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NOT IN GOOD FAITH

Elizabeth A. Nowicki*

Abstract

Corporate directors are obligated to act “in good faith,” and directors face personal monetary liability to their shareholders for acts “not in good faith.” Yet no modern court has imposed liability accordingly. Every time the issue of a director’s good faith comes up in court, the court forces the complaining shareholder to prove that her directors acted affirmatively in bad faith as opposed to merely in the absence of good faith. The judiciary completely misses the point that acts lacking good faith are not always the same as acts affirmatively taken in bad faith. A director can act in the absence of good faith without going so far as to act affirmatively act in bad faith. More troubling, the academics who write in the area of corporate law also completely miss the distinction between acts showing a lack of good faith—acts “not in good faith”—and acts in bad faith.

This wordsmith failure changes the entire nature of a director’s duty to her shareholders, and it renders impotent a director’s obligation to act in good faith. This becomes most evident when reviewing allegations of director inattention. For example, if a director votes on her CEO’s compensation package without actually reading the compensation agreement because it is not finalized in time for the board meeting, that director is not acting in good faith. Yet she is also not affirmatively acting in bad faith—she is not deliberately trying to hurt the corporation. Her vote is simply an inattentive act—an act not in good faith. Given the judiciary’s use of a bad-faith standard when reviewing whether a director acted in good faith, the inattentive or half-hearted director will never face liability.

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On a personal note, I much regret that my friend and mentor, Columbia Law School great E. Allan Farnsworth, did not live to learn of this “not in good faith” paper. It would have been exciting to hear what one of the modern molders of “good faith” as it pertains to contract law thought of my “not in good faith” theory. I am fortunate, however, in that fiduciary duty law gurus Virginia Supreme Court Justice Donald Lemons, Delaware Vice Chancellor Leo Strine, and one other jurist who asked to remain anonymous all encouraged me in my efforts to make sense of “not in good faith.” I thank these three men for stepping in to fill the expert sounding board and mentoring voids left by my friend, Allen Farnsworth. Requiescat in pace, Professor Farnsworth.

This paper exposes in detail the problems that stem from this careless linguistic substitution, and this paper argues for a sea change among the judiciary and members of the academy who insist on bastardizing a director's obligation to act in good faith. The erosion of a director's obligation to act in good faith does not bode well for the modern corporation and the economy, and a meaningful interpretation of "not in good faith" is necessary to help halt that erosion.

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INTRODUCTION

THE phrase "not in good faith" might seem odd as a title of a law review article. Further, an article primarily about the difference in meaning between the phrase "not in good faith" and the phrase "bad faith" might seem exceedingly trite. In any realm other than corporate law and governance, these assessments might be accurate. In the realm of corporate law, however, the phrase "not in good faith" is incredibly powerful. Every investor in the stock market should pay close attention to the phrase "not in good faith," since it is the key to preventing another decade of lethargic corporate governance. However, little notice has been paid to this phrase.

Allow me to create a context for this discussion: Directors manage corporations that are owned by shareholders, and directors therefore have a

fiduciary relationship with the corporation and its shareholders.¹ However, despite the demanding standards of conduct usually imposed on fiduciary relationships,² directors have historically been treated with a deference that belies the critical nature of their position of trust and confidence.³ Despite the host of issues that arise from managing other people's money, the actions of directors vis-à-vis their corporation are almost always viewed as beyond judicial scrutiny. Essentially, an outside director is only obligated to act "in good faith;" an outside director is only liable to shareholders for acts "not in good faith."⁴

Courts and academics, however, have substituted the phrase "bad faith" for the phrase "not in good faith" when reviewing a director's alleged failure to act in good faith. This linguistic manipulation might not appear to mean much; indeed, common parlance readily substitutes the phrase "bad faith" for the phrase "not in good faith." In the context of director liability, however, replacing the phrase "not in good faith" with "bad faith" robs shareholders of the only basis on which they can credibly have any hope of holding their directors accountable.

The import of this substitution is best considered against the corporate landscape over the past decade or so, littered with corporate governance failures, scandals, capital-raising and disclosure chicanery, incestuous business dealings, and general stockholder disregard. The behemoth Enron went completely bankrupt, due in large part to corporate dishonesty and hubris,⁵ and WorldCom investors suffered a similar fate as mismanagement and financial tomfoolery came to light.⁶ The investors in Tyco, Adelphia, and numerous other corporations fell victim to the same ilk of wrongs, ranging from simple financial mismanagement, lapses in ethics,⁷ executive gluttony,⁸ and corporate governance abdication,⁹ to dishonest

1. MELVIN A. EISENBERG, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 203 (8th ed. 2000).

2. Gregory S. Alexander, *A Cognitive Theory of Fiduciary Relationships*, 85 *CORNELL L. REV.* 767, 774 (2000).

3. See *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 810 (N.Y. App. Div. 1976) (discussing the deference usually given to corporate directors and officers).

4. *CORPORATE GOVERNANCE: LAW AND PRACTICE* § 6.02 (Bart Schwartz & Amy L. Goodman eds., 2005).

5. Thomas S. Mulligan, *The Enron Verdicts*, *L.A. TIMES*, May 26, 2006, at A1.

6. Shawn Young, Henry Sender & Deborah Soloman, *Lending the News: Worldcom Gets Judge's Approval for \$570 Million in Financing*, *WALL ST. J.*, July 23, 2002, at A3.

7. Owen Moritz, *Bada Boeing! CEO Out 37M*, *DAILY NEWS (N.Y.)*, Mar. 11, 2005, at 18 (discussing how former Boeing CEO, Harry Stonecipher, violated the company code of ethics when he had an affair with a company vice-president).

8. Mark Maremont, *Frequent Fliers: Amid Crackdown, the Jet Perk Suddenly Looks a Lot Pricier*, *WALL ST. J.*, May 25, 2005, at A1 (discussing personal use by corporate executives of corporation-owned jets for personal use; values of the personal use often well above \$500,000).

9. The Washington Post quoted Carl Icahn's discouraging observations about board behavior: "Literally, half the board is dozing off. The other half is reading the Wall Street Journal. And then they put slides up a lot and nobody can understand the slides and when it gets dark they all doze off." *Asleep in the Boardroom*, *WASH. POST*, May 23, 2002, at A32.

disclosure and other outright crimes.¹⁰ The late 1990s brought a series of corporate “scandals” that were devastating to many stockholders. Thousands of investors lost the stock they were counting on for retirement.¹¹ While much of this financial bloodshed likely could have been avoided had the directors of the corporations at issue been paying closer attention, not a single director was pilloried for these corporate failures.

A non-corporate-law scholar might wonder why corporate directors who so clearly fell asleep at their corporate helms walked away from the corporate carnage virtually unscathed—why Enron CEO Kenneth Lay was convicted of a felony while his directors, who failed to detect his flagrantly illegal conduct, appear to have kept their good names.¹² However, to a student of corporate law, the reason for this outcome is clear: The only tool shareholders have to render an outside director accountable is the director’s obligation to act in good faith, and courts have twisted this meaningful fiduciary obligation into the mere obligation to refrain from acting in bad faith. To the extent that personal liability was ever a motivator to keep directors on guard, it has ceased to be so.¹³

A director’s affirmative obligation to do right by his shareholders has been diluted over the past few decades into the impotent obligation to refrain from deliberately harming his corporation. This leaves shareholders with precious little leverage. In practice, given the difficulty of proving affirmative bad faith, an outside director’s obligation to act in good faith has been rendered all but meaningless. Refraining from affirmatively acting in bad faith requires very little of a director. The director is free to prioritize other interests above those of the corporation, fail to exercise thorough oversight, and generally be inattentive, leashed only by his obligation to refrain from affirmatively trying to harm or act against the interests of his corporate charge. So when a shareholder complains that her director failed to follow-up on a costly technology lapse,¹⁴ failed

10. Constance L. Hays, *As Stewart Attends Hearing, Company Studies Options*, N.Y. TIMES, Mar. 9, 2004, at C2 (discussing the board of directors of Martha Stewart Living Omnimedia grappling with Martha Stewart’s position with the company after she was convicted of criminal obstruction of justice).

11. See David Barboza, *From Enron’s Rubble, Life on a Luxury Tightrope*, N.Y. TIMES, May 19, 2002, § 3, at 1 (stating that thousands of former Enron employees lost millions of dollars in retirement benefits); see also Ronald Brownstein, *Enron Fallout Proves Personal Loss Can Have Big Political Consequences*, L.A. TIMES, Feb. 20, 2002, at A10 (discussing how widespread increases in the diversity of stock ownership over the past twenty-five years have led to wide-spread interest in the Enron scandal and resultant Enron stock decimation).

12. Mulligan, *supra* note 5, at A1.

13. Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERKELEY BUS. L.J. 315, 329 (2005) (“[F]iduciary duties and personal liability rules fail to create a sufficient incentive to act in the best interest of the corporation.”).

14. Paul Davies & Joann S. Lublin, *Director’s Choice, As Crises Pile Up, Bristol CEO Relies on Board Allies*, WALL ST. J., July 1, 2005, at A1 (discussing how, despite Bristol-Myers Squibb’s CEO Peter Dolan’s bungling of a new product potential release (Erbitux) and related “channel-stuffing” to account for lost revenues, the Bristol-Myers board allowed Dolan to keep his job); accord Barbara Martinez & Ilan Brat, *Vioxx Posed Heart Risk After Just a Few Weeks, Data Suggest*, WALL ST. J., July 26, 2005, at A17 (discussing

to read financial statements littered with misstatements,¹⁵ ignored shareholder concerns,¹⁶ or skipped the annual meeting,¹⁷ courts will do nothing unless the complaining shareholder can establish the notoriously elusive element of bad faith.

For those who believe that legal liability is one of the precious few ways to motivate directors to do their jobs well,¹⁸ this “good faith”/“bad faith” substitution is devastating. Obligating a director to merely refrain from acting in bad faith is a paltry legal obligation. When forced to prioritize obligations, professional or personal, a director who is only accountable for bad faith acts is more likely to short-change her corporation over another, more empowered, demanding constituency, such as a spouse. This is not to say that directors are ill-intentioned or sluggards—they are not. They are, however, busy professionals who often do not have enough time in the day to pay careful attention to all of their personal and business responsibilities.¹⁹ It would be naïve to think that directors, when forced to choose how they prioritize their time and resources, always put their corporate charges at the top of their list, given the lack of penalties for not fully prioritizing the corporation.

It is for this reason that all investors in the public markets should care how the phrase “not in good faith” is defined. To the extent that the phrase “not in good faith” is the only stick available in a world where carrots are freely offered, the phrase deserves close consideration. Successful lawsuits against directors who failed to fulfill their obligation to act in good faith should go far to inspire corporate governance self-reform. For this reason, the measly phrase “not in good faith” merits its own article.

In this Article, I reexamine what it means for a director to act in good faith and what it means for a director to *fail* to act in good faith. I examine what courts and contemporary corporate-law scholars have indi-

research which shows that even early clinical trials of Vioxx offered results indicating that the risk of increased heart problems among Vioxx users was statistically significant; no indication that Merck’s board of directors ever pushed for more data regarding Vioxx trials.)

15. Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 417–20 (2004) (discussing Enron’s misleading financial statements).

16. Merissa Marr, *One Year Later, Disney Attempts Smoother Ride*, WALL ST. J., Feb. 7, 2005, at B1 (discussing the lack of board action regarding the 45% of investor shares which voted to withhold support for Disney CEO Eisner being re-elected to the board).

17. Chad Terhune, *Home Depot’s Critics Tear into Firm’s Practices, Conduct*, WALL ST. J., May 27, 2006, at B3.

18. See James Andreoni, William Harbaugh & Lise Vesterlund, *The Carrot or the Stick: Rewards, Punishments, and Cooperation*, 93 AM. ECON. R. 893, 894 (2003) (discussing the value of punishment as compared to reward); accord Linda D. Molm, *Is Punishment Effective? Coercive Strategies in Social Exchange*, SOC. PSYCHOL. Q. Jun. 1994, at 75 (testing competing predictions about the effectiveness of coercive strategies in social exchange).

19. See Abigail Aims, *2005 Trends in Corporate Governance Practices of the 100 Largest U.S. Public Companies*, 1523 PRAC. L. INST.—CORP. 223, 247 (2006) (reporting on multiple-board membership among directors at 100 large U.S. companies).

cated regarding a director's obligation to act in good faith, and how these groups have resorted to defining "not in good faith" as "bad faith." Ultimately, in this Article, I debunk the myth that it is acceptable for a court examining the question of whether a director acted in the absence of good faith to instead examine whether the director acted in bad faith, and I propose a simple structure within which to assess whether a director failed to honor his obligation to act in good faith.

Part I of this Article, I describe generally a director's fiduciary duty of care as a foundation for the discussions in the rest of the Article. I explain the duty of care standard of conduct, and I examine the standard of review that is applied by courts when faced with an alleged breach of a director's duty of care. In a summarized fashion, I explore the workings of the ephemeral business judgment rule, which is best described as a protective presumption that is automatically afforded to a director whose conduct is under judicial review based on an alleged breach of the duty of care. The business judgment rule presumption works to protect directors from being second-guessed by complaining shareholders and governs when the presumption's protections will be stripped from a director. Next, Part I briefly explores legislative limitations on a director's liability exposure, ending with a summary of the critical role of the phrase "good faith" in the duty of care and director liability calculus.

Part II of this Article contains a brief definitional analysis of the phrases "good faith," "not in good faith," and "bad faith." This Part examines the literal meanings of these phrases and uses the examination to compare, and ultimately contrast, the definitions of bad faith and not in good faith as they apply to director conduct. Showing how the phrases differ in meaning (though they sometimes overlap in application), Part II discusses the troubling trend of defining a director's fiduciary obligation to act in good faith as simply the obligation to *refrain from acting in bad faith*. I make the argument that, as a matter of linguistics, the phrases "bad faith" and "not in good faith" simply cannot be interchanged in the corporate law context. It is one thing to require those entrusted with investors' money to act "in good faith," and it is quite another to require those fiduciaries to merely refrain from acting "in bad faith."

Part III of this Article discusses two additional ramifications of the bad faith substitution: Requiring a complaining shareholder *qua* plaintiff to prove that a director acted in true bad faith, as opposed to having to prove that a director exhibited a lack of good faith, imposes a burden on the plaintiff beyond that which she should rightfully carry. Bastardizing the phrases "good faith" and "not in good faith" erodes one of the pillars of corporate governance—the obligation of corporate agents to act in the best interests of the corporation.

Part IV of the Article revisits a few topics that appear and reappear in the broader director liability dialogue. Debate regarding the "not in good faith" interpretation and application I advocate in this Article is likely to lead naysayers to raise concerns regarding Delaware's infamous

case of *Smith v. Van Gorkom*, directors and officers insurance, and the potential for the director pool to dry up in response to liability exposure focus. In this part, I show that (a) *Smith v. Van Gorkom* did not, contrary to popular belief, expand the personal liability of directors for fiduciary duty breaches, (b) the fear that imposing personal liability on directors for acts “not in good faith” will lead to a directors’ and officers’ insurance crisis is unfounded, and (c) holding directors accountable for acts “not in good faith” will not significantly impact the market for qualified corporate directors. In a related vein, Part V of the Article discusses a few practical points pertaining to mitigating director liability for fiduciary duty breaches, such as professional directors and corporate governance best practices.

I. A DIRECTOR’S FIDUCIARY DUTIES

The corporate form is defined by the separation of ownership from control.²⁰ Shareholders “own” the corporation, but the board of directors “controls” the corporation: directors are statutorily charged with managing the business and affairs of the corporation.²¹ This separation is beneficial to the passive investor, but it raises an interesting issue: How

20. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 84–89 (1948).

21. *Id.*; see *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. 1985) (discussing the separation of ownership and control); see also Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 141(a) (2001) (providing the statutory separation of ownership and control). Most boards of directors of large contemporary corporations delegate their authority for managing the daily minutia of the corporation to executive officers, pursuant to the authority to delegate given to directors in section 141(a) (or the equivalent in the statutory code for the state in which the corporation is incorporated). (Delaware will be used as the primary state of reference for purposes of statutory analysis or close examination of case law, given that Delaware is home to 60% of the Fortune 500 and 50% of all publicly traded companies in the United States. See Delaware Division of Corporations, <http://www.corp.delaware.gov/>.)

Much has been written about the ramifications of Delaware’s pro-management statutory and judicial efforts to encourage corporations to incorporate in Delaware and whether Delaware’s efforts and the responsive efforts of other states have led to a “race to the bottom” in terms of corporate management deference and protection. *E.g.*, ARTHUR R. PINTO & DOUGLAS M. BRANSON, *UNDERSTANDING CORPORATE LAW* § 1.08, at 14 (1st ed. 1999) (citing William Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L.J. 663 (1974)); accord *Liggett v. Lee*, 288 U.S. 517, 557–58 (1933) (Brandeis, J., dissenting); see generally DEL. STATE DEPT., CORP. DIV., 2005 ANNUAL REPORT (2005), <http://www.corp.delaware.gov/2005%20doc%20ar.pdf> (including statistics and discussing Delaware’s efforts to increase the number of corporations incorporated in Delaware).

The “race to the bottom” discussion is both fascinating and beyond the scope of this Article. That said, I am increasingly sympathetic to Professor Lawrence Mitchell’s position:

The laxity of Delaware law, or its significance, has long been a subject of dispute. With such shameful and disingenuous opinions as *In re Caremark Int’l*, 698 A.2d 959 (Del. Ch. 1996) and *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997), I believe the matter can no longer be in dispute.

Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance*, 48 VILL. L. REV. 1189, 1189 n.2 (2003). Professor Mitchell reflects what was so poetically penned by other corporate-law scholars about Delaware almost a decade prior:

Predicting the course of Delaware law from prior case law is like watching clouds. They seem, at times, to take on recognizable shapes and forms, even

should directors manage assets owned by a different constituency, the shareholders?²² Because corporations do not have the unity of ownership and control exhibited in a sole proprietorship, where the owner herself directly manages her business, some minimum behavioral standards for directors are needed to ensure that corporate directors devote the same attention and effort to the corporation as they would devote to a business owned by them personally.²³ For this reason, directors have been charged with fiduciary duties: Directors are fiduciaries both of their shareholders and the corporation.²⁴

Directors have two distinct fiduciary duties: the duty of loyalty and the

to resemble something familiar. But you know that whatever shapes you think you see can vanish in a puff of wind.

Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)*, 49 *BUS. LAW.* 1593, 1626 (1994).

22. A useful discussion of the issues underpinning this question is discussed in STEVEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS*, §§ 5.2–5.3, at 194–95 (2002).

