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Robert B. Thompson
Georgetown University Law Center, thompson@law.georgetown.edu

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The Delaware Supreme Court’s 2009 decision in Lyondell Chemical Co. v. Ryan provides a marker for the end of the period during which the concept of good faith occupied a significant and independent place in the debate over director liability as to corporate governance. Good faith, of course, has long been a part of fiduciary duty generally and likely will remain so; the law expects that directors will faithfully undertake their corporate responsibilities. But over the last two decades, it assumed a more prominent role after the Delaware Supreme Court in 1993 declared it as part of the “triad” of fiduciary duties (along with the duties of care and

* New York Alumni Chancellor’s Chair in Law and Professor of Management, Vanderbilt University.

1 970 A.2d 235 (Del. 2009).

2 See, Leo Strine E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti, and Jeffrey M. Gorris, Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law, 98 Georgetown L. J. 629 (2010) (tracing good faith’s long-established role as part of the duty of loyalty and noting the common origins of loyalty, faithfulness and good faith).
loyalty) at the core of director liability.\textsuperscript{3} Yet, in 2006, that same court in Stone v. Ritter\textsuperscript{4} demoted good faith from the triad and in that case and in Lyondell ended its free-standing liability function.

This essay examines why good faith gained such added prominence during this recent period and what its eclipse tells us about the evolution of the law of fiduciary duty. Three explanations for the rise of good faith are examined:

- As the latest in a series of failsafe doctrines to enable courts to review director conduct that seems to satisfy traditional standards used to test director behavior, but where the decision simply doesn’t make sense;
- As a vehicle to avoid the reach of Delaware §102(b)(7),\textsuperscript{5} the exculpation provision for directors added by the Delaware legislature in the aftermath of the Delaware Supreme Court’s decision in Smith v. Van Gorkom;\textsuperscript{6}

\textsuperscript{3} See Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993) (a stockholder wishing to rebut the presumption of the business judgment rule “assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty, or due care.”).

\textsuperscript{4} 911 A.2d 369 (Del. 2006).

\textsuperscript{5} Del. Code Ann. tit. 8 §102(b)(7).

\textsuperscript{6} 488 A.2d 858 (Del. 1985).
• As reflecting the “sermonizing” function of Delaware courts, exhorting corporate managers to adhere to best practices but not imposing individual liability for some shortcoming in a way that distinguishes standards of conduct for directors from the standards of liability;

In a post-Lyondell world there seems to be little support for either of the first two hypotheses. The opinion in Lyondell itself undercuts much of the argument for the third hypothesis, such that good faith now seems orphaned in terms of having a liability function in corporate law.

I. Good Faith and the Need for a Fail Safe Doctrine to Address Director Action.

Delaware law puts corporate power in the hands of the directors or under their control. Their broad authority is cabined by statutory provisions permitting shareholders to elect directors and requiring shareholder approval as to a few corporate actions such as mergers, once they have been proposed by directors. More importantly for this discussion, courts are

7 See Del Code Ann. tit. 8 §141(a) ("the business and affairs of every corporation…shall be managed by or under the direction of a board of directors...").

8 See Del Code Ann. tit. 8 §§211 (providing for an annual meeting of shareholders to elect directors).

9 See e.g. Del Code Ann. tit. 8 § 251(c) (requiring a shareholder vote for approval or rejection of a merger, after the board has approved a plan for merger).
given broad power to review director action for compliance with fiduciary duties.\textsuperscript{10} In this context, courts approach fiduciary duties cases starting with a presumption of the propriety of the directors’ action which can only be overcome if the plaintiff shows sufficient facts to refute the directors’ care or loyalty.\textsuperscript{11} My focus here is on the judicial space beyond the well-developed care and loyalty standards. In addition to those cases, there are recurring examples of judicial uses of a failsafe mechanism by which courts could intervene if a challenged substantive decision was sufficiently beyond the pale even if not covered by the usual rules. Such discussions at different times have occurred under the rubric of waste or substantive duty of care; more recently, good faith appeared to provide another illustration of that pattern.

\textsuperscript{10} In Delaware, this is a function of common law, as reflected in the cases discussed in this essay. The fiduciary standard has been codified in a majority of the other states. See note 70 and accompanying text. The director role is subject to other limitations, such as the requirement from federal law and stock exchange listing requirements that a majority of directors be independent in public corporations, but fiduciary duty remains the most visible ex post check on director action. See 15 U.S.C. §78-j-1(m(3) (requiring each member of an audit committee be independent); New York Stock Exchange Listed Company Manual §303A.05-07 (requiring three committees of the board with independent members—nominating, compensation and audit committees) available at http://www.nyse.com/lc/lcm_section.html

