delaware-based corporations, Section 102(b)(7) allows corporations to voluntarily limit the liability of directors for breaches of their fiduciary duties. However, it does not limit liability for “any breach of the director’s duty of loyalty” or “for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.”⁶⁶ Because of the well-known legislative history of the statute and the case that inspired its creation, many commentators summarize 102(b)(7) as permitting a corporation to limit directors’ personal liability for “breaches of the duty of care.”⁶⁷ That was indeed the law’s intent—to allow directors to make decisions without fearing personal liability for negligent conduct, even for conduct that constitutes gross negligence, as in *Smith v. Van Gorkom*.

After the passage of 102(b)(7), Delaware courts had a difficult time reconciling the duty of good faith as used in that law with the duty of good faith as it already existed in the case law. Since at least 1993, the Delaware Supreme Court seemed to insist that a director’s fiduciary obligations consisted of three

64. As the Delaware Supreme Court noted in *Disney V*, “the good faith concept has recently been the subject of considerable scholarly writing.” 906 A.2d at 63 n.99 (providing a nearly exhaustive then-current list). In the wake of the decision in *Stone v. Ritter*, yet more ink has been spilled on the subject. See Gold, *supra* note 34, Bainbridge, *supra* note 25, and two articles by Claire A. Hill and Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. LAW 833 (2007) and ‘*Stone v. Ritter*’ and the Expanding Duty of Loyalty, 76 FORDHAM L. REV. 1769 (2007).

65. The primary problem with the decision in *Van Gorkom* was not the principle that allowed imposition of liability for gross negligence but that many observers believed that the facts did not justify the conclusion that the directors had been grossly negligent in the first place.

66. Del. Code Ann. tit. 8, § 102(b)(7) (2009).

67. See, e.g., Carter G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, 2007 MICH. ST. L. REV. 905, 905-06 (2007).

different duties: care, loyalty, and good faith.⁶⁸ At the same time, the Delaware Court of Chancery followed its own formulation, insisting that good faith was merely a “subsidiary requirement” of the duty of loyalty.⁶⁹ The Delaware Supreme Court finally addressed the issue head-on in its 2006 decision in the case of *Stone v. Ritter*.

In *Stone*, a shareholder derivative lawsuit alleged that the board of directors violated its duty of good faith by failing to institute adequate measures to ensure compliance with federal financial regulations.⁷⁰ In the wake of the decision, a number of commentators quickly pointed out that the court’s opinion did not fully resolve the widespread confusion on the issue of good faith.⁷¹ Nonetheless, a close reading of the case provides a pretty clear understanding of the parameters of the duty.

Oddly, the court’s formulation of the duties of good faith and loyalty describes good faith as a “subsidiary element” of the duty of loyalty although, instinctively, most would think it should be the other way around.⁷² At first blush, the duty of good faith seems broader than the duty of loyalty because it is hard to think of a disloyal act that would not also be in bad faith, but it is easy to think of an act that is bad faith that is not necessarily disloyal (at least in the sense of self-interested).⁷³ *Stone* resolved this apparent inconsistency by defining the duty of loyalty to encompass much more than merely actions taken in self-interest.

A close reading of *Stone* and these earlier cases makes clear that, under Delaware law, a director acts disloyally if he does not believe in good faith that his actions are in the best interests of the corporation, regardless of whether those actions benefit the director at the expense of the corporation. Chancellor Strine first chiseled out this definition in *Guttman v. Huang*,⁷⁴ a case heavily relied upon by the court in *Stone*. In *Guttman*, a case involving a shareholder derivative lawsuit against corporate directors for their failure to prevent certain accounting irregularities, Strine emphasized that actions amounting to disloyalty need not benefit the disloyal party. Under his formulation, a director

68. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

69. *In re Gaylord Container Corp. Shareholders Litigation*, 753 A.2d 462, 476 (Del. Ch. 2000).

70. *Stone v. Ritter*, 911 A.2d 362, 366 (Del. 2006).

71. Stephen Bainbridge and his co-authors, for example, argue that the opinion’s formulation of good faith “makes little sense.” Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 584 (2006).