23. See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 *VAND. L. REV.* 83, 85–86 (2004) (discussing the two competing views among academics as to which constituency's interests—directors' or shareholders'—shall prevail). Whether directors actually prioritize shareholder interests as opposed to the directors' own interests has been the fodder for much debate. Some academics embrace the "shareholder primacy model" of corporate governance, and other scholars instead focus on the "director primacy model" of corporate governance. For purposes of this discussion, we step away from this theoretical distinction, because neither perspective alters the fact that directors are inarguably fiduciaries for *something else* (the corporation) or *someone else* (the shareholders). Directors generally own stock in the corporation, such that they are shareholders, but they are also paid a salary and often awarded already in-the-money stock options such that they do not "need" an increase in the net present value or the market value of the corporation to the same degree that a mere shareholder, not drawing a salary from the corporation, will value.

24. There is not absolute agreement on what *specific* fiduciary label is appropriate for directors—whether agent, trustee, or something else. Corporate officers and directors have traditionally been viewed as agents. FLOYD R. MECHEM, *A TREATISE ON THE LAW OF AGENCY* 33–34 (1889) ("[O]nly through the employment of agents [can] the executive functions of the corporation be exercised."); FRANCIS B. TIFFANY, *HANDBOOK OF THE LAW ON PRINCIPAL AND AGENT* 104, 187–88 (2d ed. 1924) ("a corporation . . . can act only through the intervention of agents") ("The corporate executive . . . is an agent for the shareholder."); see also VICTOR MORAWETZ, II *THE LAW OF PRIVATE CORPORATIONS* § 575, 547 (2d ed. 1886) ("There are few acts which a corporation aggregate can possibly perform without the intervention of an agency of some kind," such that "[c]orporations almost invariably act through agents.").

Yet, some scholars argue that officers and directors cannot be agents because the relationship between the director and the shareholder (the "agent" and the "principal," as it were) is not a product of contract, as it would be in the traditional agency relationship. Robert C. Clark, *Agency Costs Versus Fiduciary Duties, in PRINCIPALS AND AGENTS: THE STRUCTURE OF A BUSINESS* 56 (John W. Pratt and Richard J. Zeckhauser eds., 1985) ("[D]irectors are not agents of the corporation but are *sui generis* . . . neither [are] directors . . . agents of the stockholders[.]").

Additionally, case law also indicates that the director-shareholder-corporation relationship involves both a trust relationship *and* an agency relationship:

[T]he ordinary rules of law relating to an agent are applicable in considering the acts of a board of directors in behalf of a corporation when dealing with third persons [Whereas] [t]he relation of the directors to the stockholders is essentially that of trustee and *cestui que trust*.

People *ex rel.* Manice v. Powell, 94 N.E. 634, 637 (N.Y. 1911). Yet the Restatement Third of Trusts notes that:

duty of care.²⁵ To fulfill her duty of loyalty, a director is obligated to act

There are many similarities and also differences in the roles and duties of trustees and those of corporate officers or directors, partners of various types of partnerships, and member-managers of limited-liability companies.

For example, trustees and corporate officers and directors, as fiduciaries, manage the affairs, respectively, of the trust or the corporation for the benefit of the beneficiaries or the shareholders. Corporate officers and directors, however, do not hold title to the property of the corporation and therefore are not trustees; accordingly their fiduciary duties are not within the scope of this Restatement.

RESTATEMENT (THIRD) OF TRUSTS § 5 cmt. g (2003).

Regardless of the debate about which specific fiduciary label to put on directors, it is undisputed that directors hold *some* sort of fiduciary relationship with respect to their corporation and its shareholders. See *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (1996). This fiduciary nature, regardless of its precise categorization, brings with it fiduciary duties.

25. The two fiduciary duties of directors have historically been the duty of care and the duty of loyalty. See *Ostrowski v. Avery*, 703 A.2d 117, 121–22 (Conn. 1997); see also *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003). Interestingly, however, over the past several years, the Delaware Supreme Court has, on occasion, referred to the fiduciary duties as a “triad,” including the duties of care, loyalty, and good faith. See *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (“The directors of a Delaware corporation have a triad of primary fiduciary duties: due care, loyalty, and good faith”). This third duty—the duty of good faith—appears to have become a “duty” (which I take to mean something beyond merely an obligation, and something for which independent recourse exists) essentially overnight. Compare *id.*, and *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 54 (Del. 1989) (“Eight of Fairchild’s nine directors are charged with breach of their fiduciary duties of good faith and due care. . . .”), with *Paramount Comm’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994) (“[T]he directors must act in accordance with their fundamental duties of care and loyalty.”) (quoting *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989), and citing *Mills Acquisition Co. v. Macmillan*, 559 A.2d 1261, 1280 (Del. 1989)), and *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (referring to “the triads of [a directors’] fiduciary duty—good faith, loyalty or due care”). The Delaware Supreme Court has never explained where they pulled this third duty from, and, indeed, more than one jurist on the Delaware Chancery Court has questioned the appearance of this new “duty.” *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003). In addition, the Delaware Supreme Court has not been consistent in including this duty of good faith in its recitations of a director’s fiduciary duties. While I certainly agree that directors have the obligation to act in good faith, the obligation to act in good faith has historically been subsumed both in the duty of care and the duty of loyalty as opposed to being a stand-alone duty. See *Continuing Creditors’ Comm. of Star Telecomms. Inc. v. Edgecomb*, 385 F. Supp. 2d 446, 440 n.9 (D. Del. 2004) (“Although the Plaintiff also invokes the duty of good faith as separate from the duty of loyalty, Delaware case law states that the two duties are identical.”) (quoting *Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000)).

For purposes of this Article, I am ignoring the duty of loyalty. Professor Lyman Johnson, however, makes a convincing argument that the duty of care issues that come up in cases such as *Smith v. Van Gorkom*, 488 A.2d at 864, and *In re Walt Disney Co. Derivative Litig.*, 825 A.2d at 286, could also be addressed as duty of loyalty issues. Lyman P.Q. Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003). Are you being loyal, Professor Johnson would ask, and are you being *faithful*, when you (the director) pay little attention to the compensation of senior executives (for example)? In a more user-friendly hypothetical, would we call a friend who we have authorized to use our money to pay our dogsitter while we are on vacation “loyal” if that friend gave the dogsitter a \$200 tip just because the dogsitter showed up every day (like she was obligated to do anyway)? No. Our friend was not loyal; she was frittering away our money needlessly. If we view “loyal” conduct in the director context the way we view “loyal” conduct in real life—faithful conduct for the benefit of the one to whom we are loyal—then many “duty of care” fact patterns could just as well be viewed as “duty of loyalty” cases. See generally Lyman P.Q. Johnson & David Millon, *Recalling Why Corpo-*

in a way that puts the interests of the corporation ahead of her own interests.²⁶ A director's fiduciary duty of care obligates her "to use that amount of care which ordinarily careful and prudent men would use in similar circumstances" when managing corporate affairs.²⁷ While this standard of conduct is already lenient, courts employ an even more generous standard of review when a director is alleged to have failed to meet the standard of conduct.²⁸ When reviewing an alleged breach of her duty of care, a director will be afforded the protection of the business judgment rule, which is a presumption in favor of the director, insulating the director from liability, unless the complaining shareholder can show that the director was conflicted, did not act in good faith, or was grossly negligent in becoming informed about the matter regarding which it is alleged she breached her fiduciary duty.²⁹ Only rarely is this business judgment rule presumption rebutted by a complaining shareholder, such that the

rate Officers Are Fiduciaries, 46 WM. & MARY L. REV. 1597 (2005) (discussing fiduciary duties in the context of the role that corporate officers and directors have played in recent corporate scandals).

26. In a situation where a director is "conflicted," such as when she has a business relationship with the corporation that she serves beyond simply her director relationship, she must favor first the interests of the corporation.

27. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); accord I DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, *THE BUSINESS JUDGMENT RULE* 109 (5th ed. 1998) ("[T]he duty of care requires that directors exercise the care that a person in a like position would exercise under similar circumstances."). Some states (such as New York and California) have codified the standard of conduct for directors, while other states (such as Delaware) have no such statutory provisions. See CAL. CORP. CODE § 309(a) (West 2007); NY BUS. CORP. LAW § 717 (2007); see generally PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) (1994).

28. See MELVIN ARON EISENBERG, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS* 544-45 (8th ed. unabridged 2000):

On their face, the duties of directors are fairly demanding, insofar as they are measured by reasonability. In practice, however, the standards of review applied to the performance of these duties are less stringent than the standards of conduct on which the duties are based.

Judge Winter of the Second Circuit Court of Appeals similarly went so far as to admit in an opinion:

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading . . . [A] corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation.

Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982).

29. The business judgment rule operates as a protective *presumption*, based on the assumption that "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action [at issue] was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citing *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971)); see also Norman E. Veasey, *Access to Justice*, 12 WASH. U. J.L. & POL'Y 1, 6 (2003). More specifically, the four factual assumptions identified in *Aronson* as justifying the business judgment rule presumption are (1) a decision having been made, (2) after the directors became reasonably informed about the matter at issue, and (3) the directors acted in good faith, (4) without any self-interest or conflict. *Aronson*, 473 A.2d at 812; accord *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (the business judgment presumption is based on the assumption that "the decision made was the product of a process that was either deliberately considered in good faith or was otherwise rational"). *Id.*

director's actions are subject to closer scrutiny.³⁰

Even in the rare case where shareholders are able to rebut the business judgment rule presumption, directors are usually insulated from personal liability by statutory provisions such as Delaware General Corporate Law (DGCL) section 102(b)(7), which provides that a corporation can include in its certificate of incorporation:

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

The business judgment rule presumption, with its very deferential “irrationality” standard of review, serves a sound policy goal: it encourages directors to exercise their discretion in making decisions based on then-existing facts without fear of being second-guessed. EISENBERG, *supra* note 28, at 547–48; see Stephen M. Bainbridge, *The Business Judgment Rule as an Abstention Doctrine*, 57 VAND. L. REV. 83 (2004) (discussing the two competing views among academics as to which constituency's interests shall prevail).

A lenient measure of post hoc review protects against hindsight bias. As a result of a systematic defect in cognition known as the hindsight bias, however, under a reasonableness standard of review fact-finders might too often erroneously treat decisions that turned out badly as bad decisions, and unfairly hold directors liable for such decisions, and experimental psychology has shown that in hindsight people consistently exaggerate the case with which outcomes could have been anticipated in foresight.

EISENBERG, *supra* note 28, at 25; see *Joy v. North*, 682 F. 2d 880, 886 (2d Cir. 1982) (“[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later . . .”). A court will not, therefore, second-guess a decision made by a director that, in hindsight, was merely wrong, a mistake, or an unfortunate choice among multiple options. BLOCK, *supra* note 27, at 109. Although the relatively recent Delaware case of *Aronson v. Lewis* is usually cited to support this deference, this concept is actually not a modern one. See, e.g., FLOYD R. MECHEM, *A TREATISE ON THE LAW OF AGENCY* § 502, 337–38 (1889) (“The law does not presume negligence on the part of the agent. On the other hand, it presumes that the agent has done his duty, until the contrary appears, and the burden of proof is upon him who alleges a misfeasance, to establish it.”).

This deference to directors is sensible, because we want directors to make somewhat “risky” decisions, given that “potential profit often corresponds to the potential risk.” *Joy*, 692 F.2d at 886 (discussing the risk and reward calculus that weighs in favor of directors sometimes making riskier decisions to achieve greater benefits for the shareholders because shareholders can diversify away a corporation's risk); see also Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 32 (1981). Shareholders, knowing of this risk-reward calculus, can either elect not to buy stock, given that the market offers an array of other investment vehicles, or shareholders can mitigate the risk inherent in any given investment by diversifying their investment portfolio and holding many different stocks in disparate industries. *Joy*, 692 F.2d at 885–86. The Second Circuit in *Joy* went so far as to say “[g]iven mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying.” *Id.* at 886. This diversification or voluntary decision to invest in stock with an understanding of the general volatility of the market frees the directors of each individual corporation to more broadly make appropriately risky decisions. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 233–35 (8th ed. 2000).

30. See *McGowan v. Ferro*, 859 A.2d 1012, 1028 (Del. Ch. 2004) (“If the director defendants had disabling conflicts of interest or acted in bad faith . . . they would have to prove the fairness of the transaction.”); EISENBERG, *supra* note 28, at 545–46 (discussing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993)).

breach of the director's duty of loyalty to the corporation or its stockholders; (ii) *for acts or omissions not in good faith* or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.³¹

This provision of the DGCL, which has been broadly used by most of the 300 Delaware-incorporated corporations on the Fortune 500, allows a business that is incorporated in Delaware to fully insulate its directors against personal liability for any fiduciary duty breach other than those in the limited categories of breach of the duty of loyalty and acts or omissions "not in good faith."³²

31. DEL. CODE ANN. tit. 8, § 102(b)(7) (2007) (emphasis added). Every state in the union except Ohio, Nevada, and Indiana has a statutory provision limiting a director's personal liability for duty of care breaches. See ALA. CODE § 10-2B-2.02 (adopted in 1994); ALASKA STAT. § 10.06.210 (adopted in 1988); ARIZ. REV. STAT. ANN. § 10-202 (adopted in 1987); ARK. CODE ANN. § 4-27-202 (adopted in 1987); CAL. CORP. CODE § 204 (adopted in 1987); COLO. REV. STAT. § 7-108-402 (adopted in 1993); CONN. GEN. STAT. § 33-636 (adopted in 1994); GA. CODE ANN. § 14-2-202 (adopted in 1987); IDAHO CODE ANN. § 30-1-202 (adopted in 1997); 805 ILL. COMP. STAT. 5/2-10 (adopted in 1994); IOWA CODE § 490.831 (adopted in 1989); KAN. STAT. ANN. § 17-6002 (adopted in 1987); KY. REV. STAT. ANN. § 271B.2-020 (adopted in 1988); LA. REV. STAT. ANN. § 12:24 (adopted in 1987); ME. REV. STAT. ANN. tit. 13-C, § 202 (adopted in 2001); MD. CODE ANN., CORPS. & ASS'NS §§ 2-104, 2-405.2 and MD. CODE ANN., CTS. & JUD. PROC. § 5-418 (adopted in 1988); MASS. GEN. LAWS ch. 156B, § 13 (adopted in 1986); MICH. COMP. LAWS § 450.1209 (adopted in 1987); MINN. STAT. § 300.64 (adopted in 1987); MISS. CODE ANN. § 79-4-2.02 (adopted in 1991); MO. REV. STAT. § 351.055 (adopted in 2000); MONT. CODE ANN. § 35-2-213 (adopted in 1991); NEB. REV. STAT. § 21-2018 (adopted in 1995); N.H. REV. STAT. ANN. § 293-A:2.02 (adopted in 1992); N.J. STAT. ANN. § 14A:2-7 (adopted in 1987); N.Y. BUS. CORP. LAW § 402 (adopted in 1987); N.C. GEN. STAT. § 55-2-02 (adopted in 1987); N.D. CENT. CODE § 10-19.1-50 (adopted in 1993); OKLA. STAT. tit. xviii, § 1006 (adopted in 1987); OR. REV. STAT. § 60.047 (adopted in 1987); R.I. GEN. LAWS § 7-1.1-48 (adopted in 1987); S.D. CODIFIED LAWS § 47-1A-202.1 (adopted in 1987); TENN. CODE ANN. § 48-12-102 (adopted in 1987); TEX. REV. CIV. STAT. ANN. art. 1302, § 7.06 (adopted in 1987); UTAH CODE ANN. § 16-10a-841 (adopted in 1992); VT. STAT. ANN. tit. 11A, § 2.02 (adopted in 1993); VA. CODE ANN. § 13.1-692.1 (adopted in 1988); WASH. REV. CODE § 23B.08.320 (adopted in 1989); W. VA. CODE § 31D-2-202 (adopted in 2002); WYO. STAT. ANN. § 17-16-202 (adopted in 1989). A few states offer statutory duty of care protection that differs slightly from Delaware's protection, but the differing statutes still serve to limit the personal liability exposure of the directors. For example, Virginia's statutory insulation offers directors protection via a monetary liability cap. The Virginia code limits the recoverable damages that can be garnered from any one director in any proceeding brought by or in the right of the corporation or its shareholders to the lesser of the monetary cap specified in the articles of incorporation or shareholder-approved by-laws, or the greater of \$100,000 or the cash compensation receive by the director from the corporation over the twelve months prior to the actions alleged to be fiduciary violations. See VA. CODE ANN. § 13.1-692.1(A) (2007).

32. In truth, the business judgment rule presumption as discussed in *Aronson* does exactly the same thing as section 102(b)(7) in terms of the protection it affords to directors. See *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223-25 (Del. 1999) (stating that the "statutory enactment of Section 102(b)(7) was a logical corollary to the common law principles of the business judgment rule"). Apparently, corporate directors wanted even more assurances than the business judgment rule presumption offered.

As an aside, as best I can tell, I am perhaps the only corporate law scholar who maintains that DGCL section 102(b)(7) does not insulate against duty of care violations if the violation is a result of the director's failure to act in good faith. Phrased differently, as I read *Aronson* together with DGCL section 102(b)(7), a stockholder in a corporation with a 102(b)(7) provision in its charter cannot sue for a duty of care violation if the claim is

Together, the business judgment rule presumption and state statutes such as DGCL section 102(b)(7) mean that a shareholder who is dissatisfied with the quality of management provided by disinterested directors,³³ whom he elected to act on his behalf, only has a chance of making it into the courtroom with a fiduciary duty claim if the director at issue was conflicted or acted “not in good faith.” As discussed in the introduction, it is for this reason that I maintain that the long-term health of corporate governance will hinge in part on the reigning interpretation and application of the phrase “not in good faith.” To the extent that one believes, as I do, that a successful lawsuit imposing personal liability on a director for acting in the absence of good faith has deterrent value or will serve to induce directors to be more thoughtful in their decision-making, the meaning and interpretation of “not in good faith” is far more significant than appears at first glance.

II. GOOD FAITH, BAD FAITH, AND “NOT IN GOOD FAITH”

A. GOOD FAITH

Before addressing “not in good faith,” it is necessary to define the phrase “good faith” as it is relevant in the context of a director’s actions. A clear definition of good faith is critical both to give directors guidance as to what is expected of them and to offer a standard against which to gauge alleged failings. Interestingly, the judiciary and contemporary academics have generally either refrained from defining good faith when assessing whether a director acted in good faith, or have defined the phrase without discussion.³⁴ Therefore, I addressed in depth in a recent article what it means for a director to act in good faith.³⁵

based on the director’s failure to become adequately informed prior to making a decision. However, in my view, the “good faith” language in DGCL section 102(b)(7) leaves room for a director to be sued on a duty of care claim that is *founded or based on allegations of the absence of good faith*, as opposed to allegations that the directors were grossly negligent in becoming informed.

