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# **Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law**

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JOHN M. OLIN CENTER FOR LAW, ECONOMICS, AND BUSINESS

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## Loyalty's Core Demand: The Defining Role Of Good Faith In Corporation Law

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### Abstract

*The duties owed by independent directors of large corporations to monitor the corporation's affairs have never had more political salience. Given the Enron-era debacles, the recent meltdown in our nation's financial sector, the dependence of workers on equity investments to secure their retirements, the globalization of American corporate law principles, and the complexity of managing corporations with international operations, the legal standards used to evaluate whether directors have complied with their fiduciary duties will be a subject of growing international policy interest. This article addresses an important dimension of that issue by examining the role of good faith in corporate law, and its use as the definition of the state of mind with which a director must act to comply with the fiduciary duty of loyalty. In particular, this article employs an historical, etymological, and policy-oriented analysis to address the question of whether the obligation of directors to act in good faith is a separate, free-standing fiduciary duty, or a fundamental aspect of the core duty of loyalty.*

*We conclude, consistent with the Delaware Supreme Court's recent decision in *Stone v. Ritter*, that in the American corporate law tradition, the basic definition of the duty of loyalty is the obligation to act in good faith to advance the best interests of the corporation. What this article also shows is that the duty of loyalty has traditionally been conceived of as being much broader than the duty to avoid acting for personal financial advantage. The duty of loyalty also precludes acting for unlawful purposes, and affirmatively requires directors to make a good faith effort to monitor the corporation's affairs and compliance with law.*

*Finally, we highlight a critical policy implication resulting from *Stone v. Ritter*, which is that an independent director who is accused of having failed in her monitoring duties may only be held liable if a court finds that she breached her duty of loyalty by consciously failing to make a good faith effort to comply with her duty of care. By requiring a finding of bad faith before imposing liability on an independent director, the corporate law, as explicated by *Stone*, protects the policy interests underlying the business judgment rule from erosion.*

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## I. Introduction

### A. *The Goal: Understanding and Reinvigorating the Traditional Role of Good Faith*

In dictum in *Cede & Co. v. Technicolor, Inc.* (“*Technicolor*”), the Delaware Supreme Court announced for the first time that corporate directors owe a “triad[]” of fiduciary duties, including not only the traditional duties of loyalty and care, but a third duty of “good faith.”<sup>1</sup> Since that time, vast reservoirs of ink have been exhausted probing the consequences of this new judicial discovery, with proponents of the new discovery being passionate in their view that the retention of the newly-discovered third component of the “triad” — a free-standing fiduciary duty of good faith — was vital to the integrity of Delaware’s corporation law.<sup>2</sup>

And with good reason: a great deal is at stake in defining the role of good faith in corporate law. *Technicolor*’s dictum referring to the triad potentially overcame a sizable obstacle to director liability for conduct not involving self-interest. If, instead of characterizing lack of diligence as gross negligence, plaintiffs frustrated by the

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<sup>1</sup> *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

<sup>2</sup> See, e.g., Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 11 (2006) (“In short, the duty of good faith has long been both explicit and implicit in corporation statutes and implicit in case law. Recently, it has become explicit in case law as well.”); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 457, 494 (2004) (advocating the need for “a separate duty of good faith” to address “those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts”); see also Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 491 (2007) (arguing that an “exacting definition of the phrase ‘not in good faith,’” which describes conduct by directors that cannot be exculpated under § 102(b)(7), “is needed to ensure directors are held accountable for meeting their good faith obligation”); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 IOWA J. CORP. L. 833, 833 (2007) (suggesting “an extension of the duty of good faith” by having “courts articulate a doctrine requiring more scrutiny of decisions made in an environment of structural bias”); cf. Carter G. Bishop, *Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law*, 2007 MICH. ST. L. REV. 905, 937 (“[B]y imposing a positive duty of devotion upon directors, expanded loyalty fills the gap sought to be filled by the more amorphous concept of bad faith.”); Other contributors on the topic include Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 WAKE FOREST L. REV. 1131 (2006).

prevalence of exculpatory charter clauses adopted pursuant to § 102(b)(7) of the General Corporation Law of the State of Delaware<sup>3</sup> could argue that a lack of effort amounted to bad faith, they could seek to escape the reach of the exculpation clause and subject the directors to damages liability even in the absence of improper subjective motivation.

In particular, advocates and scholars who opposed the passage of § 102(b)(7) saw room to argue that a director could be held liable, not because a fact-finder ultimately found her to have acted in subjective bad faith, but because she had fallen below some “objective” standard of good faith.<sup>4</sup> In other words, the kind of objectivity that is reflected in tort law’s requirement that a person act in the manner that a reasonable person would in the same or similar circumstances would be poured in to the free-standing duty of good faith, and directors would be held liable if they fell short of this objective standard.<sup>5</sup>

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<sup>3</sup> 8 *Del. C.* § 102(b)(7).

<sup>4</sup> *See, e.g.*, Elizabeth A. Nowicki, *Not in Good Faith*, 60 *SMU L. REV.* 441, 469 (2007) (arguing that § 102(b)(7) states that directors may not be exculpated for acts or omissions “not in good faith” and that “[m]ental state is irrelevant” to the determination of whether an act is “not in good faith”); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 *DEL. J. CORP. L.* 1, 23 (2006) (“Good faith in law . . . is not to be measured always by a man’s own standard of right, but by that which the law has adopted and prescribed as a standard for the observance of all men in their dealings with each other. Indeed, in law generally, the objective elements of good faith dominate the subjective element.”) (internal quotation omitted); *cf.* Ethan G. Stone, *Business Strategists and Election Commissioners: How the Meaning of Loyalty Varies with the Board’s Distinct Fiduciary Roles*, 31 *J. CORP. L.* 893, 898 (2006) (“My reason for equating ‘good faith’ with the core fiduciary duty of loyalty is to emphasize that the liability rules commonly called the duty of loyalty are evidentiary shortcuts to proving violations of this basic duty. It is very difficult to prove that a fiduciary acted for an improper purpose. Courts have, accordingly, identified objective conflicts of interest that cast enough doubt on a fiduciary’s motives to establish a ‘per se’ case for breach without any need to convince the judge of the fiduciary’s actual state of mind. It is these easy cases for disloyalty that have come to define the duty itself.”)

<sup>5</sup> *See, e.g.*, Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 *DEL. J. CORP. L.* 1, 72 (2006) (“The terms ‘intentional’ and ‘conscious,’ as used in [Disney’s statement of the standard for good faith] and some other tests, need interpretation. The formulations that employ these terms would make little or no sense unless they mean either that the manager was conscious that he was disregarding his duties or that a reasonable person in the manager’s position would have known that he was disregarding his duties—not that the actual manager was subjectively conscious that he was disregarding his duties.”).

In its 2006 decision in *Stone v. Ritter*,<sup>6</sup> the Delaware Supreme Court undermined the doctrinal premise of this potential approach to director liability. Specifically, the court clarified that the requirement that directors act in good faith was at the core of the duty of loyalty, and does not constitute a separate fiduciary duty. That decision has generated anxiety in some quarters.<sup>7</sup>

In this article, we seek to show that *Stone v. Ritter* was an important, but ultimately, mundane and unsurprising decision. The concept of good faith has long been a vital one in Delaware's corporate law, but not as a fiduciary duty separate from the fundamental duty of loyalty. Rather, we demonstrate that the term good faith has long been used as the key element in defining the state of mind that must motivate a loyal fiduciary. To wit, the duty of loyalty most fundamentally requires that a corporate fiduciary's actions be undertaken in the good faith belief that they are in the best interests of the corporation and its stockholders. Delaware law has traditionally subjected the protection of the business judgment rule and the use of authority under the statutory corporate law to the important condition that fiduciary power be exercised for proper

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<sup>6</sup> 911 A.2d 362 (Del. 2006).

<sup>7</sup> See, e.g., Stephen M. Bainbridge, Star Lopez, & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 604-05 (2008) (worrying that after *Stone v. Ritter*, "a conscious decision by the board of directors that the costs of a law compliance program outweigh the benefits may no longer be protected by the business judgment rule" and that "the *Stone* court arguably disallows director liability in the paradigm case in which a board over a sustained period of time simply failed to even consider whether a law compliance program was necessary"); Eric A. Chiapinelli, *Delaware Supreme Court on Good Faith (Again) and the Duties of Care and Loyalty*, [http://businessentitiesonline.typepad.com/new\\_developments/2006/11/delaware\\_suprem.html](http://businessentitiesonline.typepad.com/new_developments/2006/11/delaware_suprem.html) (Nov. 8, 2006) (expressing concern that after *Stone v. Ritter*, the "the duty of care may, in fact, be or become chimerical"); Gordon D. Smith, *Good Faith, Care, and Loyalty in Delaware*, [http://www.theconglomerate.org/2007/01/good\\_faith\\_care.html](http://www.theconglomerate.org/2007/01/good_faith_care.html) (Jan. 3, 2007) (questioning why it was necessary for *Stone v. Ritter* to place the duty of good faith under the duty of loyalty when *Disney* had already defined the duty of good faith and distinguished it from the duty of care). But see Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1770 (2007) ("*Stone* opens the door to a more analytically satisfactory articulation of the standard of liability for breach of fiduciary duty.").

corporate reasons, and not to advance a personal agenda of any kind.<sup>8</sup> Indeed, we show that the Delaware Supreme Court, both in *Technicolor* itself and other decisions contemporaneous with it, understood and frequently applied the concept of good faith in just this traditional way, as the state of mind required of a loyal director.

Perhaps more importantly, we demonstrate that the duty of loyalty has, for good reason, been central to Delaware’s approach to corporate law. That approach begins with a statute — the General Corporation Law of the State of Delaware (“DGCL”) — that is broadly enabling, in the sense that it gives directors capacious authority to undertake lawful actions of various kinds in the pursuit of profit, subject to two important constraints: (1) a discrete set of mandatory statutory rules, such as requirements for director elections and stockholder votes; and (2) the requirement that director actions authorized by law be undertaken in conformity with equity.

Because the discretion that the DGCL affords directors is so wide, it is vitally important that directors exercise this discretion to advance the corporation’s best interests, and not for improper purposes. Likewise, because the DGCL embraces a strong republican model of representation, investing corporate directors with broad managerial powers and duties during their terms in office, it is essential that directors take their responsibilities seriously by actually trying to manage the corporation in a manner advantageous to the stockholders.

For these reasons, it has been traditional for the duty of loyalty to be articulated capaciously, in a manner that emphasizes not only the obligation of a loyal fiduciary to

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<sup>8</sup> See *infra* text accompanying note 31 and Part III(D).



refrain from advantaging herself at the expense of the corporation, but as importantly, to act affirmatively to further the corporation's best interests. In this respect, our law has been clear that the duty of loyalty is implicated by all director actions, because all such actions must be undertaken in good faith to advance the corporation's best interests and because directors owe an affirmative obligation to put in a good faith effort to responsibly carry out their duties.

After examining this reality, we note an odd, but pervasive, feature of arguments for a free-standing duty of good faith separate from the duty of loyalty. That involves the rhetorical shrinking of the concept of loyalty so as to create a gap — never thought to exist before 1993 — in Delaware's corporation law. The obvious reason for that rhetorical move is to show that there is a need for an independent duty of good faith.

We argue, to the contrary, that this rhetorical move obscures the true nature of what is at stake. We readily concede that the concept of good faith is an important and vibrant one of enduring relevance. But we see no basis to conclude that the traditional place of good faith in our law — as the definition of a loyal state of mind — should be altered. To shrink the hallmark duty of loyalty to make way for a separate duty that simply embraces the traditional definition of a loyal state of mind adds confusion not clarity.

In so stating, we acknowledge that the duty of loyalty remains, as it always has, most difficult to apply to circumstances when directors act without an apparent selfish interest for injuring the corporation. We also acknowledge that it is in that context that the concept of good faith has its greatest utility. But that context, we note, is also one in

which the traditional role of good faith — as the definition of a loyal state of mind — works to help courts assess whether directors have breached their affirmative duty of loyalty, rather than simply suffered a lapse in attention.

In the end, we believe that the contending forces in the argument about the circumstances in which directors should be subject to liability would have a clearer and more useful debate by having it within the tradition of our law, in which there are two fundamental fiduciary duties, those of loyalty and care. The important work of substance, rather than rhetoric, is defining principles that allow courts to fairly distinguish between two forms of director conduct: (1) conduct that involves a breach of the duty of loyalty and that should be remediable by an award of monetary damages, and (2) conduct that involves an exculpable or indemnifiable breach of the duty of care. The traditional divide aids in that hard work, by surfacing the real policy issues at stake, rather than obfuscating them.

### *B. A Map of the Trip Ahead*

We begin the article with a basic consideration of the central role of the duty of loyalty in corporation law. Then, we very briefly outline the basic Delaware approach to corporate law, with particular emphasis on the relationship between law and equity. From there, we examine the underpinnings of the concept of good faith as it relates to the duties of directors: we start with etymology, then examine the role of good faith in Delaware's corporate statutes, and in case law and scholarly commentary before *Technicolor*. From that perspective, we venture an answer as to why the triad came to be invented and why the triad was likely, from the start, to lack enduring utility. Finally, we

emphasize the important, but focused, role good faith will continue to have in corporate law. As the defining state of mind of a loyal fiduciary, good faith's explication by the judiciary will largely determine when directors without a conflicting, financial self-interest have breached the fiduciary duty of loyalty and face liability for compensatory damages not involving a return of improper personal gain.

## **II. Two Fundamental Duties Cover All Director Action, Leaving No Room For Company**

The invention of the triad purported to add a third, co-equal duty to the traditional core duties recognized in fiduciary duty law, the duties of loyalty and care. As we show later, the room to be taken by the new duty of good faith largely had to come at the expense of the other two central duties, particularly that of loyalty, by having good faith cover domain previously covered by another core duty.

We are willing to go further and to say that it is possible to conceive of there being only one core duty, that of loyalty, and that the duty of care is itself simply a component of what is expected of a faithful fiduciary. That is, we think it uncontroversial that the corporate law duty of loyalty has an affirmative aspect, which demands that a fiduciary make a good faith effort to advance the best interests of the corporation and its stockholders.<sup>9</sup> The Hippocratic maxim to first do no harm is of course relevant to a

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<sup>9</sup> *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987) (“This involves duties of loyalty and care. The former embodies not only an affirmative duty to protect the interests of the corporation, but also an obligation to refrain from conduct which would injure the corporation and its stockholders or deprive them of profit or advantage. In short, directors must eschew any conflict between duty and self-interest.” (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)). “They cannot succumb to influences which convert an otherwise valid business decision into a faithless act.” (citing *Aronson v. Lewis*, 473 A.2d 805, 816 (1984)); *In re The Walt Disney Co. Derivative Litig.* (“*Disney III*”), 2004 WL 2050138, at \*5 n.49 (Del. Ch. Sept.10, 2004) (“As this Court previously stated, the “duty of loyalty . . . imposes an affirmative obligation to protect and advance the interests of the corporation and mandates that [a director] absolutely refrain

corporate fiduciary's role, but, like the role of a physician, the director's job demands affirmative action, to protect and better the position of the corporation.<sup>10</sup>

Because of that basic concept, every fiduciary act implicates the duty of loyalty, because every act must be taken for a proper corporate purpose. Moreover, precisely because a loyal fiduciary must protect the corporation, she is duty-bound to *try* in good faith to perform her duties with care.<sup>11</sup> The job of a corporate fiduciary is a serious obligation and a loyal fiduciary thus knows she must genuinely attempt to carry out her duties carefully, skillfully, and prudently.

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from any conduct that would harm the corporation. This duty has been consistently defined as '*broad and encompassing*,' demanding of a director '*the most scrupulous observance*.' To that end, a director may not allow his self-interest to jeopardize his *unyielding obligations* to the corporation and its shareholders." (quoting *BelCom, Inc. v. Robb*, 1998 WL 229527 at \*3 (Del. Ch. Apr. 28, 1998))). The proposition that the fiduciary duty of directors has an affirmative aspect is long-standing. *See, e.g.*, *Aberdeen Railway Co. v. Blaikie*, 1 McQueen's Rep. 461 (1854) (quoted in *The Cumberland Coal & Iron Co. v. Sherman*, 30 Barb. 553 (N.Y. Sup. Ct. 1859) ("The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents and it is, of course, the duty of those agents so to act as best to promote the interests of the corporations whose affairs they are conducting."); *Cumberland Coal & Iron Co. v. Sherman*, 30 Barb. 553 (N.Y. Sup. Ct. 1859) ("Those who assume the position of directors . . . , assume also the obligations which the law imposes on such a relation. The stockholders confide to their integrity, to their faithfulness, and to their watchfulness, the protection of their interests."); THOMAS W. WATERMAN, 1 A TREATISE ON THE LAW OF CORPORATIONS 420 (New York, Baker, Voorhis & Co. 1888) ("A corporate body can only act by agents, and it is of course the duty of those agents so to act as best to promote the interests of the corporations, whose affairs they are conducting.").

<sup>10</sup> *See generally* Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003) (providing an incisive analysis that demonstrates that the duty of loyalty includes the concept of affirmative attention and devotion in addition to nonbetrayal).

<sup>11</sup> *E.g.*, *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988) (contending that the loyalty principles articulated in *Guth v. Loft*, 5 A.2d at 510, "demand that corporate fiduciaries . . . affirmatively protect and defend the interests entrusted to them . . . [and] must exert all reasonable and lawful efforts to ensure that the corporation is not deprived of any advantage to which it is entitled."); HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 359 (1927) ("It is important that directors realize the responsibility which they assume. They are expected to exercise an active and vigilant supervision over the officers of the company. They are expected to be familiar with the requirements of the by-laws of the corporation and enforce them. They are supposed to take the usual methods to inform themselves of the true conditions of the affairs of the company."); *id.* at 360 ("The director of a corporation cannot remain silent, when he knows that a fraud is being attempted against the corporation and ultimately against its shareholders. It is his duty . . . to use every effort to prevent the consummation of the fraud. If he permits by passive acquiescence any part of the assets of the corporation to be fraudulently diverted or secret profits to be obtained he is guilty of a neglect of duty to the corporation for which he is liable in damages, notwithstanding the fact that he did not profit financially thereby.").

It is thus in this manner that the duty of care can be properly regarded as a subsidiary requirement of the duty of loyalty. *A faithful fiduciary is duty-bound to try to act with care.*

The policy rub, of course, is over whether the law should hold culpable fiduciaries who try to act carefully, but who, based on some after-the-fact review, are found to have fallen short of what is objectively expected of a reasonable fiduciary in the particular circumstances. Many respected commentators have believed that there should be no corporate law duty of care that is enforceable by way of a damages judgment.<sup>12</sup> So long as a fiduciary made a good faith effort to exercise care, that was all the stockholders could reasonably expect.<sup>13</sup> Others, of course, believe that corporate fiduciaries should,

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<sup>12</sup> See *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996) (Chancellor Allen stating “I start with what I take to be an elementary precept of corporation law: 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.”); STEPHEN M. BAINBRIDGE, *CORPORATE LAW* ch. 5 (2d ed. 2009) (arguing that the business judgment rule should be used to cause courts to abstain from reviewing whether disinterested directors made a decision with reasonable care, and articulating the policy reasons why a disinterested director’s duty of care should not be enforceable by way of a monetary damage award); Reiner Kraakman & Jay Kesten, *The Story of Francis v. United Jersey Bank: When a Good Story Makes Bad Law*, in *CORPORATE STORIES* 163, 186 (J. Mark Ramseyer ed., 2009) (asserting that *Francis* was “wrongly decided, both by traditional standards and by the standards of good corporate law policy” because it “broke with the tradition of insulating negligent directors from liability in almost all cases”); Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 *WAKE FOREST L. REV.* 1131, 1176 (2006) (“The Delaware legislature should establish by statute that monetary liability may not be imposed on corporate directors for breach of the ‘duty of care,’ but that monetary liability may be imposed for breach of the ‘duty of loyalty,’ defined to include cases involving financial conflicts of interest, other improper personal benefits, conscious malfeasance, and conscious nonfeasance.”); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 *BUS. LAW.* 1437, 1441 (1985) (contending that the business judgment rule should preclude judicial review of a directors’ decisions to acquire information before making decisions because, among other things, liability rules should be “relatively unimportant” where it is difficult to distinguish between performance and breach of fiduciary duty); Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 *STAN. L. REV.* 927, 937 (1983) (arguing that “very little of any value would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit” and that many benefits would result, including “savings in litigation expense, insurance premiums, unnecessary record building, and risk-averse decisionmaking by the board,” as well as the opportunity for the law to more effectively and efficiently address duty of loyalty claims).

<sup>13</sup> See *Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924) (“Directors are not specialists, like lawyers or doctors. They must have good sense, perhaps they must have acquaintance with affairs; but they need not—indeed, perhaps they should not—have any technical talent. They are the general advisers of the business, and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable.”).

like other professionals, face damages liability if, even when putting in a good faith effort, they acted negligently and caused harm.<sup>14</sup> Indeed, the *Van Gorkom* decision appeared to adopt this view, but, to give directors more freedom to take risk, held that only grossly negligent conduct would support damages liability.<sup>15</sup>

For now, what is important is to note that the invention of a third core duty was, from the get-go, an improbable discovery of anything of value, precisely because the two existing duties, particularly that of loyalty, already covered everything that directors do.

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<sup>14</sup> See, e.g., D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 853 (2007) (“[I]t is not clear why directors should not be held to an ordinary negligence standard.”); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion*, 67 S. CAL. L. REV. 287, 327 (1994) (“The bottom line is that utilizing the business judgment rule to insulate directors from liability for ordinary negligence creates differences in treatment between individuals which cannot be explained by any policy justifications.”). The early treatise writers reflected the same divergent viewpoints that exist modernly on whether directors should be held culpable for mere negligence, gross negligence, or any breach of care not accompanied by an improper state of mind. Compare WILLIAM M. CLARK, JR., HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS, 646 (1916) (stating that directors and officers are liable by “reason of negligence and inattention to duties of their trust, though there may be no actual bad faith”); *id.* at 648 (“Directors are liable if they suffer the corporate funds or property to be lost or wasted by gross negligence, and inattention to the duties of their trust, though there is no bad faith.”); HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 362 (1927) (stating that directors “are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. They cannot excuse imprudence on the ground of . . . the honesty of their intentions.”); *id.* at 359 (explaining that the liability of directors “is not limited to willful breaches of trust or excess of power, but extends also to negligence”); *id.* at 361 (advocating a simple negligence standard requiring the directors to have acted with the care and diligence that would be expected of ordinarily careful and diligent persons acting under similar circumstances) with WILLIAM J. GRANGE, CORPORATION LAW FOR OFFICERS AND DIRECTORS: A GUIDE TO CORRECT PROCEDURE 410-11 (1935) (“A director is not liable for honest mistakes, such as entering in good faith into a contract which afterwards turns out to be unprofitable. On the other hand, if a particular act authorized by the directors is so obviously foolish or absurd that it may be said to evince an entire lack of judgment or good sense, the courts will hold the directors accountable for the loss sustained. The question is one of degree, but where honesty, good faith, and a reasonable effort to perform his duties have been shown, the courts will go a long way in excusing a director’s blunders.”); 2 ARTHUR W. MACHEN, JR., MODERN LAW OF CORPORATIONS § 1533 (1908) (“The rule is that for any mere error of judgment directors are not ordinarily liable. Their negligence, it is said, in order to give the company a cause of action against them, must be ‘crass’ or ‘gross.’”); HENRY OSBORN TAYLOR, LAW OF PRIVATE CORPORATIONS § 620 (5th ed. 1902) (“Directors acting in good faith are not liable, in the absence of gross negligence, for doing what they have been authorized to do, even though it was imprudent; nor for error of judgment in matters within the scope of their discretion, even when the errors seem palpable, and such as men of ordinary prudence would not have committed.”).

<sup>15</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); see also *Lutz v. Boas*, 171 A.2d 381, 395 (Del. Ch. 1961) (finding “grossly negligent directors” liable for failure to perform publicly stated supervisory functions and prevent misconduct by the mutual fund company’s investment adviser); cf. *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (embracing a negligence standard to address a claim that a director failed to monitor the operations of a reinsurance broker and was responsible for losses caused by the misappropriation of funds by her sons, the broker’s other two directors).

