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ESSAY

STONE v. RITTER AND THE EXPANDING DUTY OF LOYALTY

Claire A. Hill* & Brett H. McDonnell**

Stone v. Ritter is the first post-Disney Delaware Supreme Court case articulating the doctrine of good faith. Taking Stone v. Ritter as a point of departure, we propose a way of understanding how good faith fits within the broader context of Delaware fiduciary duty cases. We see potential cases as arrayed along a continuum from traditional care cases to traditional loyalty cases. In between are cases where director or officer objectivity is impaired, but less so than in traditional loyalty cases. The emerging law of good faith helps courts deal with such cases. Particular clusters of cases develop detailed guidance for certain recurring problematic situations—the adoption of takeover defenses, board responses to shareholder derivative suits, the approval of executive compensation, and so on. At the same time, a more general doctrine of good faith is emerging, one that provides an expressive handle on which to ground future holdings and encourage the development of appropriate norms.

INTRODUCTION

After the latest Disney decision, good faith had been poised to take on a new and prominent role in Delaware corporate law. Whether good faith would be treated as an independent duty or as a component of one of the traditional fiduciary duties—loyalty or care—was, however, not clear. In the next case to arise, Stone v. Ritter,1 the Delaware Supreme Court quite specifically characterized the duty of good faith as part of the duty of loyalty. The court also threw in a bit of a shocker in Stone, characterizing In re Caremark International Inc. Derivative Litigation,2 until then a paradigmatic duty of care case, as a duty of loyalty case.3 How can we understand what happened? What now becomes of good faith and the duty

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1. 911 A.2d 362, 370 (Del. 2006).
2. 698 A.2d 959 (Del. Ch. 1996).
of care? And, most importantly, how do we understand directors’ standards of conduct? When will directors be liable, and when will they not? More specifically, when will section 102(b)(7) excusal be available?

In this Essay, we argue that the court in Stone got it right and, indeed, should have gone further. Stone recasts Caremark-type “care” as a species of the duty of loyalty; however, we think the duty of care in toto, including both Caremark-type care and the more generic inattention-type care, is properly understood as largely subsumed by the duty of loyalty. Stone opens the door to a more analytically satisfactory articulation of the standard of liability for breach of fiduciary duty. It provides the analytic underpinnings for a continuum of liability where the vast middle ground is good faith, understood as a component of the duty of loyalty.

In this Essay, we propose a way of understanding how good faith fits within the broader context of Delaware fiduciary duty cases. We see potential cases as arrayed along a continuum. At one end are traditional care cases, cases that raise no concern about the objectivity of directors and officers; at the other end are traditional loyalty cases, cases in which the objectivity of directors and officers is clearly impaired and their ability to profit at the corporation’s expense is significant. In traditional care cases, the only conflict between directors and the corporation arises from the natural human tendency not to work as hard or carefully as one might when one is not reaping all the fruits of one’s labors. In the traditional loyalty cases, a decision maker has a material pecuniary interest that directly conflicts with that of the corporation—for instance, where a director or officer is selling land to the corporation. In between are cases where director or officer objectivity is impaired, but less so than in traditional loyalty cases. The emerging law of good faith helps courts deal with such cases. We suggest that this law is developing at two levels of abstraction. Particular clusters of cases develop detailed guidance for certain recurring problematic situations—the adoption of takeover defenses, board responses to shareholder derivative suits, the approval of executive compensation, and so on. At the same time, a more general doctrine of good faith is emerging that helps courts deal with more unique circumstances or with emerging problematic business practices; the more general doctrine provides an expressive handle on which to ground future holdings and encourage the development of appropriate norms. The law thus provides guidance, structured and unstructured, as well as flexibility.

This Essay proceeds as follows: In Part I, we discuss the doctrinal background leading up to Stone, setting the stage for good faith to assume a prominent role. In Part II, we discuss Stone. In Part III, we set forth our view of what fiduciary duty really consists; we show how present duty of care and loyalty cases, and emerging case law on good faith, fit into one continuum. In Part IV, we develop a proposal making use of our continuum

and our previous work on structural bias, distinguishing stylized classes of cases and establishing procedures for each; we discuss how different types of cases would come out under our proposal.

I. DOCTRINAL BACKGROUND

The doctrine of good faith in Delaware corporate law followed a rather twisted path on its way to Stone v. Ritter. We do not chart that path in detail here. Rather, we highlight some of the main turns and milestones along the way. One could go back further, but we start with the state of Delaware doctrine in the early eighties.