72. Indeed, this author took the broadest possible view of the duty of good faith, arguing that “[t]he duty of good faith should apply to all the obligations of a corporate director and not just to the duty of loyalty...” Rosenberg, *supra* note 26, at 515. Although this definition seems entirely irreconcilable with that of the Delaware Supreme Court, the disjunction hinges more on the definition of “loyalty” than the definition of “good faith.”

73. A decision that I believe will hurt the company but that will not necessarily help me is plainly made in bad faith but is not plainly disloyal in the sense of deliberately benefiting myself rather than my fiduciaries.

74. 823 A.2d 492 (Del. Ch. 2003).

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acts disloyally if he believes that his actions are not in the best interests of the corporation, regardless of whether or not those actions in turn benefit the director himself. With the *Gagliardi* opinion's string of adverbs⁷⁵ several years past, Strine reached for the thesaurus and conjured up a string of adjectives instead. Strine stated: "the reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it *venal, familial, collegial, or nihilistic*"⁷⁶) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless."⁷⁷

Subsequent Court of Chancery opinions closely followed the *Guttman* formulation. These opinions made clear that bad faith (and therefore disloyalty) is not limited to actions that benefit the director at the expense of the corporation but can also include any of a number of "moral failings."⁷⁸ In *Disney IV*, Chancellor Chandler (with some apparent delight) enumerated these failings with a string of nouns worthy of the adverbs and adjectives of his colleagues:

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.⁷⁹

The faithless director described here knows that he is acting against the best interests of the corporation due to a "moral failing" embodied in the above list of vices. Ignorance, by itself, Chandler notes, is probably not enough, "but ignorance attributable to any of the moral failings previously listed could constitute bad faith."⁸⁰ Once he established that bad faith is a knowing failure to act in the interests of the corporation due to a bad (immoral?) motive⁸¹, it

75. *Gagliardi*, 683 A.2d at 1052 ("foolishly risky! stupidly risky! egregiously risky").

76. I suspect that Strine thought long and hard about including "nihilistic" motives among those that can constitute disloyalty. It suggests that shareholders ought to be able to overcome the presumptions of the business judgment rule even without alleging specific bad motives on the part of the directors. It comes very close to suggesting that the ineffectiveness of the directors' action itself is enough to constitute bad faith. For a discussion of how courts evaluate the substance of director's decisions while claiming that they don't see Rosenberg, *supra* note 62.

77. *Guttman*, 823 A.2d at 506 n.34 (emphasis added).

78. *Disney IV*, 907 A.2d at 754.

79. *Id.* (emphasis added). The court incorrectly cited *Guttman*, 823 A.2d at 506 & n.34. In fact, the quote comes from *In re RJR Nabisco, Inc. S'holder Litig.*, 14 DEL. J. CORP. L. 1132, 1159 (1989). (emphasis added). Impressively, between the quotations from Chancellor Allen's opinion in *RJR Nabisco* and Chancellor Chandler's opinion here, the Delaware Court of Chancery officially recognizes as bad faith in the context of corporate director actions 71% of the Catholic Church's seven deadly sins (i.e. greed, lust, envy, pride and sloth). I leave it to other scholars to contemplate the implications of this apparent invocation of religious doctrine on the United States Constitution's prohibition on governmental establishment of religion.

80. *Disney IV*, 907 A.2d at 754.

81. It is unclear whether ignorance on the part of a corporate director could possibly exist without the commission of at least one of the other enumerated vices by the director himself or by someone else who has similar duties. A director might act in good faith and yet remain ignorant, due perhaps to the failure of a seemingly reliable expert to keep the director properly informed. In such a case, the director

was not hard to equate bad faith with disloyalty: “Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation.”⁸²

The Delaware Supreme Court’s decision in *Stone v. Ritter* finally confirmed the counterintuitive proposition that, under Delaware law, any act made in bad faith is also disloyal.⁸³ There is no “triad” of separate fiduciary duties; when a director acts in bad faith he has violated his duty of loyalty.⁸⁴ Put another way, conscious breaches of any duty (including knowing breaches of the duty of care) are henceforth considered disloyal. As Stephen Bainbridge et al. explain:

By subsuming good faith into the duty of loyalty . . . *Stone* extends the domain of the duty of loyalty to cases in which the defendant received no financial benefit . . . [and thus,] [l]iability for acts in bad faith . . . will look a lot more like that imposed in cases involving a breach of the duty of care than the duty of loyalty.⁸⁵

After *Stone*, certain breaches of the duty of care (i.e. knowing breaches) will not enjoy the protection of the business judgment rule because they will be breaches of the duty of loyalty as well.⁸⁶

Two other commentators, Claire A. Hill and Brett H. McDonnell, nicely parse how a knowing breach of the duty of care might be defined as a breach of the duty of loyalty. As they note, a breach of the duty of loyalty in the classic sense takes place when a director takes for himself a benefit that should otherwise be the corporation’s.⁸⁷ On the other hand, “[c]lassic duty of care

ought to be free from liability, but the aggrieved plaintiffs should be able to hold the expert responsible for failing to fulfill his obligations.

82. *Disney IV*, 907 A.2d at 755. In a case decided only a few weeks after *Disney V*, Chancellor Strine called it “conscious torpor” where a director knowingly decides to fail to discharge his fiduciary obligations. *Teachers’ Ret. Sys. of Louisiana v. Adinoff*, 900 A.2d 654, 668 (Del. Ch. 2006).

83. *Stone*, 911 A.2d 362, 370 (Del. 2006).

84. *Stone* thus explicitly affirms Strine’s assertion in *Guttman* that “[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.” *Stone*, 911 A.2d at 370 (affirming *Guttman v. Huang*, 823 A.2d 492, 506 n.34). The terminology gets very confusing here because the opinion also explicitly affirms *Guttman*’s definition of good faith as a “‘subsidiary element,’ i.e., a condition, ‘of the fundamental duty of loyalty.’” *Id.* At the same time, however, *Stone* expands the meaning of disloyalty to include acts for which the director did not have a “good faith belief that her actions are in the corporation’s best interest.” *Stone*, 911 A.2d at 370. While the court narrows the definition of bad faith so that it becomes merely a subset of disloyalty, it expands the definition of disloyalty to include acts which earlier might have simply met the definition of bad faith but not necessarily disloyalty in the sense of being self-serving.

85. Bainbridge et al., *supra* note 25, at 585. The authors are right: including as disloyalty acts that do not benefit the director does indeed make the duty of good faith look a lot like the duty of care. Essentially, *Stone*’s duty of loyalty includes breaches of the duty of care in bad faith.

86. Further, in the wake of *Disney V* and *Stone*, courts must reevaluate the scope of the protections granted by 102(b)(7). Focusing on the language of the law itself (and not its widely accepted paraphrase), it appears that 102(b)(7) allows waivers of liability for most breaches of duty of care but not those breaches of that duty that might be considered disloyal according the Delaware Supreme Court’s definition in *Stone*. It is entirely possible then, after *Stone*, that a 102(b)(7) waiver would no longer protect directors for the authorization of a risky project where the directors deliberately ignored the relationship between the chances of success of the project and its rewards for the corporation.

87. Hill & McDonnell, ‘*Stone v. Ritter*’ and the Expanding Duty of Loyalty, *supra* note 64, at 1795. In a nice turn of phrase, Carter G. Bishop characterizes this aspect of the duty of loyalty as “an obligation of devotion” to the corporation that includes more than simply not enriching oneself at the

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cases also involve a director taking for herself something which should otherwise be the corporation's: her attention and diligence."⁸⁸ Therefore, it makes sense to label a director's actions disloyal when that director knowingly fails to pay attention or knowingly acts in a slothful manner. Such a director has indeed deliberately acted against the best interests of the corporation and in her own interests. The diligence and attention that was supposed to benefit the corporation may now be used (or perhaps saved up) by the director himself for pursuits unrelated to decision-making on behalf of the corporation. Viewed this way, *Stone's* expansive notion of loyalty does not seem so incongruous after all.