\textsuperscript{11} If the presumption is overcome, the fiduciary usually has the obligation of proving the entire fairness of the transaction. See, Cede & Co. v. Technicolor, Inc. 634 A.2d 345, 361 (Del. 1993).
Waste has long been a doctrinal vehicle for entertaining such challenges, particularly for executive compensation.\(^{12}\) Essentially, the waste doctrine allows courts to find directors liable where direct proof of disloyalty or lack of procedural due care is absent, but the substantive decision seems explainable only as a product of the directors’ failure to carry out their fiduciary responsibilities.\(^{13}\) In the early 20th century, waste provided a vehicle for high profile challenges to what were perceived as excessive executive compensation, including the 1933 U.S. Supreme Court case in Rogers v. Hill involving the American Tobacco Company.\(^{14}\) That case, however, was settled before a ruling on the merits and over the remainder of the decade courts backed away from a broad use of the waste standard.\(^{15}\) In the 1950s, Delaware courts provided another interlude of more intensive review of substantive decisions, this time in the context of

\(^{12}\) See Lewis v. Vogelstein, 699 A.2d 327, 338 (Del Ch. 1997) (the “classic waste standard does offer some protection against egregious cases or constructive fraud.”)

\(^{13}\) Steiner v. Meyerson, 1995 WL 441999 at *1 (Del Ch. July 18, 1995) (“Classic waste occurred when a corporation is caused to affect a transaction on terms that no person of ordinary sound business judgment could credibly represent as a fair exchange.”)

\(^{14}\) 289 U.S. 582 (1933) (shareholder approval of a bylaw setting up a bonus plan could not insulate bonus payments that had no relation to the value of services; remanded to the district court to determine if the payment constituted misuse or waste.)

\(^{15}\) See e.g. Heller v. Boylan, 29 NYS 2d 653, 680 (N.Y. Sup. Ct. 1941) ("Courts are ill-equipped to solve or even to grapple with these entangled economic problems.") Harwell Wells provides an excellent and interesting account of this period. See Harwell Wells, No Man Can Be Worth $1,000,00 a Year: The Fight Over Executive Compensation in 1930s America, 44 U. Rich. L. Rev. 689 (2010) (describing the greater effect of disclosure as impacting compensation).
stock options for senior executives. In this setting, as in the earlier period, judicial review quickly dissipated, this time in the face of legislative changes the following year and a return to more deferential judicial review in subsequent years.

A 1980s challenge to the size of the premium General Motors paid to repurchase H. Ross Perot’s stock in the company provided another example of a court holding out the possibility of substantive review of director conduct. There the court proceeded from the starting point that courts would review director decisions focusing both on the traditional grounds of procedural due care and also on substantive due care—the purchase terms of the decision

16 Kerbs v. California Eastern Airways, 90 A.2d 652 (Del 1952) (Chancery Court should determine if corporation actually received compensation for stock requiring reasonable relationship between value of services and value of option). See also Gottlieb v. Heyden Chemical Corp., 90 A.2d 669 (Del 1952).

17 See Del Code Ann. tit. 8 §157(b) (“In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.” Added by 49 Del. Laws, c. 315 §2).

18 See e.g. Beard v. Elster 160 A.2d 731 (Del 1960) (where approval by a disinterested board and shareholder ratification, judicial review by the business judgment rule; court “precluded from substituting [its] uninformed opinion for that of experienced business managers….who have no personal interest in the outcome.” Id at 738-39. See generally, Randall S. Thomas & Harwell Wells, Executive Compensation in the Courts: Board Capture, Optimal Contracting and Officer Fiduciary Duty, (manuscript on file with the author, 2010).


itself.21 Even the Technicolor decision in that inserted good faith into the triad of fiduciary duties has been described as Supreme Court Justice Horsey “tilting against what he perceived to be a move by Chancellor Allen to cabin the effect of Justice Horsey’s prior decision for the Court in Van Gorkom” 22 that had expanded director liability.

Yet by the mid 1990s, Delaware law had congealed around the stated belief that substantive review was inappropriate as to the care of director decisions and that waste in those 1950s cases had strayed beyond its classical (and appropriately narrow) roots. This is

21 Here the court cited a Chancery Court decision, Saxe v. Brady, 184 A.2d 602, 610 (Del Ch. 1962) which had been a challenge to advisory fees approved by the board of an open-end investment company. The Court in Grobow concluded that as to the substantive ground, the complaint, at most, alleged a claim for waste “based on an assertion that GM’s board paid such a premium for the Perot holdings as to shock the conscience of the ordinary person.” 539 A.2d at 189. In Grobow, as in Saxe, the court found insufficient facts to support the waste allegation.