33. For ease of analysis, I am limiting my discussion to disinterested directors to avoid having to discuss the duty of loyalty and the issue of conflicted directors. Do not take this to mean that I accede to the treatment by courts and most scholars of conflicted directors. I do not—both constituencies tend to (a) be disinclined to find a conflict on any but the most egregious of facts and (b) review even a conflicted director with a “fairness” review that often strikes me as meager. To facilitate a more straightforward “not in good faith” discussion, however, it is easier to limit the discussion to outside directors because they are not inherently conflicted or interested such that the business judgment rule presumption or DGCL section 102(b)(7) provisions are treated differently.

34. It is interesting that the Delaware Supreme Court has not yet thoughtfully analyzed and then defined “good faith” in the context of director liability, given the reputation of the court as the ultimate arbiter of corporate law. To be fair, I have found no evidence that the Delaware Supreme Court has been directly asked to define good faith. Indeed, in the recent Disney shareholder litigation where the issue of whether or not the directors acted in good faith was crucial, plaintiff-appellant’s counsel did not even once propose an affirmative definition of good faith. Opening Brief of Petitioner-Appellant, *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006) (No. 411, 2005), 2005 WL 2777912.

35. See Elizabeth A. Nowicki, *A Director’s Good Faith*, 55 BUFF. L. REV. 459 (2007).

In that article, I closely examined the definition of good faith from other areas of the law. I examined the role of good faith in the context of director conduct, and I assessed the value of the phrase “good faith” in the context of corporate governance. I concluded that importing a definition of good faith into the context of director conduct from other areas of law is not ideal, because most definitions of good faith are context-specific. The director-shareholder-corporation relationship confounds even the most well-established definition of “good faith” in the arms-length context, such as in the commercial law context, where the definition of “good faith” is generally agreed upon. That being said, I observed that most good faith definitions include some common themes, such as demanding honesty, lack of ill-intentions, fairness, full disclosure, and sincere attempts to honor an obligation. In addition, in the fiduciary context, including the areas of agency, trust, and insurance, the notion of good faith means “more than just the absence of the intent to harm.”³⁶ Good faith in these contexts includes the obligation to protect the interests of the person being served or to use all of one’s “power, influence, and skill” to serve one’s principal.³⁷ Taking honesty and an attempt to honor one’s agreements as a minimum and adding a definitional component to account for the fiduciary nature of the director liability context, I ultimately concluded that a sensible definition of good faith is “in the best interests of the shareholders.”³⁸ For purposes of the instant Article, I will use this definition of good faith.³⁹

36. See *Shell Oil Co. v. Nat’l Union Fire Ins. Co.*, 52 Cal. Rptr. 2d 580, 588 (Cal. Ct. App. 1996) (quoting *Smoral v. Hanover Ins. Co.*, 37 A.2d 23, 25 (N.Y. App. Div. 1917)).

37. *Myer v. Preferred Credit, Inc.*, 117 Ohio Misc. 2d 8, 32 (Ct. Com. Pl. 2001) (affirming award of punitive damages for mortgage broker’s improper, fraudulent, and dishonest dealings under the Mortgage Brokers Act).

38. *Black’s Law Dictionary* defines “good faith” as:

A state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one’s duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage.—Also termed *bona fides*.

BLACK’S LAW DICTIONARY 701 (8th ed. 2004). However, beneath the definition is a paragraph of text that seems to imply that good faith is not so easily defined. The paragraph quotes the Restatement (Second) of Contracts in which it is noted that “[t]he phrase ‘good faith’ is used in a variety of contexts, and its meaning varies somewhat with the context.” *Id.* (quoting RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981)).

39. Admittedly, this good faith definition is not particularly novel or creative. Indeed, it appears that my method of defining good faith is not even original:

The solution adopted here [to defining good faith] is to focus the inquiry by means of a provisional definition of the principle based on two assumptions which, it is submitted, are quite reasonable. The first is that *any* definition of the principle must include the universally accepted good faith rule that ‘contracts’ must be observed (*pacta sunt servanda*) and must also include the elements of honesty, fairness and reasonableness which have been indelibly associated with the concept of good faith throughout centuries of legal history.

J.F. O’Connor, *Good Faith in English Law* 11 (1990).

The second assumption is that a large part of the “normal” rules of *any* legal system will reflect the substantive ethical content of good faith. A meaningful *principle* of good faith must therefore be a common denominator of rules which are not simply normal rules of the system concerned.

What, then, does the phrase “not in good faith” mean? According to the definition of good faith that I am adopting, not in good faith means *not* in the best interests of the shareholders. But, as will be discussed below, courts and academics in the corporate law realm tend instead to fall back on the phrase “bad faith” when assessing whether a director acted without the requisite good faith.⁴⁰ This linguistic substitution—substituting bad faith for the absence of good faith⁴¹—might not appear to be of import, as the phrases are used interchangeably in casual conversation. However, this linguistic substitution proves critical in the context of shareholder protection and corporate governance. The absence of good faith and the affirmative existence of bad faith have two distinct meanings with respect to a fiduciary such as a director,⁴² and substituting bad faith for not in good faith for purposes of the business judgment rule presumption and DGCL section 102(b)(7) changes the substance of the law in the corporate governance context.⁴³ Moreover, obligating a complaining shareholder to prove that a director acted in affirmatively bad faith imposes a significantly heavier burden on the shareholder than that imposed on a shareholder who is attempting to prove that a director acted in the absence of good faith.

The next section will examine how courts and academics have used bad faith as a shortcut to assessing whether a director failed to act in good faith and analyze the meaning of the phrase “not in good faith.”

B. BAD FAITH

Bad faith conduct is generally considered to be conduct that is tantamount to fraud or “nearly unconscionable behavior.”⁴⁴ Proving bad faith has been referred to as a “daunting” task.⁴⁵ Bad faith requires “a wrong

Yet I devoted an entire law review article to examining the phrase “good faith” and defining it—albeit not in an earth-shattering new way—in the context of director behavior for reasons of strategy: I meticulously constructed a justifiable definition of good faith in order to lay the foundation for analyzing the phrase “not in good faith.” Though defining good faith in the director liability context is important, defining good faith for purposes of creating the foundation on which the phrases “the absence of good faith” or “acts or omissions not in good faith” can be constructed is, to me, much more important.

40. The occasional court will mention the “not in good faith” rubric, but rarely, if ever, is that phrase used as a measure for a director’s conduct.

41. Throughout this Article, “in the absence of good faith,” “not in good faith,” “without good faith,” and similar phrases will be used interchangeably to mean the same thing. In addition, for purposes of this discussion, definitional differences between “acts,” “actions,” “behavior,” and “conduct” will be ignored. “Good faith acts,” “good faith actions,” “good faith conduct,” “conduct indicating good faith,” etcetera will be used to mean the same thing.

42. Compare Part II.B with Part II.C, *infra*.

43. See *infra* Part II.D (examples provided in scenarios 1–4).

44. U.S. Fid. & Guar. Trust Co. v. DJF Realty & Suppliers, Inc., 58 B.R. 1008, 1011–12 (N.D.N.Y. 1986) (finding that a bankruptcy court was clearly erroneous when it found that a guaranty company had acted in bad faith by soliciting a creditor subcontractor to join an involuntary bankruptcy petition against a debtor general contractor).

45. United States v. Gilbert, 198 F.3d 1293, 1302–03 (11th Cir. 1999) (referring to a statute that requires a showing of bad faith in federal criminal prosecutions).

committed for dishonest, discriminatory, or malicious purposes.”⁴⁶ To prove bad faith, the complainant must “prove that a party consciously committed a wrong for dishonest, discriminatory, or malicious purposes.”⁴⁷

When assessing whether the complaining shareholders have successfully rebutted the presumption that the directors acted in good faith, Delaware courts often resort to an assessment of whether the plaintiff shareholders have established that their directors acted in bad faith.⁴⁸

46. *Id.* at 1299. See *Aikens v. Microsoft Corp.*, 159 F. App'x 471, 478 (4th Cir. 2005) (per curiam) (unpublished opinion) (dismissing state breach of contract claims against Microsoft: “[T]he plaintiffs failed to allege how Microsoft acted with sinister or morally questionable motives. Given these omissions, this Court cannot infer the essential elements of a bad faith breach of contract claim.”).

47. *Med. Specialist Group, P.A. v. Radiology Assocs., L.L.P.*, 171 S.W.3d 727, 734 (Tex. App.—Corpus Christi 2005, pet. denied) (citations omitted).

48. See, e.g., *In re Gen. Motors (Hughes) S'holder Litig.* No. Civ. A. 20269, 2005 WL 1089021, at *19 (Del. Ch. May 4, 2005):

Plaintiffs' good faith claims are merely a rehash of their duty of loyalty claims. For all the reasons stated herein, plaintiffs fail to state a claim that the Defendant directors' actions were predicated on bad faith. Therefore, because the Complaint contains no allegations that would allow the Court to infer that the Hughes split-off was an irrational business decision or a transaction that amounted to waste, Counts I through IV are hereby dismissed in their entirety.

Interestingly, one can find fiduciary duty opinions from Delaware courts where bad faith is assessed, and, yet, good faith is never even mentioned. See, e.g., *Unisuper Ltd. v. News Corp.*, No. 1699-N, 2005 WL 3529317 (Del. Ch. Dec. 20, 2005). In these cases, the obligation to act in good faith has quite literally morphed into the obligation not to act in bad faith.

Indeed, in the twenty years since its 1986 *Smith v. Van Gorkom* decision, which is roundly viewed as the definitive modern case marking a shift in director liability common law, the Delaware Supreme Court has only *once* written about good faith in a way that even roughly equated with an affirmative definition such that an assessment of what the phrase “not in good faith” meant was possible. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). In *Barkan v. Amsted Industries, Inc.*, the former Amsted shareholders challenged a management-sponsored buy-out, challenging the fairness of the buy-out price and maintaining that the directors should have conducted a market test to fully assess the prices for the purchase. The court arguably defined good faith when saying:

Thus, while numerous factors—timing, publicity, tax advantages, and Amsted's declining performance—point to the directors' good faith belief that the shareholders were getting the best price, we decline to fashion an iron-clad rule for determining when a market test is not required. The evidence that will support a finding of good faith in the absence of some sort of market test is by nature circumstantial; therefore, its evaluation by a court must be open-textured. However, the crucial element for supporting a finding of good faith is knowledge. It must be clear that the board had sufficient knowledge of relevant markets to form the basis for its belief that it acted in the best interests of the shareholders.

Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1288 (Del. 1989).

Every other time in the past twenty years that the Delaware Supreme Court has dealt with a director's obligation to act in good faith, the court has done so by way of defining and looking for the existence of bad faith. See, e.g., *White v. Panic*, 783 A.2d 543, 546, 553–54 n.36 (Del. 2001) (alleging, in a derivative action, board failed to take action to stop or sanction sexual misconduct of corporate officer).

To prevail on a waste claim or a bad faith claim, the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests.

For example, when considering whether a complaining shareholder rebutted the presumption of good faith afforded to his directors under the business judgment rule, Vice Chancellor Parsons examined whether the shareholders proved bad faith, noting:

[B]ad faith is conduct that is “so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.” . . . Bad faith is “not simply bad judgment or negligence,” but rather “implies the conscious doing of a wrong because of dishonest purpose or moral obliquity . . . it contemplates a state of mind affirmatively operating with furtive design or ill will.”⁴⁹

Similarly, in the context of a merger, Vice Chancellor Lamb used the phrase “illicit motivation” to mean bad faith, obligating complaining shareholders to establish that the directors affirmatively acted with an illicit motivation.⁵⁰ The Delaware Supreme Court has taken the position that the business judgment rule presumption insulates a board’s decision from close scrutiny “in the absence of evidence of ‘fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment.’”⁵¹ The way to overcome the presumption of good faith in what the Delaware Supreme Court has deemed a “bad faith claim” is “by showing that the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.”⁵²

In a candid admission, Chancellor Chandler indicates that the bad faith shorthand is used for purposes of ease:

Good faith has been said to require an “honesty of purpose,” and a genuine care for the fiduciary’s constituents, but, at least in the corporate fiduciary context, it is probably easier to define bad faith rather than good faith.⁵³

The Chancellor continues, observing:

Bad faith has been defined as authorizing a transaction “for some purpose *other than* a genuine attempt to advance corporate welfare or [when the transaction] is *known to constitute* a violation of applicable positive law.” In other words, an action taken with the intent

Id. at 554; *see also* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 71 (Del. 1989) (describing how shareholder of purchased corporation sued former board of directors, alleging breach of fiduciary duty and gross negligence). The final opinion from the Delaware Supreme Court in the recent *Disney* litigation deals with the meaning of not in good faith, but the Delaware Supreme Court *still* never defines the phrase good faith. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

49. *McGowan v. Ferro*, 859 A.2d 1012, 1031, 1036 (Del. Ch. 2004) (searching for evidence of bad faith regarding a DGCL section 102(b)(7) issue and a business judgment rule issue).

50. *In re Lukens Inc. S’holders Litig.*, 757 A.2d 720, 731 (Del. Ch. 1999) (explaining that DGCL section 102(b)(7) allows claims that present a showing “that the directors’ conduct was the product of bad faith”).

51. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993).

52. *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001).

53. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 603, 753 (Del. Ch. 2005) (citations omitted).

to harm the corporation is a disloyal act in bad faith.⁵⁴

With respect to the corporate law academics who have chimed in on the good faith dialogue with respect to director liability, it appears that most have implicitly accepted the “bad faith” substitution regarding a director’s obligation to act in good faith. For example, Professor Hillary Sale makes no attempt to define good faith in her article, *Delaware’s Good Faith*, and she instead says “[a]though a breach of good faith need not be intentional or conscious, it does require some sort of obvious, deliberate, or egregious failure.”⁵⁵ Professor David Rosenberg takes a very robust view of the reach of good faith in his contractarian article, and he states that “good faith is a circle around which all duties, corporate or contractual, are surrounded. A director who agrees to adhere to the terms of a corporate charter must do so in good faith”⁵⁶ Professor Rosenberg then defaults to language which makes clear that he has acceded to the position that a director’s lack of good faith is assessed by looking for bad faith. Professor Melvin A. Eisenberg, arguably one of the founding fathers of modern corporate governance, seems to speak for most of the academy when he says directly in his article: “For ease of exposition, unless the context indicates otherwise, in the balance of this article the terms action and conduct will be used interchangeably, and the term *lacks good faith* will be used synonymously with the term *in bad faith*.”⁵⁷

54. *Id.* (internal citations omitted). The Delaware Supreme Court affirmed the lower court, and, in the Delaware Supreme Court’s opinion, various articulations of “bad faith” and “not in good faith” are approved. See *infra* Part IV.B.

55. Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456, 493 (2004). Oddly, after noting that a “breach of good faith need not be intentional or conscious,” she goes on to proclaim that the good faith “standard is like the standard of review applied to pleadings of scienter in securities fraud claims: motive is relevant, but not required. Intentional misstatements or omissions are actionable and intentional breaches of fiduciary duties should be as well.” *Id.* With due respect, it is unclear to me exactly what she means. A breach of good faith does not need to be “intentional or conscious;” motive is not required. Yet it seems like the gist of her paragraph concludes that, in her view, some level of intent or reckless disregard that is almost assumed to equate with intent is required. *Id.* at 487 (“If the conduct at issue is sufficiently irresponsible . . . good faith is implicated.”).

Professor Sale continues to say that good faith conduct does not include conduct that is “deliberately indifferent, egregious, subversive, or knowing,” though she does not tell us what any of these terms mean. *Id.* at 488. In addition, at one point Professor Sale suggests that “egregious, subversive, or deliberately indifferent conduct” does not evince good faith. *Id.* at 490. It is unclear to me how deliberately indifferent conduct differs substantively from normal indifference. Does Sale mean “malicious indifference” versus “indifference” (perhaps “agnostic indifference”)? I suppose that that is a subtlety much like the difference between “intentionally subversive conduct” (which would violate a director’s fiduciary duties according to Sale) and unintentionally subversive conduct.

56. David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 513 (2004).

57. Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 21 (2006); see also Reza Dibadj, *Delaying Corporate Law*, 34 HOFSTRA L. REV. 469, 488 n.116–17 (2005) (substituting the phrase “bad faith” without discussion in the context of DGCL section 102(b)(7)).

C. NOT IN GOOD FAITH

If an act in good faith is an act in the best interests of the shareholder, it follows that an act not in good faith is an act that is “not in the best interests of the shareholder.”⁵⁸ These acts “not in good faith” are the acts for which directors are personally liable under statutes such as DGCL section 102(b)(7) and the business judgment rule. A complaining shareholder who maintains that her director did not act in good faith could substantiate her position by showing how the director’s acts were *not* in the best interests of the shareholders.

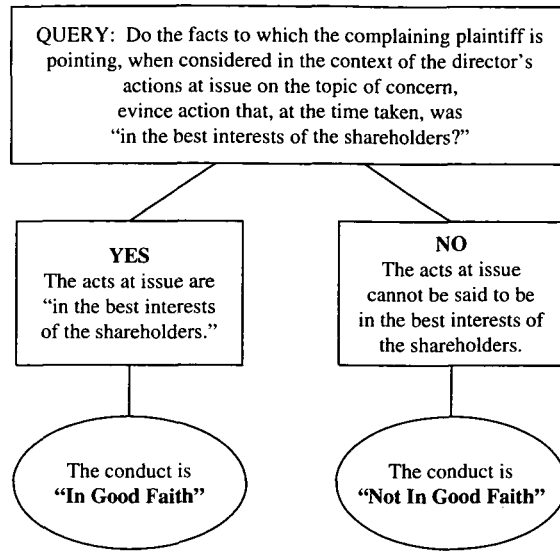
While this focus on the absence of good faith might initially seem linguistically curious and might appear to require proof of a negative, this application actually mirrors the interpretation of “good” versus “not good” from other contexts in normal daily life. Consider the situation where a person is asked upon her return from the movie theater “was the movie good?” If the movie-viewer was not pleased with or impressed by the movie, she could say, “no, the movie was not good.” The movie-viewer’s response is not limited to the response, “no, the movie was bad.” Indeed, the movie patron might be further asked, “well, was the movie *bad*?” A reasonable response from the movie-viewer would be: “No, the movie was not bad. It just was not good.” What the movie-viewer would be saying, loosely, is that the movie was mediocre. The movie was not affirmatively bad, but it also was not good. The movie patron did not leave the theater mid-way through the movie, but the movie patron would not spend \$3.99 to rent the movie when it becomes available for rental.