V. WHERE RISK-TAKING AND OVERSIGHT MEET

With the exception of the *Disney* cases, most of the decisions that gave rise to this definition of good faith and loyalty involved the oversight function of the board of directors rather than its function as manager and strategic decision-maker. Nonetheless, the jurisprudence of good faith that has evolved in these cases can easily apply to situations in which directors choose (or choose not) to take affirmative risks on behalf of the corporation. Bainbridge et al. note that, when designing oversight and compliance programs, directors inevitably must take risks that may or may not turn out to benefit the company.⁸⁹ Weighing the costs and benefits of certain safeguards against rules violations, a board might decide that the safeguards are simply not worth the price given the likelihood of a potential violation and the gravity of the harm it would do.⁹⁰ According to Bainbridge et al., assuming that the directors arrived at the decision not to implement the safeguards in good faith, they would plainly be protected under the *Caremark* standard.⁹¹ The decision to suffer a risk by not implementing a costly safeguard is therefore not different from the decision to take a risk by pursuing, for example, a new and untested technology, or to invest in financial instruments backed by sub-prime loans; at least they are not different with respect to the way a court should evaluate the good faith of the corporate authorities who chose to take the risk in the first place.

By clarifying the definition of good faith in *Stone*, the Supreme Court of Delaware created the opportunity to re-evaluate the way that the business judgment rule addresses risk-taking by corporate directors. As *Stone*

company's expense. Carter G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, 2007 MICH. ST. L. REV. 905, 924 (2007).

88. Hill & McDonnell, *supra* note 64, at 1795.

89. Bainbridge et al., *supra* note 71, at 600-01.

90. *Id.* at 601.

91. *Id.* ("After all, a decision not to act does not differ from a decision to take action. Accordingly, the thrust of Allen's opinion [in *Caremark*] suggests that the business judgment rule ought to protect directors who rationally elect against adopting a compliance program after weighing the costs against the benefits.").

established, it is not good faith “where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation.”⁹² Therefore, deliberately failing to pay attention to the risks of pursuing a new idea or to the risks of an investment in a highly uncertain financial instrument would be bad faith and would fall outside the protections of the business judgment rule. Perhaps, as Bainbridge and his co-authors fear, such failure looks a lot like a breach of the duty of care masquerading as a case involving a breach of the duty of good faith.⁹³ But under *Stone*’s very high threshold, only knowingly careless conduct becomes disloyal conduct and therefore bad faith. This new standard should not threaten the culture of innovation and risk-taking enjoyed by corporate directors.⁹⁴

Other commentators have argued that courts should use some kind of negligence standard in this context and that such a standard would not really change the way that corporate boards operate. For example, in a prescient article, Franklin A. Gevurtz recognized that the law plainly acknowledges in numerous contexts that risk-taking resulting in a negative outcome is not necessarily negligence.⁹⁵ He explains that any simple application of the negligence standard to corporate board activity will only impose liability where the decision is unreasonable—i.e. where the expected probability of failure is high in relation to the magnitude of gain should the action prove successful.⁹⁶

In fact, Gevurtz’s formulation does not seem all that different from one application of the *Stone* standard of good faith to a risky decision. Suppose that a board of directors were to decide to embark on a series of costly and risky projects knowing that the available information suggested a 10% chance of success for each project and a potential gain of 500% of the cost for every successful outcome. One need not wait to review this decision in the hindsight of its likely failure to be able to say that the directors did not act “in the good

92. *Stone*, 911 A.2d 362, 369 (Del. 2006).