This reality is perhaps best illustrated by citing a verbal tic that the Delaware courts have frequently employed in two types of cases calling for the context-specific applications of the duty of loyalty and care. In so-called *Revlon* cases, which involve courts in determining whether directors have complied with their fiduciary duties to maximize the sale value of the corporation when embarking on a corporate change of control, Delaware courts have frequently said that the sale of control context implicates both the duties of loyalty and care.<sup>16</sup> Likewise, in cases dealing with the disclosure obligations directors owe when asking stockholders to vote on a particular matter, Delaware courts have often said that the duty to disclose all material facts arises out of, or implicates, both the duty of loyalty and care.<sup>17</sup>

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<sup>16</sup> See, e.g., *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (explaining that the “the basic teaching of [*Revlon*, as well as *Unocal* and *Moran*] is simply that the directors must act in accordance with their fundamental duties of care and loyalty.”); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1284 n.34 (Del. 1988) (“In *Ivanhoe*, 535 A.2d at 1345, we made it abundantly clear that both [the duty of care and the duty of loyalty] were involved in *Revlon*, and that both had been breached.”); *Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427, at \*12 (Del. Ch. July 29, 2008) (“The so-called ‘*Revlon* duties’ are not unique fiduciary obligations, but they do guide a board in the discharge of its unyielding fiduciary duties of care and loyalty in the sale context.”); *In re MONY Group Inc. S’holder Litig.*, 852 A.2d 9, 19 (Del. Ch. 2004) (“[T]he basic teaching of *Revlon* and its progeny is that the directors must act in accordance with their fundamental duties of care and loyalty.” (quotation omitted)); *In re Lukens Inc. Shareholders Litig.*, 757 A.2d 720, 731 (Del. Ch. 1999) (“‘*Revlon* duties’ refer only to a director’s performance of his or her duties of care, good faith and loyalty in the unique factual circumstance of a sale of control over the corporate enterprise.”); *Wells Fargo & Co. v. First Interstate Bancorp.*, 1996 WL 32169, at \*11 n.3 (Del. Ch. Jan. 18, 1996) (“‘*Revlon* duties’ are not distinctive board duties at all, but a changed standard of judicial review. That is when ‘*Revlon* duties’ are triggered a burden will shift to the directors and the court will undertake more active review of the traditional directorial duties of care and loyalty under a reasonableness standard.”); *QVC Network, Inc. v. Paramount Commc’ns, Inc.*, 635 A.2d 1245, 1267 (Del. Ch. 1993) (“The basic teaching of *Revlon* and *Unocal* is simply that the directors must act in accordance with their fundamental duties of care and loyalty.” (quotation omitted)); *In re RJR Nabisco, Inc. S’holders Litig.*, 1989 WL 7036, at \*4 (Del. Ch. Jan. 31, 1989) (“[T]he *Revlon* case does not establish a basis for director liability or for the issuance of the protective remedy of injunction independent of the traditional bases for such liability or such relief: a breach of the duty of loyalty or of the duty of care with resulting injury.”).

<sup>17</sup> See, e.g., *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998) (“The duty of directors to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty and good faith.”); *Zirn v. VLI Corp.*, 621 A.2d 773, 778 (Del. 1993) (“The requirement that a director disclose to share-holders all material facts bearing upon a merger vote arises under the duties of care and loyalty.”). The frequency with which the mantra has been repeated is evident from its inclusion in at least six cases during 2008 alone. See *Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427, at \*19, n.113 (Del. Ch. July 29, 2008) (“The so-called duty of disclosure, of course, is not an independent fiduciary duty standing on the same footing as the fiduciary duties of care and loyalty.”); *Wayne County Employees’ Ret. Sys. v. Corti*, 954 A.2d 319, 330 (Del. Ch. 2008) (“The fiduciary duty of disclosure, which

The repetition of this obvious truism demonstrates the pervasive nature of the traditional duties. Because every act of a director must be done for a proper, loyal purpose, every act in every context implicates the duty of loyalty. And because a loyal director must try to perform her acts with care, and because the law has embraced an enforceable duty of care, every act by a director implicates the duty of care.

Of course, the reality that the duties of loyalty and care are at issue whenever a dispute arises about the propriety of legally authorized director action does not mean that the judicial job of fleshing out what those duties entail in the myriad of contexts requiring director action is easy. But, what it does mean is that the idea that there is yet another omnipresent core duty — discovered only in 1993! — that is always implicated by director action in any context, is highly implausible.

Rather, the real hard work in the evolution of corporate fiduciary duty law — a vibrant form of judge-made common law, albeit of the equitable variety — remains identifying what conduct is expected of a loyal and careful fiduciary in an ever-changing

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is a specific application of the duties of care and loyalty, requires that a board of directors disclose fully and fairly all material information within the board's control when it seeks shareholder action." (internal quotation omitted)); *David P. Simonetti Rollover IRA v. Margolis*, 2008 Del. Ch. LEXIS 78, at \*17-\*18 (Del. Ch. June 27, 2008) ("When the directors of a Delaware corporation seek shareholder action, they are bound by their fiduciary duties of due care and loyalty to disclose fully and fairly all material information within the board's control." (internal quotation omitted)); *Raymond Revocable Trust v. MAT Five LLC*, 2008 WL 2673341, at \*4 (Del. Ch. June 26, 2008) ("The duty of disclosure is not an independent duty, but derives from the duties of care and loyalty."); *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346 (Del. Ch. 2008) ("Although usually labeled and described as a duty, the obligation to disclose all material facts fairly when seeking shareholder action is merely a specific application of the duties of care and loyalty."); *Pfeffer v. Redstone*, 2008 WL 308450, at \*8 (Del. Ch. Feb. 1, 2008) ("The duty of disclosure is not an independent duty, but derives from the duties of care and loyalty.").



world, involving much greater transactional and organizational speed, complexity, size, and volume.<sup>18</sup>

Consistent with our view that the concept of loyalty pervades all of Delaware corporate law, we embark next on sharing why, if there were to be a third duty that is usefully separate and distinct from the duty of loyalty, the most unlikely candidate of all would be that of good faith.

### **III. The Close Relationship Between The Duty Of Loyalty And The Concept Of Good Faith**

#### *A. A Broad Duty Of Loyalty Is Central To The Delaware Model Of Corporation Law*

We do not break new ground in the following articulation of the essential elements of Delaware corporation law. But a reminder of these basic elements is helpful in understanding the role of the duty of loyalty in our system of law.

The statutory backbone of our law is the Delaware General Corporation Law. That statute has commonly been referred to as enabling in character and as a general matter gives directors capacious authority to pursue lawful ends by lawful means. Indeed, one of the most important Delaware corporate lawyers involved in the last comprehensive revision of the DGCL, Samuel Arsht, was said to have described the essence of Delaware corporate law as follows: “Directors of Delaware corporations can

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<sup>18</sup> *TW Services*, 1989 WL 20290 at \*8, n.14 (“[N]o matter what our model [of corporate law], it must be flexible enough to recognize that the contours of a duty of loyalty will be affected by the specific factual context in which it is claimed to arise . . .”).

do anything they want, as long as it is not illegal, and as long as they act in good faith.”<sup>19</sup>  
That statement is only a bit exaggerated.<sup>20</sup>

The key exaggeration is that it ignores a number of important mandatory terms in the DGCL (and its statutory predecessors) that act to ensure that the corporation is managed with fidelity toward its stockholders. For example, the DGCL requires that corporations hold annual meetings at which directors are elected<sup>21</sup> and mandates that stockholders approve a variety of important transactions.<sup>22</sup> These mandatory provisions play a critical role in ensuring that directors manage corporations in a responsible way, because they subject directors, through various means, to accountability for actions that are contrary to the stockholders’ best interests.

But Arsht’s central point was true, which is that the DGCL gives directors a very strong hand to manage the corporation and that the primary non-ballot box legal constraint on them is the enforcement of their equitable fiduciary duties. Without risk of facing any serious historical counter-argument, we can even safely state that the primary equitable duty that was thought to constrain directors until the issuance of the *Van Gorkom*<sup>23</sup> decision in 1985 was the duty of loyalty. Before that time, the duty of care had

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<sup>19</sup> Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997).

<sup>20</sup> We claim, in fact, that Arsht’s aphorism could be made even simpler by eliminating the explicit reference to illegality, because we maintain that the loyalty-implementing concept of good faith requires managing the corporation’s affairs in compliance with law. *See infra*.

<sup>21</sup> 8 *Del. C.* § 211.

<sup>22</sup> 8 *Del. C.* § 241 (charter changes); § 151 (issuance of new classes of stock not previously provided for in the charter requires a charter amendment); § 251 (mergers); § 271 (sale of substantially all assets).

<sup>23</sup> *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

largely an admonitory, rather than enforceable, basis in American corporate law.<sup>24</sup> But for present purposes, whether that is or is not true is not of moment.

What is of importance is a recognition that the powers entrusted to directors by the DGCL may only be exercised to advance proper corporate interests. Modernly, that principle is most famously embodied in the Delaware Supreme Court's decision in *Schnell v. Chris-Craft*, which reaffirmed the long-standing notion that "inequitable action [is] not . . . permissible simply because it is legally possible."<sup>25</sup> *Schnell* emphatically voiced the Delaware Supreme Court's acceptance of the importance of fiduciary duty review to ensuring that the capacious authority granted to directors by the DGCL was not

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<sup>24</sup> See, e.g., William T. Allen, *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in *COMPARATIVE CORPORATE GOVERNANCE*, 307, 321 (Klaus J. Hopt et al. eds., 1998) ("The long history that was inconsistent with courts directly imposing liability on corporate directors for violation of the objective standard of care was interrupted by the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*."); Henry Ridgely Horsey, *The Duty Of Care Component Of The Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 977 (1994) ("Those who surveyed the duty of care case law in this country before the mid-eighties found an infertile field and were in nearly unanimous agreement as to their findings: the business judgment rule had been applied in such a manner as to constitute an almost per se bar to shareholder claims of directors' breach of their fiduciary duty of care." (citing Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 594 (1983)); 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."). Although there are almost no cases holding directors liable for a breach of the duty of care, a number of early treatises suggest that distinguished commentators believed a cause of action for some form of negligence could be successful. The treatises are often confusing about the evidentiary standard that would be used. E.g., WILLIAM L. CLARK & WILLIAM L. MARSHALL, *MARSHALL ON PRIVATE CORPORATIONS*, at 1012-1013 (1902) (stating that directors would not be liable for "mere mistake or errors of judgment, either of law or fact, or for nonfeasance or negligence, where they have brought to the discharge of their duties and exercised such a degree of attention, care, skill and judgment as ordinarily prudent and diligent men would exercise under similar circumstances"); WILLIAM M. CLARK, JR., *HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS*, 646 (1916) (directors and officers can be held liable "by reason of negligence and inattention to duties of their trust, though there may be no actual bad faith"); *id.* at 648 ("Directors are liable if they suffer the corporate funds to be lost or wasted by gross negligence, and inattention to the duties of their trust, though there is no bad faith."); WILLIAM J. GRANGE, *CORPORATION LAW FOR OFFICERS AND DIRECTORS: A GUIDE TO CORRECT PROCEDURE*, 410-11 (1935) ("A director is not liable for honest mistakes, such as entering in good faith into a contract which afterwards turns out to be unprofitable. On the other hand, if a particular act authorized by the directors is so obviously foolish or absurd that it may be said to evince an entire lack of judgment or good sense, the courts will hold the directors accountable for the loss sustained. The question is one of degree, but where honesty, good faith, and a reasonable effort to perform his duties have been shown, the courts will go a long way in excusing a director's blunders.").

<sup>25</sup> 285 A.2d 430, 437 (Del. 1971).

misused. Indeed, *Schnell's* articulation was a shorter formulation of that used by Adolf Berle in a famous article in the Harvard Law Review in 1931, entitled *Corporate Powers as Powers in Trust*.<sup>26</sup> In that article, Berle feared that Delaware's then existing corporate statute — whose drafting and enactment he attributed to powerful New York business lawyers<sup>27</sup> — gave managers extremely broad power without accompanying statutory limitations. To address that problem, Berle called on traditional fiduciary principles, particularly those from trust law, as a solution.

By requiring that director action be justified in reference to whether it was undertaken in the best interests of the corporation's stockholders, equity would police the broad powers granted to the managers by law. Berle therefore formulated the core inquiries relevant to resolving any challenge to director action thusly:

[I]n every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second by equitable rules somewhat analogous to those which apply in favor of cestui que trust to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary.<sup>28</sup>

Central to Berle's argument was the importance of ensuring that corporate managers had enforceable fiduciary duties that constrained their misuse of power. To Berle's way of thinking, that required a clear benchmark — the best interests of stockholders — that courts could use to assess whether managers had acted in good faith. That is, Berle believed it critical that managers be required to justify their actions as being undertaken in good faith to profit the stockholders ratably to their ownership

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<sup>26</sup> 44 HARV. L. REV. 1049 (1931).

<sup>27</sup> Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1366, 1371 (1932).

<sup>28</sup> Adolf A. Berle, *Corporate Powers As Powers In Trust*, 44 HARV. L. REV. 1049, 1049 (1931).

interest in the corporation, fearing that equity would not act as a sufficiently potent restraint if managers could justify their actions as beneficial to other corporate constituencies. Stated simply, Berle viewed it to be an infeasible job of equity courts to ensure that managers were loyal to stockholders by subjecting all corporate action to equitable review for fidelity to stockholder interests.<sup>29</sup> In his classic work with Gardiner C. Means, Berle put it this way:

All the powers granted to management and control are powers in trust.

Tracing this doctrine back into the womb of equity, whence it sprang, the foundation becomes plain. Wherever one man or a group of men entrusted another man or group with the management of property, the second group became fiduciaries. *As such they were obliged to act conscionably, which meant in fidelity to the interests of the persons whose wealth they had undertaken to handle.* In this respect, the corporation stands on precisely the same footing as the common-law trust.<sup>30</sup>

Delaware statutory and common law makers have spent the 75 years since Berle wrote these words putting into action his policy prescription. They have done so by conditioning all corporate action to a fundamental test of loyalty, which requires that the action have been undertaken in good faith to advance the interests of the corporation and its stockholders.<sup>31</sup> As a final preliminary, we note one circumstance where a fiduciary, despite acting in subjective good faith, may be found liable for acting disloyally. This exceptional circumstance actually tends to prove the general point we argue, which is that

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<sup>29</sup> Adolf A. Berle, *Corporate Powers As Powers In Trust*, 44 HARV. L. REV. 1049, 1074

<sup>30</sup> ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 338 (1932) (emphasis added).

<sup>31</sup> The classic case standing for this proposition is, of course, *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971).

a director cannot act loyally if she uses her corporate powers in bad faith to pursue improper ends.

The circumstance, of course, is when the corporate action under challenge involves a self-dealing transaction approved by a conflicted board majority. In that circumstance, the entire fairness standard of review applies in the first instance, rather than the business judgment rule standard. Because even a subjectively well-motivated fiduciary might deal with himself less aggressively than he would with a third party, Delaware law requires that the interested party prove that the transaction was entirely fair to the corporation, in the sense that it was on terms as favorable as could have been achieved in an arms-length deal subject to market competition.<sup>32</sup> A failure to carry that burden of proof could expose even the subjectively well-motivated, but self-interested, fiduciary to liability.

But even when board action does not involve self-dealing and the business judgment rule standard of review is applicable, a plaintiff can prevail by showing that the directors breached either their duty of loyalty or care.<sup>33</sup> In the case of the duty of loyalty, the plaintiff does so by showing that the board action was not undertaken in a good faith effort to further the stockholders' best interests, but for some personal reason, such as

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<sup>32</sup> By way of example, in *Alcott v. Hyman*, the Delaware Supreme Court said that when corporate directors bore the burden to show entire fairness, they were required to show that they acted with "utmost good faith" and that the transaction was "scrupulous[ly] fair." 208 A.2d 501, 506 (Del. 1965); *see also* *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding the same).

<sup>33</sup> *See, e.g.*, *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (explaining that a plaintiff may rebut the presumption of the business judgment rule by providing evidence of a breach of fiduciary duty); *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 52 (Del. 2006) (same).

entrenchment.<sup>34</sup> If the plaintiff proves subjective bad faith of that kind, it can have the challenged action set aside in equity as a breach of the duty of loyalty and potentially recover monetary damages or other relief for injury to the corporation.

As we will show, good faith is the defining term that Delaware courts employing the business judgment rule standard of review use to articulate the state of mind required of a loyal fiduciary exercising corporate powers. The Delaware General Assembly uses good faith in an identical way in the DGCL by requiring that certain powers be used with fidelity to the corporation, i.e., with “good faith.” Therefore, to divorce good faith from loyalty is to leave the fundamental and broad-reaching duty of loyalty without a definition, other than the narrow duty to refrain from unfair self-dealing. That is, the only function of a separate duty of good faith would be to fill the conceptual space created by the shrinking of the traditionally broad duty of loyalty required to accommodate the conversion of the long-standing definition of a loyal state of mind into a free-standing duty. The free-standing duty of good faith is thus a solution to the problem of its own invention.

Before demonstrating that that is so, we first undertake briefly to deal with the linguistics of the relationship between the concepts of loyalty and good faith.

## *B. The Close Linguistic Relationship Between Loyalty And Good Faith*

### 1. Etymology

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<sup>34</sup> See, e.g., *Bennett v. Propp*, 187 A.2d 405, 411 (Del. 1962) (holding director/chief executive officer liable for damages to the corporation resulting from stock repurchases motivated by a desire to perpetuate control).

In our view, it is not at all surprising that the term good faith has played such an important defining role in relationship to the duty of loyalty. After all, loyalty,<sup>35</sup> fidelity,<sup>36</sup> and faithful<sup>37</sup> are all synonyms. A classic way to describe a disloyal director is as a “faithless fiduciary,”<sup>38</sup> which is not surprising as the term faithless means that one has been “disloyal,” in the sense of having been “untrue to what should command one’s fidelity or allegiance.”<sup>39</sup> Faithless “applies to any breach . . . of allegiance or loyalty.”<sup>40</sup>

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<sup>35</sup> Among Webster’s definitions of loyal are “faithful in allegiance to one’s lawful . . . government,” “faithful to a private person to whom fidelity is due,” “faithful to a cause, ideal, or custom.” WEBSTER’S NINTH NEW COLLEGIATE DICTIONARY 708 (1988) [hereinafter WEBSTER’S]. Webster’s also directs readers to “faithful” as a synonym for loyal. *Id.* Loyalty is defined primarily as “the quality or state of being loyal” and the reader is directed to “fidelity” as a synonym. *Id.* The Oxford English Dictionary and the American Heritage Dictionary of the English Language are identical in substance on all these points. 9 THE OXFORD ENGLISH DICTIONARY 74-75 (2d ed. 1989) [hereinafter OED]; AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 1038 (4th ed. 2000) [hereinafter AMERICAN HERITAGE]. The etymological origins of loyal and loyalty can be traced to the Old French leial, which originally was from the Latin legalis, or legal, and lex, or law, and then became loyal. ERIC PARTRIDGE, ORIGINS: A SHORT ETYMOLOGICAL DICTIONARY OF MODERN ENGLISH 344-45, 367 (1966). Given the root of loyal and loyalty, it is unsurprising that an obsolete usage of those terms was “legal” and “lawfulness, legality.” 9 OED at 74-75; *see also* WEBSTER’S at 708 (same).

<sup>36</sup> Webster’s defines fidelity as “the quality or state of being faithful” and identifies allegiance and loyalty as key synonyms. WEBSTER’S at 460; *see also* 5 OED at 876 (defining fidelity as “[t]he quality of being faithful; faithfulness, loyalty, unswerving allegiance to a person, party, bond, etc.”). More particularly, Webster’s says that “fidelity implies strict and continuing faithfulness to an obligation, trust, or duty” and that loyalty “implies a faithfulness that is steadfast in the face of any temptation to renounce, desert, or betray.” WEBSTER’S at 460. The American Heritage Dictionary of the English Language defines fidelity as “faithfulness to obligations, duties, or observances.” AMERICAN HERITAGE at 655. It traces the origin of the word to the Latin, fidelis, or faithful, which came from the Latin fides, or faith. *Id.* It indicates that “fidelity” and loyalty are nouns denoting faithfulness and that fidelity implies “the unfailing fulfillment of one’s duties and obligations and strict adherences to vows or promises,” with loyalty implying “steadfast and devoted attachment that is not easily turned aside.” *Id.*

<sup>37</sup> Webster’s defines faithful as “steadfast in . . . allegiance,” “firm in adherence to promises or in observance of duty,” and “firm in adherence to whatever one owes allegiance” and that faithful and loyal “impl[y] a firm resistance to any temptation to desert or betray.” WEBSTER’S at 446; *see also* 5 OED at 876 (defining faithful as “[f]irm in fidelity or allegiance . . . constant, loyal, true” and “abiding by a covenant or promise, steadfast”). The American Heritage Dictionary of the English Language uses a similar definition and states that “[f]aithful and loyal both suggest undeviating attachment,” and that the adjectives “faithful” and “loyal” mean “adhering firmly and devotedly to someone or something that elicits or demands one’s fidelity.” AMERICAN HERITAGE at 636.

<sup>38</sup> A search of the Lexis corporate case law database as of June 26, 2008 revealed 92 uses of this term.

<sup>39</sup> WEBSTER’S at 446.

<sup>40</sup> *Id.* Again, the American Heritage Dictionary of the English Language defines faithless in a substantively identical manner. *See* AMERICAN HERITAGE at 636.



As should be equally obvious, the word faith cannot be divorced from concepts of fidelity, loyalty, and faithfulness.<sup>41</sup> For one thing, faith is the root word for two of these words, and comes from the Latin *fides*.<sup>42</sup> *Fides*, of course, is the Latin root of the word *fiduciary*, which means a person “that stands in a special relation of trust, confidence, or responsibility in certain obligations to others.”<sup>43</sup>

Central to the definition of faith is loyalty. Hence, one of Webster’s primary definitions of faith is “allegiance to duty . . . : Loyalty.”<sup>44</sup> Likewise, the American Heritage Dictionary defines faith as “Loyalty to a person or thing; allegiance.”<sup>45</sup> The Oxford English Dictionary also uses “loyalty” to define faith.<sup>46</sup>

Put together with the word “good,” the word “faith” bears an unbreakable relationship to concepts of fidelity and loyalty.<sup>47</sup> When used as a noun, the words “good

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<sup>41</sup> This 19<sup>th</sup> century description of a director’s duty well illustrates this point and the use of various forms for the word faith to define the obligation loyalty:

Those who assume the position of directors . . . , assume also the obligations which the law imposes on such a relation. The stockholders confide to their integrity, to their *faithfulness*, and to their watchfulness, the protection of their interests. . . . The principals are not present to watch over their own interests; they cannot speak in their own behalf; they must trust to the *fidelity* of their agents. If they discharge these important duties and trusts *faithfully*, the law interposes its shield for their protection and defense; if they depart from their line of duty, and waste, or take themselves, instead of protecting, the property and interests confided to them, the law, on the application of those thus wronged or despoiled, promptly steps in to apply the corrective, and restores to the injured what has been lost by the *unfaithfulness* of the agent.

*Cumberland Coal & Iron Co. v. Sherman*, 30 Barb. 553 (N.Y. Sup. Ct. 1859) (emphasis added).

<sup>42</sup> AMERICAN HERITAGE at 636; WEBSTER’S at 446.

<sup>43</sup> AMERICAN HERITAGE at 656; WEBSTER’S at 460 (defining a fiduciary as “one having a relation “of, relating to, or involving a confidence or trust”); *see also* Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J. CORP. L. 333, 333 (2002) (“The fiduciary concept, as we know, had its origin in the law of trusts, where its literal meaning—faithfulness—correctly described the duty or responsibility owed by one who held title, but not ownership, to property of another, who lacked legal title but could, in equity, claim the benefits of ownership.”).

<sup>44</sup> WEBSTER’S at 446.

<sup>45</sup> AMERICAN HERITAGE at 636.

<sup>46</sup> 5 OED at 679.

<sup>47</sup> The Oxford English Dictionary defines good faith as “fidelity, loyalty” and directs the reader to the following definition of faith: “[t]he quality of fulfilling one’s trust; faithfulness, fidelity, loyalty.” 5 OED at 679.

faith” are often broadly defined as “honesty or lawfulness of purpose”<sup>48</sup> or “compliance with standards of decency and honesty.”<sup>49</sup> But that broad usage is fully consistent with the requirement that to be “good,” one has to be true to a certain form of “faith.” Indeed, it is well understood that the word good is often used as an adjective to refer to someone who is true to a particular cause, such as a “good Republican.”<sup>50</sup>

The words “good faith” are, as Adolf Berle observed, relational and raise the question of the object to which the obligation must be directed.<sup>51</sup> Motivating Berle’s important *Corporate Powers as Powers in Trust* articles was the notion that it was important that the object of corporate managers’ obligation of good faith had to be clear in order for judges to apply the concept in a meaningful way, which is why Berle argued for focusing the judicial inquiry on whether the managers were acting in good faith toward the corporation’s stockholders.

In whatever context, good faith has this relational quality and requires a state of mind and resulting behavior faithful to one’s contextual obligations.<sup>52</sup> Thus, in the

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<sup>48</sup> WEBSTER’S at 527.