And so it is with “not in good faith” in the director liability context. The broad category of “not in good faith” includes *any* conduct that is not in good faith, including bad faith conduct, agnostic conduct, almost good faith conduct, and “no faith” conduct. Any conduct that is not “in the best interests of shareholders” is not good faith conduct. This can be reduced to a simple proof, which is illustrated by a diagram below, evincing the following principles:

1. Either an act is in good faith or the act is not in good faith,⁵⁹
2. *Good faith acts* are acts in the best interests of the corporation/ shareholders, and
3. *Acts not in good faith* are acts that are not in the best interests of the corporation/shareholders.

58. Either an act is “in good faith” or it is not, according to the law of the excluded middle. Some would try to say that either an act is in good faith or in bad faith. This exhibits a logical fallacy. Good faith and bad faith are not the only two “faith” categories available. See *Bertrand Russell, THE PROBLEMS OF PHILOSOPHY* 72 (1959).

59. Either a woman is pregnant or she is not. There is no middle ground.



A complaining shareholder-plaintiff who is trying to either rebut the business judgment rule presumption or strip from a director the protection of a DGCL section 102(b)(7) charter provision could do so by identifying facts that show that the acts of the directors do not fit within the definition of "good faith."⁶⁰

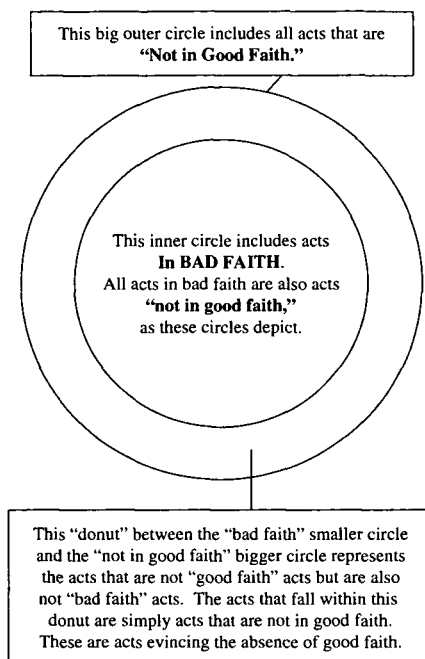
60. Some might worry that this analysis means that the directors will no longer automatically be given the protection of the business rule presumption. That worry is not merited; the directors will still receive the benefit of the presumption. The burden will still be on the plaintiffs to prove that the directors did not act in good faith, and, though "proving" a negative is perhaps a counter-intuitive concept, it certainly is not an ethereal task from a practical standpoint. If the plaintiffs cannot rebut the presumption of good faith by showing that good faith acts—acts in the best interests of the shareholders—were actually lacking or the acts at issue do *not* fit within the phrase "in the best interests of the shareholders," a director will forever hold the business judgment rule presumption's protection in that case.

I had an interesting and related debate on the internet about this topic and these scenarios with armchair philosopher Benjamin Nelson. See Posting of Elizabeth Nowicki to Concurring Opinions, http://www.concurringopinions.com/archives/2006/06/the_disney_opin.html (June 9, 2006, 17:59 EST) (my initial posting); Posting of Benjamin Nelson to Law & Society Blog, <http://www.lawsocietyblog.com/archives/208> (June 10, 2006) (Nelson's response); Posting of Elizabeth Nowicki to Concurring Opinions, http://www.concurringopinions.com/archives/2006/06/benjamin_nelson.html (June 20, 2006, 14:17 EST) (my reply); Posting of Benjamin Nelson to Law & Society Blog, <http://www.lawsocietyblog.com/archives/210> (June 21, 2006) (Nelson's rejoinder).

In his June 21, 2006 post, Benjamin Nelson made the excellent point that, in some contexts, the absence of good faith is easily identified while it is also clear that bad faith (as the word is used in the normative sense) is not at issue. To illustrate this point, Nelson made reference to the Kitty Genovese case, which involved thirty-eight neighbors who allegedly witnessed Kitty Genovese being stabbed (or beaten) to death in an alley and waited a half-hour before calling the police. The witnesses had no mal-intentioned reason for not calling the police; they were not acting affirmatively in bad faith, with the intent to harm Ms. Genovese. They were not aligned with or "rooting for" Ms. Genovese's attacker. Rather, the neighbors were impacted by what was later termed the "bystander effect," the tendency to resist offering help when part of a group although the help would be freely offered were the bystander alone. In such a case, could anyone credibly say that the bystanders who saw Ms. Genovese get attacked but said nothing were acting "in good

D. BAD FAITH VERSUS NOT IN GOOD FAITH

After discussing both the absence of good faith and the existence of bad faith, the difference between the two as a matter of substance is clear: Bad faith means “dishonesty of belief or purpose,”⁶¹ “dishonest motive or purpose,”⁶² or the “conscious doing of a wrong because of dishonest purpose or moral obliquity. . . [and] a state of mind affirmatively operating with furtive design or ill will.”⁶³ The absence of good faith refers to “acts not in the best interests of shareholders.” The phrases are not synonymous, but the former is a sub-category of the latter, as the diagram below indicates:⁶⁴



faith”? I doubt anyone would take that position. But if the neighbors were not acting in good faith and they were not acting in bad faith, there has to be another category. In Nelson’s (correct, in my opinion) view, the Kitty Genovese case clearly makes the point that some conduct can neither be labeled “good faith” nor “bad faith,” hence the “not in good faith” category.

61. BLACK’S LAW DICTIONARY 134 (8th ed. 2004).

62. BRITTINGHAM v. BD. OF ADJUSTMENT OF REHOBOTH BEACH, No. Civ. A. 03A-08-002 2005 WL 1653979, at *2 (Del. Super. Ct. Apr. 26, 2005) (unpublished opinion).

63. Desert Equities, Inc. v. Morgan Stanley Leveraged Equities Fund, II, L.P., 624 A.2d 1199, 1208 n.16 (Del. 1993).

64. An act lacking good faith is not necessarily the same as an affirmative act “in bad faith” any more than a fruit that is “not an apple” is necessarily “an orange.” A fruit that is “not an apple” *might* be an orange, but it does not have to be. An act that is “not in good faith” might be an act in bad faith, but it does not have to be. “Bad faith” behavior is a sub-category of the “not in good faith” behavior category, and the “not in good faith” category embraces much more than does the bad faith category.

My observation that the absence of good faith is not the same as the existence of bad faith is not novel. For example, in *Art Form Interiors, Inc. v. Columbia Homes, Inc.*, the court said: "We view with considerable consternation the disturbing lack of good faith . . . , but we are not prepared to hold that the appellants' actions constituted bad faith."⁶⁵ In *Zdravkovich v. Bell Atlantic-Trion Leasing Corp.*, the Maryland Court of Appeals said that "[t]he District Court's finding that Zdravkovich 'has not shown good faith' is not the equivalent to a finding of 'bad faith' and cannot be the basis for the imposition of sanctions."⁶⁶ The court in *Commonwealth v. Belcher* offered that "[a]lthough the court finds no bad faith, the court does not find good faith here either."⁶⁷ Judge Bistline, in *State v. Prestwich*, observed in his concurrence that "[t]he trial judge did not find good faith; he only found lack of bad faith," concluding succinctly that "I submit that the two are not synonymous."⁶⁸ Similarly, Richard Rector describes this distinction regarding a failure to act in good faith versus an affirmative finding of bad faith as "noteworthy, if slightly metaphysical" in the context of government contracts. Mr. Rector observes that "good and bad faith are not mirror images of one another . . . [a party] can fail to act in good faith without necessarily acting in bad faith."⁶⁹

Ward v. Herr Foods, Inc. is a noteworthy case, as it involved a question of awarding prejudgment interest when the standard for such referred to both "good faith" and "not . . . in good faith." The statute at issue allowed a court to award prejudgment interest if

the court determines at a hearing held subsequent to the verdict or decision in the action that the party required to pay the money *failed to make a good faith effort* to settle the case and that the party to whom the money is to be paid *did not fail to make a good faith effort* to settle the case.⁷⁰

65. *Art Form Interiors, Inc. v. Columbia Homes, Inc.*, 609 A.2d 370, 375 (Md. Ct. Spec. App. 1992).

66. *Zdravkovich v. Bell Atl.-Tricon Leasing Corp.*, 592 A.2d 498, 503 (Md. Ct. App. 1991).

67. *Commonwealth v. Belcher*, F88-140, 1988 WL 619393, at *1 (Va. Cir. Ct. Nov. 18, 1988).

68. 783 P.2d 298, 302 (Idaho 1989) (Bistline, J., concurring). Additionally, some might add the category of "no faith" to the categories of "good faith," "not in good faith," "bad faith," and "not in bad faith." This "no faith" option was discussed in *Thomas v. Western World Insurance Co.*, when the court analyzed an insurance company's refusal to defend an insured against the insurer's fiduciary obligation to exercise good faith in defending or settling claims against an insured: "In the case before us, there is no threshold question of 'good faith' vs. 'bad faith.' For here, the company exercised no faith at all." 342 So. 2d 1298, 1304 (Fla. Dist. Ct. App. 1977).

69. See Richard Rector, *Infotech and the Law: Good Faith, Bad Faith in Government Contracts*, WASH. TECH., Jan. 22, 2001, available at <http://www.washingtontechnology.com/print/15-20/16188-1/html> (quoting an Armed Services Board of Contract Appeals case in which the board observed that "[t]he mere absence of bad faith . . . does not mean the government met its obligation . . . to negotiate in good faith").

70. *Ward v. Herr Foods, Inc.*, No. 456, 1990 WL 118868, at *13 (Ohio Ct. App Aug. 16, 1990) (emphasis added).

The court observed that “one need not prove that the party acted in bad faith but only that the party did not act in good faith.”⁷¹ This case is particularly interesting to consider because it implicates a party’s affirmative obligation to *do something*.⁷² When dealing with the failure to do something that is required, to wit, make a good faith effort to settle, the court refused to substitute the requirement of proving bad faith for the requirement to merely identify facts evincing the absence of good faith.

As a definitional matter, then, it is clear that “bad faith” and “not in good faith” do not mean the same thing. Substituting “bad faith” for the absence of good faith changes the law. The impact of defining acts “not in good faith” literally, as I am proposing, instead of defining acts that lack good faith as only bad faith acts,⁷³ as many courts currently do, becomes apparent when dealing with cases involving director inattention or abdication. For at least the past two decades, directors who could justifiably be labeled “asleep at the wheel” when something devastating and preventable happened to the corporation could evade liability for acting “not in good faith” because the directors did not intend to hurt the corporation. Directors who did not question acquisition-related fairness letters written by the same investment bank that had been retained to find the target, directors who failed to read financial statement footnotes closely enough to realize their corporation had hundreds of special purpose entities, directors who signed off on the hiring and firing of top-level executives without being involved with or informed about the search process and the executives selected,⁷⁴ and directors who did not inquire further when they began seeing information on the annual reports about a rash of product failure lawsuits could all evade fiduciary duty liability because they were not affirmatively acting in bad faith or intending to harm their corporate charges. As long as their inattention did not amount to “a conscious disregard for one’s responsibilities,”⁷⁵ which requires an actual train of thought in the director’s mind regarding whether he should follow-up or ask questions, directors are beyond the reach of the phrase “bad faith.”

Under my definition of conduct that is “not in good faith,” however, directors who fail to follow-up on issues that seem to be red flags, fail to ask questions on important matters, are inattentive in situations where attention is required, and do other non-malicious things that evidence the failure to act in the best interests of shareholders fall into the category of “not in good faith,” such that those directors will not be protected by the business judgment rule presumption or exculpatory state statutes. Below

71. *Id.*

72. This obligation to affirmatively try to settle a case is similar to a director’s obligation to affirmatively act in good faith.

73. Note that I am using “bad faith” as the phrase is normally used in the normative sense, to mean something close to fraud or intentional, malicious conduct.

74. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

75. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003).

are a few examples of instances where this definitional distinction will be noticeable:

SCENARIO 1:

Director Jones, who has only been a director for ten months, hears through the grapevine that the CEO of the publicly-traded, Fortune 100 corporation that he serves is incredibly difficult to work with, such that the company cannot retain other qualified senior executives. Director Jones never raises the issue at a board meeting or informally with his fellow outside directors. He is of the view that his fellow directors, all six of whom have been on this board for several years, would be raising the issue if it was a problem.⁷⁶

IS THIS "GOOD FAITH" CONDUCT? Is this failure to inquire further or raise the issue with at least one other director an act in the best interests of the shareholders?

NO. The conduct is "NOT IN GOOD FAITH."

IS THIS "BAD FAITH" CONDUCT? Is Director Jones keeping quiet due to a desire to harm the company or to serve himself? NO.

SCENARIO 2:

Director Doe is on the board of a large, publicly traded corporation. The day before Christmas, he receives a phone call from the General Counsel of the corporation, telling Doe that he will be faxing to Doe a board resolution to sign. The fax would authorize an award of stock options to the CEO, the CFO, and the COO, in accordance with the Stock Option Plan, which affords these executives stock options, to be awarded twice per year, on December 31 and June 31, if they meet the performance numbers set by the board for the previous six months. Doe queries whether the senior officers have reached the required performance numbers, and the General Counsel affirms that they have. The General Counsel faxes to Doe only the signature page for the directors' resolution, because the Associate General Counsel has not yet drafted the text of the resolution. Doe receives the fax, he signs the resolution signature page, and he faxes it back, not noticing that it is dated July 2.

IS THIS "GOOD FAITH" CONDUCT? Is the director acting affirmatively in the best interests of the stockholders when he signs a document without reading it? Is the director acting affirmatively in the best interests of the stockholders when he signs a blanket resolution signature page without ever seeing the actual resolutions themselves, which deal with a large number of stock options?

NO. When dealing with a document that has the potential to be important, perhaps in terms of dollar amount or impact on the company or

76. Michael Eisner, recently ousted from the Disney helm, was well-known for his inability to work well with others inside Disney. Joseph Menn, *Quietly Keeping the Spotlight on Disney; CEO Robert Iger has kept a low profile while mending fences broken under his predecessor and forging key deals with Pixar and iTunes*, L.A. TIMES, Oct. 8, 2006, at C1.

product issues, a director does not act in good faith if he signs the document without reading it.

IS THIS BAD FAITH CONDUCT? No. There is no reason to believe that Doe's lack of attention is egregious or motivated by an ill will. He did not notice the July 2 date nor did he recall how the options were supposed to be dated, given that he was not on the board when the option plan was adopted.

THIS IS CONDUCT THAT IS JUST "NOT IN GOOD FAITH."

SCENARIO 3:

Director Smith is on a publicly traded, Fortune 100 corporation's three-person compensation committee. She approves a costly executive pay package for a new COO without ever seeing the final compensation agreement. The agreement is being negotiated by the CEO and one of the other compensation committee members who has served on the committee for over a decade. That committee member, Director Williams, tells Director Smith that the new executive will be getting a pay package worth approximately \$138 million over five years (the actual value of the stock options to be awarded is uncertain), and Williams assures Smith that the amount is in line with the compensation being paid to the incumbent CEO.⁷⁷

IS THIS "GOOD FAITH" CONDUCT? Is the failure by Director Smith to insist on seeing, reading, or discussing the pay agreement or a specific summary of the package an act that is "in the best interests of the shareholders?"

No. Given that the pay package is for a top executive and is sizeable, and given that the topic of "executive compensation" has been a nettlesome topic for corporations over the past several years, the failure of a director who knows she is one of only three directors on a compensation committee to be active in the compensation review process is not "in the best interests of the shareholders."

IS THIS "BAD-FAITH" CONDUCT? Is this failure by Director Smith an act that is a "conscious doing of a wrong because of dishonest purpose or moral obliquity. . . [and] a state of mind affirmatively operating with furtive design or ill will?"⁷⁸

No. Nothing in the facts indicates that Smith has a dishonest purpose or is acting with ill will. THIS IS CONDUCT THAT IS MERELY "NOT IN GOOD FAITH."

Note that if the pay package was clearly insignificant such that it did not merit Smith's time and attention, voting on the package without seeing it or more fully reviewing it might not be an act not in good faith.

77. In the recent Disney litigation, outside Disney director Sidney Poitier, who sat on the compensation committee charged with the task of reviewing Ovitz's pay package, essentially asked no questions nor made any inquiry into the compensation he was voting to offer Ovitz. *In re Walt Disney Co. Derivative Litig.* 906 A.2d, at 39-40.

78. *Desert Equities, Inc. v. Morgan Stanley Leveraged Equities Fund, II, L.P.*, 624 A.2d 1199, 1208 n.16 (Del. 1993).

Voting without seeing the package might actually be a wise expenditure of her limited resources. In some situations, close attention is not merited. This assessment is akin to the materiality assessment in the securities fraud context: At some point, some information is so clearly insignificant as to be easily deemed by the court to be immaterial.

SCENARIO 4:

Director Lauder is on the board of a pharmaceutical company. At the board meetings, held by teleconference every month, the Senior Executives rarely say more than a few words on product liability issues, given that there are so many things on the agenda for discussion at each meeting. After reading in the newspapers about the recent Bausch & Lomb issues⁷⁹ and the Vioxx litigation,⁸⁰ Director Lauder wonders how far a potential products liability issue will develop before the Senior Executives bring the issue to the board. Lauder never gets around to asking the Senior Executives that question; the board meetings are too busy, and Lauder does not want to offend the Senior Executives by asking.

IS THIS "GOOD FAITH" CONDUCT? Is the director affirmatively acting in the best interests of the stockholders when he sits complacently in an industry (pharmaceuticals) where products liability issues do arise and expose companies to huge, potentially bankrupting liability?

PROBABLY NOT. While Director Lauder is certainly not acting in bad faith, it would be difficult to say that a director acting in the best interests of the shareholders would ask no questions to at least be apprised of what sort of information he can expect (and when). Particularly given the nature of the industry, the failure to ever ask about products liability issues is probably an act "NOT IN GOOD FAITH."⁸¹

79. Bausch & Lomb was recently involved in a spate of complaints and lawsuits filed against it, alleging that Bausch & Lomb's ReNu with MoistureLoc™ increased the risk of its users suffering from Fusarium keratitis, an eye infection that could lead to blindness. *Bausch & Lomb Yanking Cleaner Tied to Infections*, CHI. TRIB., May 16, 2006, at C3.

80. See Kris Hundley, *Meet Merck*, ST. PETERSBURG TIMES, Feb. 18, 2007, at 1D (discussing significant liability and financial uncertainty that Merck faces as a result of lingering Vioxx claims).