93. Bainbridge et al., *supra* note 71, at 585.

94. Still, the threshold might very well allow adjudication of claims against corporate directors who approved investment in mortgage-backed securities where the directors plainly did not take care to ensure that the nature of risk involved was understood. Indeed, apparently, this is one significant component of the meltdown of 2008. See, e.g., Saul Hansell, *How Wall Street Lied to Its Computers* (2008), <http://bits.blogs.nytimes.com/2008/09/18/how-wall-streets-quants-lied-to-their-computers/> (describing how Wall Street investment firms “continued to trade very complex securities concocted by their most creative bankers even though their risk management systems weren’t able to understand the details of what they owned.”). See also, Eric Dash & Julie Creswell, *Citigroup Saw No Red Flags Even as It Made Bolder Bets*, N.Y. Times, Nov. 23, 2008, at A1.

95. Gevurtz, *supra* note 17, at 305.

96. *Id.* at 305-06. See also, Telman, *supra* note 17, at 846. Gevurtz is careful to take into account the state of mind of the decision-maker at the time the decision was made. His standard does not call for applying what might ultimately be a true assessment of the risk of an action. Rather he uses the *expected* gain and probability of success *ex ante*. This is no different from the standard under *Stone* which might impose liability where a director knowingly takes a risk in which the expected gain is disproportionately low in relation to the likelihood of success.

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faith belief that [their] actions [were] in the corporation's best interest."⁹⁷ Under *Stone*, such action (whether or not one calls it careless, negligent or unreasonable) breaches the duty of good faith (by knowingly making a decision against the corporation's interest). In so doing, the action also necessarily breaches the duty of loyalty and is outside the protections of the business judgment rule.⁹⁸ *Stone*, however, goes further still and condemns as bad faith knowing breaches of the duty of care where the directors did not take the time to evaluate the wisdom of the decision they made.

Some might conclude that this interpretation of *Stone* has eviscerated *Gagliardi's* lofty vision of the business judgment rule. But another close look at *Gagliardi* suggests otherwise. The decision in *Gagliardi* is correctly premised on the belief that shareholders want directors to take risks because that is how directors best serve the interests of the shareholders. Although Chancellor Allen said that foolish, stupid, and egregious risks⁹⁹ should be protected, even he seemed to allow for an examination of the directors' attentiveness and care that *Stone* contemplated. Allen stated that it is "an elementary precept of corporation law," that "in the absence of facts showing self-dealing or *improper motive*, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith."¹⁰⁰ He later said that there cannot be director liability without a conflict of interest or "*suspect motivation*."¹⁰¹ Since he mentioned self-dealing and conflicts of interest separately, he clearly intended "*improper motive*" and "*suspect motivation*" to include some other kind of potentially actionable shortcoming by directors. Allen seems to have left open the possibility that a range of director misconduct other than self-dealing might indeed be actionable. After all, one could easily think of examples of conflict-of-interest decisions that are not bad faith,¹⁰² but it is harder to conjure up a decision that is based on an improper or suspect motive constituting good faith.

Stone broke no new ground in its treatment of self-dealing and conflicts of interests (because they were already clearly bad faith). It did, however, change the way Delaware law approaches other bad decisions (from simple well-meaning but wrong decisions to those very bad decisions which, because the directors knew they were bad, rise to the level of bad faith). *Stone's* equation of

97. *Stone*, 911 A.2d at 370 (quoting *Guttman*, 823 A.2d 492).

98. Note that this example does not bring *Stone* as far as Bainbridge and his co-authors fear. They warn that "the point of the business judgment rule is that shareholders should not be allowed to recover monetary damages simply because the directors made the wrong decision." Bainbridge et al. *supra* note 25, at 593.

99. *Gagliardi*, 683 A.2d at 1052.

100. *Id.* at 1051.

101. *Id.* at 1053.