22 Strine et al., supra note 2 at 684, note 218. The Chancellor, in analyzing the duty of care had cited Judge Learned Hand’s decision in Barnes v. Andrews for the plaintiff’s duty to prove a proximate cause connection between gross negligence and a measurable injury. Cinerama, Inc. v. Technicolor, Inc. 1991 WL 111134 at *17 (Del Ch. 1991) (quoting Barnes v. Andrews, 298 F. 614, 616-618 (S.D.N.Y. 1924)). The Supreme Court termed this use of Barnes as “misguided” and that it was a “mystery” how the Chancellor had come upon that decision by Judge Hand. Technicolor, 634 A.2d at 370. The Supreme Court’s surprise at the lower court’s citation to one of the country’s most well-known jurists of the 20th century and a case that appeared in more than one corporations casebook is itself a mystery. The Supreme Court picking this fight with the Chancellor seems out of proportion given the larger inroads on Van Gorkom by the Delaware legislature in Section 102(b)(7) as discussed in the next section.
best illustrated in the jurisprudence of Chancellor William Allen in the concluding years of his term. In Caremark, still the most complete exposition of a director’s duty to monitor, the Chancellor asserted that substantive review has no place in the analysis of the duty of care:

“What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director’s duty of care can never appropriately be determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed.”

He was willing to acknowledge that waste was a theoretical exception to this approach of making substantive review off limits, but made clear he did not see this in practice as a large area:

“the waste theory represents a theoretical exception to the statement very rarely encountered in the world of real transactions. There surely are cases of fraud; of unfair self-dealing and, much more rarely, negligence. But rarest of all-and indeed, like Nessie, possibly non-existent-would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste!.”

Note that Chancellor Allen’s exhortation against substantive review in the Caremark case quoted above included a possible exception for good faith and recall the Delaware Supreme Court’s then still

24 698 A.2d at 967 (emphasis in the original).
25 Steiner v. Meyerson, 1995 WL 441999 at *5 (Del Ch. July 18, 1995). Chancellor Allen later observed that the waste standard used in the earlier Delaware cases from the 1950s was “rather distant from the substance of a waste standard of review” and more like “a form of heightened scrutiny that is now sometimes referred to as an intermediate or proportionality review.” See Lewis v. Vogelstein, 699 A.2d at 337 (Del Ch. 1997).
26 See supra note 24.
recent inclusion of good faith in the triad of fiduciary duties beyond care and loyalty.\textsuperscript{27} When the Delaware courts were faced with a high-profile challenge to another large excessive payout in early 2000s, good faith seemed to have potential beyond the now cabined roles for waste and substantive review of care.\textsuperscript{28} The context was litigation relating to the Walt Disney Company’s decision to pay a fired president $140 million after only a year or less of work in what was a failed effort to find a successor to Chief Executive Officer Michael Eisner.\textsuperscript{29} The company and its directors initially achieved a dismissal of the complaint, and the Supreme Court affirmed.\textsuperscript{30} The Supreme Court shut down the plaintiff’s efforts to frame the complaint as a breach of substantive due care declaring: “such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors’ judgments.”\textsuperscript{31} Nevertheless, the Court left room for judicial review framed more in terms of good faith as an alternative to waste\textsuperscript{32} and included language that suggested a judicial willingness to review the substance of the decision under such doctrine:

\begin{quote}

\textit{Brehm v. Eisner, 746 A.2d 244 (Del 2000).}
\end{quote}

\textsuperscript{27} See, supra note 3.

\textsuperscript{26} “Good faith is used as a loose rhetorical device that courts can wield to find liability to enjoin actions that do not quite fit within established doctrinal categories.” Sean J. Griffith, Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence, 55 Duke L. J. 1, 34 (2005).

\textsuperscript{29} See Brehm v. Eisner, 746 A.2d 244 (Del 2000).

\textsuperscript{30} Id.

\textsuperscript{31} Brehm, 746 A.2d at 264. See also, the earlier statement of Chancellor Allen in Lewis v. Vogelstein, 699 A.2d at 336 (noting that courts are ill-fitted to judge ex post appropriate degrees of business risk).

\textsuperscript{32} Brehm, 746 A.2d at 264 (“ Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith which is a key ingredient of the business judgment rule.”)
“this is potentially a very troubling case on the merits...the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions.”33

As the case proceeded the societal and legal contexts evolved in the plaintiffs’ favor in their effort to broaden the reach of director duties. The Enron and WorldCom scandals focused new attention on the misconduct of corporate officers. Chief Justice E. Norman Veasey warned in a speech that directors could have their behavior “treated as a breach of the fiduciary duty of good faith.”34 Four months later, Chancellor Chandler rejected defendant’s motion to dismiss the repleaded complaint in language that suggested that lack of good faith would trigger judicial review of the transaction:35

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 material importance to their corporation. Instead, the facts alleged in the new 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, in my opinion, that may not have been taken honestly and in good faith to advance the interests of the company. Put differently, all of the alleged facts, if true, imply the defendant directors knew that they were making material decisions

33 Brehm v. Eisner, 746 A.2d 244, 249 (Del 2000) (affirming dismissal of complaint but permitting repleading on “potentially a very troubling case on the merits”).
35 In re Walt Disney Co. Derivative Litigation, 825 A.2d 275, 289 (Del. Ch. 2003)
without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."  