81. In the case of *In re Caremark International Inc. Derivative Litigation*, the court recognized that there is a contextual element to the meaning of an action in the best interest of shareholders:

The vocabulary of negligence while often employed, e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) is not well-suited to judicial review of board attentiveness, see, e.g., *Joy v. North*, 692 F.2d 880, 885–86 (2d Cir. 1982), especially if one attempts to look to the substance of the decision as any evidence of possible "negligence." Where review of board functioning is involved, courts leave behind as a relevant point of reference the decisions of the hypothetical "reasonable person", who typically supplies the test for negligence liability. It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of ordinary judgment and prudence might. The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what an persons [sic] of ordinary or average judgment and average risk assessment talent regard as "prudent" "sensible" or even "rational", such persons will have a strong incentive at the margin to authorize less risky investment projects.

IS THIS “BAD-FAITH” CONDUCT? Is this failure by Director Lauder an act that is “so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith”?⁸²

NO. Nothing in the facts indicates that Lauder has a dishonest purpose or is acting with ill will. THIS IS CONDUCT THAT IS MERELY “NOT IN GOOD FAITH.”

SCENARIO 5:

For two consecutive years, under the “Risks” heading in the annual report, Widget Corporation has reported new lawsuits brought by female former employees who allege that they were discriminated against by Widget’s Senior Vice President of Human Resources. Director Loe asked the General Counsel (“GC”) about the lawsuits, and the GC said that the lawsuits were not really a matter of concern. These lawsuits usually settle for a nominal amount of money, he said. He explained that the Senior Vice President of Human Resources (“SVP”) was just an old-fashioned male who felt that women should stay in the kitchen, barefoot and pregnant. The brand managers for each of Widget’s three biggest product lines apparently felt the same way, so the SVP never sent them female job applicants. The GC said the four men were just artifacts who had never gotten over the movement of women into the workplace fifty years ago, and, despite religiously attending the annual diversity and workplace equality training, these four men could not seem to fully shed their biases. The good news, said the GC, was that these four men were brilliant and made Widget Corporation significant amounts of money. Loe leaves well enough alone, although she admonished the GC to “stay on top of this.”

IS THIS “GOOD FAITH” CONDUCT? Is Loe’s failure to follow-up on this potential landmine of liability “in the best interests of the shareholder?”

NO. Her failure to act is conduct that is “NOT IN GOOD FAITH.” Given the nature of the issue—lawsuits and sexual harassment—and given the

Indeed, one wonders on what moral basis might shareholders attack a *good faith* business decision of a director as “unreasonable” or “irrational”. Where a director *in fact exercises a good faith effort to be informed and to exercise appropriate judgment*, he or she should be deemed to satisfy fully the duty of attention. If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors. Judge Learned Hand made the point rather better than can I. In speaking of the passive director defendant Mr. Andrews in *Barnes v. Andrews*, Judge Hand said:

True, he was not very suited by experience for the job he had undertaken, but I cannot hold him on that account. After all it is the same corporation that chose him that now seeks to charge him . . . Directors are not specialists like lawyers or doctors . . . They are the general advisors 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. Must a director guarantee that his judgment is good? Can a shareholder call him to account for deficiencies that their votes assured him did not disqualify him for his office? While he may not have been the Cromwell for that Civil War, Andrews did not engage to play any such role.

698 A.2d 959, 967–68 (Del. Ch. 1996) (quoting *Barnes v. Andrews*, 298 F. 614, 618 (S.D.N.Y. 1924)).

82. *McGowan v. Ferro*, 859 A.2d 1012, 1031 (Del. Ch. 2004) (citations omitted).

potential size of the issue—there were four managers who discriminated on gender, presumably against many women—Loe’s failure to ask for further information or bring the issue to the attention of her colleagues is not in the best interests of the shareholders. Does this mean that Director Loe needed to micro-manage the hiring and firing of employees? No. A director acting “in the best interests of the shareholder” does not need to fully resolve the issue herself; she needs, rather, to do something that advances the ball in terms of protecting the shareholders. That might include asking the GC to have someone evaluate the size of the potential exposure, raising the issue at a board meeting, or simply saying to the GC: “This issue troubles me. Let’s discuss it further.” Doing almost nothing regarding an issue that has at least some superficial indicia of the reasonable potential to turn into a material problem for the corporation is not an act in good faith.

IS THIS “BAD FAITH” CONDUCT? Is Loe’s failure to follow-up on this potential liability exposure evidence of a conscious doing of a wrong? No.

III. BAD FAITH FALL-OUT

As the examples above indicate, the (mis)interpretation and (mis)application of the phrase “not in good faith” has significant practical ramifications when dealing with instances of corporate devastation due to director inattention. As the law exists now, inattention has to rise to the level of “intentional dereliction of duty, a conscious disregard for one’s responsibilities,” before it is subject to scrutiny as an act of “bad faith.”⁸³ Yet the literal interpretation of “not in good faith” captures conduct far less dramatic than that. In addition to the fact that the absence of good faith and the existence of bad faith just do not *mean* the same thing, such that corporate law jurists and academics who substitute the latter for the former are mangling the law, there are at least two other important corporate governance implications of this sloppy wordsmithing in the corporate law realm:

(1) Obligating a plaintiff to affirmatively prove bad faith is very different and more demanding than obligating the complaining shareholder to prove that good faith is lacking. The burden of proof in the former case is much heavier.

(2) Substituting “bad faith” for “not in good faith” has the effect of turning a director’s *affirmative* obligation to act in good faith into the mere obligation not to deliberately do bad acts with a venal motive. This changes the nature of a director’s role from that of a fiduciary to that of an arms-length party to a transaction.

With respect to the first point, as discussed in Part II.B, bad faith is provable in the corporate law context by showing “that the board’s deci-

83. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64 (Del. 2006) (citations omitted).

sion was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests," or that the decision "is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."⁸⁴ Even the least demanding of bad faith articulations from the Delaware courts requires substantiation that the directors "*consciously and intentionally disregarded their responsibilities.*"⁸⁵ Bad faith is focused more on mental state, and it has a clear subjective bent. Yet, as discussed above, an act "not in good faith" refers to conduct that simply does not represent an act in the best interests of the shareholder. Mental state is irrelevant. "Not in good faith" focuses on the goal of the conduct at issue. Was the act or was the act not in the best interests of shareholders based on the facts available at the time?⁸⁶ Obligating shareholders to instead prove that ill-intentions drove a director's conduct saddles the shareholder with an onerous evidentiary burden.

With respect to the second point, recall that directors are fiduciaries, and a fiduciary is obligated to affirmatively try to advance the interests of the party she serves. The fiduciary has a duty—an obligation—to act in the best interests of the shareholders and the corporation. It is not enough for a fiduciary to just refrain from deliberately doing bad acts.⁸⁷ More is required of a director *qua* fiduciary than is required of parties to an arms-length transaction.

Introducing bad faith to the discussion of a director's fiduciary duties eviscerates the affirmative nature of a director's obligation to act in good faith. Inasmuch as "bad faith" acts basically include only egregious and intentional acts—acts such as "fraud" or deliberately reckless behavior—courts are changing the fiduciary nature of a director's role by freeing the director from the obligation to exercise a level of attention and monitoring that rises to the level of "in the best interests of the shareholder." For a fiduciary—someone who has the obligation to act affirmatively on behalf of and for the best interests of the shareholder—the elimination of

84. *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001).

85. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003) (emphasis in original).

86. This more objective articulation has been described as follows:

What is required is that the directors must do what they honestly believe to be right—i.e. subjective good faith—and . . . they will normally succeed in satisfying this test unless it can be shown (objectively) that they have not behaved in accordance with the standards expected of honest and reasonable men of affairs. *Even if directors have not been consciously dishonest, they will be in breach of their duty if they have not considered whether their action is in the interests of the company.*

J.F. O'CONNOR, *GOOD FAITH IN ENGLISH LAW* 53–54 (1990).

87. The adage for a fiduciary relationship, at least in the corporate governance realm, should be "First, try to do some good." Rosenberg, *supra* note 56, at 513 ("Fiduciary duties are substantive obligations which must be honored in good faith in the same way that contractual obligations must be honored in good faith.").

liability for inattentiveness is preposterous.⁸⁸

If courts and academics continue to substitute the phrase “bad faith”⁸⁹ for the phrase “not in good faith,” the fundamental fiduciary nature of the director role will be eroded to essentially that of a disinterested contractual third party, and, more troubling, shareholders will find themselves left holding stock governed by new, unilaterally changed rules.⁹⁰ The shareholders will be left with a directorate that cannot be held accountable for essentially being “asleep at the wheel” because the subjective aspect of bad faith is lacking in most cases of inattention. That simply cannot be acceptable behavior under the definition of “good faith” as it pertains to a fiduciary.⁹¹ Good faith cannot contemplate a

88. *Id.*; see Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U.L. REV. 75, 117 (2004) (“[A] director’s fiduciary duty entails positive actions to benefit the corporation and its shareholders . . .”).

89. Note that, under some definitions of “bad faith,” conduct that is less egregious than fraud or something of that ilk—conduct that I refer to as “other” not in good faith conduct—is indeed reachable as “bad faith” conduct. For example, Black’s Law Dictionary makes reference to the RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981), which provides that bad faith includes things such as “lack of diligence and slacking off” and “willful rendering of imperfect performance.” BLACK’S LAW DICTIONARY 134 (8th ed. 2004). Under this definition of bad faith, conduct that I reach with my “not in good faith” language—conduct that falls short of overt fraud—would easily be included.

My fear about the corporate bar, judiciary, and academics trying to substitute the phrase “bad faith” for the phrase “acts or omissions not in good faith” assumes those parties would not adopt the broader reading of “bad faith,” but, rather, would continue using bad faith narrowly to only mean something akin to or very close to fraud.

90. Embracing the contractarian view of the firm does not result in a different meaning of the phrase “not in good faith.” Perhaps, at first glance, one might think exactly the opposite: The director’s relationship with the corporation and its shareholders is viewed as a contractual, arms-length relationship, such that it is inappropriate to inject fiduciary principles. But, actually, the fiduciary contours of the “contractual” corporate relationship would inform the way “good faith” should be used as a gap-filler, and the fiduciary nature of the director’s role in general would be used as the default perspective from which to interpret the director’s agreement—contract—with the shareholders. See E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 672 (1963).

Good faith performance as used in the realm of contract and commercial law emphasizes “faithfulness to an agreed common purpose” and “consistency with the justified expectations of the other party.” RESTATEMENT (SECOND) OF CONTRACTS § 205, cmt. a (1981). With respect to the “asleep at the wheel” director or the “too busy to have noticed” director, he clearly is not emphasizing any sort of faithfulness to an agreed common purpose unless the agreed common purpose was for the director to do a half-hearted job of serving the corporation. From that standpoint, when asking whether a director failed to fulfill his contractual obligation to act in good faith, Professor Farnsworth would suggest we should favor the party with less control and power (in the corporate context, the shareholder) as we make our assessment. Farnsworth, *supra* note 90, at 672. In addition, the general fiduciary nature of the relationship and the trust and confidence aspect of the relationship would inform the contractarian’s interpretation of good faith for purposes of filling gaps: “Fiduciary duties minimize agency costs associated with the separation of ownership and from management rights.” Larry Ribstein, *The Evolving Partnership*, 26 IOWA J. CORP. L. 819, 845 (2001) (citing Michael Jensen & William Meckling, *Theory Of The Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976)); see also Frank Easterbrook & Daniel Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426–27 (1993).

91. *Burdett v. Miller*, 957 F.2d 1375, 1381 (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.”); *Swinney v.*

lack of attention paid to that with which the fiduciary has been entrusted and has voluntarily agreed to keep watch over in return for a salary.⁹²

How, then, did we get here? Below I examine a few critical issues implicated in the misevolution of director liability for fiduciary duty violations.

IV. DIRECTOR LIABILITY REVISITED

Changing a director's affirmative fiduciary obligation to well-manage a shareholder's assets into the mere obligation to refrain from intentionally causing harm to the corporation might seem inexplicable to an outsider. The range of the director abdication categories of cases totally beyond the reach of a court using the phrase "bad faith" is huge. Any corporate law scholar, however, is familiar with the reasons underpinning the refusal of courts and academics to interpret reasonably a director's obligation to act in good faith.

Courts, academics, and the corporate defense bar are largely adamant that directors must be insulated from personal liability except in the most egregious cases in order to avoid (a) a drought in available, qualified, willing directors and (b) a directors' and officers' "insurance crisis." This position was cemented in 1985, when the Delaware Supreme Court refused to dismiss a fiduciary duty-based lawsuit against the directors of the Trans Union Corporation in the case of *Smith v. Van Gorkom*.⁹³

Only by showing how directors were never over-exposed to liability and how their fears are misplaced is there any hope that corporate law will evolve in a way that reflects the true meaning of the phrase "not in good faith." To that end, this section does three things:

1. Show how *Smith v. Van Gorkom* was unremarkable, such that it did not merit any sort of fear of increased liability exposure;
2. Explain how the director's and officer's insurance crisis fear was and is unfounded;

Keebler Co., 480 F.2d 573, 578 (4th Cir. 1973) ("[I]f the sellers of control [majority shareholders] are in a position to foresee the likelihood of fraud on the corporation . . . their fiduciary duty imposes a positive duty to investigate the motives and reputation of the would-be purchaser . . ."); *Mid-Northern Oil Co. v. Walker*, 211 P. 353, 355 (Mont. 1922) ("[T]he fiduciary relationship existing between the United States and the particular Indian wards imposed upon the government a positive duty to lease the Indian lands and to secure for the Indians the most advantageous terms available . . ."); *Rova Farms Resort, Inc. v. Investors Ins. Co.*, 323 A.2d 495, 507 (N.J. 1974) ("[A]n insurer . . . has a positive fiduciary duty to take the initiative and attempt to negotiate a settlement within the policy coverage.").

92. Prior to the 1900's, directors had mainly been "gratuitous mandatories," with no paid salaries. *Personal Liability of Directors for Corporate Mismanagement*, 65 U. PA. L. REV. 128, 129 (1916). In the latter part of the nineteenth century, however, directorates evolved into well-paid, "coveted" positions. *Id.* at 132 ("It is the merest sophism to speak of a modern director as a gratuitous [sic] mandatory."). It is at that point that courts began to more closely hold directors accountable as fiduciaries. *Id.*

93. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

3. Debunk the myth that holding directors liable for failing to act in good faith will result in a problematic unwillingness of qualified directors to serve.

A. THE DELAWARE SUPREME COURT CASE OF *SMITH V. VAN GORKOM*

*Smith v. Van Gorkom*⁹⁴ merits its own section in this paper for two reasons: (1) *Van Gorkom* led to the adoption of DGCL section 102(b)(7) and the chorus of naysayers warning of a director liability insurance crisis, and (2) *Van Gorkom* is a duty of care case referred to by many corporate law scholars and practitioners as a seminal case,⁹⁵ yet it is painfully misinterpreted. This case, wherein the Delaware Supreme Court reversed the Delaware Chancery Court's interpretation and assessment of a board of directors' alleged failure to satisfy their duty of care, set off a chorus of wailing from the corporate bar, with practitioners and academics complaining bitterly about the Delaware Supreme Court's opinion and the corporate ruin that was sure to follow. The holding in *Van Gorkom* sent shockwaves of fear through corporate boardrooms, and a directors' and officers' liability insurance crisis was anticipated. As noted, it was the holding in *Van Gorkom* which led to the hasty, and misled, adoption of DGCL section 102(b)(7). It is useful, then, to discuss the case in some detail.

1. *The Facts*

Trans Union was a publicly traded company whose principal earnings were generated by its railcar leasing business.⁹⁶ While the company had a strong cash flow, it had difficulties in generating enough taxable income to offset its investment tax credits ("ITCs").⁹⁷ Seeking to address this issue, Trans Union lobbied Congress to have ITCs be refundable in cash to firms that could not utilize the credits and also pursued an acquisition program designed to increase available taxable income by acquiring the taxable income of other target businesses.⁹⁸ By late summer of 1980, Jerome Van Gorkom, Trans Union's Chairman and Chief Executive Officer,⁹⁹ was under the belief that Congress would not follow Trans Union's suggestion about refunding ITCs in cash.¹⁰⁰ In July of 1980,

94. *Id.*

95. Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"*, 30 CORNELL INT'L L.J. 381, 427 n.179 (1997) (characterizing *Van Gorkom* as a "seminal case"); Charles M. Elson, *Corporate Law Symposium: The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 676-77 (1995) (discussing how the *Van Gorkom* court created "a number of new and important guideposts to 'informed' decisionmaking").

96. *Van Gorkom*, 488 A.2d at 864.

97. *Id.*

98. *Id.* at 864-65.

99. *Id.* at 864.

100. *Id.* at 865.

Trans Union's management presented to its Board of Directors ("Board") a report indicating that Trans Union would have a cash surplus of about \$195 million and the ITC problem continued to be a "nagging problem."¹⁰¹ The report listed four alternative uses for the cash surplus: (1) stock repurchase; (2) dividend increases; (3) a major acquisition program; and (4) a combination of the above.¹⁰² The report did not mention the sale of Trans Union, and the report specifically stated that there had not yet been "sufficient time to fully develop [a] course of action."¹⁰³

Van Gorkom took it upon himself to pursue the sale of Trans Union to an entity that could use Trans Union's ITCs, and Van Gorkom called an unexpected meeting of the Trans Union Board to spring upon them his decision to support an acquisition of Trans Union by corporate takeover specialist Jay Pritzker.¹⁰⁴ The Board approved the buy-out by Pritzker after only two hours of discussion, without having seen a copy of the deal proposal or a draft merger agreement.¹⁰⁵ That same day, Van Gorkom signed the agreement at a formal social affair that he was hosting.¹⁰⁶ Neither Van Gorkom nor any other members of the Board read the merger agreement before Van Gorkom signed it.¹⁰⁷

When the acquisition was announced, Trans Union senior management publicly balked at the agreement and threatened resignation.¹⁰⁸ As a result, Van Gorkom agreed to negotiate modifications to the merger agreement to mollify management. Although Van Gorkom did negotiate modifications, which the Board later approved, these modifications, contrary to the representations made by Van Gorkom, did not assuage any of the senior management's concerns.¹⁰⁹

In February of 1981, a majority of the Trans Union stockholders approved the Pritzker acquisition.¹¹⁰ Plaintiff stockholders then filed suit against the directors of Trans Union, requesting, among other things, damages resulting from the Board's breach of their duty of care in approving the sale of Trans Union.¹¹¹ Following a trial, the Court of Chancery granted judgment for the defendant directors, finding that the approval of the Pritzker acquisition fell within the protection of the business judgment rule.¹¹²

101. *Id.*

102. *Id.*

103. *Id.* at 865.