Classically, courts and commentators have identified two types of fiduciary duties of corporate officers and directors: the duty of loyalty and the duty of care. The duty of loyalty applies where managers engage in interested transactions with the corporation. If there is no conflict of interest, then the duty of care applies and defendants receive the protection of the business judgment rule. This two-part understanding of fiduciary duty is enshrined in corporate law casebooks. The Model Business Corporation Act and the American Law Institute Principles of Corporate Governance both codified this understanding.

By the mid-eighties, the classical division between loyalty and care had already been complicated by the introduction of several new standards of care. The Unocal standard applied where a board adopted measures to defend against a hostile takeover. The Revlon standard applied where a board had put its corporation up for sale. The Zapata standard applied where a board had appointed a special litigation committee to review the facts in a pending shareholder derivative lawsuit and the committee had recommended dismissing the suit. We shall include these special standards in our story below. However, those standards apply to limited, albeit important, factual circumstances. For most sorts of corporate decisions, and cases resulting from them, the basic division into loyalty and care still hold.

5. See Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) ("A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders. Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the shareholders." (citations omitted)).


So how did good faith come into the picture? There are a variety of sources, but let us focus on one judicial doctrine and one statute. The doctrine is the business judgment rule. This rule shields corporate managers from judicial scrutiny of their decisions. It does not apply if the plaintiffs can demonstrate that the transaction in question involved a conflict of interest. If the plaintiffs cannot do so, the business judgment presumption comes into play. According to the canonical formulation of the business judgment rule as it took form by the early eighties, it is “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”

This formulation of the business judgment rule provides three ways in which a plaintiff may attempt to rebut the presumption: by showing that the directors either did not act on an informed basis, did not act in good faith, or did not have an honest belief that the action they took was in the best interests of the company. Following the Smith v. Van Gorkom decision, most attention focused on the informed basis prong. The duty of care came to be seen as focused on whether the directors had followed adequate procedures in informing themselves before making a decision.

However, good faith lay dormant within that formulation, and eventually became more important after the legislative response to Van Gorkom. Responding to concerns of rampant director liability and a consequent crisis in Directors’ and Officers’ (D&O) liability insurance, the Delaware legislature added section 102(b)(7) to the state’s corporate law. This section allows corporations to put provisions in their certificates of incorporation that waive personal liability of directors for violations of fiduciary duty. However, liability for several types of fiduciary duty

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11. Several other statutory provisions, beyond that discussed in the text, are notable for their use of the good faith concept as well. These include Del. Code Ann. tit. 8, § 141(e) (2001) (good faith reliance on records and opinions), Del. Code Ann. tit. 8, § 144 (good faith board or shareholder approval of interested transactions), and Del. Code Ann. tit. 8, § 145 (indemnification allowed for liability incurred as a result of actions in good faith, thus apparently disallowing indemnification for liability incurred as a result of actions lacking good faith).


15. Section 102(b)(7) quickly became part of the story told by the many corporate law scholars who thought director liability had no teeth—as some said, an outside director has more chance of being hit by lightning than being found liable for breaching his fiduciary duty. See Bernard Black, Brian Cheffins & Michael Klausner, Outside Director Liability, 58 Stan. L. Rev. 1055, 1139–40 (2006); Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. Pa. L. Rev. 1735, 1791 (2001). Interestingly, Delaware Chancellor Leo Strine and Professor Lynn Stout now think directors are too responsive to pressures from public shareholders, and that firms
violations cannot be waived. Duty of loyalty violations, for example, may not be waived.\textsuperscript{16} Crucially, neither may decisions that are not in good faith.\textsuperscript{17}

Notice, then, the incentives created for plaintiffs’ lawyers by this combination of the business judgment rule and section 102(b)(7). If plaintiffs’ lawyers cannot succeed in pleading that a conflict of interest existed, their next best strategy is to plead that the board did not act in good faith. If they can succeed in this argument, two positive consequences follow. First, the defendants lose the protection of the business judgment rule. Second, the defendants will not be able to use section 102(b)(7) to avoid personal liability.

Plaintiffs’ lawyers are not stupid, nor are they immune to the effect of incentives. Although it may have taken longer than one might have expected, ultimately the predictable happened: plaintiffs’ lawyers started to include arguments that defendant directors had not acted in good faith. This has gradually forced the Delaware courts to begin to consider how to handle such claims.