This trend, however, turned out to be no more lasting as a constraint on director action than the developments described above based on waste and substantive care. After a 37 day trial, the trial court found no good faith violation or waste and the Supreme Court affirmed. The courts’ opinions each provide the same three non-exclusive examples of what would be lack of good faith: (1) subjective bad faith where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation; (2) acting with the intent to violate positive law; and (3) (the focus of the chancellors pre-trial motion and post-trial opinion), a conscious disregard of duty evidenced by an intentional failure to act.

This third category has captured most of the attention to date. Three recent opinions build on the discussion, one by saying what is not within this category and two providing illustration of what could be within it. The Disney Supreme Court affirmance makes clear that good faith is different than gross negligence. In Stone v. Ritter, the Delaware Supreme Court expressly linked the third category to the

36 In re Walt Disney Co. Derivative Litigation, 825 A.2d 275, 289 (Del. Ch. 2003) (emphasis in the original).
37 In re the Walt Disney Co. Derivative Litigation, 907 A.2d 693 (Del Ch. 2005) aff’d 906 A.2d 27 (Del. 2006).
38 In re Walt Disney Co. Derivative Litigation, 906 A.2d at 64; In re the Walt Disney Co. Derivative Litigation, 907 A.2d at 55-56.
39 906 A.2d at 64-65 (“we address the issue of whether gross negligence (including a failure to inform one's self of available material facts), without more, can also constitute bad faith. The answer is clearly no.”)
standard developed by Chancellor Allen in Caremark as to when directors might be held liable for lack of sufficient oversight of a corporation’s affairs, a standard which itself incorporated good faith:

The third of these examples describes, and is fully consistent with, the lack of good faith conduct that the Caremark court held was a “necessary condition” for director oversight liability, i.e., “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....” [In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959, 971 (Del.Ch. 1996)].40

In Lyondell Chemical Co. v. Ryan,41 the Delaware Supreme Court used the failure to monitor standard from Caremark and Stone in a decision challenging director decisions in a merger that in many ways resembled the conduct at issue in Van Gorkom. In Lyondell, the directors agreed, over a one week period, to sell the company for a premium on facts that suggested to the trial court a failure to get the best price for shareholders in violation of the fiduciary duty set out in the Delaware Supreme Court’s

40 911 A.2d 362, 369 (Del. 2006) (“Indeed, our opinion in Disney cited Caremark with approval for that proposition. [In re Walt Disney Co. Deriv. Litig., 906 A.2d at 67 n. 111]) The Court held that Caremark articulates the necessary conditions predicate for director oversight liability:“(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. [Guttmann v. Huang, 823 A.2d 492, 506 (Del.Ch. 2003)]. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, [In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del.2006)], they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith. [See Guttmann v. Huang, 823 A.2d at 506].”Id at 370.

41 Lyondell Chemical Co. v. Ryan, 970 A.2d 235 242-244 (Del. 2009).
landmark Revlon case.\textsuperscript{42} In substance, the vice chancellor saw this as a complaint about process which could only survive defendant’s motion for summary judgment by overcoming the protection provided by Lyondell’s exculpatory clause in its charter. The trial court saw the board’s failure to engage in a more proactive sales process as a possible breach of the good faith component of the duty of loyalty as set out in Stone v. Ritter and denied a motion for summary judgment. The vice-chancellor’s analysis of the facts echoes earlier judicial concern at the time of the Chancellor’s denial of the dismissal of the Disney complaint and in Van Gorkom itself.\textsuperscript{43} For the Supreme Court in Lyondell, however, good faith, as reflected in the conscious disregard aspect of the term, \textit{could reach} the allegations against these directors. The opinion first notes the “vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.”\textsuperscript{44} Before a court could find directors liable for intentional disregard of their duty, there must be a showing that they “knowingly and completely failed to undertake their responsibilities.”\textsuperscript{45} And this was to be measured not from how far below perfection the director actions might be said to be, but rather by how far above nothing the


\textsuperscript{43} Ryan v. Lyondell Chemical Co. 2008 WL 2923427 (Del. Ch. 2008) (denying summary judgment) reversed 970 A.2d 235 (Del 2009) (“Once one scratches the patina of this ‘blowout’ market premium, however, a troubling board process emerges.” Id at *1).

\textsuperscript{44} Lyondell, 970 A.2d at 242.

\textsuperscript{45} Lyondell, 970 A.2d at 244.
action falls. “[T]he inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.”

Thus after sixteen years of sparring over how big a window good faith might offer to reach director conduct that allegedly falls short of best practices, the Delaware court has told us that both for monitoring and for transactional decision, it must be the “utter failure to attempt” such conduct. There may be some possibility of directors' liability that remains after these decisions, but it is likely to be the needle in the haystack that Professor Bishop invoked to describe the rarity of director liability in the absence of a breach of loyalty long before good faith achieved its prominence. Viewed against this backdrop, good faith has not changed the space for director liability in any measureable way.