<sup>49</sup> AMERICAN HERITAGE at 756.

<sup>50</sup> AMERICAN HERITAGE at 756; *see also* WEBSTER’S at 527 (also noting that one of the definitions of good as an adjective is loyal).

<sup>51</sup> Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1054 (1931).

<sup>52</sup> In this regard, it is traditional for the words good faith to be followed by the words “and in the best interest of” whatever or whoever is the object of the fiduciary’s duty. For example, in corporate law, the basic articulation of the business judgment rule states that the business judgment rule is a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith *and in the honest belief* that the action was taken in the best interest of the company.” *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (emphasis added). In a host of other related contexts this “good faith and” formulation is used. *See, e.g.*, *Teamsters v. Terry*, 494 U.S. 558, 567 (1990) (Marshall, J.) (“Just as a trustee must act in the best interests of the beneficiaries, 2A W. Fratcher, *Scott on Law of Trusts* § 170 (4th ed. 1987), a union, as the exclusive representative of the workers, must exercise its power to act on behalf of the employees in good faith, *Vaca v. Sipes*, 386 U.S., at 177, 87 S.Ct., at 909-910.”); *First Nat. Bank v. Converse*, 200 U. S. 425, 443 (1906) (Brewer, J., dissenting) (“It did so, and, so far as the record shows, everything was done *in good faith and in the belief that the best interests of the bank would be promoted thereby.*” (emphasis added)); *Price v. Forrest*, 173 U.S. 410, 428 (1899) (Harlan, J.) (“As he had acted *in good faith, and in the belief that he was promoting the best interests of the government . . .*” (emphasis added));

context of contracts, the traditional circumstance when a party might be found to have violated the implied obligation of good faith is when the party takes action that, although not explicitly proscribed by the literal terms of the contract, has the intended effect of depriving the other party of its part of the mutually crafted bargain.<sup>53</sup> By such conduct, the party breaks faith with the parties' negotiated deal.<sup>54</sup>

In the corporate context, action undertaken in good faith means action undertaken consistent with one's duty, for a faithful and loyal purpose. The requirement for "honesty of purpose" is relevant to this central idea because it requires the fiduciary to act for the proper faithful reason she surfaces as her motivation and not for some other concealed

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Clark v. Bever, 139 U.S. 96, 104 (1891) (Harlan, J.) ("[A]lthough the settlement upon that basis may have been demanded by the best interests of the company, and was made in good faith, without intention to harm the corporation or to defraud its creditors, existing or subsequent . . ."); In re Feldman, 400 F.3d 292, 293 (5th Cir. 2005) ("The district court, however, affirmed the conclusions of the bankruptcy court that 'the settlement of doubtful and disputed claims' for \$25,000 was 'entered into in good faith' and 'was in the best interest of the Estate.'"); Juvelis by Juvelis v. Snider, 68 F.3d 648, 654 (3d Cir. 1995) ("Under New York law, a guardian may change the domicile of an incompetent ... if done *in good faith and in the best interest of the conservatee.*" (quoting *Love v. Roosevelt Hospital*, 1993 WL 190345, at \*1 (S.D.N.Y. 1993)) (emphasis added)); Cornwell v. City of Riverside, 896 F.2d 398, 399 (9th Cir. 1990) ("Under a California statute enacted in 1985 a public entity other than the state is authorized to pay punitive damages awarded against its employees if the public entity finds that the employees were acting within the course of their employment, *in good faith and 'in the apparent best interests of the public entity,*' and the payment would be 'in the best interests of the public entity.'" (emphasis added)); Eng v. Coughlin, 858 F.2d 889, 898 (2d Cir. 1988) ("We think that for inmates disabled by confinement in SHU, or transferred to another facility, the right to substantive assistance is an obligation imposed by the Due Process Clause of the Fourteenth Amendment. Further, the assistance must be provided *in good faith and in the best interests of the inmate.*" (internal citation omitted) (emphasis added)).

<sup>53</sup> See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a ("Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness."); *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) (explaining that the implied covenant of good faith and fair dealing "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain" (internal quotation omitted)).

<sup>54</sup> The academic debate over the definition of the implied contractual obligation of good faith demonstrates its focus on faithfulness to the parties' contractual bargain. Compare Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 373 (1980) (stating that good faith performance of a contract requires that a party exercising discretion in performing a contract must do so consistent with the reasonable expectations of the contracting parties and not to recapture opportunities forgone upon contracting) with Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 262-63 (1968) (explaining that "good faith" in contract law functions to exclude the many different forms of bad faith, which in most cases involves "frustrat[ing] the justified expectations of another").

and improper purpose. An edition of the Corporate Director’s Guidebook captured this connection well, by stating that the requirement to act in good faith requires “acting honestly and dealing fairly; in contrast, a lack of good faith would be evidenced by acting, or causing the corporation to act, for the director’s personal benefit or for some other purpose other than to advance the welfare of the corporation and its economic interests.”<sup>55</sup> The Guidebook makes clear that the obligation to act “in good faith” and “in a manner the director reasonably believes to be in the best interests of the corporation”<sup>56</sup> is the “baseline standard . . . central to the mandate often referred to as the ‘duty of loyalty.’”<sup>57</sup>

2. Clarifying that Good Faith Means Loyalty to the Objectives of the Corporation As Defined By The Law Authorizing The Corporation’s Creation

By demonstrating that the term good faith bears a traditional and logical linguistic connection to concepts of loyalty and fidelity, we do not pretend to have resolved the long-standing argument about what is the appropriate object of a corporate fiduciary’s duty of loyalty to the corporation. What we have shown is that it is linguistic nonsense to divorce the defining concept of good faith from the terms — faith, fidelity, and loyalty — to which it gives effective life.

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<sup>55</sup> ABA COMM. ON CORPORATE LAWS, CORPORATE DIRECTOR’S GUIDEBOOK 11 (4th ed. 2004) [hereinafter DIRECTOR’S GUIDEBOOK].

<sup>56</sup> *See also id.* (indicating that the reference to the “best interests of the corporation . . . emphasize[s] the director’s primary allegiance to the corporate entity”).

<sup>57</sup> *Id.*; *see also* BARRY REITER, DIRECTORS’ DUTIES IN CANADA 54 (3d ed. 2006) (defining the duty of loyalty under Canadian corporate law as the “director’s duty to act honestly and in good faith with a view to the best interests of the corporation”).

In fact, such a divorce has an Orwellian, obscuring effect. By conceiving of a possibility that directors can simultaneously act loyally toward the corporation and its stockholders, yet somehow act in bad faith toward some other cognizable interest, all one is doing is bifurcating the object of a directors' obligation of fidelity. As to some objects, directors would owe a duty of "loyalty." As to other objects, the directors would owe a duty of "good faith." Because of the reflexively defining nature of the relevant terms, it would not matter into which linguistic category the objects of fidelity fell.

To be concrete, we note the attempt to justify in linguistic terms the need for a free-standing duty of good faith on the grounds that the duty of loyalty is not offended when directors intentionally cause the corporation to violate the law in an effort to increase its profitability. A distinguished commentator has argued that the duty of good faith is needed in this circumstance because the directors would have been acting for the loyal purpose of increasing the corporation's profits and therefore there is a need for a constraining duty of good faith, to recognize that the directors owe an obligation to follow society's laws.<sup>58</sup> This commentator apparently conceives of it as loyal for a corporate director to engage in consciously ultra vires conduct, conduct inconsistent with a basic condition of the corporation's receipt of its charter and that causes the corporation to become a criminal, subject to penalty and loss of its right to life.

We see no support for this argument in linguistics. All that has been done is to embrace a very narrow — and legally wrong — answer to the "loyal to what" question in order to create the need for a separate "good faith to what" category. For example, if one

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<sup>58</sup> Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 16 (2006).

read the duty of loyalty in corporate law as emphasizing in its most fundamental respect an obligation to be faithful to the laws of the chartering society in exercising corporate powers, it is easy to play the same linguistic game. “By refusing to violate the pollution laws when that would have increased corporate profits, the directors discharged their obligation of loyalty to society, but acted in bad faith toward the stockholders.” All that has changed are the devotional objects of the now balkanized concepts of loyalty and good faith. This is not a form of persuasive or useful reasoning.

In so concluding, we wish to avoid any implication that we believe that corporate directors somehow have free range to break the law intentionally in pursuit of corporate profits. We do not, and think such conduct is disloyal in the most fundamental sense.

In so contending, we not only have the support of judicial decisions and statutory law, but of a perhaps unlikely source, one Milton Friedman. In his famous article arguing that the social responsibility of corporations was the pursuit of profits for their stockholders, Friedman made clear that corporate managers had to pursue profits within the bounds set by the law.<sup>59</sup>

That is, even leading advocates of the proposition that corporations should have as their primary objective the creation of profits for stockholders, rather than the interests of other corporate constituencies, such as workers or communities within which the corporation operates, accept that the corporation must pursue profits only through lawful

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<sup>59</sup> Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine) (quoting his book *Capitalism and Freedom* for the proposition that “there is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game”).

conduct.<sup>60</sup> When viewed maturely from the perspective of citizens of a republic, that is of course hardly surprising.

When viewed in the context of the history of for-profit corporations, it is equally mundane. When for-profit corporations were first recognized, they were specifically chartered to accomplish legislatively-authorized ends through legislatively-authorized means.<sup>61</sup> Since the advent of general corporation laws, it has become common for corporations to have the ability by charter to conduct diverse forms of business, without the need for specification. But society's willingness to generally charter for-profit corporations has been subject to an essential bottom-line requirement, which is that corporations only engage in lawful business.<sup>62</sup> Section 101(b) of the DGCL exemplifies this, stating:

A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purposes, except as may otherwise be provided by the Constitution or other law of this State.<sup>63</sup>

Section 102(a)(3) of the DGCL says that a corporate charter's statement of purpose will be sufficient if it states that the "purpose of the corporation is to engage in any lawful act

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<sup>60</sup> Einer Elhauge, *Sacrificing Corporate Profits In the Public Interest*, 80 N.Y.U. L. REV. 733, 755-56 (2005) ("[M]ost advocates of a duty to profit-maximize concede it should have an exception for illegal conduct."); ROBERT CHARLES CLARK, *CORPORATE LAW* § 1.2, at 17-18 (1986) (stating that a corporation's purpose is to "maximize the value of the company's shares, subject to the constraint that the corporation must meet all its legal obligations to others who are related to or affected by it").

<sup>61</sup> Gregory A. Mark, *Comment: The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1452 (1987) ("That a corporation derived its powers from the sovereign was inherent in the contractual conception of the grant theory. The government granted nothing unless it agreed to the objects of the proposed corporation. The benefits that the corporation was expected to produce were exchanged for the powers necessary to produce them."); see also Model Bus. Corp. Act Ann. § 3.01 historical background.

<sup>62</sup> Indeed, a well-researched article argues that American corporate law has not only never authorized directors to violate the law in search of profits, it has gone in the other direction by leaving directors with a great deal of discretion to manage the corporation in a manner that leads to fewer profits, if that less aggressive managerial approach advances the public interest as rationally understood by the directors. Einer Elhauge, *Sacrificing Corporate Profits In the Public Interest*, 80 N.Y.U. L. REV. 733 (2005).

<sup>63</sup> 8 *Del. C.* § 101(b).

or activity for which corporations may be organized” and by such statement “all lawful acts and activities shall be within the purposes of the corporation.”<sup>64</sup> Similarly, DGCL Section 284(a) demonstrates that the very existence of the corporation depends on basic fealty to its lawful purposes: that statute confers upon the Court of Chancery “jurisdiction to revoke or forfeit the charter of any corporation for abuse, misuse or nonuse of its corporate powers, privileges or franchises.”<sup>65</sup>

Cumulatively, the consequences of statutes like these are, to our mind, clear. For a corporate director knowingly to cause the corporation to engage in unlawful acts or activities or enter an unlawful business is disloyal in the most fundamental of senses. A publicly chartered corporation becomes a legal citizen, imbued with rights and responsibilities. When directors knowingly cause the corporation to do what it may not — engage in unlawful acts or unlawful businesses — they are disloyal to the corporation’s essential nature.<sup>66</sup> By causing the corporation to become a lawless rogue, they make the corporation untrue to itself and the promise underlying its own societally-authorized birth. No agent can act loyally toward a principal by, without authority,

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<sup>64</sup> 8 *Del. C.* § 102(a)(3).

<sup>65</sup> 8 *Del. C.* § 284(a). *See, e.g.*, *Craven v. Fifth Ward Republican Club*, 146 A.2d 400, 402 (Del. Ch. 1958) (granting a preliminary injunction against illegal liquor sales, and holding that “continued serious criminal violations by corporate agents in the course of the discharge of their duties could very well constitute the misuse of a charter”); *Southland v. Decimo Club, Inc.*, 142 A. 786, 792 (Del. Ch. 1928) (revoking the charter of a corporation chartered for non-profit purposes, stating “where . . . a non-profit corporation shows by its conduct that profit-making is one of its most important purposes, if not its chief one, I can see no escape from the conclusion that it has misused and abused its franchise”).

<sup>66</sup> Purely in linguistic terms, the word loyalty might actually be thought a far more natural term than good faith to refer to the basic obligation of a director to manage the corporation in a way that is faithful to its fundamental mission as articulated in the corporate law giving it birth. In dictionaries considering the related meanings of loyalty, faith, and fidelity, loyalty is associated more commonly with being true to the law or the nation. WEBSTER’S at 708; AMERICAN HERITAGE at 1038; 9 OED at 74. That is perhaps because the English word loyal has its roots in the Old French (*leial* and *loial*) and Latin (*legalis*) words for legal, which derive from the Latin word for law, *lex*. *See* AMERICAN HERITAGE at 636.



undertaking consciously unlawful activity in the name of the principal.<sup>67</sup> In the case of a corporation, the corporation has no power to give directors that authority, as the corporation's existence is premised on the non-defeasible promise that it will conduct only lawful business through lawful activities. Law-compliance thus comes ahead of profit-seeking as a matter of the corporation's mission and directors owe a duty of loyalty to that hierarchy.<sup>68</sup> In so creating that hierarchy, the corporation law has imbued all

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<sup>67</sup> See RESTATEMENT (SECOND) OF AGENCY § 440 (1958) (“unless otherwise agreed, the principal is not subject to a duty to indemnify an agent: . . . (c) if the agent’s loss resulted from an enterprise which he knew to be illegal.”); see also 8 Del. C. § 145 (corporation has no power to indemnify a director, officer or agent in a criminal action or proceeding unless that person “had no reasonable cause to believe” her conduct “was unlawful”); 8 Del. C. § 102(b)(7) (charter may not insulate a director from liability to the corporation or its stockholders for breach of fiduciary duty involving knowing violations of law). We note that Section 145 could be read to extend to the corporation the power to indemnify a director for loss associated with activity that, while profit-generating, was consciously undertaken in violation of civil (as opposed to criminal) law. Such a reading is possible because Section 145 states the corporation has the power to indemnify a director for losses related to civil and criminal proceedings “if the [director] acted in good faith and in manner the person reasonably believed to be in or not opposed to the best interests of the corporation” and only adds the requirement that the director “had no reasonable cause to believe [his] conduct was unlawful” for criminal proceedings. 8 Del. C. § 145(a). But see S. Samuel Arshnt & Walter K. Stapleton, *Delaware’s New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 78 (1967). (“It was also apparent that revision [to Section 145] was appropriate with respect to the limitations which must necessarily be placed on the power to indemnify in order to prevent the statute from undermining the substantive provisions of the *criminal law and corporation law*.”) (emphasis added). The problem for those who wish to use a free standing good faith as a firewall against lawbreaking, e.g., Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 31-38 (2006), is that the very statute that suggests indemnification is available for civil law-breaking thus equates good faith with profit-seeking and not requiring law compliance. Section 145(a) thus creates some muddle about the issue of law compliance. But that muddle is not clarified by a third core fiduciary duty. Clarity comes when the loyalty inquiry is focused in the right way; in requiring a director to be loyal to the societally authorized corporation, an entity duty-bound to try to conform itself to lawful behavior and law businesses. In any event, we believe that it would be mistaken for anyone to read § 145(a) as suggesting a tolerance for intentional law-breaking of any kind by directors or officers of Delaware corporations. Authoritative commentary on § 145(a) suggests that it had a very narrow purpose to address the possible unfairness that might arise if corporate officials acting in good faith to benefit the corporation unwittingly committed acts that were illegal. S. Samuel Arshnt & Walter K. Stapleton, *Delaware’s New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 78 (1967) (“If indemnification in criminal proceedings were to be included within the scope of the statute, the full deterrent effect of the anti-trust law, for example, could be maintained only if indemnity were limited to situations where the party involved had no reasonable cause to believe his conduct was unlawful.”).

<sup>68</sup>The recognition that the directors must be loyal to the corporation’s legally authorized purposes is not a new one. In 1989, for example, Chancellor Allen described the duty of loyalty as requiring directors to endeavor to “manage the corporation within the law, with due care and in a way intended to maximize the long run interests of shareholders.” *TW Services, Inc. v. SWT Acquisition Corp.*, 1989 WL 20290, at \*7 (Del. Ch. Mar. 2, 1989). The potential liability directors face if they cause the corporation to violate the positive law is also not new. See, e.g., WILLIAM J. GRANGE, *CORPORATION LAW FOR OFFICERS AND DIRECTORS: A GUIDE TO CORRECT PROCEDURE*, 411 (1935) (“There are, however, some classes of cases where mere good faith [toward the stockholders] and honest intention are not sufficient. *If the directors use the corporate funds in a transaction which is outside the corporate*

corporations with the mandatory value system of many sole proprietors, who would rather make less money than reap profits by engaging in illegal businesses or activities. Fidelity to that hierarchy is required of corporate directors in their supervision of the corporation's affairs.

For that reason, courts before and after the invention of the triad have had little difficulty in concluding that directors breach their fiduciary duty when they knowingly cause the corporation to violate the law and are responsible for any harm suffered by the corporation as a result.<sup>69</sup> That is because courts recognize that directors must be loyal to the corporation's basic charter, a charter that precludes the corporation from pursuing profits by illegal means.

It is only by creating the artificial idea that a director may be loyal to the corporation by causing it to pursue profit through unlawful activity that there is any need

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powers (*ultra vires*) or which is forbidden by statute, they are exceeding their authority, and if loss results, they must make it good . . . ." (emphasis added)).

<sup>69</sup> *Metro Comm'n. Corp. v. BVI v. Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 163-64 & 131 (Del. Ch. 2004) (holding that if directors engaged in unlawful bribery for the purpose of helping the corporation obtain governmental permits, they had violated their "duty of loyalty" and further stating that "[u]nder Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the activity will result in profits for the entity"); *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) ("[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey."); *Miller v. Am. Tel. & Tel. Co.*, 507 F.2d 759, 762 (3d Cir. 1974) ("[D]irectors must be restrained from engaging in activities which are against public policy."); *Roth v. Robertson*, 118 N.Y.S. 351, 353 (N.Y. Sup. Ct. 1909) (holding that where directors and officers of a corporation engage in illegal acts "and they cause loss to the corporation, they must be held jointly and severally liable for such damages"). Bainbridge, Lopez and Oklan caution that "the highly regulated nature of the U.S. economy and the growing use of criminal law to regulate corporate conduct [means that] the adoption of a per se rule of liability lacking even an exception for de minimis violations of laws *malum prohibitum* in fact is a significant restriction on the discretionary powers of boards of directors." Stephen M. Bainbridge, Star Lopez, & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 594 (2008). We think not. Limiting the exception in § 102(b)(7) to knowing violations of law avoids any serious concern about undue limitation on the discretion of boards of directors. Furthermore, unless the corporation has itself suffered a major detriment as a consequence of law-breaking, the liability threat to directors is miniscule. Where, however, a corporation faces major injury as a result of illegal conduct, we see no reason why corporate fiduciaries should not face responsibility if they knowingly caused or tolerated the illegal conduct.

to use good faith as a gap filler.<sup>70</sup> That is, only if one denudes the concept of corporate loyalty of a critical societally-imposed limitation on corporate conduct is there a hole in equity that must be filled.<sup>71</sup>

That move solves a non-existent problem and creates another. As we have already indicated and will make clear, the most common use of good faith in corporate law is as the identification of a state of mind consistent with loyalty to the corporation's best interests. Thus, it is common for courts and statutes to ask whether a director acted in the good faith belief that his actions were in the best interests of the corporation.<sup>72</sup> To

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<sup>70</sup> See Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 31-38 (2006) (making this move — i.e., that directors can be loyal by seeking corporate profit by illegal means — to create a law compliance justification for a separate duty of good faith).

<sup>71</sup> In so stating, we are not oblivious to the difficult public law issues that sometimes arise in this area. For example, constitutional law scholars often reflect on the conduct of President Lincoln in suspending habeas corpus and in taking other actions that were of doubtful legality and consider whether that conduct was nonetheless faithful to the Constitution in a deeper sense. See, e.g., DANIEL FARBER, *LINCOLN'S CONSTITUTION* 163 (2003). Some of the same considerations are raised by the methods used to adopt the Fourteenth and Fifteen Amendments in the wake of the Civil War. See generally John Harrison, *The Lawfulness of the Reconstruction Amendments*, 68 U. CHI. L. REV. 375 (2001).

We think it a profanity against our republic's values to compare a corporate director facing a situation when violating the law could reduce corporate costs and increase profits to the dilemma faced by President Lincoln. Certainly, one cannot use Lincoln's dilemma as an excuse to formulate the need for a fiduciary duty requiring directors to attempt to comply with the law in exercising their corporate powers. The question in Lincoln's case was whether literal compliance with some laws would endanger the endurance of the republic and therefore the larger body of laws and values the republic was created by the people to protect. It was not whether to generate lucre at the cost of illegally polluting a river.

That is also why it is both inflammatory and a non-sequitur to use comparisons to loyal mafia members and Nazi party members as justifying a need for a fiduciary duty of good faith requiring law compliance. Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 16, 22 (2006). Loyalty to a criminal organization, in the case of the mafia, necessarily requires disloyalty toward the law. In the case of Nazi Germany, good faith law compliance by a German corporation with the then-extant German legal regime in the loyal pursuit of profits would have done little to ensure moral behavior.

American corporate law embeds law compliance within the very mission of the corporation. Loyalty to the corporation's obligation as a citizen to attempt in good faith to abide by the law is not incidental to a director's duties, it is fundamental. We find it dismaying that this point is even arguable.

<sup>72</sup> See 8 Del. C. § 145 (directors may only receive indemnification if they acted in good faith and in a manner the person reasonably believed to be in the best interests of the corporation); DIRECTOR'S GUIDEBOOK, *supra* note 55, at 16 (stating that the obligation to act "in good faith" and "in a manner the director reasonably believes to be in the

somehow contend that it is loyal to engage in consciously unlawful conduct because the directors believed in good faith that that conduct would be in the best interests of stockholders desiring profits, but in bad faith toward society is, well, silly. Most elementary school students can grasp the means limitation central to the corporation's mission, and therefore to the duty of loyalty owed to it by those who manage it. To premise a separate fiduciary duty of good faith on the presupposition that adults cannot grasp that limitation and to thereby impoverish the duty of loyalty and deprive it of its defining terms is unjustifiable.

### 3. One Linguistic Concession We Readily Make

In our review of statutory and case law, we admit that we have come across more than a few instances when judges in particular have referred in the same sentence or paragraph to both the words “loyalty” and “good faith,” leading to the argument that they must be wholly distinct concepts and that one cannot be subsumed within the other. As we hope to show, such arguable redundancies do nothing to change the reality that good faith has been pervasively used as the defining term for a loyal fiduciary's state of mind. Writers often use related terms for emphasis and rhetorical flourish.<sup>73</sup> That this has been done with loyalty and good faith does not make a case for a separate duty because if it did, there would obviously arise the case for a separate duty of fidelity.<sup>74</sup>

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best interests of the corporation” is the “baseline standard . . . central to the mandate often referred to as the ‘duty of loyalty’”).