Case law on good faith grew slowly, though. Moreover, a tension developed in the cases between the Delaware Supreme Court and Chancery Court.\textsuperscript{18} In the nineties, Delaware Supreme Court cases started referring to a triad of fiduciary duties: loyalty, care, and good faith.\textsuperscript{19} For instance, in \textit{Cede & Co. v. Technicolor, Inc.} it said,

\begin{quote}
To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care.\textsuperscript{20}
\end{quote}

However, these cases just referred to good faith; the decisions were not based on that duty, and hence the cases gave no guidance as to what the duty might entail.

The Delaware Chancery Court rather insolently resisted the triad notion. Instead, it located good faith within the duty of loyalty in several cases.\textsuperscript{21}

\begin{footnotes}
\item[17] See id. § 102(b)(7)(ii).
\item[20] Cede, 634 A.2d at 361.
\end{footnotes}
A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest. For this reason, the same case that invented the so-called "triad" of fiduciary duty also defined good faith as loyalty.

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

In the meantime, several cases interpreting the process by which a defendant may invoke section 102(b)(7) confirmed the importance of determining when plaintiffs have successfully pleaded a lack of good faith. *Emerald Partners v. Berlin* held that section 102(b)(7) "is in the nature of an affirmative defense." *Malpiede v. Townson* clarified this point. If plaintiffs can succeed in adequately pleading either a loyalty violation or bad faith, then the case cannot be dismissed on the pleadings through invoking section 102(b)(7). If the case survives the pleading stage, then defendants attempting to invoke section 102(b)(7) must prove good faith. Thus, since most Delaware corporations have exculpation clauses in their certificates, whether or not a pleading can survive a motion to dismiss may frequently depend on whether the plaintiffs have adequately pled a lack of good faith.

What, then, do the Delaware courts mean when they refer to action not taken in good faith? The most in-depth answer to that question thus far

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22. Guttman, 823 A.2d at 506 n.34 (citations omitted).
25. See supra note 11.
comes from the Disney cases. The key formulation in the Disney cases is as follows: "[T]he concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." In a more detailed elaboration, the court said,

A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

The courts, both chancery and supreme, applied this standard to the facts surrounding the hiring, and then the firing, of Michael Ovitz as second-in-command at Disney, and found that the board's conduct was in good faith (or at least, that the plaintiffs had not succeeded in showing that the directors had acted in bad faith). The conduct was fairly close to the edge under this standard insofar as the Chancery Court held that the pleadings were suggestive enough of bad faith to withstand a motion to dismiss. The case thereby gives us a general, although rather vague, formulation for good faith, and one, albeit important, data point in deciphering how to apply that vague formulation to a complicated fact pattern.

The most direct precedent in the cases leading up to Stone is Caremark. Simply put, Caremark employees violated federal and state laws, with the result that Caremark had to pay $250 million in fines and reimbursements. The board neither knew of nor approved the employees' conduct.
Shareholders sued, alleging that, by failing to adequately monitor employee behavior, the directors violated their fiduciary duty. Chancellor William Allen labeled Caremark as a case alleging a breach of the "duty of attention or care in connection with the on-going operation of the corporation's business." He divided cases involving the "duty to exercise appropriate attention" into two classes. The first class concerns liability that "may be said to follow from a board decision that results in a loss because that decision was ill advised or 'negligent.'" This would seem to be the standard duty of care case, epitomized by Van Gorkom.

The second kind of failure to exercise appropriate attention case "entail[s] circumstances in which a loss eventuates not from a decision but, from unconsidered inaction." Caremark is such a case. These cases raise the question as to whether boards have a duty to install some sort of monitoring system that may catch corporate wrongdoing. Chancellor Allen argued that there is such a duty in contemporary business culture:

Can it be said today that, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that a corporate information gathering and reporting system exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations? I certainly do not believe so.

However, only the most egregious of circumstances will violate this duty: "[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."

So what sort of fiduciary duty does Caremark represent? The conventional answer has been that it arises under the duty of care. After all, it involved no self-dealing or conflict of interest, the standard hallmarks of the duty of loyalty. Moreover, the question in the case is whether or not the board paid adequate attention to company affairs, the classic duty of care question. Corporate law casebooks include this case in the chapter on the duty of care—including Chancellor Allen's own casebook.
But consider the highlighted language above referring to good faith. Good faith language appears elsewhere in the opinion as well.\textsuperscript{42} If good faith did represent a separate duty from care, there would be a decent textual basis for characterizing Caremark as a good faith case and not as a care case at all. Thus, before Stone, there was some question as to whether the Caremark duty should be classified under the duty of care or the duty of good faith. Stone answers the categorization question. It turns out, though, that the answer is actually door number three: the duty of loyalty.