Strine, Hamermesh, Balotti & Gorris, in a thoughtful article that advances the understanding of good faith, have told us that good faith is the key element in defining the state of mind of a loyal fiduciary. This fits within one of the enduring core principles of corporate laws that directors are expected to act in the best interest of the corporation, not their own interest. Indeed corporate law reflects a well-developed series of remedies to respond to director conflict of interest that illustrate a departure from

46 Lyondell, 970 A.2d at 244.
47 Joseph W. Bishop, Jr. Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L. J. 1078, 1099 (1968) (“The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.”)
48 Strine et al., supra note 2 at 633,
49 See, e.g. Mod. Bus. Corp. Act §8.30 (a) (“Each member of the board...shall act (in good faith, and (2) in a manner the director reasonable believes to be in the best interests of the corporation.”)
this state of grace.\textsuperscript{50} Strine, Hamermesh, Balotti and Gorris expect the greatest utility of good faith to be in policing loyalty breeches when directors act \textit{without} apparent selfish interest.\textsuperscript{51} Perhaps this additional clarity about the origins and goals of good faith will permit courts to fill in the good faith space in more detail, but to this point, good faith is not different in kind than previous judicial efforts built around waste and substantive due care.

\section*{II. Good Faith as a Response to Section 102(b)(7).}

A second explanation for the rise in the use of good faith is as an effort to avoid Section 102(b)(7) of the Delaware General Corporation Law, permitting exculpation of director liability for care but not good faith.\textsuperscript{52} This statute, in turn, was the legislative response to limit the Delaware’s Supreme Court’s liability-enhancing decision in Smith v. Van Gorkom.\textsuperscript{53} That 1985 3-2 decision held directors of the Trans Union Corporation personally liable for selling their company to a third party in a leveraged buyout that provided a handsome premium for the shareholders, but after a process seen as hasty and insufficient by the court.\textsuperscript{54}

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\textsuperscript{50} See e.g. Del. Code Ann. tit 8 §144 (relating to conflict of interest transactions).
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\textsuperscript{51} See Strine et al., supra note 2 at 634.
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\textsuperscript{52} Del. Code Ann. tit. 8 §102(b)(7).
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\textsuperscript{53} 488 A.2d 858 (Del. 1985).
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\textsuperscript{54} 488 A.2d at 869, note 9. The price was a 48\% premium over the last closing price before the announcement of the offer.
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The deal lacked any direct conflict of interest in that the company was sold to an outside purchaser with no payments to insiders other the stock price received by all shareholders. The Court concluded that the board did not reach an informed business judgment to sell the company, conduct that, at a minimum, was grossly negligent. The liability decision raised concern among directors generally and in the wake of a rise in director insurance premiums, the Delaware legislature quickly amended its corporations law to permit Delaware corporations to exculpate directors for monetary liability for breach of fiduciary duty. The provisions, however, provided exceptions as to conduct for which liability could not be eliminated; these non-excludable actions included breach of duty of loyalty and “for acts and omissions not in good faith or which involve intentional misconduct or a knowing violation of law.” The linear phrasing suggested good faith as separate from loyalty and knowing violation of law in a way that would open up a separate category of liability for non-exculpated director conduct.

55 The CEO who pushed the deal through was nearing mandatory retirement age, which may have made him more open to a deal to sell the company. Id at 866.

56 Id at 874.

57 Del Code Ann. tit. 8 §102(b)(7).

58 Id at (ii).

59 See Strine et al., supra note 2 at 660 (read as a source of fiduciary duties, section 102(b) (7) is a “confusing muddle, riddled with overlap and ambiguity”; obvious purpose was to enable corporate charters to insulate corporate directors from liability for acts of negligence and gross negligence.)
The drafting history of 102(b)(7), as reported in a 2010 article, was that the plaintiff’s bar lawyer on the four person bar committee that drafted the section wanted very broad exceptions to the ability of stockholders to exculpate for breaches of fiduciary duty and that the rest of the drafters agreed to inserting the good faith exception so as avoid opposition from the plaintiff’s bar in adopting the change.60

Considered against the case law discussed in the previous section, the insertion of good faith did provide plaintiff room to avoid Section 102(b)(7,) at least at the motions stage of litigation. Chancellor Chandler, in refusing to dismiss the repleaded Disney complaint, found allegations that under the conscious disregard standard of conduct would support claims “that fall outside the liability waiver provided under Disney’s certificate of incorporation.”61 Vice-Chancellor Noble in Lyondell said that the board’s failure to engage in a more proactive sales process could constitute a breach of good faith to overcome the protection offered by the company’s exculpatory charter provision.62 The Supreme Court’s Disney affirmance permitting the repleaded complaint to continue to trial was clear that the Chancellor’s conscious-disregard category must be properly treated as “a non-exculpable, nonindemnifiable violation of the