<sup>73</sup> See, e.g., MERRIAM-WEBSTER'S DICTIONARY OF ENGLISH USAGE 805 (1994) (explaining that redundancy “protects the message and it facilitates the reception of the information or the idea the speaker or writer is trying to communicate”). Jurists often use redundancy to elucidate and emphasize important concepts. For example, redundant terms are commonly used to underscore conduct that should be avoided by directors serving on special committees. See, e.g., William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fancy?*, 45 BUS. LAW. 2055, 2060 (1990) (“When . . . it appears as artifice, ruse or charade, or when the board unduly limits

Lest one think we are overstating the case, it is worth observing that the linguistic possibilities for partitioning the duty of care are even more considerable.<sup>75</sup> The duties of informedness,<sup>76</sup> prudence,<sup>77</sup> advisedness,<sup>78</sup> preparedness,<sup>79</sup> and diligence<sup>80</sup> could step

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the committee or when the committee fails to correctly perceive its mission—then one can expect that its decision will be accorded no respect.”); E. Norman Veasey, *Counseling Directors On The Duty Of Loyalty And The Use Of Special Committees*, 8-FALL DEL. LAW. 30, (“[T]he committee should not be, or give the impression that they are, ‘supine’ or ‘torpid’ or that their process is a ‘charade’ when dealing with interested management.”). Likewise, legal terms of art — think “cease and desist” or “null and void” — are frequently redundant. A good example of a legal complex that, at bottom, involves one concept, is the phrase “to indemnify and hold harmless,” a phrase that expresses one central intent — to grant the right to indemnification — through redundancy. See *Majkowski v. American Imaging Mgmt. Services, LLC*, 913 A.2d 572, 587-593 (Del. Ch. 2006) (discussing the lineage of this legal phrase and its singular meaning).

<sup>74</sup>Our favorite examples of redundancy are when courts have used both good faith and its Latin equivalent *bona fide* in the same sentence. See, e.g., *Lynch v. Vickers Energy Corp.*, 1978 WL 5681, at \*3 (May 12, 1978) (“In the absence of divided interests, the judgment of the majority stockholders and/or the board of directors, as the case may be, is presumed made in good faith and inspired by *bona fides* of purpose.” (quoting a prior Court of Chancery ruling in the case)); *Caudill v. Sinex Pools, Inc.*, 2006 WL 258302, at \*1 (Del. Super. Ct. Jan. 18, 2006) (“A corporation *de facto* is a corporation which failed to incorporate properly, despite a good faith and *bona fide* effort, but is nevertheless treated as a duly formed corporation by the Courts.”). But other good examples of this tendency abound. See, e.g., *Pohl v. National Benefits Consultants, Inc.*, 956 F.2d 126, 128 (7th Cir. 1992) (“A fiduciary duty is the duty of an agent to treat his principal with the utmost candor, rectitude, care, loyalty, and good faith—in fact to treat the principal as well as the agent would treat himself.”); *Design Strategy, Inc. v. Davis*, 469 F.3d 284, 300 (2d Cir. 2006) (“Under New York law, an agent is obligated to be loyal to his employer and is prohibited from acting in any manner inconsistent with his agency or trust and is at all times bound to exercise the utmost good faith and loyalty in the performance of his duties.”).

<sup>75</sup> One early treatise on corporate directors unintentionally underscored the myriad possibilities for describing the duties of directors:

The members of the board of directors are held to a high degree of integrity and fidelity in the discharge of their duties. They must administer the corporate affairs honestly, diligently, carefully, vigilantly, unselfishly, and in good faith.

Attempting more precisely to define standards of duty, the courts have said, on various occasions, that corporate directors must exercise reasonable care and diligence; ordinary care and prudence; reasonable diligence and their best judgment; reasonable intelligence; business discretion; ordinary skill, vigilance, judgment, and diligence. The application of objective criteria to a solution of the problem results in judicial statements that the directors must use the same degree of care that is properly employed by an ordinarily prudent, skillful, diligent, careful, discreet, average business man in his own affairs, or such business of like nature, character, and importance, under the same of similar circumstances.

HOWARD HILTON SPELLMAN, A TREATISE ON THE PRINCIPLES OF LAW GOVERNING CORPORATE DIRECTORS § 207 (1931) (citations omitted).

<sup>76</sup> *Technicolor*, 634 A.2d at 367 (“The duty of the directors of a company to act on an informed basis . . . forms the duty of care element of the business judgment rule.”); see also *TW Services, Inc. v. SWT Acquisition Corp.*, 1989 WL 20290, at \*8 n.13 (Del. Ch. Mar. 2, 1989) (discussing the requirement that directors must be “informed”).

<sup>77</sup> *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005), *aff’d*, 906 A.2d 27 (Del. 2006) (“The fiduciary duty of due care requires that directors of a Delaware corporation ‘use that amount of care which ordinarily careful and prudent men would use in similar circumstances’ . . . .”) (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963)); *TW Services*, 1989 WL 20290, at \*7 (describing *Revlon* as requiring director to “exercise judgment (in good faith and prudently) in an effort to maximize immediate share value”)

<sup>78</sup> *TW Services*, 1989 WL 20290, at \*11 (board’s actions in declining to enter a merger agreement are immune from judicial sanction as long as the board “functions on the question in good faith pursuit of legitimate corporate

forward and proudly voice their own demand to be afforded the dignity that comes with recognition as free-standing fiduciary duties. By that means, the law would accomplish the same end served by a separation of the duty of loyalty from its defining term: leaving the duty of care as a tautology.

C. “Good Faith” Under the Delaware General Corporation Law

As we will now discuss, the DGCL uses the term good faith in several instances to define the state of mind required of persons seeking to use powers granted by the statute. To us, this usage is not consistent with the idea that there is an independent duty of good faith. Rather, it emphasizes the conditional quality of grants of authority to corporate directors, which subjects statutorily-authorized action to the additional test of equity, requiring that authority be exercised in good faith to advance a proper corporate purpose. Consistent with tradition and the basic concept of loyalty we have previously outlined, the DGCL also uses the term good faith as a way of identifying a director’s honest, non-pretextual use of power for the benefit of the corporation, implicitly contrasting it with a dishonest, pretextual use of power for non-corporate purposes.<sup>81</sup>

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interests and advisedly”); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (*Unocal* requires board using takeover defenses to act “advisedly, in good faith in pursuit of a corporate interest”).

<sup>79</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (finding the directors’ lack of preparation in advance of a decision to sell the company, which ultimately resulted in the directors making an uninformed decision, to be a violation of the duty of care); *cf. Moran v. Household Int’l Inc.*, 500 A.2d 1346, 1350 (Del. 1985) (explaining that “it seems even more appropriate to apply the business judgment rule” to the board’s decision to adopt a poison pill on a clear day because “pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment”).

<sup>80</sup> *In re CompuCom Sys. S’holders Litig.*, 2005 WL 2481325 at \*5 (Del. Ch. Sept. 29, 2005) (phrasing the business judgment rule as an inquiry into whether the board acted “*faithfully and with due diligence*” (emphasis added)); *see also Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (“[A] board’s actions must be evaluated in light of relevant circumstances to determine if they were undertaken *with due diligence and in good faith*. If no breach of duty is found, the board’s actions are entitled to the protections of the business judgment rule.”(emphasis added)).

<sup>81</sup> The term “good faith” is used approximately 17 times (as of this writing) in the DCGL to refer to such diverse actors as directors, officers, filers with the Secretary of State, law schools, etc. It would unduly lengthen this article

For example, § 141(e) of the DGCL provides directors with protection if they “rely[] in good faith” on the reports of officers or expert advisors.<sup>82</sup> This requirement seems to mean that the director must have genuinely relied on the information provided to make his decision for a proper purpose, and not to paper over an unfair or otherwise dubious deal.<sup>83</sup> That is, the term good faith is used as it is in the business judgment rule, to define the state of mind of a loyal fiduciary.

No section of the DGCL makes the defining quality of good faith clearer than §144. Section 144, after all, is the statute that addresses the transactions even those with a narrow and begrudging concept of loyalty accept as implicating the duty of loyalty:

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to discuss each section. We simply note that the term cannot be said to relate to a fiduciary duty in each instance. Rather, the definition which fits best in these varied instances is that posited by Chancellor Chandler in his post-trial *Disney* decision: “Good faith has been said to require an ‘honesty of purpose,’ and a genuine care for the fiduciary’s constituents . . . .” In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 753 (Del. Ch. 2005), *aff’d*, 906 A.2d 27 (Del. 2006) (citing E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U.J.L. & POL’Y 1, 9 (2003)); *see also* E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U.J.L. & POL’Y 1, 9 (2003) (“In my opinion, good faith requires an honesty of purpose and eschews a disingenuous mindset of seeming to act for the corporate good without genuinely caring for the well-being of the constituents of the fiduciary.”).

Under this definition, the actor must, in each instance, believe that she is acting for the proper purpose set forth in the statute or fulfilling her duties as a fiduciary.

Similarly, when the courts use the term “good faith” with respect to officers and directors, they necessarily mean a specific application of the term “honesty of purpose.” The purpose for which officers and directors act is, of course, to advance the interests of the corporation and its stockholders. Hence, the term “good faith,” as discussed herein, when specifically applied to officers and directors, means that state of mind of the fiduciary that she honestly believes that her actions were for the benefit of the corporation and its stockholders.

Thus, the term “good faith” should have the same general meaning in both the DCGL and the caselaw — honesty of purpose, in the sense that the actor whose conduct is being addressed must be genuinely attempting to accomplish a proper purpose. When specifically applied to officers and directors, honesty of purpose means that they must act in the honest belief that their actions benefit the corporation and its stockholders.

<sup>82</sup> 8 *Del. C.* § 141(e).

<sup>83</sup> Section 172 is similar to § 141(e) and has the same thrust. Section 172 provides directors making decisions to grant a dividend or purchase or redeem corporate stock with protection if they rely in good faith on books and records of the corporation or management or expert advisor reports regarding the corporation’s financial status, including whether it was in a financial condition to issue a dividend lawfully. The requirement of good faith conditions protection on the director’s honest reliance on the information provided.

transactions between the corporation and members of the board of directors.<sup>84</sup> The most obvious purpose of § 144<sup>85</sup> is to eliminate the old common law rule that interested transactions were voidable at the instance of any objecting stockholder.<sup>86</sup> The statute does that by stating that an interested transaction is not voidable solely for that reason, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee *in good faith* authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved *in good faith* by vote of the shareholders; or

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<sup>84</sup> Professor Folk's report to the Delaware Corporation Law Revision Committee discusses at some length the genesis of Section 144 and, in particular, its references to "good faith." Ernest L. Folk III, Report to the Delaware Corporation Law Revision Committee, 70-71 (1964) [hereinafter "Folk Report"], available at <http://law.widener.edu/LawLibrary/Research/OnlineResources/DelawareResources/%7E/media/Files/lawlibrary/corporations/folkreportpt1.ashx>. According to Professor Folk, the statute, not previously part of the DGCL, was modeled after comparable statutes in New York, California, Connecticut, North Carolina, and South Carolina, and the choice of language to guard against abuse was "not easy." A reference to fairness in subsections (1) and (2) was rejected in favor of a reference to good faith. *Id.* at 70 ("[I]t seems sufficient to specify only "good faith" in conjunction with the requirement of disinterested approval.").

<sup>85</sup> The question of whether § 144 was intended to create a safe harbor from equitable review if its provisions obviating a statutory fairness burden were met is controversial. See R. Franklin Balotti *et al.*, *The (Mis)Application of Section 144*, DEL. LAW., Spring 2008, at 22-23; S. Samuel Arshat & Walter K. Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 82 (1967) (suggesting that compliance with § 144 (a)(1) or (2) would have ratification effect, and insulate the transaction from claims other than waste by stating that "an interested director transaction approved by the disinterested members of the board, the stockholders, or both, may, of course, still be overturned if the challenging stockholder proves that it could not have been the product of honest business judgment"). To date, the Delaware courts have generally read the statute more narrowly, while drawing on it in crafting rulings in equity. See *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 614- 615 (Del. Ch. 2005) ("[Section] 144 has been interpreted [by the Delaware Supreme Court] as dealing solely with the problem of per se invalidity . . . . The somewhat different question of when an interested transaction might give rise to a claim for breach of fiduciary duty . . . was left to the common law of corporations to answer. Mere compliance with § 144 did not necessarily suffice.").

<sup>86</sup> Blake Rohrbacher, John Mark Zeberkiewicz, and Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719 (2008); EDWARD P. WELCH, ANDREW J. TUREZYN & ROBERT S. SAUNDERS, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 144.1* (5th ed. 2008) ("The principle of *per se* voidability for interested transaction[s], which was sometimes characterized as the common-law rule, was significantly ameliorated by the 1967 enactment of section 144 of the Delaware General Corporation Law.").



(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.<sup>87</sup>

Therefore, in order for either disinterested director approval or shareholder approval of an interested transaction to have the effect of eliminating the common law rule of voidability, the approval had to be in “good faith.” To us, it is obvious that this requirement reflects a statutory adoption of the core concept of loyalty, which is that directors must act in the good faith belief that their decision will benefit the corporation and its stockholders ratably, and not for an improper purpose.<sup>88</sup> Thus, for immunizing effect from the common law rule of voidability to be given, the qualifying vote must have been motivated by the corporation’s best interests, rather than a desire to advantage the interested director on the other side of the transaction.<sup>89</sup> Section 144 therefore makes

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<sup>87</sup> 8 *Del. C.* § 144 (emphasis added).

<sup>88</sup> The use of good faith to require that a person acting under the DGCL do so for a proper purpose and not as a pretext for some other interest or motive is demonstrated by other sections of the DGCL using the term good faith in reference to persons who are not corporate officials. *See, e.g.*, 8 *Del. C.* § 125 (conditioning the right of a corporation to grant academic degrees on a finding by the Department of Education that the “corporation is engaged in conducting a bona fide [note: Latin usage of term for good faith] institution of higher learning . . . or that the corporation proposes, in good faith, to engage in that field”); *id.* (addressing special circumstance of a law school and requiring that school to demonstrate that it was “attempting, in good faith,” to comply with American Bar Association accreditation standards); § 162 (providing that a transferee of shares who takes “in good faith and without knowledge or notice that the full consideration” has not been paid for the shares “shall not be personally liable” for the unpaid consideration); § 203 (exempting from the general definition of a controlling stockholder under the antitakeover statute a person or group controlling 20% or more of the vote, institutions that are holding shares in “good faith and not for the purposes of circumventing this section,” i.e., holders such as Cede who hold shares for many non-affiliated shareholders but not an institution that was holding the voting power to act as a front for a person or group seeking to avoid the reach of the statute). In the same vein, obscure provisions of the DGCL permit, with certain exceptions, a corporate instrument to be effective as of the date a filer attempted in “good faith” to file the document with the Secretary of State but could not do so because of an “extraordinary condition.” 8 *Del. C.* § 103(i). In that circumstance, the filing party must file an affidavit swearing that she had made a “good faith effort” to deliver the instrument and pay the required fees and taxes at the earlier point for which the effective date was sought. *Id.* Thus, the filing party must demonstrate that she made a good faith earlier effort to file and could not complete that filing because of an extraordinary condition and is not seeking in bad faith to have a document back-dated.

<sup>89</sup> There is a distinction in § 144 between the ratification methods. Section 144(a)(1) requires that a majority of disinterested directors give their approval in good faith. Section 144(a)(2) does not require approval only by disinterested stockholders but does require good faith. That distinction tracks ratification doctrine before the comprehensive revision of the DGCL in 1967. *Harbor Finance Partners v. Huizenga*, 751 A.2d 879, 900 n.80 (Del.

plain the definitional relationship between good faith and the duty of loyalty, with the term good faith identifying the loyal state of mind required for an approving vote to be given immunizing effect. The use of good faith in this manner does not establish a new duty, it gives life and meaning to the central duty of loyalty.

Likewise, the DGCL's provision on indemnification uses good faith consistently with the way it is used to give life to the duty of loyalty in judicial decisions employing the business judgment rule. Similar to the linguistics of business judgment rule cases,<sup>90</sup> § 145 generally conditions eligibility for indemnification on a finding by the board that the corporate official seeking indemnity has "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."<sup>91</sup> Although § 145 never uses the word loyalty, there seems to be little doubt that the statute's use of the words that traditionally define it in business judgment cases was intended as a general prohibition against the indemnification of directors

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Ch. 1999) ("A non-comprehensive review of the treatises suggests that the law earlier in the century was far less clear about whether 'interested' persons could vote as stockholders to ratify or approve transactions."). But, as a matter of equity, Delaware courts have long required that only transactions supported by a vote of disinterested stockholders will receive ratification effect. *Id.* at 900 ("Delaware fiduciary law ensures that a majority or controlling stockholder cannot use a stockholder vote to insulate a transaction benefiting that stockholder from judicial examination."); *see also* Folk Report, *supra* note 84, at 71 (confirming this).

For present purposes, what is important is that the lack of any requirement in § 144(a)(2) for a disinterested stockholder vote actually demonstrates the connection between loyalty and good faith. Regardless of whether the voting stockholder was interested, his vote would only count under the statute if it were cast in "good faith," that is, with the honest belief that the transaction was fair to the corporation. *See* Folk Report, *supra* note 84, at 71 (noting that disinterested shareholder requirement was unnecessary because "the 'good faith' requirement should sufficiently guard against abuse").

<sup>90</sup> *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (defining the business judgment rule as "a presumption that in making a business decision the directors of a corporation 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"); *see also* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) ("The presumption initially attaches to a director-approved transaction within a board's conferred or apparent authority in the absence of any evidence of fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment." (internal citation omitted)).

<sup>91</sup> 8 *Del. C.* § 145(a), (b).

breaching the duty of loyalty.<sup>92</sup> Indeed, § 145(b) gives the Court of Chancery the extraordinary authority to approve indemnification to a corporate director even as to a case in which the director was found liable to the corporation, but only if the director “acted in good faith and in a manner [she] reasonably believed to be in or not opposed to the best interests of the corporation.”<sup>93</sup> Thus, this special power granted to the Court of Chancery cannot be used in cases of violations of the duty of loyalty, but only as to violations of the duty of care.

Of course, we must confront the section of the DGCL with text suggesting that a corporate director can commit a “breach of fiduciary duty” causing monetary damages to the corporation or its stockholders through “acts or omissions not in good faith” but not simultaneously violate the “duty of loyalty.” That section is the provision of the DGCL that was adopted in the wake of *Smith v. Van Gorkom* to permit corporate charters to immunize directors from liability to the corporation for breaching the duty of care.

Section 102(b)(7) states in pertinent part that the certificate of incorporation may include:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

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<sup>92</sup> See S. Samuel Arsht & Walter K. Stapleton, *Delaware’s New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 78 (1967) (“The need for a similar provision to protect the corporation law’s requirement of loyalty to the corporation was equally apparent, but more difficult to formulate. Ultimately, it was decided that the power to indemnify should not be granted unless it appeared that the person seeking indemnification had ‘acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interest of the corporation.’”). We say generally because § 145 has its complexities, including a provision requiring indemnification when officials have been successful on the merits or otherwise of an action, and a provision purporting to give this court the right to grant indemnification to a director who has suffered an adverse judgment in a derivative action. 8 *Del. C.* § 145(b), (c).

<sup>93</sup> 8 *Del. C.* § 145(b).

(iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.<sup>94</sup>

We do not pretend that § 102(b)(7) does not create a suggestion that there is a category of bad faith acts that cause corporate injury that is somehow beyond the reach of the duty of loyalty. The separate references to the duty of loyalty and to acts “not in good faith” can be thought to have exactly that implication.

But once one recognizes the reality that redundancy is actually a pervasive presence in statutes and contracts, and operates as a belt-and-suspenders protection against unintended consequences, the idea that § 102(b)(7)’s terms provide support for the creation of separate new categories of fiduciary duty becomes far less reasonable. We say new categories for a reason, which is that if the separate articulation in §102(b)(7) from the duty of loyalty of “acts not in good faith” as a category of non-exculpable conduct supports a more general fiduciary duty of “good faith,” § 102(b)(7) becomes a source of several new fiduciary duties. Along with the duty to act in good faith, there would emerge no fewer than four other duties, including: (1) the duty not to engage in intentional misconduct; (2) the duty to not knowingly violate the law; (3) the duty not to pay dividends in violation of § 174; and (4) the duty not to receive improper personal benefits. We have difficulty reading the statute as having any such intention.<sup>95</sup>

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<sup>94</sup> 8 *Del. C.* § 102(b)(7).

<sup>95</sup> See *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) (“The General Assembly could contribute usefully to ending the balkanization of the duty of loyalty by rewriting § 102(b)(7) to make clear that its subparts all illustrate conduct that is disloyal. For example, one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey. See 8 *Del. C.* § 102(b)(7)(ii). Many recent events have only emphasized the importance of that obvious component of the duty of loyalty. But it would add no substance to our law to iterate a ‘quartet’ of fiduciary duties, expanded to include the duty of ‘legal fidelity,’ because that requirement is already a subsidiary element of the fundamental duty of loyalty.”); see also *In re Gaylord Container Corp. S’holders Litig.*, 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (explaining that “the subsidiary requirement to act in

To do so would create precious little that is of utility and generate much confusion. For example, we have difficulty conceiving of how an act of intentional misconduct that injures the corporation could be loyal. And even those inclined to view the obligation of loyalty as an extremely narrow one consisting only of the negative obligation not to profit at the expense of the corporation must admit of the difficulty distinguishing between a breach of the duty of loyalty and a breach of the duty not to receive an “improper personal benefit.” The improper personal benefit category seems to get at a central concern of the negative aspects of the duty of loyalty, to restrain insiders from using their control to extract unfair personal profits at the expense of the corporation and its other stockholders.

Furthermore, § 102(b)(7) cannot aid those scholars who have sought to justify a fiduciary duty of good faith on the need for a constraint on director action that is intended to increase corporate profits, but through intentionally unlawful conduct. Why? Because just as § 102(b)(7) separates the duty of loyalty from “intentional misconduct” and the receipt of “improper personal benefits,” so too does § 102(b)(7) separate its references to “acts not in good faith” from “knowing violations of law.” Put simply, if read as a source of fiduciary duties, § 102(b)(7) is a confusing muddle, riddled with overlap and ambiguity.

But § 102(b)(7) makes more sense when read in light of its obvious purpose, which was to enable corporate charters to insulate corporate directors from liability for

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good, rather than bad, faith toward the company and its stockholders” logically rests within the traditional duty of loyalty).

acts of negligence or gross negligence. Delaware faced a lot of negative feedback in the wake of *Van Gorkom*, which held independent directors liable for approving a third-party premium-paying transaction on the grounds that they had acted with gross negligence.<sup>96</sup> Many commentators viewed the decision as applying more of a simple negligence standard and retroactively imposing on directors acting in 1980 responsibility for adhering to mergers and acquisitions protocols that first became common a half-decade later.<sup>97</sup> Fear that verdicts like *Van Gorkom* could be common drove up D & O insurance costs and gave directors reason to be concerned about service.<sup>98</sup>

Section 102(b)(7) was the General Assembly's answer to that problem. As is generally true of our corporation law, § 102(b)(7) was first proposed by the council of the Corporation Law Section of the Delaware State Bar Association. One of us, Mr. Balotti, was among the four members of the council charged with drafting the section; the others were Joseph A. Rosenthal, a prominent member of the plaintiff's bar; A. Gilchrist Sparks III, a distinguished corporate lawyer from Morris, Nichols, Arsht & Tunnell; and E. Norman Veasey, then a corporate partner at Richards, Layton & Finger and later Chief Justice of Delaware.

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<sup>96</sup> See, e.g., Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985).

<sup>97</sup> See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 128 (1988) (“While the majority opinion claimed to have articulated a ‘gross negligence’ standard as governing the case, the facts did not support a finding of negligence, much less gross negligence.”); see also *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1052 n.4 (Del. Ch. 1996) (“I count *Smith v. Van Gorkom*, not as a ‘negligence’ or due care case involving no loyalty issues, but as an early and, as of its date, not yet fully rationalized, ‘Revlon’ or ‘change in control’ case.” (citing Macey & Miller, *supra*)).

<sup>98</sup> See, e.g., Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) (stating that the *Van Gorkom* decision “exemplifies the legal uncertainty that contributed to the insurance crisis; most practitioners, like the lower court, would have predicted that the facts in *Van Gorkom* would not constitute gross negligence under Delaware’s duty of care standard”).

The commentary that the Council circulated with the draft of § 102(b)(7) is devoid of any indication that the statute was intended to recognize new fiduciary duties. The commentary mentions “good faith,” but just as part of a summary description of the exceptions in the statute.<sup>99</sup> There is no discussion of its definition. There is no discussion of creating or recognizing a separate fiduciary duty. Had the drafters actually intended the subsection to have had the important effect of creating new fiduciary duties, it would have been in the commentary because that would have been a very important feature of the proposal.

But that was not, as Mr. Balotti remembers it, what the drafters were trying to achieve. Rather, the drafters were simply trying to reach consensus on the terms of a statute that would immunize conduct that only breached the duty of care, but not that involved more serious misconduct.

The statute is easy to understand when that purpose is kept in mind. By its own terms, § 102(b)(7) acknowledges only one actual fiduciary “duty,” which is the fiduciary duty of loyalty. None of its other terms are phrased in that way. That the duty of loyalty is recognized in the statutory scheme tells us that the drafters knew how to recognize a fiduciary duty if they chose to do so. They did not do so with respect to the other exceptions, including that involving “acts not in good faith.”