II. \textit{Stone v. Ritter}

As the Chancery Court said, Stone was ""a classic Caremark claim,""\textsuperscript{43} Employees at AmSouth Bancorporation failed to file suspicious activity reports, as required by banking law.\textsuperscript{44} These failures led to fines and civil penalties, and the banking regulators found that AmSouth's legal compliance program was inadequate.\textsuperscript{45} Shareholders brought a derivative suit against the board claiming that it had violated its fiduciary duty by failing to institute an adequate program for monitoring legal compliance.\textsuperscript{46}

The outcome in the case was not surprising: the Delaware Chancery Court dismissed the claim, and the Delaware Supreme Court affirmed. Caremark duties are deliberately structured to make it extremely hard for plaintiffs to win. Of slightly more interest, the Delaware Supreme Court explicitly upheld the Caremark standard.\textsuperscript{47} That is notable, but not a surprise. It confirms what most observers expected.

What did surprise many observers\textsuperscript{48} was the Delaware Supreme Court's discussion of where Caremark duties fit analytically within the general structure of fiduciary duty law. The placement matters because AmSouth
had an exculpation clause. Since there was no plausible self-dealing claim, if Caremark claims were to fall under the duty of care rubric, then under Emerald Partners and Malpiede simple invocation of the exculpation clause would lead to immediate dismissal. However, if a Caremark claim does not fall under the care rubric, then the court must consider whether plaintiffs have adequately pled facts which support a Caremark claim, and not dismiss if they have succeeded in doing so.

The Delaware Supreme Court goes on to closely analyze the reasoning of Caremark. It points to the Chancery Court’s repeated reliance on the concept of good faith, in the language quoted above and elsewhere. It thus seems to categorize Caremark as a good faith case. But then the Delaware Supreme Court pushes a step further:

It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under Caremark as we construe that case. The phraseology used in Caremark and that we employ here—describing the lack of good faith as a “necessary condition to liability”—is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith “is a subsidiary element[,]” i.e., a condition, “of the fundamental duty of loyalty.” It follows that because a showing of bad faith conduct, in the sense described in Disney and Caremark, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

Thus, in this paragraph, what had been generally understood to be an instance of the duty of care, indeed perhaps the leading operative instance of the duty of care, became officially an instance of the duty of loyalty.

The court goes on to articulate two doctrinal consequences of this formulation. First, despite being described “colloquially” (by the Delaware Supreme Court, that oh-so-colloquial body), as one of a “triad,” good faith is not an independent fiduciary duty. Only loyalty and care can result in direct liability, while failure to act in good faith only indirectly results in liability. The second consequence is the widening of the duty of loyalty. No longer is loyalty only about “financial or other cognizable fiduciary conflict of interest.” It also includes good faith. As the court puts it, quoting one of the Chancery Court cases that had so insolently, but in the end triumphantly, disputed the Delaware Supreme Court’s triad, “‘A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.’”

49. See supra notes 23–24 and accompanying text.
50. Stone, 911 A.2d at 369–70.
51. Id. at 370.
52. Id.
53. Id. (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).
What does this all mean as a matter of doctrine? As a matter of the English language? As a practical matter for those subject to Delaware law? Those are the questions to which we now turn.

III. IS THERE ONLY ONE FIDUCIARY DUTY?

As we argued in an earlier paper, we think the duty of care was always fundamentally a duty of loyalty:

Ultimately, directors and officers owe only one fiduciary duty to a corporation—the duty to actively pursue the best interests of the corporation. The duties of loyalty, care, and good faith address differing aspects of this duty. The traditional duty of loyalty addresses situations where directors or officers have material conflicts of interest that are likely to tempt them to favor their own interests over those of the corporation. The duty of care addresses the natural human tendency of directors and officers to not actively exert themselves in pursuing the interests of others. However, on some profound level, it, too, is a breach of the fiduciary duty of loyalty, although the courts do not consider it such—directors and officers are taking leisure that they are not entitled to.\textsuperscript{54}

There was, and remains, a need to distinguish different sorts of cases to establish different procedural requirements and burdens of proof and persuasion. But those distinctions, important as they may be, do not take away from the critical feature these breaches share: that the directors and officers are taking for themselves something that belongs to the corporation.