104. *Id.* at 865, 867.

105. *Id.* at 869. Until that meeting, the Board had not previously discussed selling Trans Union.

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.* at 870. Rather, the amendments authorized by Van Gorkom essentially worsened some of the issues concerning management by *constraining* Trans Union's ability to negotiate a better deal or to withdraw from the agreement entered into with Pritzker.

110. *Id.* Only 69.9% of the outstanding Trans Union shares were voted for the sale of Trans Union, while 7.25% were voted against, and 22.85% were not voted. *Id.*

111. *Id.* at 863-64.

112. *Id.* at 864.

On appeal to the Delaware Supreme Court, the plaintiff stockholders achieved a very different result. The Delaware Supreme Court concluded that the Court of Chancery's rulings were clearly erroneous, and "the Board's decision . . . to approve the proposed cash-out merger was not the product of an informed business judgment."¹¹³ The Delaware Supreme Court issued an opinion reversing the ruling of the Court of Chancery and remanding the case for an evidentiary hearing on damages (i.e., the fair value of the plaintiffs' Trans Union shares).¹¹⁴

The Supreme Court of Delaware disagreed with the Court of Chancery's holding that the Board's approval of the Pritzker merger proposal was protected by the business judgment rule, and the court concluded that the Board failed to reach an informed business judgment when they agreed to sell Trans Union.¹¹⁵ The Delaware Supreme Court focused on three things: (1) the Board failed to adequately inform themselves about Van Gorkom's role in the sale of Trans Union and in setting the per share purchase price; (2) the Board was uninformed about the intrinsic value of the company; and (3) given these informational failures, the Board was, at a minimum, grossly negligent in approving the sale of Trans Union after only two hours of discussion, without having considered the possibility previously, and in acting so quickly on such a significant issue in the absence of a crisis or emergency.¹¹⁶

The court noted that the Board approved the cash-out merger based solely on Van Gorkom's twenty-minute oral presentation about the merger proposal, and the Board failed to review any documents (or ask for a written summary of the merger terms) before approving Pritzker's proposal.¹¹⁷ Further, although the Trans Union shares were purchased at a price that represented a premium over the price at which the shares were then trading, the court held that, in the "absence of other sound valuation information," a premium alone would not be an adequate basis for the Board to assess the fairness of Pritzker's offer.¹¹⁸ Trans Union's market price was known by the Board to be historically undervalued, yet the Board sought no other valuation information in determining that the offered premium over Trans Union's \$38 market price per share was a fair value.¹¹⁹ No director asked for a review of the valuation calculations or an explanation of what the "fair price range" for Trans Union securities covered.¹²⁰ The court rejected the notion that the Board's "collective

113. *Id.* at 864.

114. *Id.* at 893.

115. *Id.*

116. *Id.* at 869, 873, 893.

117. *Id.* at 869.

118. *Id.* at 875.

119. *Id.* at 876.

120. *Id.* at 877. Although the court noted that an outside valuation or a fairness opinion by independent investment bankers was not absolutely necessary to support an informed business judgment, the Board was not informed enough in this case to reach an informed business judgment as to the fairness of the \$55 per share purchase price for Trans Union's shares. *Id.* at 876.

experience and sophistication” provided a sufficient basis for concluding that they reached an informed business judgment regarding the acquisition.¹²¹

The court ultimately concluded that “Trans Union’s Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal,”¹²² and the record compelled the conclusion that “the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of the \$55 per share for sale of the Company.”¹²³ Accordingly, the court concluded that the trial court erred in affording to the defendant directors the protections of the business judgment rule,¹²⁴ and the Board was liable to the complaining shareholders for the fair value of their shares.¹²⁵

2. *The Bar’s Response*

This holding took the corporate defense bar by surprise. The Court of Chancery in this case originally had found easily for the defendant directors, and duty of care cases in Delaware that had been decided in favor of stockholders were few and far between. Therefore, with seemingly little attention paid to the egregious facts of the *Van Gorkom* case, the corporate bar rallied to object mightily to the Delaware Supreme Court’s holding.¹²⁶ The objectors took the position that the holding in *Van Gorkom* (a) was a travesty of justice, achieving a horribly wrong result, (b) had created a directors’ and officers’ insurance (“D&O insurance”) crisis, precluding many corporations from being able to afford D&O insurance, and (c) was going to chill the willingness of qualified potential directors to serve corporations for fear of personal liability.¹²⁷

The corporate bar-controlled Delaware legislature responded to the outcries following *Van Gorkom* quickly and aggressively. Within twelve months of the Delaware Supreme Court’s *Van Gorkom* opinion, the Delaware legislature adopted DGCL section 102(b)(7).¹²⁸ As discussed in Part I, this statutory provision allows corporations to include in their certificate of incorporation a provision insulating outside directors of the corporation from personal monetary liability for almost all fiduciary duty

121. *Id.* at 880.

122. *Id.* at 881.

123. *Id.* at 878.

124. *Id.* at 888.

125. *Id.* at 893.

126. See Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 793–94 (1994) (summarizing the holding of *Van Gorkom* and the corporate bar’s reaction to the case); see also Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985) (noting that the corporate bar viewed the *Van Gorkom* decision as “atrocious”).

127. See Loewenstein, *supra* note 126, at 793–94; E. Norman Veasey, Jesse A. Finkelshtein & C. Stephen Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 400–01 (1987).

128. See Loewenstein, *supra* note 126, at 794, 815 n.45.

breaches except acts “not in good faith.”¹²⁹

3. *The Impropriety of the Bar’s Response*

The Delaware Supreme Court’s holding in *Van Gorkom* should not have surprised any board or corporate law attorney, and the holding did not call to be met by a caustic legislative reaction. The holding in *Van Gorkom* was consistent with prior case law, created no new or heightened liability standards for directors, and the facts at issue in *Van Gorkom* were particularly egregious, such that it made sense to hold the directors of Trans Union liable for their unconsidered actions (and failures to act).

Moreover, the language used by the court in *Van Gorkom* should not inspire fear in the thoughtful director. Specifically, the court said that “Trans Union’s Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal,”¹³⁰ and the record compelled the conclusion that “the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of the \$55 per share for sale of the Company.”¹³¹ With respect to the “grossly negligent” point, note that the court did not say “the Board was negligent and is therefore liable.” Instead, the court used the phrase “grossly negligent” to qualify the phrase “failed to act with informed reasonable deliberation.”¹³² Neither of those two phrases imposed any new standard. Negligence (or gross negligence) had always been invoked in the context of director liability, and the “informed reasonable deliberation” requirement already existed.¹³³

With respect to the facts in the *Van Gorkom* case, it is unlikely that that level of irresponsible decision-making will be replicated in a thoughtful boardroom. To begin with, the *Van Gorkom* case involved a merger. Acquisitions, dissolutions, mergers, and changes in control have always been treated by the courts with particular care. The extra scrutiny to which these transactions have always been subjected reflects the import of

129. Specifically, this exculpatory legislation provides that a corporation can include in its certificate of incorporation:

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

DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

130. *Van Gorkom*, 488 A.2d at 881.

131. *Id.* at 878.

132. *Id.* at 874 (the directors were “grossly negligent in approving the ‘sale’ of the Company upon two hours’ consideration”) (emphasis added).

133. Barry F. Schwartz & James G. Wiles, *Trans Union: Neither “New” Law Nor “Bad” Law*, 10 DEL. J. CORP. L. 429, 430 (1986) (contending that *Van Gorkom* “represents a reiteration of existing Delaware law”).

change-in-control events in the “life” of a corporation.¹³⁴ Yet despite the critical nature of the transaction at issue, the Trans Union Board was uninformed (and was content to remain uninformed) about the intrinsic value of the company and about the key merger terms, such as the existence (and effect) of a lock-up provision and Trans Union’s ability to call off the acquisition. Moreover, even if the Trans Union Board had gleaned the minimum level of information that they needed to reach an informed decision, the Board did not carefully deliberate on the acquisition in a way that was consistent with the exercise of due care. The Board approved the sale of Trans Union after only two hours of discussion, without having previously considered a sale at all. Moreover, there were no extenuating circumstances that mandated quick action on a significant issue.¹³⁵ Despite these circumstances, the merger agreement ultimately signed by Van Gorkom was not reviewed, even in summary form, by the Board, and the actual document was signed by Van Gorkom at a social event he was hosting.

On these facts, the holding in the *Van Gorkom* case should not have come as a surprise to any savvy corporate lawyer. Clearly, “Trans Union’s Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal,”¹³⁶ and “the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of the \$55 per share for sale of the Company.”¹³⁷ *Van Gorkom* stands for the unremarkable proposition that directors need to inform themselves prior to voting on big-ticket items such as the sale of the corporation. If anything, this proposition should have been reassuring to the corporate bar (as opposed to provoking the call for legislative action): If directors inform themselves prior to making a decision (actually, “try, in a way that is not grossly negligent, to inform themselves”), they will be insulated from liability, even if their decision is, in hindsight, bad.¹³⁸

134. That is to say, a shareholder holding stock in a corporation that is to be acquired, to be dissolved, or to experience a change in control stands to have the true nature of her holding changed.

135. *Van Gorkom*, 488 A.2d at 874.

136. *Id.* at 881.

137. *Id.* at 878.

138. To that end, the court in *Van Gorkom* goes so far as to discuss DGCL section 141(e), and the court indicates that the Trans Union board could have informed itself about the proposed sale by asking officers and outside experts for reports, appraisals, and opinions on the sale. *Id.* at 874–76. (DGCL section 141(e) provides that directors, in performing their duties, shall be fully protected from liability in relying in good faith upon reports prepared by outside experts or officers.). See DEL. CODE ANN. tit. 8, § 141(e) (2007); accord *Van Gorkom*, 488 A.2d at 874–75; *Michaelson v. Duncan*, 386 A.2d 1144, 1156 (Del. Ch. 1978). The court did not require the directors to over-exert themselves in looking for every available piece of informational minutia about the proposed sale—the directors could have delegated in good faith the actual fact-gathering, technical, tedious portion of the task of becoming informed. *Id.*

B. DIRECTORS' AND OFFICERS' INSURANCE

As noted above, the Delaware legislature adopted DGCL section 102(b)(7) in response to a perceived "directors' and officers' insurance liability crisis" following the Delaware Supreme Court's ruling in *Smith v. Van Gorkom*.¹³⁹ It was feared that the perceived D&O insurance crisis and directors' fears of more personal liability threatened to dry up the market for qualified corporate leadership. Yet there exists no compelling evidence that there was in 1986 or shortly thereafter a true insurance "crisis" such that the fear of the potential director pool drying up was valid. Moreover, DGCL section 102(b)(7)'s legislative history provides no meaningful, quantitative evidence of such.¹⁴⁰ Indeed, the legislative his-

139. *Malpiede v. Townson*, 780 A.2d 1075, 1095 (stating that DGCL section 102(b)(7) "was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985 Delaware Supreme Court decision in *Smith v. Van Gorkom*"); see Jeffrey P. Weiss, *The Effect of Director Liability Statutes on Corporate Law and Policy*, 14 J. CORP. L. 637, 643 (1989) (noting that "the Delaware General Assembly responded to the Van Gorkom decision and to the director and officer insurance crisis" by adopting DGCL sections 102(b)(7) and 145(c)); Kristin A. Linsley, Comment, *Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule*, 24 HARV. J. ON LEGIS. 527, 529 (1987) (citing section 102(b)(7) and noting that its stated purpose is "to help alleviate the perceived crisis in the availability of liability insurance for directors"); see also JAMES D. COX, THOMAS LEE HAZEN, & F. HODGE O'NEAL, *CORPORATIONS* 201 (1997) ("[T]he impetus for these exonerating statutes was decisions, such as *Smith v. Van Gorkom*, that appear to be exposing outside-director judgments to closer scrutiny and to the difficulties many corporations were then experiencing in obtaining adequate levels of liability insurance.") (citations omitted); Balotti & Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 7-8 (1987); Steven J. Schleicher, Comment, *Director Liability Dilemma: Providing Relief for Executive Anxiety*, 56 UMKC L. REV. 367, 367-69 (1988); Veasey, Finkelstein & Bigler, *supra* note 127, at 400-01.

140. For quite some time, I tried unsuccessfully to find the entire legislative history of DGCL section 102(b)(7) so that I could independently assess the basis for its adoption. I finally stumbled across a student comment from the 1987 Harvard Journal on Legislation which indicated to me that I was having a hard time finding the legislative history for DGCL section 102(b)(7) because the legislature did not draft this legislation. Linsley, *supra* note 139, at 530-31. Instead, a lawyer in private practice in Wilmington, Delaware, A. Gilchrist Sparks III (Mr. Sparks was the defense counsel in *Van Gorkom*), drafted the text of the legislation. See Ron Ostroff, *Delaware Law Could Limit Director Liability*, L.A. DAILY J., June 23, 1986, at 3, col.1 (identifying A. Gilchrist Sparks III as the draft bill's author); see also Letter from L. Black, Jr., A. Sparks III & J. Johnston of Morris, Nichols, Arsht & Tunnell, Wilmington, Del., to Clients (May 7, 1986) (on file with author) (discussing the drafted legislation, with a "proposed amendments" memo attached to the Letter to Clients) [hereinafter *Sparks Letter*]. Mr. Sparks drafted the legislation (perhaps with the advice of or input from the Corporation Law Section of the Delaware Bar Association), and his draft appears to have been adopted by the Delaware legislature and governor without much, if any, debate.

The "legislative history," then, such as it is, for DGCL section 102(b)(7) consists of three documents:

1. The Sparks Letter,
2. The attachment to the Sparks Letter, titled "Proposed Amendments to Sections 102 and 145 of the Delaware General Corporation Law" [hereinafter *Proposed Amendments Memo*], and
3. The Synopsis to Delaware S.B. No. 533, 133D Gen. Assem. (1986) [hereinafter *Synopsis to Amendments*].

The Synopsis to Amendments includes only two paragraphs that discuss the need for and purpose of DGCL section 102(b)(7), and both paragraphs summarize the hyperbole in the Sparks Letter and its attached Proposed Amendments Memo regarding insurance unavail-

tory cites only three Wall Street Journal articles to support the contention that there was a widespread D&O insurance crisis, such that directors (and qualified potential directors) were unwilling to serve because corporations could not afford to insure them.¹⁴¹ Those articles, when read closely, do not compel the conclusion that the D&O insurance market was in crisis or that the only way to address the “crisis” was with liability-limiting legislation. For example, only one of the articles relied upon in the Proposed Amendments Memo makes reference to director resignations after losing D&O insurance coverage.¹⁴² This article notes that five smaller-sized corporations lost their directors when their D&O insurance coverage lapsed. Yet five corporations losing directors does not a crisis make.

Additionally, another Wall Street Journal article mentioned in the legislative history of DGCL section 102(b)(7) focused not on D&O insurance, but rather on: products liability, a skiing resort that raised its prices “to compensate for a sixfold premium increase,” the professional insurance issues involving lawyers, doctors, and engineers, and problems governments are experiencing procuring insurance.¹⁴³ This article even noted that the “immediate cause of the sharp premium increases and lack of coverage are losses that insurers suffered from competitive rate cutting on commercial property liability policies in the six years through 1984. The companies had hoped to offset claims payments with income earned from investing premium dollars.”¹⁴⁴ Further, “[i]nsurers acknowledge that many of their financial wounds are self-inflicted, but they claim a more serious problem is the rising cost of defending and settling lawsuits and paying big jury awards.”¹⁴⁵ So nowhere, then, in sources referenced in DGCL section 102(b)(7)’s legislative history is there compelling evidence that (1) there was a quantifiable insurance crisis in the D&O insurance arena, (2) the director’s duty of care and the *Van Gorkom* decision was the reason for any insurance issues, (3) these issues, to the extent that they existed, could not be addressed with self-insurance or other tools, or (4) there was a true deficit in the potential director pool, created by this D&O insurance “crisis,” such that any defecting directors could not be

ability and the unwillingness, therefore, of qualified directors to serve. As discussed in the text, the documented legislative history of DGCL section 102(b)(7) provides scant evidence that DGCL section 102(b)(7) was needed.

141. See Proposed Amendments Memo at 1 (citing *Director Insurance Drying Up*, N.Y. TIMES, Mar. 7, 1986, at D1); *Insurers Beginning to Refuse Coverage on Directors, Officers In Takeover Cases*, WALL ST. J., Jan. 20, 1986, at 3; *Liability Insurance Is Difficult to Find Now for Directors*, WALL ST. J., July 10, 1985, at 1; *The Insurance Crisis: Businesses Struggling to Adapt as Insurance Crisis Spreads*, WALL ST. J., Jan. 21, 1986, at 31.

142. See *Director Insurance Drying Up*, N.Y. TIMES, Mar. 7, 1986, at D1 (noting that “the Control Data Corporation, the Continental Steel Corporation, the Lear Petroleum Corporation, South Texas Drilling and Exploration Inc. and Sykes Datatronics have all lost directors when their insurance ended”).

143. *The Insurance Crisis*, *supra* note 141.

144. *Id.*

145. *Id.*

replaced.¹⁴⁶

Part of the post-*Van Gorkom* cries were due to the fact that D&O insurance premiums were increasing immediately before and soon after the case was decided. Even assuming the *Van Gorkom* case had any relation to the premium increases,¹⁴⁷ the response to the increased premiums did not necessarily have to be statutory insulation. Rather, there were at least two other options: self-insurance and liability caps.

With respect to self-insurance, it is common for corporations to set aside financial reserves for various liabilities that lurk on the horizon, to hopefully cover any loss the liability might create in the future. A corporation could maintain a sizeable “director liability reserve” exclusively to cover any potential liability exposure of the board. Additionally, self-insurance has the positive benefit of fostering increased professional care and attention.¹⁴⁸

Liability caps are also useful. For example, the Virginia code limits the recoverable damages against any one director in any proceeding brought by or in the right of the corporation or its shareholders to the lesser of the monetary cap specified in the articles of incorporation or shareholder-approved by-laws, or the greater of \$100,000 or the cash compensation receive by the director from the corporation over the twelve months prior to the act complained of.¹⁴⁹ The financial exposure of directors is minimal (given that, for most directors, the compensation they receive for being a director is not their sole source of support), yet shareholders will still have the ability to police their directors via threat of legal liability.

146. One of the articles referenced in the Proposed Amendments Memo mentions that the “lack of coverage is making some directors more cautious,” and quotes a bank chairman who notes that, in response to having to operate without insurance, his board is modifying their level of care: “I’m sure that before [our board] undertook a risky investment or anything out of the ordinary we would discuss it at great length.” *Id.* This is evidence of a thoughtful response to *Van Gorkom*; this does not evince an impending drought of directors.