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<sup>99</sup> *Proposed Amendments to Sections 102 and 145 of the Delaware General Corporation Law*, undated memorandum (on file with R. Franklin Balotti), at 3-4 (“The proposed amendment to Section 102(b)(7) . . . would permit a corporation, in its original Certificate of Incorporation or an amendment validly approved by the stockholders, to eliminate or limit personal liability of board members for violation of the duty of care. It would not permit stockholders to eliminate liability for failure to fulfill the duty of loyalty, or where directors failed to act in good faith, engaged in intentional misconduct or a knowing violation of law.”).

That the drafters did not simply assume that readers would recognize that the excepted conduct would constitute a breach of the duty of loyalty is understandable. The drafters were not trying map out the full contours of the duty of loyalty. They were trying to insulate directors from liability for breaches of the duty of care by crafting a politically and ethically credible solution. It is in this context that the exceptions came into place.

As Mr. Balotti recalls it, the addition of “acts not in good faith” arose in exactly that context. It was put in one afternoon in a Morris Nichols conference room in the old I.M. Pei building in Wilmington, Delaware when Morris Nichols was in that building many years ago. The collective memory of the four drafters<sup>100</sup> is that Mr. Rosenthal wanted very broad exceptions to the ability of stockholders to exculpate for breaches of fiduciary duty. He wanted “acts not in good faith” included.

The participants recall the conversation going something like this: Mr. Balotti and Mr. Sparks asked Mr. Rosenthal, “Well, how does that differ from violations of the duty of loyalty?” Mr. Rosenthal said, “I don’t know, but I need it in there to get my people on board.” The rest of the drafters agreed to inserting “good faith violations” in there so as not to get the plaintiff’s bar opposing the adoption of § 102(b)(7). Then the drafters added, by the way, the word “omissions” to cover situations when directors, as a result of bad faith, failed to disclose a material fact.

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<sup>100</sup> Mr. Balotti has spoken to each of the other three drafters and this rendition is based on the collective memory of all four drafters.



All in all, it would have been more felicitous had § 102(b)(7) been written to read as follows:

The certificate of incorporation may include a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damage for breach of fiduciary duty of care as a director, provided that such provisions shall not eliminate or limit the liability of a director for a breach of the duty of loyalty, including but not limited to, any:

- i) transactions from which the director derived an unfair or improper personal profit or benefit;
- ii) acts or omissions not in good faith;
- iii) intentional misconduct;
- iv) knowing violations of law.

In addition, the certificate may not limit a director's liability for a violation of § 174 of this chapter.

But the net effect of the statute is as if that was the case. Unless one is to construe the duty of loyalty as only constricting directors from personally receiving unfair benefits in self-dealing transactions not involving "personal benefits," several of the other statutory sections clearly cover loyalty violations.

That possible redundancy did not bother the drafters because their purpose was to use a fine net that would exclude from immunity any director conduct involving conscious wrongdoing or self-enrichment. They were not in the business of defining the contours of enforceable fiduciary duties; they were involved in the narrower, albeit important, task of defining conduct that could not be exculpated. By its plain terms, all that § 102(b)(7) says is what acts cannot be exculpated. There is no independent creation of liability as there should be if there were a duty being recognized. The work of recognizing and defining fiduciary duties was left where it had always been, with the courts of equity.

D. *Good Faith in the Case Law And Scholarly Commentary Before The Invention Of The Triad In Technicolor*

The use of the term “good faith” in the DGCL did not, of course, emerge fully formed from the creative minds of the drafters of the DGCL. The term has had a long history in fiduciary duty jurisprudence, both in corporate law and in the law of agency and trusts that has informed — although by no means fully defined — the law of fiduciary duties of corporate directors.<sup>101</sup> In this section we aim to show that in this long jurisprudential history, the term “good faith” is solidly tied to the concept of loyalty and motivation to serve the legitimate interests of those to whom fiduciary duties are owed.

We begin this particular examination with an appeal to common sense. Can it truly be believed that the existence of a fiduciary duty of good faith, distinct from long-recognized duties of loyalty and care, was somehow discovered by the Delaware Supreme Court in 1993, like a planet, brought into focus by modern technology, that had eluded the keenest observers for hundreds of years before? To the contrary, if such a duty were to exist, one would expect to find some distinguished court or commentator, or the American Law Institute, having articulated, before 1993, some role, function or character for a duty of good faith distinct from those associated with the duties of loyalty

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<sup>101</sup> There can be no doubt about the rooting of directors’ fiduciary duties in trust law. *See, e.g.*, *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (“While technically not trustees, [directors] stand in a fiduciary relation to the corporation and its stockholders”); *Cahall v. Lofland*, 114 A. 224, 228 (Del. Ch. 1921) (“[D]irectors and officers are stewards, or trustees, for the stockholders, and their acts are to be tested as such according to the searching, drastic and far-reaching rules of conduct which experience has found to be salutary to protect the trust beneficiaries.”); *see also* *Hoyle v. Plattsburgh & Montreal Ry. Co.*, 54 N.Y. 314, 328 (N.Y. 1873) (“Whether a director of a corporation is to be called a trustee or not, in a strict sense, there can be no doubt that his character is fiduciary, being intrusted by others with powers which are to be exercised for the common and general interests of the corporation, and not for his own private interests.”); *Cumberland Coal & Iron Co. v. Sherman*, 30 Barb. 553 (N.Y. Sup. 1859) (“A director of a corporation is the agent or trustee of the stockholders, and as such has duties to discharge, of a fiduciary nature, towards his principal; and is subject to the obligations and disabilities incidental to that relation.”).

or care. Although we make no claim of exhausting all possible sources, we can find no such separate articulation. There is no section of any Restatement of the Law (of agency, trusts or otherwise) entitled “The Duty of Good Faith,” as distinguished from the duty of loyalty and the duty of care. There is no judicial opinion, before 1993, identifying such a distinct duty with content independent of the duties of loyalty or care.

The closest we have come to observing such a distinct, explicit expression of a “duty of good faith” divorced from the concept of loyalty before 1993 is the prescription, in § 8.30(a) of the Model Business Corporation Act, that a director, “when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.”<sup>102</sup> The Official Comment to the Model Act describes § 8.30(b) as containing “the duty of care element”

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<sup>102</sup> Model Bus. Corp. Act § 8.30(a) (4th ed. 2008). The good faith language has remained the same since the statutory definition of a director’s duties was added to the Model Business Corporation Act in 1974:

A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

*Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act*, 30 BUS. LAW. 501, 502 (1975). The origins of the familiar “in good faith” and “in a manner he reasonably believes to be in the best interests of the corporation” can be traced, in large measure, to the same language in the 1967 version of the DGCL indemnification provision because the Model Act copied that provision and the Model Act’s definition of a director’s duties was written to parallel its indemnification provision. *See id.* at 504 (“The standard provided in Section 35, as revised, sets forth the duty of care applicable to directors (including a director’s right to rely on others), reflects the good faith concept embodied in the so-called ‘business judgment rule,’ which has been viewed by the courts as a fundamental precept for many decades, and to the extent possible parallels the Act’s indemnification provisions.”); Orvel Sebring, *Recent Legislative Changes In The Law Of Indemnification Of Directors, Officers And Others*, 23 BUS. LAW. 94, 96 (explaining that the Model Act’s indemnification provision is virtually identical to the 1967 DGCL provision). The Model Act’s formulation of a director’s duty is similar to some earlier state statutory articulation of directors’ duties. *See, e.g.*, WILLIAM J. GRANGE, CORPORATION LAW FOR OFFICERS AND DIRECTORS 406 (1935) (“Officers and directors . . . shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.” (citing L. 1933, Ch. 185, Sec. 33 (Washington))).

of a director's duties.<sup>103</sup> What, then, is the obligation to act "in good faith" as described in part (1)? The Official Comment to the Model Act is quite clear on this point as well: describing the use of the same term "good faith" in § 8.31(a)(2)(i), it explains that "a lack of good faith is presented where a board 'lacked an actual *intention to advance corporate welfare*' and 'bad faith' is presented where 'a transaction ... is authorized for some *purpose other than a genuine attempt to advance corporate welfare* or is known to constitute a violation of applicable positive law.'"<sup>104</sup> In short, where a duty of good faith has been distinctly articulated, it has been put forward as a statement of a loyalty-oriented duty of precisely the sort we conceive: namely, as a duty to be motivated to serve the legitimate purposes of the corporation.

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<sup>103</sup> Model Bus. Corp. Act § 8.30 cmt. para. 3 (4th ed. 2008); *see also id.* § 8.30(b) (stating that "members of the board of directors . . . shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances").

<sup>104</sup> *Id.* § 8.31 cmt. § a, para. 1 (quoting *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996)). The Model Act's commentary on good faith is consistent with the usage of good faith in other Committee on Corporate Laws publications. *See, e.g.*, Committee on Corporate Laws, *Other Constituencies Statutes: Potential For Confusion*, 45 BUS. LAW. 2253, 2269 (1990) ("Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their fiduciary duty of loyalty runs (and in what proportions), poorer decisions can be expected."). That commentary is echoed across our northern border as well: Section 122(1) of the Canadian Business Corporation Act provides, "Every director and officer of a corporation in exercising their powers and discharging their duties shall (a) act honestly and in good faith with a view to the best interests of the corporation; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." R.S.C. 1985, c. C-44 § 122(i). Here again, the concept of good faith is one of subjective motivation, and is explicitly distinct from the concept of required care. The United Kingdom's Companies Act 2006 also equates good faith to subjective motivation in its duty to promote the success of the company. *See* Companies Act 2006 § 172(1) (U.K.) (providing that "[a] director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole"); PALMERS COMPANY LAW FROM SWEET AND MAXWELL § 8.2608 (explaining that Section 172 is a "subjective test"); *see also* Companies Act 2006 § 174(1) (U.K.) (providing separately that a "director of a company must exercise reasonable care, skill and diligence"). Another noteworthy feature of the United Kingdom's Companies Act 2006 is that it separates the duty to promote the success of the company, which turns on subjective motivation, from the duty to avoid conflicts of interest, which is absolute regardless of subjective motivation. *Compare id.* § 172 *with id.* § 175-77.

None of this is intended to suggest that the law of agency, trusts or corporate directors is devoid of references to good faith. What is notable, however, is that in both agency law and trust law, references to good faith on the part of the agent or trustee are overwhelmingly (but unsurprisingly) linked to the proposition that the duty of loyalty requires the agent or trustee to act in furtherance of the legitimate interests of the principal or beneficiaries in the relationship. By way of very clear example, a 1962 Pennsylvania Supreme Court decision recites that “an agent owes a duty of loyalty to his principal and in all matters, affecting the subject of his agency, he must act with the utmost good faith in the furtherance and advancement of the interests of his principal.”<sup>105</sup>

Some agency law treatises are similarly explicit in their linkage of the concepts of loyalty and good faith. For example, one treatise uses the title “Good Faith and Loyalty” to describe the “paramount” duty owed by an agent to his principal.<sup>106</sup> Another treatise articulates the nexus:

The relation existing between a principal and his agent is a fiduciary one, and consequently the most absolute good faith is essential. The principal relies upon the fidelity and integrity of the agent, and it is the duty of the agent, in return, to be loyal to the trust imposed in him, and to execute it with the single purpose of advancing his principal’s interests.<sup>107</sup>

A third treatise, in a section just after and distinct from the one describing the agent’s duty of care, skill and diligence, recites that “[i]t is the duty of the agent to exercise good

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<sup>105</sup> *Sylvester v. Beck*, 178 A.2d 755, 757 (Pa. 1962).

<sup>106</sup> THE AMERICAN AND ENGLISH ENCYCLOPAEDIA OF LAW 1071 (David S. Garland & Lucius P. McGehee eds., 2d. ed., 1896) (explaining that “[t]he paramount and vital principle of all agencies is good faith, for without it the relation of principal and agent could not well exist”). This treatise also lists the duty of “Reasonable Skill and Diligence” as among an agent’s duties. *Id.* at 1063; *see also id.* at 1058, 1086 (listing the other duties as “Fidelity to Instructions” and “Keeping and Rendering Accounts”).

<sup>107</sup> ERNEST L. HUFFCUT, HUFFCUT ON AGENCY § 90 (2d ed. 1901).

faith and loyalty toward the principal in the transaction of the business intrusted to him.”<sup>108</sup> The treatise explains that this duty “requires . . . that [the agent] shall not assume any position in which his interests will be antagonistic to those of the principal.”<sup>109</sup> Thus, it is the agent’s general duty to act loyally — *i.e.*, in the interests of the principal — that gives rise to the more specific duty to avoid taking positions in which the agent’s interests are in conflict with those of the principal.<sup>110</sup>

Trust law has been to same effect.<sup>111</sup> In 1823, the United States Supreme Court examined a challenge to a trustee’s transfer of trust real estate to a third party in order to discharge debt owed by the trustee himself.<sup>112</sup> The Court therefore noted that “there are circumstances in the case (*i.e.*, the trustee’s financial self-interest) . . . which raise a presumption of bad faith on the part of the trustee.”<sup>113</sup> The Court reasoned that “the trustee was invested with a large discretion, and a peculiar and exclusive confidence was placed in his judgment. Of necessity, therefore, it was contemplated, that his judgment should be free and impartial, and unbiassed [*sic*] by personal interests.”<sup>114</sup> So important was this mandate, according to the Court, that a trustee “cannot be at once vendor and

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<sup>108</sup> FRANCES B. TIFFANY, *HANDBOOK ON THE LAW OF PRINCIPAL AND AGENT*, § 146 (2d ed. Richard R.B. Powell 1924). The section on the agent’s duty of care, skill and diligence is section 145.

<sup>109</sup> *Id.*

<sup>110</sup> We acknowledge that not all authorities so clearly link the duty of loyalty with the concept of good faith. One authority, under the general heading describing the agent’s duty “Not to be Negligent,” notes that “the agent is, in all cases, bound to act in good faith, and to exercise reasonable diligence, and such care and skill as are ordinarily possessed by persons of common capacity engaged in the same business.” 1 *Mechem on Agency* §1279 (2d ed. 1914). We do not quarrel with this generalization, but we question why there is a reference in this precise context to a duty to act in good faith, and the author does not offer any explanation for this. It appears to be an importation of more generalized statements about an agent’s overall duties.

<sup>111</sup> Edward Rock & Michael Wachter, *Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 *Nw. U. L. REV.* 651, 653-657 (2002) (summarizing fiduciary duties under trust law and reviewing their “transplanting” into corporate law; as reflected particularly in *Litwin v. Allen*, 25 *N.Y.S.2d* 667 (N.Y. Sup. Ct. 1940)).

<sup>112</sup> *Wormley v. Wormley*, 21 *U.S.* 421 (1823).

<sup>113</sup> *Id.* at 438.

<sup>114</sup> *Id.* at 441.

vendee, . . . and the law has wisely prohibited any person from assuming such dangerous and incompatible characters.”<sup>115</sup> Irrespective of that prohibition, however,<sup>116</sup> the lesson about good faith is clear: a trustee acts in bad faith when her judgment is not “free and impartial,” and is biased by personal interests. Loyalty and good faith are synonymous.

In their discussion of trusts, the leading equity treatises treat loyalty and good faith as equivalent and expressly separate that duty from the duty of care or diligence.<sup>117</sup> For example, Story’s *Equity Jurisprudence* explains the duties of the trustee in a section entitled “Trustee Should Exercise Good Faith and Due Diligence in Protection of Estate.”<sup>118</sup> Pomeroy’s *Equity Jurisprudence* states that the duties of the trustee include “To Act with Good Faith” and “To Use Care and Diligence.”<sup>119</sup> Pomeroy describes the trustee’s duty of good faith as follows: “Absolute and most scrupulous good faith is the very essence of the trustee’s obligation. The first and principal duty arising from this fiduciary relation is to act in all matters of the trust wholly for the benefit of the beneficiary.”<sup>120</sup> Again, the bond between loyalty and good faith is inseparable.<sup>121</sup>

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<sup>115</sup> *Id.*

<sup>116</sup> See generally Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 *BUS. LAW.* 35 (1966) (discussing the movement away from the absolute prohibition on transactions between a corporation and its directors).

<sup>117</sup> Although we see no need to further belabor the point, a similar pattern emerges if one looks at the early jurisprudence involving other specific applications of the fiduciary relationship. In the context of receiverships, for example, “the receiver, as an officer of the Court, is responsible as such for good faith and reasonable diligence. When the property is lost or injured by any negligence or dishonest execution of the trust, he is liable for damages.” JAMES P. HOLCOMBE, *AN INTRODUCTION TO EQUITY JURISPRUDENCE ON THE BASIS OF STORY’S COMMENTARIES* 144 (1846). Likewise, in the context of partnerships, the primary duties of a partner include “The Utmost Good Faith” and “To Devote Themselves to the Business.” FRANCIS M. BURDICK, *THE LAW OF PARTNERSHIP* 308-313 (1899); see also *id.* at 314 (listing the third primary duty of a partner as contribution).

<sup>118</sup> 3 JOSEPH STORY, *EQUITY JURISPRUDENCE* § 1676 (14th ed. 1918)

<sup>119</sup> 4 JOHN NORTON POMEROY, *A TREATISE ON EQUITY JURISPRUDENCE* § 1066, 1075 (5th ed. 1941); see also *id.* § 1062 (explaining the third duty of a trustee as “To Carry the Trust into Execution”).

<sup>120</sup> *Id.* § 1075.

<sup>121</sup> In an interesting article, Professor Ethan Stone suggests that the duty of loyalty is a component of a larger duty of good faith. Ethan G. Stone, *Business Strategists and Election Commissioners: How the Meaning of Loyalty Varies*

Returning, then, to the subject of the duties of corporate directors, the concept of good faith arose frequently, in early U.S. case law, in cases involving claims that promoters had secured to themselves profits from the corporation and failed to disclose such profits to the original subscribers to the corporation's stock.<sup>122</sup> Underscoring the link between good faith and loyalty, the prevailing concern in these cases was the use of the promoter's position of control to serve the promoter's personal interests, at the expense of the original investors.<sup>123</sup>

Older treatises on corporate law do not discuss good faith as a distinct obligation of directors, but likewise indicate the equivalence of loyalty and good faith.<sup>124</sup> One author states that because a director, like an agent,

is invested with authority to use any discretion in the exercise of the powers conferred upon him, it is an implied condition that this discretion shall be

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*with the Board's Distinct Fiduciary Roles*, 31 J. CORP. L. 893, 899 (2006). He points out that there are many contexts in which it is said that directors must act in good faith and that the specialized rules dealing with self-dealing transactions constitute a narrower subset of cases.

If, as a matter of linguistics, corporate law had come to embrace, as fundamental, the two core duties of good faith and care, we would not differ from Professor Stone. In that scenario, there would have still been a requirement for the law to grapple with self-dealing transactions in a more specific way. But in that case, we would have seen as unnecessary any need to create a third, independent duty of loyalty, distinct from the generalized obligation of good faith toward the corporation and its stockholders. That is, our central point would remain the same, which is that it is impossible to sever the relationship between loyalty and good faith. If the law adopted good faith as the overall rubric, we have little doubt that the definition of a good faith fiduciary is one who acts loyally to advance the best interests of the corporation.

<sup>122</sup> See, e.g., *Gladstone v. Bennett*, 153 A.2d 577, 582 (Del. 1959) ("Those who undertake to form a new corporation, to procure for it the rights and capital by which it is to carry out the purposes set forth in its charter, and to establish it as able to do its business, are its promoters. They occupy a fiduciary relation to the corporation and are charged with the duties imposed by good faith in their dealing with it." (citing *Hays v. The Georgian, Inc.*, 181 N.E. 765, 768 (Mass. 1932)); *Dickerman v. Northern Trust Co.*, 176 U.S. 181, 204 (1900) (stating that the promoter "is treated as standing in a confidential relation to the proposed company, and is bound to the exercise of the utmost good faith. . . . The promoter is the agent of the corporation and subject to the disabilities of an ordinary agent. His acts are scrutinized carefully, and he is precluded from taking a secret advantage of the other stockholders.").

<sup>123</sup> *Gladstone*, 153 A.2d at 582 (explaining that promoters "will not be permitted to benefit by any secret profit which they may receive at the expense of the corporation or of its members").

<sup>124</sup> One comparatively recent treatise on corporate law succinctly captured the history of a director's duties as follows: "The underlying principles have not changed during the years. Directors are held to two fundamental tests: (a) honesty and good faith; (b) diligence." 1 GEORGE D. HORNSTEIN, *CORPORATION LAW AND PRACTICE* § 431 (1959) (citation omitted).



used in good faith for the benefit of the principal, and in accordance with the purpose of the agent's appointment. . . . It is manifest, therefore, that the directors of a corporation occupy a position of the highest trust and confidence, and that the utmost good faith is required in the exercise of the powers conferred upon them.<sup>125</sup>

The term "good faith," in this expression, is no more and no less than the obligation to use one's power and discretion as a director for the benefit of the corporation. Another author similarly recites that directors "must exercise the utmost good faith in all transactions touching their duties to the corporation and its property," and that "[a]ll their acts must be for the benefit of the corporation, and not for their own benefit."<sup>126</sup>

Early Delaware corporate cases also establish the role of good faith as defining a loyal state of mind. The frequently cited case of *Cahall v. Lofland*<sup>127</sup> is a good example. That case involved claims of breach of fiduciary duty against former directors and officers who had approved the issuance of stock to themselves as compensation for services in organizing the company. Introducing its analysis invalidating the stock purchases, the court observed:

[A director or officer] stands in a fiduciary relation which requires him to exercise the utmost good faith in managing the business affairs of the company with a view to promote, not his own interests, but the common interests, and he cannot directly or indirectly derive any personal benefit or advantage by reason of his position distinct from the coshareholders.<sup>128</sup>

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<sup>125</sup> 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §516 (2d ed. 1886).

<sup>126</sup> 2 SEYMOUR D. THOMPSON, COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS §1215, at 164 (2d ed. 1909). Here is another venerable example of the use of good faith in reference to the basic duty to put the corporation's financial interest ahead of her own. WILLIAM L. CLARK & WILLIAM L. MARSHALL, MARSHALL ON PRIVATE CORPORATIONS 1007-10 (1902) ("Directors or other officers of a corporation are liable to it for any loss which it may sustain by reason of their refusal or failure to enter into a contract for its benefit, if they do not act in good faith; and if it is their duty in a particular case to enter into a contract, or to purchase or take a transfer of property, on behalf of the corporation, and, in violation of this duty, they enter into the contract or acquire the property personally, they will not be permitted to retain the benefit, but will be held as trustees for the corporation.")

<sup>127</sup> 114 A. 224 (Del. Ch. 1921).

<sup>128</sup> *Id.* at 228.

The opinion thus clearly links “good faith” with the duty to act “with a view to promote . . . the common interests” rather than personal interests — *i.e.*, loyally.<sup>129</sup>

Five years after *Cahall*, the court in *Bodell v. Gen. Gas & Elec. Corp.*<sup>130</sup> similarly confronted a challenge to director approval of an issuance of shares, and neatly captured, in the following sentence, the concept of good faith in the fiduciary duty of corporate directors: “A complete absence of selfish motive and of personal profit on their part forcefully argues that [the directors’] judgment was formed in absolute honesty and entire good faith.”<sup>131</sup>

To the same effect is the landmark case of *Guth v. Loft, Inc.*,<sup>132</sup> in which the court famously articulated the “rule of corporate opportunity,” and described it as “merely one of the manifestations of the general rule that demands of an officer or director the utmost good faith in his relation to the corporation which he represents.”<sup>133</sup> The court’s identification of good faith with loyalty is unmistakable in the most frequently cited passage in the opinion:

The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are

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<sup>129</sup> Non-Delaware corporate cases from the same era also equate good faith with loyalty. *See, e.g.*, *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (“[Fiduciaries’] dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or [controlling] stockholder not only to prove the good faith of the transaction, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.” (citing *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921))).

<sup>130</sup> 132 A. 442 (Del. Ch. 1926).

<sup>131</sup> *Id.* at 449.

<sup>132</sup> 5 A.2d 503 (Del. 1939).

<sup>133</sup> *Id.* at 510.

many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.<sup>134</sup>

Delaware's proto-takeover cases reflect the same linkage of good faith with proper motive. In *Cheff v. Mathes*,<sup>135</sup> for instance, the Supreme Court addressed a stock repurchase challenged as an improper use of corporate funds to fend off an unwanted takeover. The court identified as a threshold issue "the allocation of the burden of proof to show the presence or lack of good faith on the part of the board in authorizing the purchase of shares."<sup>136</sup> The court had already noted that it would have been improper for the directors to have used "corporate funds to advance the selfish desires of directors to perpetuate themselves in office," but that "if the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for the decision."<sup>137</sup> Having thus effectively equated "good faith" with a "sincere belief" that legitimate corporate interests would be served, the court sustained the challenged stock repurchases as "a decision by the board made in good faith that the corporate interest was served thereby."<sup>138</sup>

The landmark takeover decisions in *Unocal* and *Revlon* also clearly used the term good faith to describe a loyal state of mind. In *Unocal v. Mesa Petroleum Corp.*,<sup>139</sup> the

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<sup>134</sup> *Id.*

<sup>135</sup> 199 A.2d 548 (Del. 1964).