The classic duty of loyalty cases involve directors or officers taking for themselves in a very tangible (or at least straightforward) way what should otherwise belong to the corporations—say, a profit from a sale of an asset to the director at a below-market price or from a business opportunity offered to the corporation. What is critical to note, though, is that the corporation is as entitled to the director and officer’s time and careful attention as it is to the full profit from the sale of its assets. What it means to be a fiduciary is to “act for the benefit of another person on all matters within the scope of their relationship.”\textsuperscript{55} The conduct at issue in breaches of loyalty or care (or, as we discuss below, the emerging duty of good faith)

\textsuperscript{55} Black’s Law Dictionary 658 (8th ed. 2004) (defining “fiduciary” as “[a] person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor”). The doctrine comes from agency law. See Restatement (Third) of Agency § 1.01 cmt. e (2006). This doctrine has been put to use not only in corporate law, but in many other areas as well, most notably in trust law. Some legal relationships are considered fiduciary relationships and are governed by some general common law doctrines that essentially reflect the Black’s Law Dictionary’s definition. See generally Tamar Frankel, Fiduciary Duties, in The New Palgrave Dictionary of Economics and the Law 127 (Peter Newman ed., 1998).
is not only not “for the benefit of” the officer or director’s principal, but it is also at the principal’s expense.

Where does the duty of good faith fit in? In our view, the classic formulations of the duty of loyalty were much too limited. A broader formulation was needed to capture conduct that fell outside those bounds but was more than simply generic inattention, for which the highly deferential business judgment standard was used. One can see how, from an analytic distance, making a qualitative distinction between, as one of us says in class when explaining the two duties, snoozing and stealing makes sense. Inattention (snoozing) seems less morally culpable. However, when we consider precisely why a director would be snoozing or otherwise be less than appropriately diligent, we find that in most cases there is something rather more culpable going on, something well captured by the concept of lack of good faith. Indeed, in this regard, consider that generic inattention—simply not looking hard enough or well enough, without a suspect motive—was very rarely what was at issue in the classic duty of care cases.\footnote{56} An excellent example is \textit{Van Gorkom},\footnote{57} (the duty of care case that prompted the legislature to enact section 102(b)(7)), in which the facts strongly implicated excessive deference by the officers and directors to the chief executive officer (CEO).

The duty of good faith thus offers a conceptual framework, under the broader rubric of the duty of loyalty, to encompass cases of culpable conduct not constituting breaches of the duty of loyalty as traditionally conceived.\footnote{58} At present, the cases roughly fit into three general categories; other categories may, however, emerge as the jurisprudence develops.

One category is the familiar one of “structural bias”—roughly, again, excessive deference to the other directors or officers. A second category involves cases where director or officer self-interest may be present but the actions at issue involve core corporate concerns, and hence are appropriately not scrutinized to the same extent as cases implicating the traditional duty of loyalty. As we noted in \textit{Disney, Good Faith & Structural Bias},\footnote{59} courts might reasonably want to discourage classically (and often predominantly) self-interested activities such as hiring one’s relatives or having business dealings for one’s personal account with a corporation of which one is CEO. But the types of conduct in the class of cases we are concerned with here cannot feasibly be discouraged altogether: directors need, for instance, to consider their responses to takeovers notwithstanding the fact that they may be motivated (in part?) by a desire to entrench themselves in office. For present purposes, we call such cases “suspect

\footnote{56. And of course, after the Delaware legislature enacted section 102(b)(7), allegations that simply amounted to generic inattention became rarer still.}

\footnote{57. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).}

\footnote{58. For an argument that loyalty should be broadly conceived to include an element of affirmative devotion to the well-being of the corporation, see Lyman Johnson, \textit{After Enron: Remembering Loyalty Discourse in Corporate Law}, 28 Del. J. Corp. L. 27 (2003).}

\footnote{59. Hill & McDonnell, \textit{supra} note 54, at 852.}
motive” cases. The third category, “conduct involving illegality,” consists of either insufficient monitoring for illegal acts or actually engaging in such acts.