60 Id at 661. Frank Balotti, one of the co-authors of the article was one of the four members of the drafting committee.
61 825 A.2d at 290.
62 Lyondell Chancery opinion at *11 (denying a defendant motion for summary judgment).
fiduciary duty to act in good faith”63 and that this standard was an “intermediate category of fiduciary misconduct between gross negligence and subjective bad faith.” 64

Yet, any expectation by plaintiffs’ lawyers or others that good faith would be a vehicle to reclaim any of the Van Gorkom liability space after Section 102(b)(7) has turned out to be illusory. Indeed, there is a category with a good faith label, that after Stone v. Ritter is clearly within the duty of loyalty, such that it is outside of the exculpation provided by 102(b)(7), but coming up with conduct in a publicly held corporation that occupies that space is not easy. As illustrated in the Supreme Court’s rejection of the vice-chancellor’s concern about process in Lyondell, a good faith violation requires not just failure, but utter failure, and it is measured not against results but as to attempt. The good faith line of cases, or at least the conscious disregard aspect of it, remains an empty vessel. It may cover Mrs. Francis, the hapless director in a reinsurance firm who seemed to do nothing while her two sons emptied the corporate treasury, but not anyone else.65 Absent Francis-type facts, Chancellor Allen’s Nessie illustration

63 906 A.22d at 66.
64 906 A.22d at 67 (The court declined to decide if good faith were an independent basis for liability, Id at n. 12, a claim it decided in the negative shortly thereafter in Stone v. Ritter.)
65 Francis v. United Jersey Bank, 432 A.2d 814 (NJ 1981) (Mrs. Francis was a director of a corporation in which her two sons, who were officers and directors, had embezzled funds. The court noted that she was not active in the business, knew virtually nothing of corporate affairs, visited the corporate offices once (and briefly), was unfamiliar with the rudiments of the business and made no effort to assure the firm’s
of a rare, possibly non-existent set seems to hold not just for waste but for the conscious disregard leg of good faith. Any development of good faith as a basis for liability will likely be in the violation of law aspects or the subjective lack of bad faith, or new categories those future generations of lawyers and judges develop as new meltdowns occur.

III. Good Faith as Encouraging Best Practices or a Standard of Care Distinguished from a Standard of Liability.

Good faith, from time to time, has served a different purpose from liability, one aimed at nurturing best practices of boards of directors, more than at liability. This “sermonizing” judicial function was well-described by Professor Ed Rock: “Delaware opinions can be understood as providing a set of parables--instructive tales--of good managers and bad managers, of good lawyers and bad policies and practices, particularly pertaining to withdrawal of funds, complied with industry custom or relevant law. Id at 819.

66 See supra note 25 for the Nessie analogy. Francis, a 1981 decision of the New Jersey Supreme Court (applying New Jersey law to a three-owner local corporation incorporated in New York) was decided under a negligence rubric in an era before statutes such as section 102(b)(7) and the rise of good faith, but courts would probably treat it as a good faith case today.

67 See the discussions of the duty to obey law in the articles by Peter Konstant and Alan Palmiter in this symposium. Leo Strine et al., supra note 2 at 649, see the duty to obey as easily within the duty of loyalty.
lawyers, that, in combination, fill out the normative job description.: 68 Judges themselves acknowledge the desirability of admonishing directors to follow best practices, separate from holding them personally liable.69

Such a function becomes more likely if statutes distinguish between the sermonizing or standard-setting function and the liability function as the Model Business Corporation Act now does. In 1998, the MBCA subdivided its fiduciary duty statute into two separate sections, Section 8.30 entitled “Standards of Conduct for Directors” and Section 8.31 with the title “Standards of Liability for Directors.”70 In describing that change the authors of the MBCA Annotated observed that the previous language, dating  

68 Edward Rock, Saints and Sinners: How Does Delaware Corporate Law Work? 44 UCLA L. Rev. 1009 (1997) (“My intuition is that we come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.” Id at 1016).

69 See e.g. the Court’s acknowledgement in Disney, “our concerns about lavish executive compensation and our institutional aspirations that boards of directors of Delaware corporations live up to the highest standards of good corporate practices do not translate into a holding that these plaintiffs have set forth particularized facts excusing a pre-suit demand under our law and our pleading requirements. Brehm 746 A.2d at 249. Later in the opinion, Chief Justice Veasey wrote, “All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the inspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability. Id at 256.

from 1969, which included reference to “the care an ordinarily prudent person in a like position would exercise under similar circumstances,” had been interpreted to establish a negligence test for director liability. The annotation authors observed that this approach “tended to obscure the primary purpose of Section 8.30: “to focus on and provide guidance for the manner in which directors discharge the duties assigned to them by” the Act. The new bi-furcated standards sections have not yet been widely adopted by the states.