102. For example, a decision in which a director has an interest but that is also fair.

conscious lack of care with disloyalty bridges the gap between bad-faith conflicts of interest and decisions based on “improper” or “suspect” motivations for which Allen might search his thesaurus to label. Allowing actions for knowing breaches of the duty of care does little damage to the strength of the business judgment rule’s protections. Just as with traditionally disloyal behavior, those breaches do indeed “involve a director taking for herself something which should otherwise be the corporation’s.”¹⁰³ Chancellor Allen grasped for the adverb to modify such action and could not find it because, like most jurists and commentators pre-*Stone*, he did not equate knowing negligence with disloyalty. In *Gagliardi*, when Allen allowed for the “theoretical” possibility of recovery by shareholders for “egregious” misconduct that is not necessarily self-dealing, he must have in mind the kind of conduct that *Stone* would label disloyalty – where the directors have failed to act “in the good faith belief that [their] actions are in the corporation’s best interest.”¹⁰⁴ And as this Article has discussed, under *Stone*, a knowing failure to pay what Allen calls, “minimalist proceduralist standards of attention”¹⁰⁵ would constitute disloyalty and bad faith and therefore fall outside the protection of the business judgment rule.¹⁰⁶

VI. A GLIMPSE OF THE FUTURE

In the weeks just before publication of this Article, the Delaware Court of Chancery published opinions in two cases that provide a glimpse at how courts will address shareholder claims that directors breached their fiduciary duties in managing risk in the future. The two cases, *American International Group, Inc. Consolidated Derivative Litigation*,¹⁰⁷ and *In Re Citigroup Inc. Shareholder Derivative Litigation*,¹⁰⁸ arose from the fallout of the 2008 subprime mortgage crisis. In both decisions, shareholders brought derivative actions against members of the board of directors, attempting to hold them personally responsible for failing to fulfill their oversight obligations. While neither decision creates a radically new standard for the management of risk, the rulings do suggest that the Delaware courts might find bad faith where the plaintiffs can show that directors consciously ignored the risks to which

103. Hill & McDonnell, *supra* note 87, at 1795.

104. *Stone*, 911 A.2d at 370.

105. *Gagliardi*, 683 A.2d at 1052.

106. Bainbridge et al. therefore appear to go too far when they state that, “Under *Stone* it seems possible that a conscious decision by the board that the costs of a law compliance program outweighs the benefits no longer will be protected by the business judgment rule.” Bainbridge et al. *supra* note 25, at 47. Such a decision would be actionable only if the plaintiffs could show that the directors knew or believed that they were making a bad decision. *Stone* comes nowhere close to that.

107. *AIG v. Greenberg*, 965 A.2d 763 (2009).

108. *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106 (Del. 2009) (hereafter “Citigroup”).

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management was subjecting their companies. The decisions were thus a first step towards a new willingness by the courts to recognize that the disloyalty involved in a failure to monitor or oversee is really not all that different from the kind of self-interested disloyalty that courts have called bad faith in the past.

In *AIG*, Chancellor Strine allowed plaintiffs to proceed with a shareholder derivative lawsuit against directors for knowingly failing to stop certain fraudulent schemes carried out by the company's management.¹⁰⁹ Citing *Stone*, Strine acknowledged that "directors can be liable where they 'consciously failed to monitor or oversee [the company's internal controls] thus disabling themselves from being informed of risks or problems requiring their attention.'"¹¹⁰ Such a failure, Strine explicitly states, can constitute a breach of the duty of loyalty.¹¹¹ The decision is an affirmation of *Stone*'s extension of the definition of disloyalty to include knowing breaches of the duty of care by directors in carrying out their oversight function.

In *Citigroup*, Chancellor Chandler appeared to take a step back from Strine's decision in *AIG*. Here, plaintiff shareholders sued Citigroup's directors alleging that they breached their fiduciary duties by failing to adequately monitor the risk to which the company had subjected itself in the months leading up to the subprime mortgage meltdown.¹¹² Closely following the traditional justifications for the business judgment rule, Chandler concluded that the plaintiff's allegations were insufficient to state a claim under *Caremark*.¹¹³ The strongest claim the plaintiffs made was that Citigroup directors ignored "red flags" that seemed (in hindsight of course) to suggest that a collapse in the subprime mortgage market was imminent.¹¹⁴ Chandler refused to take the bait, insisting that the law requires something much more than evidence of incorrect decision-making to lead courts to disregard the protective presumptions of the business judgment rule.¹¹⁵ Warning signs, he says, "are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they are evidence that the directors made bad business decisions."¹¹⁶ *Citigroup* clearly requires a conscious failure to evaluate risk at all and not simply a "failure to predict the future."¹¹⁷

Chandler usefully distinguished the allegations in *Citigroup* from those in *AIG*. In the earlier case, the plaintiffs alleged that the directors knowingly failed

109. *AIG*, 965 A.2d at 23.