147. My research has indicated that the increase in premiums was due more to lagging pricing previously and the weakening of the economy than to *Van Gorkom*.

148. Interestingly, this is exactly how anesthesiologists dealt with a malpractice insurance “crisis” a couple of decades ago. To wit, with respect to the medical malpractice insurance “crisis” over the past twenty years, we see that one subset of doctors— anesthesiologists—successfully precluded a true medical malpractice insurance drought in their area of expertise by self-regulating and reforming their best practices. Anesthesiologists were once considered to be among the riskiest doctors to insure. Now, however, their malpractice insurance premiums are among the smallest, and the premiums today are smaller than they were, on average and in constant dollars, twenty years ago. This reduction in premiums and steep decline in the number of patient deaths due to anesthesia (from one in every 5,000 cases to one per 200,000 to 300,000 cases) is mainly because anesthesiologists focused on improving patient safety over the past two decades. Rather than “pushing for laws that would protect them against patient lawsuits,” the anesthesiologists chose to improve their patient safety practices and risk-management procedures, an option that, admittedly, “many doctors in other specialties did not [choose].” Joseph T. Hallinan, *Heal Thyself: Once Seen as Risky, One Group of Doctors Changes Its Ways*, WALL ST. J., June 21, 2005, at A1.

149. VA. CODE ANN. § 13.1-692.1(A) (2004). This statutory provision specifically exempts from protection “willful misconduct or a knowing violation of the criminal law or of any federal or state securities law.” *Id.* § 13.1-692.1(B).

C. DIRECTOR AVAILABILITY AND WILLINGNESS TO SERVE

An oft-repeated myth (or bad forecast, at best) is that qualified people will not want to serve as directors if they are not almost fully insulated from liability.¹⁵⁰ This argument was bandied about immediately after *Smith v. Van Gorkom*, yet there is no empirical evidence that the argument was ever true. Moreover, as a matter of policy, the argument is bootless. Other professionals, such as attorneys and doctors, are not specially insulated from professional liability for their work, yet qualified lawyers and doctors remain willing to practice. Liability is always a concern for professionals (high net-worth and otherwise), and there are ways to mitigate liability exposure, as discussed above. In addition, query whether the investing public should want their investments to be managed by directors who fear being held accountable for gross negligence in becoming informed.

V. PRACTICAL CONSIDERATIONS PERTAINING TO DIRECTOR LIABILITY

If courts, legislators, and academics reconsider director liability and “not in good faith” with a more faithful interpretation of a director’s obligation to act in good faith, directors will obviously be seeking guidance on minimizing their liability exposure for acts “not in good faith.” Below are a few thoughts.

A. PROFESSIONAL DIRECTORS

The question is occasionally raised as to whether directors are “smart enough” to detect corporate misconduct and comprehensively do their jobs.¹⁵¹ But a look at the Enron board of directors at the time Enron suffered massive financial devastation makes clear that the Enron board could not have failed due to lack of firepower. Among the board members were Ph.D. economists, former senior managers, a University President, and other people who clearly were smart enough to either understand financial documents themselves or understand enough to

150. Even if a loss had accrued as a direct and immediate consequence of [the directors’] error, still, without any other fault on their part, the law, from the wisest policy, would excuse them. No man, who takes upon himself an office of trust or confidence for another, or for the public, contracts for anything more than a diligent attention to its concerns (sometimes differing in degree) and a faithful and honest discharge of the duty which it imposes. He is not supposed to have attained infallibility; and does not, therefore, stipulate that he is free from error. To hold that the law requires this of any man is to suppose him incapable of erring; and to establish it as a rule that men are to be responsible for mistake or error of judgment, while acting in good faith, would put an end to all offices of trust—since no one who is capable or worthy could be found to accept of them.
Scott v. Depeyster, 1 Edw. Ch. 513, 534–535 (N.Y. Ch. 1832).

151. See David A. Westbrook, *Corporation Law After Enron*, 92 GEO. L.J. 61, 95 (2003) (citing an on-line poll indicating that 59% of corporate executives believe that their boards lack the financial acumen to detect cooked books).

know that they needed to ask for outside counsel.¹⁵² This is typical of the well-staffed board; either the directors are experts in the field or they are astute enough to seek the assistance of outside experts that they are specifically authorized under state statutes to consult.¹⁵³

It is hard to believe, then, that massive board failures are usually attributable to weaknesses in the quality of the directorate. Rather, it is more likely that directors are over-committed and restricted in their available time. Typical directors of Fortune 500 companies are usually either current officers of large businesses or former officers who are currently hold-

152. At the time Enron declared bankruptcy in 2001, the Enron board of directors included:

Robert Belfer, who had been an Enron director since 1983, was the Chairman and CEO of Belco Oil & Gas Corp., and was the former President and Chairman of Belco Petroleum Corp., a wholly owned subsidiary of Enron; Norman P. Blake, Jr., who had been a director since 1993, was the Chairman, President and CEO of Comdisco, Inc., and was a director of Owens-Corning Corporation; Ronnie Chan, who had been a director since 1996, was the Chairman of Hang Lung Group, and was a director of both Standard Chartered PLC and Motorola, Inc.; John H. Duncan, who had been an Enron director since 1985, and was a director of both EOTT Energy Corporation and Group I Automotive; Wendy L. Gramm, who had been a director since 1993, was the Director of the Regulatory Studies Program of the Mercatus Center at George Mason University, had been the Chairman of the Commodity Futures Trading Commission in Washington, D.C. from February 1988 to January 1993, and was a director of IBP, State Farm Insurance Company, and Invesco Funds; Robert J. Jaedicke, who had been a director since 1985, was a Professor Emeritus of Accounting at the Stanford University Graduate School of Business, and was a director of both California Water Service Company and Boise Cascade Corporation; Kenneth L. Lay who had been a director since 1985, had been both the Chairman of Enron since 1986 and Enron CEO from 1986 to February 2001, and was director of both Eli Lilly and Company and Compaq Computer Corporation; Charles A. LeMaistre, who had been a director since 1985, and was the former President of the University of Texas M.D. Anderson Cancer Center in Houston; John Mendelsohn, who had been a director since 1999, was the President of the University of Texas M.D. Anderson Cancer Center in Houston, and was a director of ImClone Systems, Inc.; Paulo V. Ferraz Pereira, who had been a director since 1999, was the Executive V.P. of Group Bozano, and was both the former President and CEO of the State Bank of Rio de Janeiro; Frank Savage, who had been a director since 1999, was the Chairman of Alliance Capital Management International, and was a director of Lockheed Martin Corporation, Alliance Capital Management L.P. and Qualcomm Corporation; Jeffrey Skilling, who had been a director since 1997, was the President and CEO of Enron since February 2001 and the President and COO of Enron from January 1997 to February 2001, and was the Chairman and CEO of Enron North American Corporation and its predecessor companies from August 1990 until December 1997; John Wakeham, who had been a director since 1994, was a former U.K. Secretary of State for Energy and Leader of the Houses of Commons and Lords, was a member of British Parliament from 1974 to 1992, and was the Chairman of the Press Complaints Commission in the U.K.; Herbert S. Winokur, Jr., who had been a director since 1985, was the Chairman and CEO of Capricorn Holdings, Inc., was a former Senior Executive V.P. and director of Penn Central Corporation, and was a director of NATCO Group, Inc., Mrs. Fields' Holding Company, Inc., CCC Information Services Group, and DynCorp.

See Enron Corp., Proxy Statement (Form 14-A), at 4-7 (Mar. 27, 2001), available at <http://www.sec.gov/Archives/edgar/data/1024401/000095012901001669/0000950129-01-001669-index.htm>; see also S. REP. NO. 107-70, at 28, 34-36, 47, 55 (2002), available at <http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf> (describing the various roles the individual directors had in the downfall of Enron).

153. See DGCL § 141(e) (authorizing corporate directors to rely on officers and outside experts such as accountants and lawyers in fulfilling their duties as directors).

ing other board or consulting positions.¹⁵⁴ They simply do not have time to thoughtfully monitor each of their charges.

This raises an interesting point for further consideration: Perhaps it is sensible to have on large boards a number of “professional directors.”¹⁵⁵ The professional director is one who serves on multiple boards of directors and does not have another job in addition to being a director.¹⁵⁶ The

154. See Aims, *supra* note 19, at 239–40 (reporting on multiple board memberships among directors of the 100 largest U.S. companies).

155. See Joe Queenan, *The Feat of the Master*, CHIEF EXECUTIVE Jan. 1, 2004, at 62, available at http://www.thefreelibrary.com/_/print/PringArticle.aspx?id=114050454.

156. *Id.* I contrast the “professional director” from the “trophy director.” The latter is invited to sit on a board of directors due in large part to his level of public visibility. I view former Disney director Sidney Poitier and former Enron director John Mendelsohn as trophy directors. They both had serious time commitments while acting as directors: They both had “day jobs.” John Mendelsohn was the President of the University of Texas M.D. Anderson Cancer Center in Houston while also serving as a director for Enron (and as a director of ImClone Systems, Inc.), and Poitier was a Disney Director from 1994 until 2003 while also serving as the Chief Executive Officer of Verdon-Cedric Productions. See *Enron Proxy*, *supra* note 152, at 6. There is no compelling reason why either director was more skilled to be a director than other people of similar backgrounds who do not have “day jobs,” other than the public visibility issue, which makes Poitier and Mendelsohn, in my view, trophy directors.

A professional director, contrariwise, is a person who has no job in addition to being a director. Perhaps he or she is on multiple boards of directors. I view this “professional director” as akin to a hired gun—a person who is asked to be on a board of directors because he is good at being a director—this is what he does for a living.

There is no agreed-upon dictionary definition of “professional director.” Academics generally agree, however, on some of the defining characteristics of a professional director: A professional director has no other demanding full-time job, and he therefore has the time to commit to monitoring vigorously the corporation for which he is a director. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 885–86 (1991). The professional director has perhaps a full-time commitment to the corporation, see C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century*, 51 U. KAN. L. REV. 77, 121–22 (2002); Gilson & Kraakman, *supra*, at 885, perhaps a staff of advisors or employees, Wells, *supra*, at 123; and a salary close to commensurate with his expertise and sufficient to justify his time commitment to the corporation, see Gilson & Kraakman, *supra*, at 885.

As to the full-time commitment to the corporation, I have found no scholar willing to say that a professional director should (a) have no other outside employment and (b) sit on only one board of directors. However, there is a difference to me between, for example, a current University President or current Law School Dean sitting on a board of directors and a retired University President sitting on a board of directors. Dean Mark Sargent, current dean of Villanova Law School, sits on the Board of Trustees of Wilmington Trust Mutual Funds. Curriculum Vitae: Dean Mark A. Sargent, <http://www.law.villanova.edu/academics/faculty/biographies/deans/sargent/curriculumvitae.pdf>. Richard L. Morrill, former President of the University of Richmond, sits on the Board of Directors of both Albemarle and Tredegar Corporations. Albemarle Corp., Proxy Statement, at 7 (Mar. 2, 2007), available at http://www.albemarle.com/Investor_information/financial_information/annual_reports/2007/AR2006_Proxy.pdf; Tredegar Corp., Proxy Statement, at 11 (Mar. 28, 2007), available at <http://www.tredegar.com/PDF/07proxy.PDF>. I have no issue with the latter as a matter of good corporate governance. Morrill, having previously juggled the time demands of being a university president, can surely juggle the time demands of sitting on two boards. The former, however, gives me pause: Dean Sargent is uniquely qualified to be a good director. He is an expert in financial and legal matters, he is a guru in the world of ethics (particularly business ethics), and he is clearly smart, diligent, and responsible. Does he have the *time*, however, to be an attentive monitoring director? If a matter of great import and serious time pressure arises with respect to the Wilmington Trust Mutual Funds, can Dean Sargent immediately clear his schedule enough to allow him to attend

professional director is, to me, much preferable to, for example, the University President who, in his "spare time," sits on a board of directors. It is inconceivable that a person who has a full-time, demanding "day job" can do an acceptable job as a director of a publicly traded corporation. It seems more sensible to have as directors otherwise qualified professionals (former accountants, businesspeople, lawyers) who have no job other than serving on multiple boards of directors.¹⁵⁷ These directors would (a) not have a divided primary loyalty with a demanding day job, and (b) be in a unique position to exploit economies of scale. As to the latter point, if a professional director is on five boards of directors, he can compare how the boards review financial statements, how the boards deliberate, how often the boards meet, how much access to auditors and lawyers the boards are provided, and so on.¹⁵⁸ That professional director can cross-pollinate the best, most effective practices among the boards on which he serves. Nothing but good can come of that.

B. BEST PRACTICES

If directors are still worried about personal liability after *Van Gorkom* and if directors are still worried about missing an Enron-esque nightmare brewing, "best practices" can be distilled from recent events and case law to protect against needless exposure. To protect against the argument that a director was not acting "in good faith," a director should:

- (a) Attend board of directors' meetings regularly and stay awake.¹⁵⁹

marathon board meetings? What will he say to the major Villanova alumni donors who are planning to have dinner with him that week? What will he say to the top-twenty Law Review Board at whose symposium he is set to speak that week? And, assuming he can clear his schedule for a few critical days, can he so do if the initial crisis re-erupts in a few weeks? I do not know the answer to these questions, and I, therefore, take pause with the notion that someone in a busy, high-profile law school dean position is the best potential director.

157. For example, my old accountant, from Albany, New York, Aanen Nelsen, Jr., always comes to mind when I think of the potential professional director. Aanen has been an accountant for about thirty-five years. He majored in accounting at Siena College, he has his own accounting firm, and he handles accounting for various individuals, families, and businesses.

I suspect that Aanen makes about \$120,000 per year, so he likely would be willing to give up his practice and take two director seats, each paying \$85,000 per year. In return, each board on which he sat would be garnering a director who (a) has extensive financial acumen, (b) is very familiar with accounting practices and financial materials, and (c) has roughly twenty to thirty hours per week (per corporation) to devote to director-related work.

The argument that I have encountered against this sort of professional director is that experience in certain industries is critical to being a good director. Better to have a retired entertainment industry CEO who is currently still consulting for his former firm and who sits on three other Fortune 500 boards serve as director than someone with Aanen's general financial and business expertise and time availability. I disagree, and I anticipate a move toward an increase in the number of professional directors over the next decade.

158. See Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform*, 48 VILL. L. REV. 989, 1015 (2003) (discussing high-profile directors who serve on multiple boards of directors).

159. Shawn Young, Almar Latour & Susan Pulliam, *Ebbers Lawyer Paints Sullivan as Chronic Liar*, WALL ST. J., Feb. 17, 2005, at C1 (Scott Sullivan, former CFO of WorldCom,

Although directors are allowed in most jurisdictions to telephonically be present at meetings of the board of directors, and although directors are generally not sanctioned for missing meetings, it is prudent for a director to attend, in person, all meetings of the board of directors. This allows the director to at least keep apprised of corporate events and issues that are significant enough to make it onto the meeting agenda. As well, the face-to-face interaction fosters more discourse among the outside directors, which is useful in instances where the outside directors are at odds with the insiders. If a director has to miss a board meeting, the director should follow-up to ensure that he is briefed about the substance of the meeting and the issues that arose.¹⁶⁰

(b) Ask questions.

No published court opinion exists wherein a court penalizes a director for his ignorance in an instance where the director clearly made a considered attempt, proportionate to the import of the matters at stake, to edify himself and ask key questions.

(c) Become familiar with financial documents and be aware of common red flags.

Hardly a day goes by without an announcement of a major corporation's earnings restatement. While directors do not have to be financial wizards or accounting mavens, they increase their liability exposure if they do not endeavor to understand their corporation's financial statements.¹⁶¹ Asking for a two-hour financial statement familiarization seminar run by an accounting firm and reading up a bit on financial statement interpretation are easy steps for a director to take in a good-faith effort to be informed.¹⁶²

(d) Keep tabs on operational problems.

If directors know something significant is going wrong or appears to be raising concerns at an operational level, but the directors fail to keep tabs on or follow-up regarding the matter, the directors are opening the door to potential liability.¹⁶³ Directors should be briefed regularly (in writing,

testified that he "misled the board" with relative ease, given that "a lot of people weren't even awake, so there wasn't a lot of challenge").

160. See *Francis v. United Jersey Bank*, 432 A.2d 814, 819–20, 822 (N.J. 1981) (discussing the liability of a director who was inattentive, an alcoholic, and depressed: "Directors are under a continuing obligation to keep informed about the activities of the corporation."); see also *Hoye v. Meek*, 795 F.2d 893, 895–97 (10th Cir. 1986) (imposing liability on a chairman who failed to monitor investment decisions, failed to respond to the company's increasing exposure to risk, and did not regularly attend board meetings).

161. See, e.g., *Francis*, 432 A.2d at 822 ("Directors are under a continuing obligation to keep informed about the activities of the corporation."); see also *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003).

162. For example, in the *Wall Street Journal*, various easy-to-read accounting fraud articles regularly appear and help non-accountants understand signs of "cooked books." See Ian McDonald, *Ahead of the Tape, Today's Market Forecast, Lies, Damned Lies, and Earnings*, WALL ST. J. Nov. 26, 2004, at C1 (discussing the red flag of the "widening chasm between companies' earnings reported according to generally accepted accounting principles . . . and their fuzziest 'operating' figures").

163. See *In re Abbott Labs S'holder Litig.*, 325 F.3d 795, 811 (7th Cir. 2003) ("Plaintiffs . . . accused the directors not only of gross negligence, but of intentional conduct in failing

if meetings are logistically difficult) by senior management about material operational issues, and directors should be proactive in asking about potential problems looming on the horizon.¹⁶⁴ Making the “wrong” decision about how to respond to a significant operational problem is not a liability-exposing act,¹⁶⁵ but fully ignoring the problem after it has been raised is.¹⁶⁶

(e) Manage management.

Hiring, compensating, evaluating, and retaining or terminating senior management all require the attention of the board.¹⁶⁷ Issues regularly arise regarding: (a) a board’s readiness to replace senior executives, should such become necessary;¹⁶⁸ (b) the compensation, both in size and

to address the federal violation problems, alleging ‘a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith.’”) (quoting *McCall v. Scott*, 250 F.3d 997, 1001 (6th Cir. 2001)).

164. Note that directors are not obligated to find out about any and all operational missteps, and “absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company’s behalf.” *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996). Directors have the obligation only to assure “themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.” *Id.* at 970. “Obviously the level of detail that is appropriate for such an information system is a question of business judgment,” but, as a practical matter, liability for inattention and inaction could really only arise from “an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.” *Id.* at 967 (citations omitted) (emphasis in original); accord *Abbott Labs*, 325 F.3d at 806 (internal citations and quotations omitted) (This “case is not about the failure of the directors to establish and carry out ideal corporate governance practices. The facts in *Abbott [Labs]* do not support the conclusion that the directors were ‘blamelessly unaware of the conduct leading to the corporate liability.’”) (quoting *In re Caremark*, 698 A.2d at 969).