Delaware has not codified its fiduciary duty standards, but it common law reflects a similar division of the director’s duty of care and director’s duty of liability. Chancellor Allen’s decision in Caremark articulates a director duty to “assure that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and the board itself timely, accurate information 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.” At the same time, he laid down a fairly forgiving standard for directors as to when they would face personal liability, one that turned on good faith: “only a sustained or systematic failure of the board to exercise

74 In re Caremark International, Inc. Derivative Litigation, 698 A.2d 959, 970 (Del Ch. 1996).
oversight—such as utter failure to attempt to assure a reasonable information and reporting system exist—will establish the lack of good faith that is a necessary condition to liability.” 75

Professor Jennifer Arlen in a book chapter based on conversation with her academic colleague, former Chancellor Allen, describes Caremark as the Chancellor’s effort “to expand directors’ oversight duties beyond the limits of the Delaware Supreme Court’s opinion in Allis-Chalmers while establishing a standard of review more narrow than that the Delaware Supreme Court had adopted in due care cases such as Van Gorkom” 76 The former chancellor explained to the professor that the first goal was motivated by the fact that “directors had become overly passive, lulled into complacency by both Delaware’s strong business judgment rule and a business norm favoring directorial noninterference with the CEO.” 77 The second grew out of a concern of the former chancellor that “the objective reasonableness review was contrary to the central policies of the business judgment rule and would cause directors to be excessively risk-averse and spend too much money on oversight.” 78

More than a decade later, the Delaware Supreme Court in Stone approved both parts of that approach, that directors owe a duty to act in good faith to ensure existence of a compliance program,

75 Id at 971.
77 Id at 339. In Graham v. Allis-Chalmers, 188 A.2d 125 (Del. 1963) the Delaware Supreme Court held “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to expect exists.” 188 A.2d at 130.
78 Arlen supra note 76 at 340.
but can only be liable if they acted in bad faith, a standard which incorporated the Chancellor’s “utterly failed” language to implement such a system or if such a system was implemented by “conscious failure to monitor or oversee its operations thus disabling them from being informed of risks or problems requiring their attention.”

As successful as the Caremark structure was in defining current Delaware law, the impact of its preaching or aspirational language has been less so. Professor Arlen concludes that the Caremark aspirational duty was not sufficiently specific to induce active director oversight by directors reluctant to challenge management and its liability standard is too easily avoided to provide a substantial deterrence effect. She notes that the moral suasion to be derived from norm-shifting requires that directors “both be independent of management pressures to be passive and have the experience needed to oversee management. These conditions often were not met in the 1990s.”

In a series of three good faith cases over three years, the sermonizing seems to have disappeared but so has the potential for director liability based on good faith. These cases span a broad spectrum of director conduct in the absence of self-dealing—one involves director duty to actively monitor the corporation’s activities, one the director’s duty to determine executive compensation and the other, directors’ duty to get the best price. The first has been described as the context least

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79 Stone, 911 A.2d at 362.
80 Arlen, supra note 76 at 344.
83 Lyondell Chemical Co. v. Ryan, 970 A.2d 235 (Del. 2009).
likely to result in liability. Conversely, therefore, it could be an area where sermonizing was more likely, but such does not appear to be the case. More notable is that all three end up at the same place in terms of a liability standard; only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. Conditioning liability, as does the court in Lyondell in one paragraph, on the existence of an “extreme set of facts”, by which directors “completely failed to undertake” some action, and “utterly failed to attempt” duty compliance, leaves little room for sermonizing in the opposite direction.

What Good Faith Tells Us about Fiduciary Duty and the (Perhaps Surprising) Impact on Enhanced Scrutiny Review in Takeovers

The rise and fall of good faith as the basis for a liability rule in Delaware over the last decade and a half is difficult to explain by any of the more obvious theories discussed here. At different points during the period, it would have been possible to argue that the law of good faith illustrated the Delaware courts’ development of a failsafe judicial device to find liability where the contexts does not easily fit within traditional doctrine, or as the fulcrum for the debate over the reach of the exculpation statute passed after Van Gorkom, or as an illustration of the sermonizing function of Delaware law separated from liability concerns. Yet all of these have fallen away. It may simply be that we are at the low point of a liability cycle, the counter point to the breadth of liability in Smith v. Van Gorkom and that the

84 See Caremark, 698 A.2d at 959 (duty to actively monitor, absent self-dealing or other loyalty concerns, “possibly the most difficult theory on corporation law upon which a plaintiff might hope to win a judgment.”)

85 Lyondell, 970 A.2d at 244.
common law will oscillate back in the direction of liability. Certainly the more challenging economy since the time of the Lyondell transaction and the still growing list of questionable management activity during the height of the bubble will provide new contexts that may crystallize uses for good faith that we do not now see.