<sup>136</sup> *Id.* at 554.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 556. To the same effect is *Kors v. Carey*, 158 A.2d 136, 142 (Del. Ch. 1960) (in case involving what would today be described as "greenmail," noting a "presumption that directors form their judgment in good faith," and "find[ing] no evidence that a selfish desire to retain jobs on the part of the non-managerial [ ] directors was a factor in their decision" to approve a repurchase of stock from the potential bidder).

<sup>139</sup> 493 A.2d 946 (Del. 1985).

Delaware Supreme Court made plain its view that the fundamental duty of a director was to act in the “best interests of the corporation and its shareholders.”<sup>140</sup> It did so in the course of holding that a board’s response to a takeover defense was simply a different context for the application of the “basic principle that corporate directors have a duty to act in the best interests of the corporation’s stockholders.”<sup>141</sup> The Supreme Court then made plain that the enhanced burden it was imposing on directors to show that they had a good faith, reasonable basis to believe that the corporation faced a threat was designed “to ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders.”<sup>142</sup> We think it clear that the Supreme Court was giving life to the duty of loyalty in the emerging takeover defense area, by implementing an equitable standard of review designed to ensure fidelity to the corporation’s best interests and to smoke out director action that might have been influenced by the “omnipresent specter that a board [confronting a hostile takeover bid] may be acting primarily in its own interests, rather than those of the corporation and its shareholders.”<sup>143</sup> By requiring the directors to show that they were acting in subjective good faith to advance a proper purpose, the court gave the Court of Chancery a metric for assessing whether directors were acting loyally in adopting defensive measures. In *Revlon*, the Delaware Supreme Court itself read *Unocal* this way, stating: “The [*Unocal*] standard[] require[s] the directors to determine the best interests of the corporation and its stockholders, and impose[s] an enhanced duty to abjure any

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<sup>140</sup> *Id.* at 954.

<sup>141</sup> *Id.* at 955.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.* at 954.

action that is motivated by considerations other than a good faith concern for such interests.”<sup>144</sup>

Indeed, the Supreme Court’s decision in *Revlon* is a stark illustration of the duty of loyalty’s requirement that directors must prefer the interests of stockholders over other interests. Early in the takeover battle at issue in that case, the *Revlon* board had engaged in a defensive partial self-tender and encouraged its stockholders to exchange a portion of their shares for notes. The notes were subject to certain protections, which the board promised would not be waived except by the independent directors. In the context of a contest for control, the board decided to prefer one bid in part because the bidder offered to provide support for the value of the notes. Even though the noteholders were mostly still Revlon stockholders and had been encouraged to buy the notes during the course of the takeover struggle, the Supreme Court held that once the Revlon board decided to sell the company, its only obligation to the noteholders was purely contractual. “[O]btaining the highest price for the benefit of the stockholders should have been the central theme guiding director action. Thus, the Revlon board could not make the requisite showing of good faith by preferring the noteholders and ignoring its duty of loyalty to the shareholders.”<sup>145</sup> This explicitly demonstrates the use of good faith to define the core mandate of loyalty, which is to act solely in the interest of the corporation and its

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<sup>144</sup> *Revlon*, 506 A.2d at 181.

<sup>145</sup> *Id.* at 182.

stockholders, a mandate that has a narrower focus when the board has decided to sell the company.<sup>146</sup>

With this background, we find it instructive to examine how a leading exponent of Delaware corporate law addressed the topic of bad faith in 1979. In a detailed exposition of the business judgment rule, and in a section entitled “Lack of Good Faith,” S. Samuel Arsht explained that “[a] director may also lose the benefit of the business judgment rule if plaintiff proves that the director’s challenged decision was prompted by improper motive, that the director was not truly independent from an interested party, or any other circumstance demonstrating a lack of good faith.”<sup>147</sup> Arsht identified the rationale for this view as follows: “[a] rule [the business judgment rule] designed to protect directors in the honest exercise of their business judgment should not apply where such judgment is brought to bear only as an ex post facto justification for action taken primarily for

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<sup>146</sup> *Unocal* and *Revlon* are consistent with other Delaware Supreme Court jurisprudence in the 1980s clearly using the concept of good faith to give definition to the duty of loyalty. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (stating that “a director’s duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty” and that when “there were no allegations of fraud, bad faith, or self-dealing . . . it is presumed that the directors reached their business judgment in good faith, . . . considerations of motive are irrelevant,” and therefore only issues of care, rather than loyalty, were at issue); *id.* at 872 (“Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But the fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud.”); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) (“In performing their duties, the directors owe fundamental duties of loyalty and care to the corporation and its shareholders.”); *id.* at 536-37 (clearly implying that the following were instances of loyalty breaches: “fraud,” “unfairness,” and defensive actions motivated by entrenchment rather than a “good faith” effort to address a threat to the corporation); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (“In discharging [the] function [managing the corporation], the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.”); *id.* at 1280 (when entire fairness standard applies because of self-interest, directors must show good faith motives and fair results); *id.* at 1284 n. 32 (referring to the “fundamental duties of loyalty and care”); *id.* at 1284 (explaining that when directors are subject to the *Revlon* requirement to pursue the highest value, the duties of loyalty and care are both implicated, and that directors must act in an informed manner for the purpose of obtaining the best deal for the stockholders); *id.* at 1288 (citing *RJR Nabisco* with approval for the proposition that so long as directors have “fulfilled their fundamental duties of care and loyalty” in pursuing the highest value transaction, they have satisfied *Revlon*).

<sup>147</sup> S. Samuel Arsht, *The Business Judgment Rule*, 8 HOFSTRA L. REV. 93, 127 (1979).

personal reasons, such as to preserve oneself in office.”<sup>148</sup> Similarly, Arsht pointed out, where directors’ decisions are influenced by a relationship with a self-dealing person, they have been “found not to have been in good faith.”<sup>149</sup> Arsht also noted that “[b]ad faith may preclude the application of the business judgment defense where directors knowingly violate a statute or comparable expression of public policy.”<sup>150</sup> In sum, as Arsht perceived matters in 1979, the director’s obligation to act in good faith precludes use of the business judgment rule as a defense where the director acts for an improper, personal motive, whether that motive involves personal profit, partiality to a person whose interests conflict with those of the corporation, a desire to remain in office, or approving known illegal conduct. We see nothing more, and nothing less, in the concept of good faith today, 30 years later.

#### **IV. The Rise and Demise Of An Independent Duty Of Good Faith**

In the face of the etymological, statutory, precedential and analytical material reviewed above, one might well wonder how the Delaware Supreme Court came in 1993 to elevate an independent duty of good faith to membership in a newly identified “triad” of director fiduciary duties. Yet, it may seem unimportant to explore this question, with the Supreme Court now having characterized the “triad” as a mere colloquialism.<sup>151</sup> And, the history of the so-called triad may be of little interest to those, unlike us, who do not believe that the manner in which the common law evolves is of consequence. But distinguished commentators have built policy arguments around the triad recognized in

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<sup>148</sup> *Id.* at 128.

<sup>149</sup> *Id.* at 129.

<sup>150</sup> *Id.*

<sup>151</sup> *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

*Technicolor*, and have pointed to the citation of the triad by other subsequent decisions as demonstrating an acceptance of the triad's utility by the Delaware courts.<sup>152</sup> Therefore, we believe it is useful to highlight the unusual origins of the triad and the reality that the triad was never actually put into functional use even in the very case in which the Supreme Court announced its existence.

A. *Who'd Have Thunk It: Did Decisions of Chancellor Allen Actually Inspire the Invention of the Triad?*

The invention of the so-called triad might well have its origins in an ironic place: well-reasoned decisions by Chancellor Allen, the original trial judge who suffered multiple reversals in the *Technicolor* epic. Chancellor Allen was prone to using the concept of good faith to define the subjective state of mind required of a loyal fiduciary. As demonstrated in the following review of two of the most important of these decisions, this usage seems to have been the inspiration for the Delaware Supreme Court's invention of the triad.

The first of these decisions was *In re RJR Nabisco, Inc. Shareholders Litigation*,<sup>153</sup> in which Chancellor Allen addressed a request for a preliminary injunction against an acquisition of RJR negotiated and approved by a special committee of RJR's outside directors in lieu of a putatively higher-priced (but more conditional and uncertain)

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<sup>152</sup> See generally Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 457 (2004); cf. Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 34 (2005) ("In seeking to answer the basic corporate law question, courts applying the good faith standard do not confine themselves to the analytics of either traditional fiduciary duty. Instead, good faith is used as a loose rhetorical device that courts can wield to find liability or enjoin actions that do not quite fit within established doctrinal categories.").

<sup>153</sup> 1989 WL 7036 (Del. Ch. Jan. 31, 1989).



offer from a bidding group that included RJR's CEO, Ross Johnson. The plaintiffs argued that the RJR special committee preferred the KKR deal because the special committee members wished to avoid sharing in the public criticism that Johnson had endured as a result of making what many commentators viewed as a definitionally unfair bid, a management buyout.

Chancellor Allen examined the plaintiffs' claim under *Revlon*<sup>154</sup> using a traditional business judgment rule framework, which he articulated, as follows, in a way that likely inspired the triad:

The business judgment form of judicial review encompasses three elements: a threshold review of the objective financial interests of the board whose decision is under attack (i.e., independence), a review of the board's subjective motivation (i.e., good faith), and an objective review of the process by which it reached the decision under review (i.e., due care). . . . The first of these factors is, of course, a condition to the use of the business judgment form of review; if the board is financially interested in the transaction, the appropriate form of judicial review is to place upon the board the burden to establish the entire fairness of the transaction. Each of the second two elements of the rules reflects one of the two theoretically possible bases for director liability in a disinterested transaction. If each is satisfied (i.e., a plaintiff cannot show a prima facie case of, or, if such a case is made out, the balance of the evidence does not establish bad faith or gross negligence), then there is, in my opinion, no basis to issue an injunction or to impose liability.<sup>155</sup>

Although Chancellor Allen separated his business judgment rule review into three elements, those elements did not signal his embrace of a triad of fiduciary duties. Rather, the first two elements focused on whether the directors had breached their duty of loyalty. The first element — inquiring whether the members of the RJR special committee had

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<sup>154</sup> *Revlon v. McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

<sup>155</sup> *RJR*, 1989 WL 7036, at \*13 (citations omitted).

“any direct financial interest in the sale of the Company to KKR that was adverse to or even differed from the interests of all the stockholders of the Company”<sup>156</sup> — is fundamental, if by now mundane. If directors have a self-dealing interest in a transaction, the law places upon them the burden to show that the transaction was fair to the corporation.<sup>157</sup>

By contrast, the second element of Chancellor Allen’s business judgment rule framework focused on whether a plaintiff could show that directors who did not suffer from a financial conflict of interest had nonetheless acted disloyally. This inquiry focused on a question of “motivation,”<sup>158</sup> in Chancellor Allen’s terms.<sup>159</sup> In considering whether the RJR special committee had been properly motivated, Chancellor Allen expressly addressed the defendants’ argument that they could lose the protection of the business judgment rule only if they “pursu[ed] . . . financial interests opposed to those of the corporation or the shareholders.”<sup>160</sup> In the defendants’ view, only an improper financial motivation “counts in the evaluation of director good faith” for purposes of applying the business judgment rule standard of review.<sup>161</sup>

Chancellor Allen’s reasons for rejecting that view merit quotation:

Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge, or, as is here alleged, shame or pride. Indeed any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation.

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<sup>156</sup> *Id.* at \*14.

<sup>157</sup> *E.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Ryan v. Tad’s Enters., Inc.*, 709 A.2d 682, 689-90 (Del. Ch. 1996).

<sup>158</sup> *RJR*, 1989 WL 7036, at \*13.

<sup>159</sup> Or, a question of scienter, in legal jargon.

<sup>160</sup> *Id.* at \*15.

<sup>161</sup> *Id.*

But if he were to be shown to have done so, how can the protections of the business judgment rule be available to him? In such a case, is it not apparent that such a director would be required to demonstrate that the corporation had not been injured and to remedy any injury that appears to have been occasioned by such transaction?<sup>162</sup>

Therefore, after rejecting the defendants' argument, Chancellor Allen went on to examine whether the RJR special committee, which had no financial interest in preferring KKR's bid over a bid from the group led by RJR's CEO Ross Johnson, was nonetheless motivated to prefer KKR's bid because the special committee wished to avoid the personal reputation-endangering effects of embracing Johnson's bid.

Finding insufficient evidence that the special committee had acted for such an improper purpose, or that the special committee had breached its duty of care, Chancellor Allen then went on to find that so long as the special committee acted to maximize the sale price (i.e., for the loyal purpose required by *Revlon*) and with due care, as measured by a gross negligence standard,<sup>163</sup> *Revlon* was satisfied.<sup>164</sup> In so finding, Chancellor Allen rejected the contention that *Revlon* duties could be violated "if no breach of directorial duty of care or loyalty is involved" simply because "if on a *post hoc* review an auction is said to be unfair . . . or ineffective or 'unauction-like' in some material respect."<sup>165</sup>

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<sup>162</sup> *Id.*

<sup>163</sup> *Id.* at \*18.

<sup>164</sup> On this point, the *RJR* decision is probably the most controversial. To many, *Revlon* is important in two respects: making clear that the directors have the duty to seek the highest value reasonably attainable when the corporation is going to be sold *and* subjecting director conduct in that context to a heightened reasonableness review, at least for the purposes of granting injunctive relief. See, e.g., 1 BALOTTI & FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.20[B] (capturing both elements by entitling the subsection on *Revlon* "The Duty to Auction the Company -- *Revlon* Enhanced Scrutiny").

<sup>165</sup> *RJR*, 1989 WL 7036, at \*20.

Although the words “good faith” permeate the *RJR* decision, Chancellor Allen nowhere articulates a “third” duty separate from loyalty or care. Rather, Chancellor Allen uses the term “good faith” to define a loyal state of mind, a state of mind characterized by a director’s good faith pursuit of a proper corporate purpose, in this case, achieving the best available sale price. The conclusion of his inquiry into whether this good faith definition was met was what justified Chancellor Allen’s conclusion that the disinterested RJR special committee had likely not breached its duty of loyalty. In fact, in the introduction to his decision, Chancellor Allen directs the reader to the pages of his decision examining the special committee’s motivations by describing them as involving his consideration of whether the directors had breached their duty of loyalty.<sup>166</sup>

That Chancellor Allen’s *RJR* decision used good faith as the definition of a loyal state of mind is not surprising because it was not new. Consistent with the Delaware Supreme Court’s own similar usage in *Aronson*,<sup>167</sup> Chancellor Allen had consistently defined a director as having a loyal state of mind if she acted “in the good faith pursuit of corporate interests and only for that purpose.”<sup>168</sup> This was true in his important decisions in *Interco*,<sup>169</sup> *TW Services, Inc. v. SWT Acquisition Corp.*,<sup>170</sup> and *Blasius Industries, Inc. v. Atlas Corp.*,<sup>171</sup> and persisted through his full term.<sup>172</sup>

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<sup>166</sup> *Id.* at \*4.

<sup>167</sup> *Aronson v. Lewis*, 473 A.2d 805, 810 (Del. 1984).

<sup>168</sup> *City Capital Associates Limited Partnership v. Interco Inc.*, 551 A.2d 787, 802 (Del. Ch. 1988).

<sup>169</sup> *Id.*

<sup>170</sup> 1989 WL 20290 (Del. Ch. Mar. 2, 1989). In *TW Services*, Chancellor Allen covered much of the same ground as in *RJR Nabisco*, when faced with the question of *Revlon*’s relevance when a board refuses to negotiate with a bidder making a tender offer that was supported by a majority of the stockholders but was conditional on the target board’s assent to a merger agreement. In confronting that issue, Chancellor Allen posed the question thusly: “[I]n that circumstance, [d]oes a director’s duty of loyalty to the ‘corporation and its shareholders’ require a board . . . to enter a *Revlon* mode?” *Id.* at \*8. He said that the answer to that question was no if the board had made a “good faith”

These decisions, and in particular *RJR Nabisco*, were fresh in Chancellor Allen's mind when it came time for him to write the post-trial decision in *Cinerama v.*

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judgment that remaining independent would “maximize the long run interests of shareholders.” *Id.* at \*7-\*12. As in *Interco*, Chancellor Allen referred to an examination of whether the directors had fulfilled their duties of loyalty and care as critical to the application of the business judgment rule, and as turning on whether the board reached its “decision in good faith pursuit of legitimate interests, and did . . . so advisedly.” *Id.* at \*10.

<sup>171</sup> In *Blasius*, Chancellor Allen ruminated on the question of whether directors could breach their duty of loyalty if they, while acting in the good faith belief that they were benefiting the stockholders, acted for the primary purpose of preventing a majority of the stockholders from expanding the board and electing a new majority. 564 A.2d 651 (Del. Ch. 1988). As his first layer of loyalty analysis, Chancellor Allen examined whether the directors were motivated by a good faith concern for the economic welfare of the stockholders rather than their own self interest, and concluded that they likely were. *Id.* at 658. He then went on to articulate why he believed that the board had, nonetheless, committed what he characterized as an “unintended breach of the duty of loyalty.” *Id.* at 663. Indeed, Chancellor Allen's use of another synonym for loyalty — fidelity — makes clear that his examination of the board's good faith inquiry was in aid of his consideration of whether there was a loyalty breach. *Id.* at 658 (describing the directors' argument that if they acted in “good faith” to protect the stockholders, their actions could not have “constituted any violation of the duty of fidelity that a director owes”). But even though he believed the directors were acting in good faith, Chancellor Allen found an unintentional breach of the duty of loyalty because the directors' actions prevent the electorate from unseating them. *Id.* at 663. In our view, one might consider *Blasius* as involving a specialized form of the entire fairness doctrine, whereby even if directors are acting in subjective good faith, they cannot act to prevent their own unseating without demonstrating a very powerful justification for their self-serving conduct.

<sup>172</sup> See, e.g., *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1054-55 (Del. Ch. 1997) (“This existing uncertainty respecting the meaning of ‘Revlon duties’ was substantially dissipated by the Delaware Supreme Court's opinion in *Paramount*. The case teaches a great deal, but it may be said to support these generalizations at least: (1) where a transaction constituted a ‘change in corporate control’, such that the shareholders would thereafter lose a further opportunity to participate in a change of control premium, (2) the board's duty of loyalty requires it to try in good faith to get the best price reasonably available (which specifically means that the board must at least discuss an interest expressed by any financially capable buyer), and (3) in such context courts will employ an (objective) ‘reasonableness’ standard of review (both to the process and the result!) to evaluate whether the directors have complied with their fundamental duties of care and good faith (loyalty).”); *SICPA Holdings, S.A. v. Optical Coating Lab.*, 1997 WL 10263, at \*4 (Del. Ch. Jan 6, 1997) (“The core element of the fiduciary duty of loyalty impressed upon corporate directors is a good faith attempt to exercise power over corporate property or process so as to advance legitimate interests of the corporation and not for any selfish reason.”); *Dolby v. Key Box “5” Operatives, Inc.*, 1994 WL 507881, at \*5 (Del. Ch. Sept. 8, 1994) (explaining that the “[e]quitable obligations” that “are imposed in recognition” of stockholders entrusting directors with legal power over the assets of the corporation “are most centrally obligations of loyalty: the duty to try in good faith to achieve the broad original goal and not to divert the property for the benefit of the fiduciary”); *Mendel v. Carroll*, 651 A.2d 297, 304 (Del. Ch. 1994) (stating that action to dilute a controlling stockholder might be permissible if the board “acts in good faith and on the reasonable belief that a controlling shareholder is abusing its power”); *In Re Amsted Indus. Inc. Litig.*, 1988 WL 92736, at \*8 (Del. Ch. Aug. 24, 1988) (“I evaluate the prospects of ultimate vindication of a breach of loyalty theory (i.e., a failure to pursue in good faith the shareholders' interests to the exclusion of other interests) as substantially greater than a breach of due care theory.”); *In re Fort Howard Corp. S'holders Litig.*, 1988 WL 83147, at \*14 (Del. Ch. Aug. 8, 1988) (“I understand [*Revlon*] as essentially a breach of loyalty case in which the board was not seen as acting in the good faith pursuit of the shareholders' interests.”); *Citron v. Fairchild Camera and Instrument Corp.*, 1988 WL 53322, at \*17 (Del. Ch. May 19, 1988) (“The requirement that a director act in good faith in pursuit of the best interest of the corporation and its shareholders is at the core of the fiduciary duty of a director. To act in good faith, however, will not alone satisfy that duty. A director must, as well, act advisedly, with due care.”); *In re J.P. Stevens & Co. S'holders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988) (explaining *Revlon* “as a breach of loyalty case (i.e., one in which the board appeared not to be acting in good faith for the shareholders' benefit”).

*Technicolor, Inc.*<sup>173</sup> The *Technicolor* case involved a challenge to a merger by which Ronald Perelman’s MacAndrews & Forbes Group, Inc. holding corporation acquired Technicolor in a two-step transaction at \$23 per share. There are lots of little twists in the facts, but the key fact is that Perelman did not have anything close to a controlling interest in Technicolor when he negotiated the acquisition price. Rather, he was a third-party, arms-length buyer. In an early appellate ruling in the case, the Delaware Supreme Court held that the plaintiffs, a large stockholder called Cinerama, Inc., could prosecute both appraisal and fiduciary duty claims.<sup>174</sup>

A combined trial on those claims was held and it was one of the longest trials in the history of the Delaware Court of Chancery — consuming some 47 days — and was in fact one of two post-trial decisions issued by Chancellor Allen in 1990 and 1991. In his earlier appraisal decision, Chancellor Allen found that the fair value of Technicolor was \$21.60 per share.<sup>175</sup>

In his fiduciary duty decision, Chancellor Allen addressed the question of whether the directors of Technicolor had breached their fiduciary duties in connection with the sale of Technicolor to Perelman. Because none of the Technicolor directors were

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<sup>173</sup> 1991 WL 111134 (Del. Ch. June 24, 1991).

<sup>174</sup> *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988) (“*Cede I*”).

<sup>175</sup> 1990 WL 161084, \*2 (Del. Ch. Oct. 19, 1990). The appraisal decision was reversed and the appraisal part of the case has its own tortured history. Some 9 years later, another Chancellor, William B. Chandler III, concluded that Chancellor Allen had essentially been correct, finding that the fair value of Technicolor was \$21.98 per share. 2003 WL 23700218, at \*1 (Del. Ch. Dec. 31, 2003). By that time, the main financial issue in the case was the interest rate to be applied. *See id.* at 45-48. On appeal, the Supreme Court upheld Chancellor Chandler’s valuation methodology, but made changes to the discount rate and corporate debt that resulted in the Supreme Court award determining that fair value was \$28.41 per share. 884 A.2d 26, 41 (Del. 2005). Overshadowing the change in the estimate, however, was the Supreme Court’s reversal of the Chancellor’s determination that post-judgment interest should be calculated from the date of the original appraisal judgment. *Id.* at 43. That decision resulted in the extension of the pre-judgment interest rate calculated from 1983 to 1990 into 2005, thus giving the petitioners 22 years of interest at a highly favorable rate. *Id.*

affiliated with Perelman or owned an interest in MacAndrews & Forbes, none had a classic self-dealing interest. But some of the directors had other financial interests in a sale to Perelman that arguably could have led them to favor a deal with him at a price that was less than optimal.

Chancellor Allen therefore spent time framing his approach to applying the business judgment rule in addressing this particular context. He began by stating that the “business judgment form of review entails three distinct elements or inquiries.”<sup>176</sup> He then block-quoted in full his articulation of these three elements from *RJR*, stating that he was doing so not because that articulation was “authoritative” but “as a summary of my previously expressed view concerning the overall approach that form of review requires.”<sup>177</sup>

As in *RJR*, Chancellor Allen began his application of those three elements by considering whether the merger at issue was subject to entire fairness review. This was complicated in the *Technicolor* case in a way it was not in *RJR* because of two of the directors. One, Arthur Ryan, was Technicolor’s chief operating officer and had a bad relationship with the CEO, Kamerman. Cinerama contended that Ryan voted for the Perelman deal because he expected or hoped to be Technicolor’s CEO after the merger. The other director, Fred Sullivan, was an even simpler case, because he had sought and been granted a promise of \$150,000 as a finder’s fee if the merger with Perelman went through. Chancellor Allen found that in both of these cases there was enough reason to

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<sup>176</sup> 1991 WL 111134, at \*8.