An interesting related current issue concerns “technology” board committees. See, e.g., Bhattiprolu Murti, *Technology Committees Catch On in Boardrooms*, WALL ST. J., June 30, 2005, at B3. In response to increasingly complex technology issues, the technology disclosure requirements of the Sarbanes-Oxley Act, technology-related security and privacy issues such as those arising when a retailer’s or bank’s client database is compromised, and the increasing importance of technology in the infrastructure of a business, many boards are establishing “technology committees.” *Id.* While the failure to have such a committee is not a lapse in a board’s business judgment as an absolute matter, boards would be well-served to examine whether the nature, intricacies, or infrastructure of their business justifies forming a technology subcommittee of the board or directors.

165. *Salsitz v. Nasser*, 208 F.R.D. 589, 598–599 (E.D. Mich. 2002).

166. See *In re Caremark*, 698 A.2d at 967 (liability may be imposed on board when an “*unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss”) (emphasis in original); accord *McCall v. Scott*, 250 F.3d at 999 (quoting *In re Caremark*, 698 A.2d at 967).

167. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003). Remember that senior management only has their authority as a result of directors delegating *their* management authority under statutes such as DGCL section 141.

168. See J. Lynn Lunsford & Joann S. Lublin, *Boeing’s Pushed Into Search for CEO*, WALL ST. J., Mar. 9, 2005, at A6 (discussing how Boeing’s board “is now facing questions about how prepared it was to find a permanent CEO,” particularly in light of the fact that the departing CEO, Harry Stonecipher, was brought out of retirement in December 2003 because the board did not then have any other qualified CEO candidates lined up); see also Ram Charan, *Who Will Be Your Next CEO*, WALL ST. J., Feb. 8, 2005, at B2 (observing

method, of senior management;¹⁶⁹ (c) management benefits;¹⁷⁰ and (d) the termination of senior management.¹⁷¹ The outside directors on a board should regularly meet in the absence of the inside directors to assess the performance of their senior management and address any hiring, firing, or executive compensation issues.¹⁷²

that many boards “have no meaningful CEO succession plan,” and making suggestions on how to fix this internal weakness); Barbara Martinez & Joann Lublin, *Change of Formula: Merck Replaces Embattled CEO With Insider Richard Clark: As Gilmartin Accelerates Retirement, Drug Giant Plans Review of Strategy; Unusual Role for a Board Trio*, WALL ST. J., May 6, 2005, at A1 (discussing how after a wave of litigation over Vioxx, one of Merck’s biggest money-makers that was pulled from shelves due to cardiovascular issues, and struggles to keep Merck’s pipeline moving, long-time Chairman and Chief Executive Raymond Gilmartin was removed from his position ten months prior to his scheduled retirement and replaced by Richard Clark). Moreover, directors should have an informed process for screening and selecting a CEO. Carol Hymowitz, *The Perils of Picking CEOs: Add Candidate’s Character to Boards’ List of Concerns as Openings at the Top Grow*, WALL ST. J., Mar. 15, 2005, at B2 (“Micheal Leven, CEO of U.S. Franchise Systems, . . . predicts that CEO candidates ‘may soon have to undergo the kind of FBI clearances given to prospective cabinet members. And,’ he adds, ‘that may be appropriate given the money they earn and the responsibilities they’re given.’”).

169. Joann S. Lublin, *Imprisonment Doesn’t Bar Pay for Select Group of CEOs*, WALL ST. J., Mar. 2, 2005, at B1 (discussing salary and benefits either paid to or accrued for Martha Stewart (founder and senior executive of Martha Stewart Living Omnimedia Inc.), Andrew Wiederhorn (founder and former CEO of Fog Cutter Capital Group Inc.), and Steve Madden (founder and former senior executive of Steven Madden Ltd.) while they were incarcerated or upon their release).

170. See, e.g., Kathryn Kranhold, *GE Changes Policy on the Use of Its Jets by Vice Chairmen*, WALL ST. J., June 22, 2005, at B2 (GE’s board changed its policy regarding the personal use of corporate aircrafts by vice chairmen to require payment for personal use; previously, GE’s former Vice Chairman Dennis Dammerman cost GE close to a million dollars over two years for his personal use of GE corporate aircrafts).

171. See, e.g., Rick Brooks, *Krispy Kreme Ousts Six Executives*, WALL ST. J., June 22, 2005, at B3 (six senior executives at Krispy Kreme resigned or retired after a special committee comprised of two independent Krispy Kreme directors investigated concerns about the company’s franchise repurchases, concerns raised by auditors, and other operational and financial issues); Mark Maremont & Rick Brooks, *Once-Hot Krispy Kreme Ousts Its CEO Amid Accounting Woes*, WALL ST. J., Jan. 19, 2005, at A1 (Krispy Kreme CEO Scott Livengood “was pushed out by directors amid slumping sales, accounting woes and a federal probe”).

After Richard Scrushy, former Chief Executive and founder of HealthSouth Corp., was acquitted of accounting fraud, conspiracy, and related charges, he sought to reclaim his executive position with the company (he had been terminated in 2003 when the extensive multibillion-dollar fraud that took place while he was in leadership was revealed). The board adamantly maintained that they would not hire Scrushy back in any capacity. Dan Morse, *Scrushy Wants HealthSouth Job Back*, WALL ST. J., July 1, 2005, at A3.

The board’s position is clearly the correct position to take from a liability exposure standpoint—Scrushy, who maintains that all five of HealthSouth’s former finance chiefs hid their fraudulent acts from him, has shown himself to be, at the least, an inattentive senior executive and, at the worst, a fraudster. Contrast the HealthSouth board’s decisive action in terminating and refusing to re-hire Scrushy with the Disney board’s failure to terminate Michael Eisner after his egregious behavior in hiring and negotiating an obscene termination package with his friend Michael Ovitz came to light. See *infra* note 172.

172. Former SEC Chairman Arthur Levitt, Jr. recently opined that “[t]he imperial CEO is no more.” Arthur Levitt, *The Imperial CEO Is No More*, WALL ST. J., Mar. 17, 2005, at A16 (discussing recent board and shareholder activism in monitoring senior executive performance). Chairman Levitt pointed to a spate of CEO firings by boards and pressure put on management by investors to substantiate the point that “we are experiencing a cultural change in corporate America,” and “[g]one are the days of the autocratic, muscular CEO whose picture appeared on the covers of business magazines.” *Id.*; see Alan Mur-

(f) Use extra care with mergers, acquisitions, recalls, expansion, and other big-ticket items.

The lesson to be learned from *Smith v. Van Gorkom*, as discussed above, is that courts will look closely at the evaluative process employed by directors when acting on issues of significant import, such as sales or acquisitions. Courts will expect directors who are acting in good faith to gather an appropriate amount of relevant information and deliberate for a proportionate amount of time when making major decisions.¹⁷³

(g) Ask for help when needed.

ray, *Emboldened Boards Tackle Imperial CEOs*, WALL ST. J., Mar. 16, 2005, at A2 (“There seems to be a sea change going on here—a kind of maturation of American corporate governance. The king now has a parliament . . . Americans still want their CEOs to don wings and fly. But someone needs to make sure they don’t get too close to the sun.”).

For example, Carl Vogel, former chief executive of Charter Communications Inc., resigned under pressure amid board dissatisfaction, in part due to Charter’s failure to perform at a level that met the board’s expectations. Peter Grant, *Charter Communications CEO Quits Amid Board Unhappiness; May Takes Over From Vogel as Cable Giant’s Directors Cite a Slack Performance*, WALL ST. J., Jan. 19, 2005, at B3 (stating that Lance Conn, a Charter director, told analysts and investors on a conference call that Charter “has not met your expectations or ours”). Similarly, the board of Hewlett-Packard Company ousted superstar CEO Carly Fiorina after five-and-one-half years of disappointing performance and Fiorina’s resistance to the board’s plan for her to delegate some day-to-day authority to heads of Hewlett-Packard’s key business units. Pui-Wing Tam, *H-P’s Board Ousts Fiorina as CEO; How Traits that Helped Executive Climb Ladder Came to be Fatal Flaws, You Learn to Be Self-Reliant*, WALL ST. J., Feb. 10, 2005, at A1.

Some directors appear to be willing to arguably go overboard with managing management. The board of directors of Boeing forced Boeing’s president and chief executive, Harry Stonecipher, to resign after the board learned about Mr. Stonecipher’s extra-marital affair with a female Boeing executive. The board determined that Mr. Stonecipher used poor judgment and placed Boeing in a potentially damaging situation. See *Emergency Exit: Boeing’s CEO Forced to Resign Over His Affair With Employee, Stonecipher was Brought in to Restore Credibility in Wake of Other Scandals; Undone by Secret Tipster*, WALL ST. J., Mar. 8, 2005, at A1. In my opinion, the board took a conservative option in forcing Mr. Stonecipher’s resignation, as I doubt the failure to do so would have come close to breaching the board’s duty of care. Their aggressive reaction is laudable, nonetheless.

The antithesis of Boeing’s board’s derisive response is the Disney board’s apathetic response when the audacious nature of Michael Eisner’s flagrant missteps in the hiring and firing of Michael Ovitz came to light. See *supra* note 171. Specifically, it is beyond me as to why the Disney board did not fire Michael Eisner as soon as the board realized that Eisner hired Ovitz, who had little relevant experience or qualifications that would justify his senior executive position at Disney, basically because Ovitz was a long-time friend; Eisner negotiated with Ovitz a package for Ovitz that was, by most standards, wantonly excessive; and Eisner negotiated with Ovitz a termination package that was even more excessive than Ovitz’s employment package. Ovitz’s employment and later termination packages made leaving Disney more lucrative to Ovitz than staying and fulfilling his contract. Eisner was not protecting Disney’s interests and the interests of the Disney shareholders, and it astounds me that the board let Eisner remain in office when these egregious actions came to light. See *generally In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 36–46 (Del. 2006).

173. For example, when Cnooc Limited made a bid for Unocal Corporation, outside Cnooc director Kenneth Curtis “peppered” the independent advisors about the potential offer, notwithstanding the fact that Curtis had a background as an economist, was working for investment bank Goldman Sachs, and had experience with mergers and acquisitions. See *China Inc. Looks Set to Outdo Old Japan Inc.: Cnooc Outside Director Curtis Stalled Earlier Bid for Unocal Despite Goldman Funding Pledge*, WALL ST. J., June 24, 2005, at C1. Although some viewed Curtis’s requests for more information as “border[ing] on unreasonable,” *id.*, given that Cnooc would have to borrow \$16 billion to fi-

Directors are not expected to be operational mavens, financial experts, forensic accounting gurus, and legal nimrods. Directors should consult outside experts as appropriate.¹⁷⁴ That said, directors should ideally retain *disinterested* outside experts. For example, directors should employ their own separate investment bankers to provide a fairness opinion in the case of an acquisition as opposed to using the investment bank that is advising the corporation itself.¹⁷⁵

(h) Be aware of investor grumblings.

As discussed in Part I, *supra*, directors act as fiduciaries with respect to the corporation, which is owned by shareholders. It is prudent, therefore, for directors to keep a thumb on the pulse of investor sentiment,¹⁷⁶ both as a matter of law and as a matter of good corporate governance.¹⁷⁷

nance its acquisition of Unocal, Curtis's requests for more information were exactly what would justify giving Curtis the protection of the business judgment rule.

174. DGCL section 141(e) authorizes such:

A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

DEL. CODE ANN. tit. 8, § 141(e) (2007).

175. See Ann Davis & Monica Langley, *Open Secrets—Good Reviews: Opinions Labeling Deals 'Fair' Can Be Far From Independent Banks that Do Them Often Are Advisers on Transactions and Have Fees at Stake; A High-Profit Margin Item*, WALL ST. J., Dec. 29, 2004, at A1 (discussing transactions related to the sale of Crown American Realty Trust, wherein the directors, suspicious of a fairness opinion initially provided to them, demanded a new investment banking team that had not done prior conflicted work, giving them the mandate that “[y]ou report directly to the board, not the CEO.”).

176. Both the Disney litigation and the recent shakeup of Morgan Stanley were preceded by loud shareholder complaints. Ann Davis, *Purcell's Close Ties to Board Complicate Dissident's Mission*, WALL ST. J., Mar. 31, 2005, at C1. Directors are not obligated to defer to shareholder pressure, but, at some point, it makes sense to at least listen to shareholder complaints to ensure the directors are informed.

177. The Disney's directors were recently sued again by former directors Roy Disney and Stanley Gold for allegedly conducting an inadequate and biased search for Michael Eisner's replacement. Merissa Marr, *Suit is Filed Over Disney CEO Search; Ex-Directors Claim Board Misled Investors on Range of Potential Candidates*, WALL ST. J., May 10, 2005, at B4. Specifically, Messrs. Disney and Gold believe that Mr. Eisner's involvement in the search for his successor was inappropriate and external candidates for the position were being warded off. *Id.* (stating that Meg Whitman, eBay Inc.'s CEO, withdrew from Disney's CEO search because she allegedly believed the Disney board was moving slowly and seemingly set on Mr. Iger.). Given that the year prior, Disney and Gold led a shareholder revolt against Michael Eisner that led to his relinquishing his chairmanship and announcing his decision to resign within the next couple of years, the Disney board would have been wise to consult Messrs. Disney and Gold to solicit input on the CEO search.

In contrast to the Disney directors' inattention to investor concerns, after American International Group, Inc. was shaken by state and federal accounting inquiries and longtime former chairman and CEO Maurice “Hank” Greenberg was forced to resign, Interim Chairman Frank Zarb reached out to large institutional investors to solicit input on new independent director nominees. Joann Lublin, Monica Langley & Theo Francis, *Moving the Market: AIG Talks to Big Holders About Board's Composition*, WALL ST. J., June 20, 2005, at C3. While Zarb did not say directly that he was attempting to appease large shareholders, his outreach came on the heels of a perceived corporate governance failure that

(i) Know what the job of director entails.

It is difficult for a director to perform his job well if he is unclear regarding his responsibilities. For example, in the prosecution of Mark Swartz and L. Dennis Kozlowski, Tyco International Ltd.'s former chief executives who looted the company, questions were raised as to whether the Tyco directors approved the multi-million dollar loans that Swartz and Kozlowski forgave themselves.¹⁷⁸ Had the Tyco directors been clear that they were responsible for approving these sorts of loans and the forgiveness thereof, they could have questioned the reductions of Swartz's and Kozlowski's loans.¹⁷⁹

VI. CONCLUSION

Does the difference between the phrases "not in good faith" and "bad faith" matter? Absolutely. Director liability jurisprudence actually hinges on this difference. The continued bastardizing of the meaning of the failure to act in good faith is a wordsmith failure that is contrary to decades worth of fiduciary common law. If directors are to be insulated from all but bad faith actions, the language of statutes such as DGCL section 102(b)(7) should be changed to achieve that result.¹⁸⁰ Manipulating the fairly uncomplicated phrase "not in good faith" is not acceptable.

led to AIG's accounting problems (in part due to the "sometimes-uncompromising" management style of Greenberg). *Id.* Zarb seemingly attempted to solidify the confidence of AIG's large institutional investors in AIG's evolving management team. While certainly not legally necessary, the outreach was a sensible strategic move. Directors cannot delegate their management duties to shareholders, but sometimes it makes strategic sense to consult with powerful, vocal shareholders, to avoid the time waste and expense of later shareholder litigation.

As well, under Rule 14(a)(8), shareholders have some access to a corporation's proxy mechanism as well, 17 C.F.R. § 240.14a-8 (2005). When a shareholder submits to corporate officials a shareholder proposal for inclusion on the corporation's proxy statement, the corporation can look to Rule 14(a)(8) for guidance as to whether the proposal can be excluded from the proxy statement. If the procedural prerequisites to inclusion on the proxy statement are satisfied (amount of stock holding, length of stock holding, etc.), but the corporation does not want to include the shareholder's proposal on their proxy statement, the corporation can request no-action relief from the SEC's Office of Mergers and Acquisitions to support the corporation's decision not to include the proposal. The SEC has not been particularly generous to shareholders of late, but the attempt of a shareholder to submit a proposal costs the company time and effort regardless of the outcome of the SEC's review. See Bruce Orwall & Deborah Solomon, *SEC Says Disney Can Exclude Shareholder Resolution After All*, WALL ST. J., Dec. 29, 2004, at C4.

178. See, e.g., Chad Bray, *Executives on Trial: Swartz Believed Panel at Tyco Cleared Deal; Former Executive Testifies Ex-CEO Said Late Director Agreed to Loan Forgiveness*, WALL ST. J., May 6, 2005, at C2; see also *In re Walt Disney Co. Derivative Litig.*, 825 A.2d at 288-89 ("Although formal board approval appeared necessary," the plaintiffs alleged that no board member asked for a meeting to discuss Ovitz's non-fault termination.).

179. See Tyco Corp., Annual Report (Form 10-K), at 41 (Dec. 30, 2002), available at <http://investors.tyco.com/phoenix.zhtml?c=112348&p=irol-SECText&TEXT=aHR0cDovL2NjYm4uMTBrd2l6YXJkLmNvbS94bWwvZmlsaW5nLnhtbD9yZXBvPXRlbnmsmaXBhZ2U9MTk1OTUwOCZkb2M9MSZudW09Mw> (providing Tyco's financial statements, showing that loans to officers for 2002 were \$5 billion more than in 2001).

180. It is very unlikely that legislators could have gotten away with adopting a standard prohibiting directors only from "affirmatively acting in bad faith." I imagine their constituents would have objected mightily, were the flimsy language brought to their attention.

The failure to take note of and halt the mutilation of the phrase “not in good faith” will actually change the obligation of a director from the obligation “to be loyal to the trust imposed in him, and *to execute it with the single purpose of advancing his principal’s interests*,”¹⁸¹ to the mere obligation to refrain from doing things that evince “some sort of obvious, deliberate, or egregious failure.”¹⁸² This shift in obligation would effectuate a significant substantive departure from long-established fiduciary common law governing directors. The modern director would arguably be reduced in academic theory and common law to useless folderol. A more accurate, exacting definition of the phrase “not in good faith” is needed to ensure directors are held accountable for meeting their good faith obligation. Anything less is unacceptable.

181. ERNEST W. HUFFCUT, *THE LAW OF AGENCY* § 90, 110 (2d ed. 1901) (emphasis added).

182. Sale, *supra* note 55, at 493.