What we have witnessed is a long running and deeply enriching conversation about judicial review of business decisions, with good faith as a principal vehicle for much of the recent discussion. The participants have been the 10 judges, officed for the most part along two hallways in the largest city of one of our smallest states, who together make most of American corporate law. As a starting point, they eschew the substitution of judicial judgment in place of those of directors elected to govern corporations. They are, however, settled on the point that director or manager conflict of interest triggers more intense judicial scrutiny of corporate transactions. They acknowledge at least the possibility of something in between where there is no obvious conflict, but still a reason for some judicial review and good faith embodies this space. Yet their recent opinions provide a clear roadmap that all but the densest of directors should be able to use to find a path away from liability arising from good faith.

Given this result, the most lasting impact of this judicial conversation has not been a fundamental shift in the reach of good faith, but somewhat surprisingly what it has done to the Delaware’s judiciary application of enhanced (or intermediate) scrutiny of director actions in a takeovers context. This enhanced scrutiny doctrine arose during the takeover period of the mid 1980s in a context where judges faced defensive tactics taken by boards of directors in which there was no express conflict by the directors (who were not entering into transactions the with corporation) but the court perceived “the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation or its shareholders.” This context of no express conflict but worry about director loyalty
tracks the core questions in Part I, albeit one occurring some years before good faith’s insertion into the triad of fiduciary duties. The judicial solution in the takeovers context was to insert a requirement of an additional showings a defendant must make before being able to cross the threshold to the world of judicial deference reflected in the business judgment rule. The two part Unocal test, asks first if there was a threat to the company whose directors were taking defensive action, and then if the company’s response was proportional to the threat necessarily involves. At least r the second element seems to require a substantive judgment by the court. Similarly, the corollary Revlon rule, that when a break-up of the company becomes inevitable, the directors duty changes from “defenders of the corporate bastion to auctioneers charged with getting best price,” invokes a judicial review of the substantive terms of the transaction.

But Unocal and Revlon have suffered the same atrophy in the intensity of judicial review as has infected other contexts in which courts have considered allegations of loyalty in the absence of express self-dealing.. In subsequent opinions the Unocal test has been narrowed to require more intensive judicial review only if the defensive tactic is “coercive” or “preclusive,” terms that have a strict meaning. Absent such a finding, directors seeking judicial review under the deferential business judgment rule standard need only prove their actions come within a range of reasonable responses. The Court has made clear in later cases that this means a court should not second-guess board decisions, so long as

86 Unocal Corp. v, Mesa Petroleum Co., 493 A.2d 946, 955 (Del 1985).
89 Unitrin, 651 A.2d at 1387-88.
they are within such a “range of reasonableness.” The efforts a board takes to get the best price under the Revlon rule are subject to a similar level of judicial review that they be reasonable. Lyondell moves the level of judicial review down a notch or perhaps several. In a good faith context, as measured by the Lyondell opinion, reasonableness has become whether the directors “utterly failed to attempt to obtain the best sales price” with liability “only if they knowingly and completely failed to undertake their responsibilities.”

Compare the current level of enhanced judicial review to the default rule where there is no express conflict. There, judicial review is banned unless there is no rational business purpose for the decision. If a defensive tactic or sale of control raises a possible question of the director’s loyalty, judicial review will move from rational to reasonable (as well as a shift in the burden of proof from plaintiff to the defendant) Reasonable in this sense means utterly failed to attempt, so that it is difficult to see a lot of daylight between that and a search for a rational business purpose. Only if a defensive tactic is preclusive or coercive will judicial review move to something that requires substantial judicial involvement of a decision.

The discussion about the level of judicial review centered on good faith in the early 1990s has resulted in a Delaware judiciary that is less willing to engage in substantive review of

90 Paramount Communications, Inc. v. QVC Network, Inc., 337 A.2d, 34, 45 (Del 1994). If enhanced scrutiny were not applied, the court will not examine the reasonableness of the decision and will not substitute its views for those of the board if the latter’s decision can be attributed to any rational business purpose. Id at 45, note 17.

91 QVC, 637 A.2d at 45.

92 Lyondell, 970 A.2d at 243-244.
director action in a takeover context, which has been the bulk of Delaware litigation.93 It may be than when a future plaintiff seeks an injunction to stop director action alleged not to get the best price, as opposed to waiting and seeking only damages as did the plaintiff in Lyondell,94 the court will reinvigorate enhanced scrutiny. It may be that in a different market, where the evidence of a” blowout” price is not as persuasive as in Lyondell, a subsequent court will find some a complete and utter failure to attempt to comply with a Revlon duty.95 But, for now, duty of care can be exculpated by appropriate charter provisions and good faith remains only minimally available in a duty to monitor context, an executive compensation context, or even an enhanced takeovers context.

93 See Thompson & Thomas, The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions, 57 Vand. L. Rev. 133, 137 (2004) ((80% of breach of fiduciary duty claims filed in Delaware over a two year period were class actions against public companies challenging director action in an acquisition).

94 Lyondell 970 A.2d at 239, Ryan, 2008 WL 2923427 at *5.

95 See William Bratton’s article in this symposium developing how good a deal this was for Lyondell shareholders, particularly given the deteriorating market conditions after the agreement.