<sup>177</sup> *Id.*

conclude that these two directors had personal motives to favor the Perelman transaction even if it was not at an optimal price and they could not be considered disinterested for purposes of determining whether the entire fairness standard should govern his review, as an initial matter. Nevertheless, because he found that the other seven directors did not suffer from any conflict of interest, Chancellor Allen rejected Cinerama's attempt to have him apply the entire fairness standard and therefore place the burden on the defendants to show that the merger was fair.<sup>178</sup>

That did not, however, relieve Chancellor Allen of the task of considering Cinerama's breach of duty of loyalty claim. Rather, Chancellor Allen, as he did in *RJR Nabisco*, said that the structural disinterestedness and independence of the Technicolor board invoked the business judgment form of review, triggering a burden on the part of the plaintiff to prove that the defendants had breached their duties of loyalty or care.<sup>179</sup> In this regard, Chancellor Allen concluded that each of the directors, with the possible exceptions of Sullivan and Ryan,<sup>180</sup> had acted in the good faith belief that the sale to Perelman was in the stockholders' best interests.<sup>181</sup> Because of that, the Technicolor board majority had fulfilled what Chancellor Allen called "the obligation of loyalty,"

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<sup>178</sup> Because of this, Chancellor Allen did not address how he would have applied the entire fairness standard to determine the personal liability of directors who were disinterested, and acted with good faith and due care. His jurisprudence would suggest that he would not have found that such directors — having personally satisfied their duties of loyalty and care — would have shared responsibility for any judgment against the interested directors because the transaction was unfair.

<sup>179</sup> In his introduction to the decision, Chancellor Allen made clear that Cinerama bore the burden to show injury precisely because the merger was untainted by "*self-dealing or other breach of loyalty.*" *Id.* at \*3 (emphasis added); see also *id.* at \*15 (emphasizing the core nature of loyalty and care by stating that the "law cannot sensibly demand that directors abandon personal financial concerns in order to serve on a corporate board; it is enough that directors meet their duty of loyalty and care to the corporation").

<sup>180</sup> Chancellor Allen refrained from making any final conclusion about their subjective good faith because he found no reason to believe that their self-interest affected the independent board majority's actions in any manner adverse to the stockholders. *Id.* at \*2, \*14-\*15.

<sup>181</sup> *Id.* at \*15.



which was to “act[] with a genuine belief that its action is in the best interest of the corporation.”<sup>182</sup> Indeed, Chancellor Allen stated that this “obligation” was the “core of a director’s fiduciary duty.”<sup>183</sup>

Having thus disposed of Cinerama’s loyalty-based claims, Chancellor Allen turned to the claim of breach of the duty of care. Here, the Chancellor looked to support from Judge Learned Hand’s decision in *Barnes v. Andrews* to support his conclusion that Cinerama had the duty to prove both: (1) a breach of the duty of care by reference to a gross negligence standard; and (2) proximate cause between that gross negligence and a measurable injury.<sup>184</sup> For the sake of analysis only, Chancellor Allen then assumed that there was an instance of gross negligence because the Technicolor board (which had been acting in 1982 before the *Revlon* decision issued) might have undertaken a less than reasonable search for other buyers.<sup>185</sup> He did this “freely” because of his view that Cinerama had failed to prove that any deficiency in the board’s approach to the negotiation and sales process had caused any harm to the stockholders.<sup>186</sup>

*B. The Triad Is Invented In The Supreme Court’s Review Of Chancellor Allen’s Technicolor Decision*

As is well known, the appeal from Chancellor Allen’s post-trial fiduciary duty decision in *Technicolor* resulted in a decision, sometimes also known as *Cede II*, stating that a stockholder wishing to rebut the presumption of the business judgment rule “assumes the burden of providing evidence that directors, in reaching their challenged

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<sup>182</sup> *Id.* at \*16. Note here how the word “genuine” acts as a proxy for the concept of good faith.

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at \*17 (citing and quoting *Barnes v. Andrews*, 298 F. 614, 616-18 (S.D.N.Y. 1924)).

<sup>185</sup> *Id.* at \*17.

<sup>186</sup> *Id.* at \*18-19.

decision, breached any of the *triads* of their fiduciary duty — good faith, loyalty or due care.”<sup>187</sup>

Here, we focus on how this usage was, in context, clearly an imprecise embrace of Chancellor Allen’s own articulation of the operation of the business judgment rule in *RJR* and *Technicolor* itself. To make clear how this new articulation misperceived Chancellor Allen’s construction of the business judgment rule in *RJR* and *Technicolor* itself, it is useful to back up before the word “triad[]” pops up in the Supreme Court’s opinion in *Technicolor*. Just paragraphs earlier, the court had made clear that its focus was on whether Chancellor Allen had properly applied the business judgment rule standard of review in analyzing Cinerama’s claims. Therefore, the Court stated that the “princip[al] issues raised [on appeal] involve the formulation and application of the duty of loyalty and duty of care standard of the business judgment rule.”<sup>188</sup> Immediately before the sentence including the triad, the Court stated that the business judgment rule “posits a powerful presumption in favor of actions taken by the directors in that a decision made by a *loyal and informed* board will not be overturned by courts unless it cannot be attributed to any rational business purpose. . . . Thus, a shareholder challenging a board decision has the burden at the outset to rebut the rule’s presumption.”<sup>189</sup> It was the very next sentence that went on to say that the plaintiff could rebut the presumption by

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<sup>187</sup> 634 A.2d at 361. In fact, this famous sentence in *Technicolor* self-highlighted the word “triads,” suggesting three triplets of duties. Although typos are common in time-pressured judicial work, this typo suggests that the *Technicolor* panel did not view itself as establishing a new legal landmark; otherwise, one would think the panel would have focused on this key word and whether it was being used properly.

<sup>188</sup> *Id.* at 360.

<sup>189</sup> *Id.* at 361 (citations and quotations omitted) (emphasis added).

showing that the directors had breached one of a triad of duties, “good faith, loyalty or due care.”<sup>190</sup>

This train of thought, of course, resembles the three-part structure articulated in *RJR* and the trial court decision in *Technicolor*. But what happened is obvious. Rather than stating these in the terms Chancellor Allen used them — as elements in the application of a judicial standard of review — they were stated as a form of directorial duty.<sup>191</sup> In particular, *Technicolor* does not acknowledge that Chancellor Allen had used the first two elements of his three-part analysis to resolve the underlying question of whether there was a loyalty breach. In Chancellor Allen’s formulation, the first inquiry was whether the transaction was one that was subject in the first instance to entire fairness review because a majority of the approving directors had a material conflict of interest. In that circumstance, the burden was on those defendants to prove that they had treated the corporation and stockholders fairly. That is, the first inquiry was one that determined whether the business judgment rule standard of review even applied.

The second inquiry was, of course, whether, irrespective of the presence of a disinterested approving authority, the board decision under attack was tainted by any

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<sup>190</sup> *Id.*

<sup>191</sup> The Supreme Court’s transformation of the three-part inquiry of *RJR* into an articulation of separate duties represented a departure from its earlier decision in *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989). In that decision, the Supreme Court framed the application of the business judgment rule consistently with the analysis in *RJR*. The initial inquiry was whether the transaction was affected by self-dealing or self-interest thereby triggering rebuttal of the presumption and imposition of the entire fairness standard. *Id.* If that shift did not occur in the first instance, the plaintiffs could still succeed by proving that the decisions of the defendants were not undertaken in subjective good faith or resulted from a breach of the duty of care. *Id.* That is, even if the business judgment rule standard of review, rather than the entire fairness standard, applied in the first instance, the plaintiffs could still win if they proved a breach of the duty of loyalty (an improper motivation) and a breach of the duty of care (a failure to “act on an informed basis”). *Id.*

disloyalty. In that context, it was the plaintiff's burden to prove disloyalty by showing that the directors had not acted in good faith to advance the corporation's best interests.

In reality, *Technicolor's* own application of the business judgment rule was unaffected by its announcement of a triad. In fact, the Supreme Court's analysis leading to reversal actually reaffirms that directors' fiduciary duties are dyadic — loyalty and care — and not triadic.

As to Cinerama's loyalty claim, the Supreme Court was disturbed that Chancellor Allen had been willing to dismiss the case against all the defendants despite having doubts whether directors Sullivan and Ryan had acted disloyally. Indeed, the Supreme Court, contrary to Chancellor Allen's own caveat that he was not reaching any such conclusion, held that Chancellor Allen had made a "finding that at least one director, Sullivan, if not a second director, had breached his duty of loyalty."<sup>192</sup> *Technicolor* then descended into an extended consideration of that appellate fact-finding's effect on the judgment below, a consideration that heavily took into account the Supreme Court's own consideration of the potential relevance of Section 144 of the DGCL and of a provision of *Technicolor's* charter, neither of which had been the subject of briefing by the parties below or on appeal.<sup>193</sup> At bottom, the Supreme Court was concerned that Chancellor Allen's finding that Ryan's and Sullivan's interests had not tainted the majority-independent board's approval of the merger was inadequately supported and remanded

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<sup>192</sup> 634 A.2d at 358.

<sup>193</sup> *Id.* at 365 (indicating that the parties and trial court had not brought § 144 into "their reasoning or analysis" and that Cinerama did not rely on the charter provision the Supreme Court felt was helpful to its position).

the matter to him to consider the issue anew.<sup>194</sup> The Supreme Court admonished him to use an actual person standard on remand, one that considered whether the director’s self-interest was in fact material to that director, as a specific human being, rather than to a hypothetical reasonable director.<sup>195</sup> But the Supreme Court also clearly stated that simply because a director was found to have a material self-interest disqualifying him from being classified as independent did not mean that the business judgment rule did not apply to the board’s decision. In fact, the Court indicated that Chancellor Allen’s original conclusion that the board’s decision was untainted might stand if he made more thorough findings.<sup>196</sup>

In the course of so finding, *Technicolor* actually framed the issue of loyalty in a broad way that subsumes the proposition that a director must act in good faith to advance corporate, not personal, interests. In an extended treatment of the duty of loyalty claims, *Technicolor* began expounding the “broad and unyielding” duty of “loyalty” by quoting from *Guth v. Loft*.<sup>197</sup> It followed that quote with this distillation: “Essentially, the duty of loyalty mandates that the best interests of the corporation and its stockholders takes precedence over any interest possessed by a director . . . and not shared by the stockholders generally.”<sup>198</sup> Then the Court described “self-dealing” as a “[c]lassic exampl[e] of director self-interest,” but made clear that a director only acted independently with respect to a decision when her “decision is based entirely on the

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<sup>194</sup> *Id.* at 372-73.

<sup>195</sup> *Id.* at 364.

<sup>196</sup> *Id.* at 365. Ultimately, it did stand. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1168-69 (Del. 1995).

<sup>197</sup> *Technicolor*, 634 A.2d at 361 (quoting iconic language set forth at *Guth v Loft*, 5 A.2d 503, 510 (Del. 1939)).

<sup>198</sup> *Id.*

corporate merits of the transaction and is not influenced by personal or extraneous considerations.”<sup>199</sup> Nothing in the decision hints that a director could satisfy this duty of loyalty simply because the stockholder proved that the director had approved a decision she believed to be not in the corporation’s best interests, but to advance a personal interest that was not financial in nature. Rather, *Technicolor* seems to emphatically make clear that bad faith of this kind would be disloyal.<sup>200</sup>

In fact, the whole motivation for the Supreme Court’s reversal seems to be a concern that the improper motivations of two directors had tainted the board’s overall decisionmaking process, supporting a finding of a loyalty breach. Interestingly, given the dictum about a third duty, the Supreme Court noted earlier in the opinion that Cinerama had abandoned its contention that the “directors [other than Sullivan and Ryan] had acted in bad faith.”<sup>201</sup> Thus, the reference to a third duty was clearly dictum and a third duty analysis played no role in the reasoning of *Technicolor*. Rather, the actual reasoning of *Technicolor* suggests that a loyalty violation could arise if particular directors supported corporate action for personal, not proper, reasons of any kind.<sup>202</sup>

The Supreme Court’s controversial reversal of Chancellor Allen’s duty of care rulings also supports this conclusion. In that part of *Technicolor*, the Court converted the Chancellor’s assumption that the Technicolor directors had breached their duty of care

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<sup>199</sup> *Id.* at 362.

<sup>200</sup> Indeed, the Court went on to articulate that the mere possession by a director of a conflicting self-interest did not have the effect of rebutting the business judgment rule presumption and that “there must be evidence of disloyalty.” *Id.* at 363. “Examples of such misconduct include, but are certainly not limited to, motives of entrenchment, fraud upon the corporation or the board, abdication of directorial duty, or the sale of one’s vote.” *Id.* (citations omitted).

<sup>201</sup> 634 A.2d at 351.

<sup>202</sup> *Id.* at 362.

into an actual finding to that effect.<sup>203</sup> It then called his reliance upon *Barnes v. Andrews* “misguided” and agreed with Cinerama that it was an inadequately explained “mystery” how Chancellor Allen had come upon that decision by Judge Hand.<sup>204</sup> Rather than concluding that a plaintiff who showed a breach of the duty of care had to prove up his damages, the Supreme Court held that proof of a breach of the duty of care had the effect of imposing on the defendants the duty to prove entire fairness, i.e., that they had caused no harm.<sup>205</sup>

Although that ruling is consequential, as we shall see, to the later *Caremark* decision by Chancellor Allen, the more immediate pertinence of *Technicolor*'s due care section is its emphasis that there are two basic fiduciary duties that must be met for a board decision to be entitled to the protection of the business judgment rule: loyalty and care. Tilting against what he perceived to be a move by Chancellor Allen to cabin the

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<sup>203</sup> *Id.* at 369-70 (“We adopt, as clearly supported by the record, the Chancellor’s presumed findings of the directors’ failure to reach an informed decision in approving the sale of the company.”); *cf. id.* at 351 n.3 (“We borrow liberally from, and generally adopt, the Chancellor’s findings.”).

<sup>204</sup> *Technicolor*, 634 A.2d at 370.

<sup>205</sup> *Id.* at 370-71. In the course of so ruling, the Supreme Court stated that a showing of a breach of the duty of loyalty simply has the effect of requiring the directors to show that the transaction was fair. *Id.* at 371. That statement strikes us as odd if it includes within its rubric a transaction that is subject to entire fairness review because the approving majority was not sufficiently independent. In that instance, the use of entire fairness review does not mean a loyalty breach has occurred. If the directors show entire fairness in that context, they will have shown that they did not commit a loyalty breach. When a loyalty breach is proven by proof that the board acted for an improper motive, it makes more sense to say that the defendants might mitigate the remedial consequences of the breach by showing that the outcome was nonetheless fair, although that does not undo the breach or necessarily immunize the breaching fiduciary from all consequences. *See Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 445 (Del. 1996) (holding that “some recovery is warranted” for a breach of the duty of loyalty resulting from a controlling stockholder’s attempted expropriation of a corporate opportunity even though the corporation would not have been able to take advantage of the opportunity itself because of the controlling stockholder’s right to veto the potential transaction). But even in this instance, *Technicolor* echoed *RJR*. *See RJR*, 1989 WL 170356, at \*15 (asking rhetorically, “is it not apparent that . . . a director [who acted for a reason unrelated to a pursuit of the corporation’s best interests] would be required to demonstrate that the corporation had not been injured and to remedy any injury that appears to have been occasioned by such transaction?”).

effect of Justice Horsey’s prior decision for the Court in *Van Gorkom*,<sup>206</sup> Justice Horsey strove to demonstrate that the duty of care is not simply a subsidiary duty but rather a duty “of equal and independent significance” to the duty of loyalty that had been “given equal weight” in the Supreme Court’s business judgment rule jurisprudence.<sup>207</sup> Together, he wrote, the “[d]uty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders.”<sup>208</sup> Making it patent that the question of whether the board had acted in good faith was in aid of determining whether the board had satisfied its duty of loyalty, Justice Horsey added a footnote, block-quoting *Barkan v. Amsted Industries, Inc.*, with bracketed interpolation:

In *Barkan*, this Court stated:

. . . a board’s actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence [*care*] and good faith [*loyalty*]. If no breach of duty is found, the board’s actions are entitled to the protections of the business judgment rule.<sup>209</sup>

That is, the very decision that invented the triad recognized that good faith was the state of mind required of a loyal fiduciary.

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<sup>206</sup> *Id.* at 358 (stating that Chancellor Allen had subordinated the duty of care to avoid the adverse effects Chancellor Allen perceived flowed from *Van Gorkom*); *id.* at 370 (finding that Chancellor Allen had ignored controlling effects of *Van Gorkom* without explanation in favor of *Barnes v. Andrews*).

<sup>207</sup> *Id.* at 367.

<sup>208</sup> *Id.*

<sup>209</sup> *Id.* at 368 n.36.



### C. Caremark's Loyalty-Based Liability Standard

In the wake of the invention of the triad, the Court of Chancery would occasionally refer to it, without explication or analysis, as trial courts often do to show obedience to precedent.<sup>210</sup> What did not follow, however, were cases in which the outcome actually turned on the recognition of a third duty. Rather, references to the triad were largely that, mere references.

But this is not to say that the concept of good faith itself was not important in actually deciding cases. In fact, Chancellor Allen was again at the forefront in this, but also again not by himself embracing the triad. Instead, Chancellor Allen underscored the importance of good faith by sending the message that a director's duty of loyalty extended to the increasingly important context of monitoring. He did so in *In re Caremark International Inc. Derivative Litigation*.<sup>211</sup>

That decision has been the subject of extensive commentary and there is no need to dilate on the precise facts.<sup>212</sup> What Chancellor Allen used that occasion to do was to reflect upon the obligations owed by directors to monitor corporate operations. As he

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<sup>210</sup> See, e.g., *In re Emerging Communications, Inc. S'holders Litig.*, 2004 WL 1305745, at \*38 (Del. Ch. May 3, 2004) ("Having concluded that the Privatization was not entirely fair, the Court must next determine the nature of the fiduciary duty violation—whether of care, loyalty, or good faith—that resulted in the unfair transaction."); *In re Siliconix Inc. S'holders Litig.*, 2001 WL 716787, at \*9 (Del. Ch. June 19, 2001) ("When the directors of the tender target company communicate with the shareholders . . . they must, while complying with their ever-present duties of due care, good faith and loyalty, communicate honestly."); *Jackson Nat. Life Ins. Co. v. Kennedy*, 741 A.2d 377, 386 (Del. Ch. 1999) (stating that the "fiduciary obligation" owed by directors "has been characterized by the Supreme Court as a 'triad': due care, good faith and loyalty."); *Havens v. Attar*, 1997 WL 55957, at \*11 (Del. Ch. Jan. 30, 1997) ("To rebut this presumption, plaintiffs must demonstrate that the directors breached one of their fiduciary duties: good faith, loyalty, or due care." (citing *Technicolor*)).

<sup>211</sup> 698 A.2d 959 (Del. Ch. 1996).

<sup>212</sup> E.g., Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719, 730 (2007); H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post-Caremark Era*, 26 DEL. J. CORP. L. 1 (2001); Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237, 242-43, 254-55 (1997).

conceptualized it, directors could be subject to potential liability for failing to monitor the on-going operations of the corporation — or, in Chancellor Allen’s alternative words, “to exercise appropriate attention” — in two distinct contexts, both of which ultimately focused on the good faith of the directors.<sup>213</sup> In the first, the board may have made a specific decision about a matter. In that context, the traditional business judgment rule analysis applied. Consistent with Chancellor Allen’s prior jurisprudence, the *Caremark* decision indicates that the board would not face liability if it made a decision that “was deliberately considered in good faith or otherwise rational.”<sup>214</sup> Chancellor Allen did not consider the issue of financial self-interest because his focus was on the monitoring context, in which directors were acting on matters that did not involve self-dealing by them but rather their responsibility to oversee the corporation’s ongoing business operations, and particularly its compliance with the law. This was, as Chancellor Allen saw it, the most difficult situation in which to subject directors to liability, because there was no hint that they had a motive to injure the corporation.

In the context where disinterested directors made a specific decision regarding monitoring — such as how to follow up on yellow or red flags suggesting law compliance problems — the focus of the loyalty prong of the business judgment rule inquiry was on whether the directors had undertaken a good faith effort to make a reasoned decision in the interest of the corporation. More pointedly, *Caremark* focused

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<sup>213</sup> 698 A.2d at 967.

<sup>214</sup> *Id.*

on whether the directors put in an honest, good faith effort at monitoring in exchange for their director fees.

The other related context in which the board could face liability for failure to monitor involved a claim regarding what Chancellor Allen called the board's "unconsidered inaction."<sup>215</sup> Put more concretely, this was when improper conduct of officers or employees of the corporation, such as conduct in violation of positive law, exposed the corporation to liability and other forms of harm, and when a plaintiff alleged that the board's failure to monitor corporate operations had failed to prevent the misconduct. Chancellor Allen famously addressed that context by holding that directors had a duty to "assure that a corporate information gathering and reporting systems exist which represent[] a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations."<sup>216</sup>

For now, however, what is relevant is that *Caremark*'s articulation of the appropriate form of judicial review in this non-decision context is that it uses the concept of good faith just as in Chancellor Allen's previous decisions in *RJR Nabisco*, *Interco*, *TW Services*, *Blasius*, and *Technicolor*. That is, *Caremark* held that directors could only be held liable for failing to set up an adequate monitoring system if they were found to

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<sup>215</sup> *Id.* at 968.

<sup>216</sup> *Id.* at 969. *Caremark*'s conclusion that a board's decisions about the extent and instrumentality through which monitoring of this kind would occur were not properly the subject of a traditional business judgment review has been contested by distinguished commentators, who believe that a board's judgments about the corporation's monitoring systems are business judgments, entitled to deference under the traditional form of review. *See, e.g.*, Stephen M. Bainbridge, Star Lopez, & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 602 (2008) ("[T]he thrust of Allen's opinion 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.").

have acted in bad faith.<sup>217</sup> *Caremark*'s own text makes clear that it was a case about the duty of a loyal director to earn her pay by trying to be careful.<sup>218</sup> Thus, *Caremark* emphatically rejected the idea that a director could be held liable for a supposedly “negligent” or inattent[ive]” approach to monitoring, and not only because judicial second-guessing was as or more problematic, imprecise, and costly in this area of business decisionmaking, as it was in the transactional setting.<sup>219</sup> *Caremark* also recognized that high-quality candidates might eschew board service if they faced liability because a court, knowing of a corporate catastrophe, looked back and determined that non-negligent directors would have prevented the cause.<sup>220</sup> Therefore, *Caremark* held that

only a sustained or systematic failure of the board to exercise oversight – such as an *utter failure to attempt to assure a reasonable information and reporting system exists* – will establish the lack of good faith that is a necessary condition to liability. Such a test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.<sup>221</sup>

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<sup>217</sup> See *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) (explaining that *Caremark* “plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director—bad faith—because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation’s officers had developed and were implementing a prudent approach to ensuring law compliance”).

<sup>218</sup> Cf. *Canadian Comm'l Workers Indus. Pension Plan v. Alden*, 2006 WL 456786, at \*6 (Del. Ch. Feb. 22, 2006) (“The duty of oversight implicates both the duty of care and the duty of loyalty.”); see also *supra* text accompanying notes 16-17 (noting that everything directors do implicates the duties of care and loyalty); Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 932 (1983) (noting that the traditional dichotomy between loyalty and care is “not always sharp. For example, management that puts forth an inadequate and halfhearted effort could be seen as failing to take proper care in the conduct of the business or as breaching the duty of loyalty in shirking on the job and consuming more leisure.”).

<sup>219</sup> *Caremark*, 698 A.2d at 971.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* (first emphasis added; second emphasis in original).

As a textual matter, we of course must admit that *Caremark* never firmly places this new liability standard within the broader rubric of the traditional duty of loyalty. But that is the clear import of the decision, when it is read in context, as it must be, with Chancellor Allen’s prior related jurisprudence. In that regard, it is also notable that Chancellor Allen found no need to root his analysis in the triad invented in *Technicolor*, a decision that he was well aware of, having been the trial judge. Rather, *Caremark*’s only recognition of *Technicolor* rested in its prominent citation and quotation of *Barnes v. Andrews*, a leading decision by Learned Hand included in many corporate law treatises in support of the conclusion that directors should only face liability if they fail to make a good faith effort.<sup>222</sup> In *Technicolor*, the Supreme Court had indicated that it was an inadequately explained “mystery” how Chancellor Allen had come to cite *Barnes v. Andrews* in his trial court decision in *Cede* when none of the parties had referred to it in their trial briefs and that the Chancellor’s reliance upon that decision was “misguided.”<sup>223</sup> Indeed, *Caremark*’s considered rejection of the use of a gross negligence standard to apply to the monitoring context and its invocation of *Barnes v. Andrews* in support of that conclusion suggests a desire on Chancellor Allen’s part to limit the impact of *Technicolor*’s conclusion that directors who violate their duty of care have to prove that they did not cause harm. By rooting the liability analysis into a traditional and more rigorous examination of whether the directors had made a good faith effort to ensure that the corporation had an effective monitoring system, *Caremark* insulated independent

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<sup>222</sup> *Id.* at 968 (block quoting *Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924)).