110. *Id.* at 24 (citing *Stone*, 911 A.2d at 370).

111. *Id.*

112. *Citigroup*, 964 A.2d at 117.

113. *Id.* at 126.

114. *Id.* at 128.

115. *Id.* at 126.

116. *Id.* at 125.

117. *Id.* at 127.

to prevent wrongdoing.¹¹⁸ If those allegations are true, a persuasive case for bad faith exists. In *Citigroup*, however, plaintiffs alleged that the directors merely made a wrong decision: they ignored the red flags that indicated a downturn in the economy. Chandler rightly insisted that the failure of the Citigroup directors to foresee the extent of the subprime mortgage crisis is not evidence of bad faith, merely bad judgment. To hold those directors personally liable would require showing a knowing and deliberate failure to evaluate the risks of the company's policies, not a mere failure to predict the future.¹¹⁹ While the opinion in *Citigroup* is a powerful affirmation of the traditional view of the business judgment rule's protections, it nonetheless left open the possibility that a court will impose liability on directors who knowingly fail to evaluate risks presented to them.

VII. CONCLUSION

In the coming years, law-makers and judges will focus much attention on the application of the business judgment rule to risky corporate decisions. After all, the financial crisis of 2008 arose in large part from excessive and apparently unmonitored risk-taking on the part of corporations. Any legal response to the crisis must carefully balance the continuing need for a competitive marketplace in which the best risk-takers succeed with the need to protect shareholders and other stakeholders from the bad faith behavior of corporate decision makers. The rigorous application of the post-*Stone* formulation of fiduciary duties appears to set out such a regime.

Under *Stone*, courts can address risky business decisions in a way that neither pays excessive deference (or perhaps reverence) to risk-takers nor stifles the ability of corporate leaders to pursue innovative ideas, investments, and technologies. Operating in an environment in which it is accepted that risky decisions often end in failure, corporate directors can still take those kinds of risks without fear that such failure will result in personal liability. However, they plainly cannot choose a risky course of action knowing that the decision is a bad one or knowing they have not taken care to evaluate whether or not the risks involved will benefit the corporation. Delaware courts should now consider either of such failures to be disloyalty whether or not it involved self-dealing in the traditional sense.

Stone's extension of the duty of loyalty to knowing breaches of the duty of

118. *Id.* at 126.

119. Chandler ambiguously states, "There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk." *Id.* at 127. He does not mean to say that directors should receive protection for failing to recognize the existence of a company's risk; rather he must mean to say that directors should receive protection although they failed to predict accurately the extent of a company's risk.

Supplying the Adverb

care simply clarified the definition of good faith under Delaware law.¹²⁰ Though courts may now impose liability for knowing failures to pay attention when authorizing affirmative risks, this should do little to undermine the culture of innovation that is so central to the past success of American corporations. Instead, this policy would only penalize directors who have indeed acted disloyally—by failing either to pay attention or to engage in any kind of business judgment at all. Demanding that corporate directors adhere to the *Stone* standard when authorizing risk would simply bring Delaware law regarding risk-taking into line with its existing law on oversight. It is this kind of consistency, of course, that has made Delaware a center of American corporate law for generations. And it is this kind of rigor that must be imposed in order for the American economic system to recover from the damage inflicted upon it by the bad faith risk takers of the early years of the twenty-first century.

120. Sarah Helene Duggin and Stephen M. Goldman argue that “the old good faith addresses improper motivation; the new good faith addresses dereliction of duty.” Duggin & Goldman, *Restoring Trust in Corporate Directors: The Disney Standard and the “New” Good Faith*, 56 AM. U. L. REV. 211, 240 (2006). But something implicit in the dereliction of a director’s duty still brings us back to an improper motive even if it is not self-dealing in the traditional sense.