<sup>223</sup> *Technicolor*, 634 A.2d at 370 & n.38.

directors from fear that that *Technicolor* would put them in the position of having to prove that corporate cataclysms had not resulted from their negligence.

D. *From Disney To Stone v. Ritter*

That insulation soon came under attack most visibly in the widely publicized litigation involving the severance compensation package awarded by the Walt Disney Company in 1995 to Michael Ovitz at the start of his very brief tenure with the company.<sup>224</sup> The thrust of that attack was well encapsulated in the title of a 2005 law review article discussing the case: “The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket After Disney?”<sup>225</sup> The plaintiffs’ own assertions even more clearly highlighted their intent to develop the good faith leg of the “triad” as an independent duty to fill in as a basis for director liability where duty of care claims are blocked by § 102(b)(7) charter provisions: their claim, specifically, was that “directors violate their duty of good faith if they are making material decisions without adequate information and without adequate deliberation.”<sup>226</sup>

As it turned out in *Disney*, it was unnecessary to test the effect of the company’s exculpatory charter provision, and its allowance of damages liability for conduct not in good faith, because the court concluded that no violation of the duty of care had been

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<sup>224</sup> See, e.g. Rita K. Farrell, *Disney Shareholders Ask Court To Reverse Ovitz Pay Decision*, N.Y. Times, Jan. 26, 2006; Nicholas D. Kristof, *Announcing an Award for Greed*, N.Y. Times, Aug. 14, 2005; David Litterick, *US Judge Backs Disney on Ovitz Sum*, Daily Telegraph (London), Aug. 10, 2005; Andrew Countryman, *Disney Case Has Full Attention of Directors; Investor Groups Are Watching Too*, Chicago Tribune, Jan. 30, 2005; Bruce Orwall & Chad Gray, *Disney Case Breaks New Ground*, Wall St. J., Dec. 15, 2004; Michael McCarthy, *Ovitz Shows Confidence, Poise In His Testimony*, USA Today, Nov. 1, 2004; Laura M. Holson, *For \$600 A Week, Screen-Side Seats to Lawsuit Involving Disney*, N.Y. Times, Oct. 11, 2004.

<sup>225</sup> Tara L. Dunn, 83 DENV. U. L. REV. 531 (2005).

<sup>226</sup> In re The Walt Disney Co. Deriv. Litig., 906 A.2d 27, 63 (Del. 2006) (quoting Appellants’ Op. Br. at 23).

established in any event.<sup>227</sup> The court nevertheless found it relevant to venture into a discussion of the content and role of good faith, acknowledging that “the duty to act in good faith is, up to this point[,] relatively uncharted.”<sup>228</sup>

The court conspicuously declined to state categorically “whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors.”<sup>229</sup> What the court did establish in *Disney*, however, was a clear rejection of the plaintiffs’ good faith-based legal theory. Describing the plaintiffs’ position as “a verbal effort to collapse the duty to act in good faith into the duty to act with care . . . [equivalent to] putting a rabbit into the proverbial hat,”<sup>230</sup> the court affirmed that “gross negligence (including a failure to inform one’s self of available material facts), without more, [cannot] also constitute bad faith.”<sup>231</sup>

The court in *Disney* then addressed what it described as a “third category” of director misconduct, falling between subjective motivation to harm the corporation and gross negligence, involving “intentional dereliction of duty, [and] a conscious disregard for one’s responsibilities.”<sup>232</sup> The court identified “the duty to act in good faith” as the “doctrinal vehicle” for imposing sanctions upon directors guilty of such misconduct, and

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<sup>227</sup> *Id.*

<sup>228</sup> *Id.* at 63-64. Somewhat more colorfully, Chancellor Chandler had described the good faith concept as “shrouded in the fog of . . . hazy jurisprudence.” 907 A.2d at 754.

<sup>229</sup> *Disney*, 906 A.2d at 67 n.112.

<sup>230</sup> *Id.* at 63.

<sup>231</sup> *Id.* at 64-65.

<sup>232</sup> *Id.* at 64.

cited a series of Delaware cases, including *Caremark*, all referring to “deliberate,” “conscious,” or “intentional” disregard of duty, in support of this proposition.<sup>233</sup>

The *Disney* opinion left matters, very briefly, in a state of some continuing doctrinal uncertainty. At this point, though, the stage was set to acknowledge that where a director is acting with *subjectively* bad intent — for an improper purpose, for personal gain, or by consciously disregarding his responsibilities (a self-serving attitude of a sort as well) — the duty of loyalty is amply capacious enough to encompass that sort of misconduct. Thus, just five months after handing down its opinion in *Disney*, the Delaware Supreme Court decided *Stone v. Ritter* and squarely turned to the question it had deferred in *Disney*: namely, “whether a violation of the duty to act in good faith is a basis for the direct imposition of liability.”<sup>234</sup>

*Stone v. Ritter*, like *Caremark*, involved a claim that directors had violated their fiduciary duties by failing to monitor and prevent penalties and fines levied against the company — specifically, in the case of AmSouth Bancorporation, on account of failures to comply with money-laundering regulations. Not surprisingly in light of the character of the claims at issue (failure to monitor), the court turned initially to, and adopted, the legal principles articulated in *Caremark* — specifically, that “a showing of bad faith conduct . . . is essential to establish director oversight liability.”<sup>235</sup>

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<sup>233</sup> *Id.* at 67 n.111, citing *Caremark*, 698 A.2d at 971; *Allaun v. Consol. Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929) (referring to “reckless indifference to or a deliberate disregard of the interests of the whole body of stockholders”); *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 604 (Del. Ch. 1974), *aff’d*, 316 A.2d 619 (Del. 1974) (referring to directors acting “for any personal advantage or out of improper motive or intentional disregard of shareholder interests”); *Nagy v. Bistricher*, 770 A.2d 43, 48 n.2 (Del. Ch. 2000) (referring to “a director who consciously disregards his duties to the corporation and its stockholders”).

<sup>234</sup> *Stone v. Ritter*, 911 A.2d at 369 n.29.

<sup>235</sup> *Id.* at 370.



The rest of the path toward the demise of the “triad” was quick and compelling. In rapid succession, the court announced the following propositions:

- “The failure to act in good faith may result in liability because the requirement to act in good faith ‘is a subsidiary element[,]’ i.e., a condition, ‘of the fundamental duty of loyalty.’”<sup>236</sup>
- Thus, “the fiduciary duty violated by [bad faith] conduct is the duty of loyalty.”<sup>237</sup>
- “[A]lthough good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”<sup>238</sup>
- Thus, and as a corollary, “the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.”<sup>239</sup>

The “triad” was dead, at the early age of 13 years, and without ever actually having played an outcome-determinative role in any case.

## **V. The Continuing Relevance Of The Concept Of Good Faith In The Enforcement Of The Duty Of Loyalty**

There is some irony that the key area in which the debate about whether there was a free-standing “fiduciary duty of good faith” distinct from the duty of loyalty had some policy bite was in addressing the liability of directors in situations when they lacked any

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<sup>236</sup> *Id.*

<sup>237</sup> *Id.* (citing *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

<sup>238</sup> *Id.*

<sup>239</sup> *Id.*

personal economic motive to injure the corporation. The irony is that the stringency with which Chancellor Allen's *Technicolor* decisions were reviewed by the Delaware Supreme Court seems, in no small part, to have been inspired by their rather obvious goal of cabining the influence of the Supreme Court's prior *Van Gorkom* decision.

The corporate meltdowns that occurred in the decade following the invention of the triad in *Technicolor* made the standard of liability for independent directors an even more salient issue.<sup>240</sup> With board compositions tilting more heavily toward independent directors and board compensation rising with increased time commitments and incentive compensation, the monitoring function of independent directors became even more obviously central. After all, these directors were not selected because they were ideally suited to provide advice about industry trends and the company's underlying business, but because they had the freedom of conscience to act as a check on managerial excess.

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<sup>240</sup> See, e.g., Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1134 (2003) ("Although higher standards of conduct for outside directors may reduce director willingness to serve, in light of the importance of board monitoring, this may be a desirable result."); Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN'S L. REV. 767, 768 (2002) ("One of the conclusions I make in this Article is that a greater emphasis on standards of care for both directors and officers is warranted, especially in the aftermath of the corporate governance failures that scandalized Enron, WorldCom, and other large publicly held companies."); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1385-96 (2002) (suggesting that the Enron/Worldcom-era market debacle would create a renewed focus on directors' duty to make a good faith effort to monitor the corporation's compliance with its legal obligations and the soundness and prudence of the company's business strategy, especially given the prevalence of § 102(b)(7) clauses, and stating that after Enron, "one can see how plaintiffs' lawyers might approach 'duty to monitor' cases somewhat differently in the near future. They might well ask courts to infer not only that audit committee members did not know enough about their company's financial and accounting practices, but also that the committee members knew that their inadequate knowledge disabled them from discharging their duties with fidelity. Stated crudely, the court will be called on to conclude that a director who is conscious that he is not devoting sufficient attention to his duties is not acting in good faith, and is therefore not entitled to exculpation from damages liability."). Even after *Stone v. Ritter*'s helpful clarification of the place of good faith in the law of director duties, economic pressures and concerns over governance's contribution to corporate failures continue to generate commentary on standards of liability for disinterested directors. E.g., Martin Lipton, *et al.*, *Some Thoughts for Boards of Directors in 2009*, at 1 (Dec. 8, 2008), available at <http://www.wlrk.com/docs/ThoughtsforDirectors2009.pdf> ("Although the standard for director liability established in Delaware by the *Caremark* case accords directors considerable deference in fulfilling their oversight duties, there is a distinct possibility that this level of deference could end up being modified in light of the current economic crisis.").

And because these directors were becoming more highly compensated, it was hardly shocking that stockholder-plaintiffs would seek to hold them accountable for failing to fulfill their monitoring responsibilities. In these efforts, the “duty of good faith” took prominence, especially in a couple of well-known federal cases.<sup>241</sup>

Relatedly, independent directors had also been increasingly relied upon to act on M & A transactions in which management had a conflicting interest, transactions ranging from responding to a hostile bid, to addressing a management-proposed leveraged buyout, to negotiating with a controlling stockholder over a going private transaction. In these situations, experience had generated best practices that many believed should be followed by independent directors. The free-standing duty of good faith again presented an opportunity to plaintiffs’ lawyers and others who opposed § 102(b)(7) to find a way to hold directors without a conflicting financial interest liable for a transaction that they believed to be less than optimal. Prevented from arguing a breach of the duty of care, à la *Van Gorkom*, plaintiffs’ lawyers saw an opportunity to reframe the debate, and argue that the independent directors had approved a transaction in bad faith, and to push judges to treat directorial behavior that appeared to be less adroit and diligent than was reasonable as indicative of bad faith. Famously, the use of good faith by plaintiffs in a transaction

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<sup>241</sup> See *In re Abbott Labs. Derivative S’holders Litig.*, 325 F.3d 795, 809 (7th Cir. 2003) (holding that a breach of the duty of good faith would be established where “the directors knew of . . . violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses”); *McCall v. Scott*, 239 F.3d 808, 818 (6th Cir. 2001) (finding that a board’s intentional or reckless disregard of “red flags” warning of fraudulent practices could result in directors not being protected from liability by a § 102(b)(7) exculpatory provision due to the exception for “acts or omissions not in good faith”); see also Hillary A. Sale, *Monitoring Caremark’s Good Faith*, 32 DEL. J. CORP. L. 719, 735-743 (2007) (providing a detailed discussion of these cases).

setting was extended to executive compensation, in the *Disney* saga dealing with a challenge to Michael Ovitz's compensation.

The monitoring and transactionally-specific litigation contexts were distinct in important ways. In the first — the ongoing duty to monitor the firm's processes for complying with its legal obligations — the underlying question of bad faith turned on whether the director had acted with such a sustained pattern of indolence that the director had to know that she was not making a good faith effort to discharge her duties. In the second — the approval of a specific transaction — the underlying question was the much more straightforward one of whether a seemingly independent director had approved (or blocked) a transaction because it benefited management, rather than because it was good for the company and its public stockholders. What was common to both areas was that the deep question was about the mens rea test used to set the threshold for liability for the independent directors.

*Stone v. Ritter* did not cut off the need for courts to consider these questions. But, it did do something that will likely influence the evolution of Delaware law in an important way. By making clear that the duty to act in good faith was a subsidiary component of the duty of loyalty, it simultaneously made clear that the judiciary was charged with distinguishing between loyalty claims dependent on a showing that a director acted in bad faith, on the one hand, and due care claims, on the other. Indeed, because Delaware had already set the liability standard for care claims at gross negligence, *Stone v. Ritter* made plain that the judiciary could not hold a director liable for a failure in monitoring simply because her conduct was grossly negligent, even

though gross negligence requires an extreme deficiency in performance. Rather, to hold an independent director liable for a failure in monitoring, the plaintiff had to prove that the independent director acted in bad faith. Evidence of gross or inextricable sloppiness remained relevant to that scienter determination, but it was only evidence, and not a substitute for a director-specific determination of an illicit state of mind.<sup>242</sup>

We purposely avoid any prediction about the refined shape of the bad faith mens rea inquiry that Delaware courts will use in the future or any suggestions about how they should give more definition. But we do venture that the categorical line that *Stone v. Ritter* drew is not new to Anglo-American jurisprudence. Although corporate lawyers are discomfited by the idea that the consequences a defendant might face will turn on the imperfect inference a fact-finder (or 12 fact-finders on a jury) draws about the

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<sup>242</sup> We are keenly aware that the dividing line between concepts of gross negligence and of bad faith can blur, precisely because, if properly employed, the concept of gross negligence requires conducts so grossly disparate from that expected, that the person engaging in such behavior almost invites suspicions about her state of mind. *See, e.g.*, 57A AM. JUR. 2D *Negligence* § 227 (“‘Gross negligence’ is commonly defined as very great or excessive negligence, or as the want of, or failure to exercise, even slight or scant care or ‘slight diligence.’ . . . In some jurisdictions, the term ‘gross negligence’ also encompasses conduct that ‘smacks of intentional wrongdoing.’”); 27 RICHARD A. LORD, WILLISTON ON CONTRACTS § 70:49 (4th ed. 2003) (defining “gross negligence” as “the want of even scant care or an extreme departure from the ordinary standard of conduct”). Indeed, some of the post-*Van Gorkom* decisions contributed to this blur by conflating the corporate law definition of gross negligence with that of recklessness, *see, e.g.*, *Tomczak v. Morton Thiokol, Inc.*, 1990 WL 42607, at \*12 (Del. Ch. Apr 5, 1990) (“[G]ross negligence means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.” (internal quotations omitted)); *Solash v. Telex Corp.*, 1988 WL 3587, at \*9 (Del. Ch. Jan. 19, 1988) (to be grossly negligent, a “decision has to be so grossly off-the-mark as to amount to ‘reckless indifference’ or a ‘gross abuse of discretion’”), thus confusing two concepts that are often kept distinct in other contexts where mens rea is important. *See, e.g.*, Model Penal Code § 2.02 (separating recklessness from negligence in its definitions of the mental states required for culpability); *cf.* PROSSER AND KEETON ON THE LAW OF TORTS § 34 (5th ed. 1984) (noting that several courts “have construed gross negligence as requiring willful, wanton, or reckless misconduct . . . [b]ut [that] it is still true that most courts consider that ‘gross negligence’ falls short of a reckless disregard of the consequences, and differs from ordinary negligence only in degree, and not in kind”). Moreover, *Van Gorkom*’s decision to embrace a gross negligence standard as the requirement for holding a director liable for the breach of duty of care, and the legislative response in § 102(b)(7) to allow exculpation of duty of care claims established the arguably fine line between gross negligence and bad faith as the boundary between exculpated and non-exculpated behavior. To our mind, however, this reality does not diminish the importance of good faith’s role in implementing the duty of loyalty; it makes it even more important. To be faithful to exculpatory statutes like § 102(b)(7), courts must distinguish between director conduct that only involves gross negligence and that which involves bad faith.

defendant’s state of mind, that idea is a bedrock part of our legal tradition.<sup>243</sup> In the criminal context, the state of mind of the defendant committing an act is often the key determinant of whether he has committed a felony or misdemeanor, and of what punishment he faces.<sup>244</sup>

An area of law that might not seem immediately analogous to how to evaluate whether directors are liable for failures in monitoring — family law — draws a distinction very similar to that drawn in *Stone v. Ritter*. In most states, parents can lose custody if they engage in neglect. But neglect typically does not involve an act of simple negligence; rather, it more commonly means a conscious and persistent pattern of violating the duty of care owed by a parent to a child.<sup>245</sup> In other words, family law, like

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<sup>243</sup> See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976) (holding that scienter is requirement for a violation of Rule 10b-5, the general anti-fraud provision of the Securities Exchange Act); 18 U.S.C. § 472 (including an intent to defraud requirement as part of the crime of counterfeiting obligations of the United States); see also John S. Baker, Jr., *Revisiting the Explosive Growth of Federal Crimes*, at 7, available at [http://www.heritage.org/Research/LegalIssues/upload/lm\\_26.pdf](http://www.heritage.org/Research/LegalIssues/upload/lm_26.pdf) (detailing that 74 of the 91 federal criminal statutes passed between 2000 and 2007 contained a mens rea requirement). Indeed, those same corporate lawyers often draft agreements that turn on a party’s state of mind. See, e.g., *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008) (interpreting and applying a term in a merger agreement that provided for uncapped damages in the case of a “knowing and intentional breach” of the agreement).

<sup>244</sup> See, e.g., MODEL PENAL CODE § 210 (varying the type of criminal homicide based primarily on the offender’s mental state); 1 CHARLES E. TORCIA, *WHARTON’S CRIMINAL LAW* § 27 (15th ed. 1993) (“In the ordinary case, an evil deed, without more, does not constitute a crime; a crime is committed only if the evil doer harbored an evil mind.”); see also MODEL PENAL CODE § 202 (defining the mental states required for culpability); 18 U.S.C. § 2 (“Whoever *willfully* causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.” (emphasis added)); 18 U.S.C. § 115(a)(1)(B) (“Whoever--(B) threatens to assault, kidnap, or murder, a United States official, a United States judge, a Federal law enforcement officer, or an official whose killing would be a crime under such section, *with intent* to impede, intimidate, or interfere with such official, judge, or law enforcement officer while engaged in the performance of official duties, or *with intent* to retaliate against such official, judge, or law enforcement officer on account of the performance of official duties, shall be punished as provided in subsection (b).” (emphasis added)); 18 U.S.C. § 1111 (defining murder to be “the unlawful killing of a human being *with malice aforethought*” and first degree murder to include “*willful, deliberate, malicious, and premeditated* killing” (emphasis added)).

<sup>245</sup> N.Y. Social Services Law § 384-b (stating that parental rights may be terminated permanently if a parent has failed “*substantially and continuously or repeatedly* to maintain contact with or plan for the future of the child” during an extended period of time during which the child was in protective custody) (emphasis added); 23 Pa.C.S.A. § 2511 (stating that parental rights may be permanently terminated based on “[t]he *repeated and continued* incapacity, abuse, neglect or refusal of the parent has caused the child to be without essential parental care, control or subsistence necessary for his physical or mental well-being and the conditions and causes of the incapacity, abuse, neglect or refusal cannot or will not be remedied by the parent”); 1 THOMAS JACOBS, *CHILDREN & THE LAW*:

the context involved in *Caremark*, often involves a court in the difficult exercise of determining whether someone's deviations from her duty of care are so substantial that they are categorically different from a mere or even gross lapse of situational judgment. Put simply, there is nothing new about recognizing that a conscious failure to make a good faith effort to comply with the required duty of care is categorically distinct from a mere failure to fulfill that duty in a specific circumstance.<sup>246</sup>

Just as readily, however, we admit that simply because there is nothing new about such line-drawing does not make that line-drawing any easier. Indeed, recent cases where stockholder plaintiffs have attempted to hold independent directors liable for approving a particular transaction or making a discrete decision prove the point. In these cases, the plaintiffs have argued that the independent directors, despite having no motive to injure the company, acted in subjective bad faith. In support of those arguments, the plaintiffs have pointed to alleged failures in care as exemplifying and creating an inference of a director attitude of bad faith. Courts have not flatly rejected arguments of this type, even after *Stone v. Ritter*, and there remains controversy over what

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RIGHTS AND OBLIGATIONS § 3:5 (“Parental rights to custody and control of a child may be terminated in the case of a seriously neglected child. Generally, the court will require clear and convincing proof that the acts of neglect are ‘willful’ and that serious harm to the child has resulted from the neglect.”).

<sup>246</sup> See *supra* Part IV(C) and (D). A contemporaneous discussion of the debate preceding the adoption of § 102(b)(7) suggests that the participants in that debate recognized the categorical distinction between the failure to exercise due care in a particular situation and a pattern of sustained inattention:

The Delaware courts have made it quite clear that liability for failure to exercise due care in decisionmaking is predicated on concepts of gross negligence. Critics argue that such a doctrine exposes directors to personal liability on a tort theory, a jurisprudential concept which may not be appropriate in the boardroom setting, *absent a pattern of sustained inattention*.

E. Norman Veasey & Jesse A. Finkelstein, *New Delaware Statute: Allows Limits on Director Liability and Modernizes Indemnification Protection*, BUS. LAW. UPDATE, July/August 1986, at 1 (emphasis added).

circumstances generate a genuine inference of bad faith and whether the judiciary is sufficiently distinguishing between concepts of gross negligence and bad faith.<sup>247</sup>

But that does not mean that the doctrinal clarity provided by *Stone v. Ritter* is not important. Rather, the clear holding that the inquiry into good faith is an instrumental way of determining whether an act of disloyalty was committed provides a disciplinary focus to the judicial inquiry. To be true to *Stone v. Ritter*, the judiciary must ask the question whether a particular director accused of disloyalty has committed a breach by taking action in bad faith. Subjectivity in judicial treatment is ultimately required, even if, as in every situation when a fact-finder must make a state of mind determination, the objective circumstances are likely to be highly relevant and important.

This doctrinal clarity is also important for the policy debate. There are plausible arguments that can be made that well-paid independent directors hired mostly to be monitors ought to be subject to damages if they commit an act of gross negligence. Rather than push that argument directly, though, some advocates had used the *Technicolor*-inspired notion of a free-standing duty of good faith to pursue that argument in a less than overt way, by infusing the new duty with the spirit of *Van Gorkom* and pushing it away from a more rigorous standard dependent on a showing that the director acted in subjective bad faith. *Stone v. Ritter* made plain that opponents of § 102(b)(7)

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<sup>247</sup> Compare *Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427 (Del. Ch. Jul. 29, 2008) (denying defendant directors' motion for summary judgment in a stockholder class action because the record did not clearly demonstrate the absence of issues of material fact with respect to the board's good faith discharge of its fiduciary duties) with *McPadden v. Sidhu*, 2008 WL 4017052, at \*1 (Del. Ch. Aug. 29, 2008) (dismissing a stockholder suit despite a finding of gross negligence and observing that the "sometimes fine distinction between a breach of care (through gross negligence) and a breach of loyalty (through bad faith) is one illustrated by the actions of the board in this case"); In *Re Lear Corp. S'holder Litig.*, 2008 WL 4053221, at \*11 (Del. Ch., Sept. 2, 2008) ("Courts should . . . be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith.").



provisions had to make their case in forums other than courts, by pushing boards to amend charters to repeal exculpatory provisions or pushing the Delaware General Assembly to repeal § 102(b)(7). That is, these advocates had to make the straightforward argument that the duty of care ought to be enforceable through a damages award and prevail on that argument at the ballot box or in the legislature.

Meanwhile, in litigation, *Stone v. Ritter* reaffirmed the traditional relationship of good faith to the duty of loyalty, which is as the definition of a loyal state of mind. This puts plaintiffs to the test of proving that directors who have not engaged in self-dealing acted with a state of mind inconsistent with their duty of loyalty, and fact-finders to the corresponding challenge of delivering defendant-specific answers. Conceived this way, *Stone v. Ritter* did not denigrate the importance of the concept of good faith in corporate law. Rather, it restored that concept to its historically critical role in helping to define, and therefore to enforce, the most critical fiduciary duty: the duty of loyalty.