Structural bias is the obvious and paradigmatic category within our framework; it may involve problematic behavior, yet falls short of the traditional duty of loyalty violation. Consider in this regard the fact pattern alleged in Brehm v. Eisner: hasty accession to the CEO’s wishes as to hiring and compensating a crony (including as to the crony’s termination package and the crony’s entitlement thereto). There clearly was no violation of the duty of loyalty as traditionally conceived. Still, the behavior alleged to have occurred violated what the duty of loyalty properly ought to encompass: a duty to critically consider important corporate decisions and not simply rubber-stamp whatever the CEO proposes.

Consider also a decision by a board to backdate officers’ stock options. In a recent backdating case, Ryan v. Gifford, the court characterized as “conduct that is disloyal to the corporation and is therefore an act in bad faith” the “intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors’ purported compliance with that plan.” What motivates the other directors to approve such a plan and make such fraudulent disclosures is presumably structural bias. Consider as well a board or committee’s decision not to pursue, or to terminate, a shareholder derivative suit (involving board members not involved in the decision), as happened in Zapata.

In the paradigmatic structural bias situation, the director is directly furthering the interests of other directors or officers, when those interests may not be those of the corporation or its shareholders. He is furthering his own interests as well, albeit less directly: He presumably increases the chance he stays on the board or gets some perk (a donation by the company to his favored charity?). He also promotes and perpetuates as a norm the “pernicious golden rule,” perhaps building up some claim on reciprocal good treatment in his own capacity as an officer.

There are other situations where the self-interest is more direct, but those situations still do not come under a traditional duty of loyalty analysis. This is the category we call “suspect motives.” A board’s reaction to takeovers provides an example. Entrenchment, or at least a generous severance

62. 918 A.2d 341 (Del. Ch. 2007).
63. Id. at 358.
64. Id.
66. We coined this term to describe directors who are also officers of other corporations who defer in their capacities as directors because, as officers, they would want a deferential board. Hill & McDonnell, supra note 54, at 838.
67. For more on structural bias, see Velasco, supra note 60.
package, is always a possible motive. However, there can be other self-serving motives. Consider Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. To defend itself against a hostile takeover by a suitor the board did not like, a defense perhaps motivated, at least in part, by one self-serving motive—entrenchment—Revlon had issued notes to many of its shareholders in exchange for their shares. The corporation’s investment bank opined that the notes would trade at their face value; for this to continue to be true, the covenants contained in the notes had to be in effect. But Revlon waived the covenants in order to attract a bidder they preferred: Forstmann Little. The notes therefore fell in value and Forstmann then promised to support the value of the notes. The directors claimed that favoring Forstmann because Forstmann made this promise constituted good faith: the board was entitled to consider the interests of constituencies other than the shareholders, including the noteholders. The court agreed with the board in principle, but held that there needed to be “rationally related benefits accruing to the stockholders”—which, in this case, there were not. The court clearly thought that the board was not taking into account the interests of the noteholders so much as its own interests in not being sued by the noteholders. It noted that “the fiduciary standards outlined in Unocal . . . impose an enhanced duty to abjure any action that is motivated by considerations other than a good faith concern” for the best interests of the corporation and its shareholders. It held that “the Revlon board could not make the requisite showing of good faith by preferring the noteholders and ignoring its duty of loyalty to the shareholders.”

A line of case law sets forth a duty of candor and disclosure owed by the directors and officers. Where does this duty fit into our analysis? The duty paradigmatically arises when directors and officers need shareholder consent, and obtain such consent using disclosures that are false or incomplete. It arises as well when the directors and officers make other false or incomplete disclosures, notwithstanding that they were not doing so to obtain consent.

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69. 506 A.2d 173 (Del. 1986).
70. Id. at 177–79, 182–83.
71. Id. at 177.
72. Id. at 178.
73. Id.
74. Id. at 182.
75. Id. at 181.
76. Id. at 182.
78. See id. at 1146 (discussing another type of case, in which a director is acquiring stock from an outside, public stockholder). We do not discuss this type of case because no action even purportedly on behalf of the corporation is involved.
In *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, a case involving options “spring loading” (options grants made immediately prior to the announcement of good news), the court noted that

[d]isclosure violations may, but do not always, involve violations of the duty of loyalty. A decision violates only the duty of care when the misstatement or omission was made as a result of a director’s erroneous judgment with regard to the proper scope and content of disclosure, but was nevertheless made in good faith. Conversely, where there is reason to believe that the board lacked good faith in approving a disclosure, the violation implicates the duty of loyalty.

One can easily imagine some breaches of the duty of disclosure as being encompassed within the traditional duty of loyalty. Imagine the CEO lying and saying he bought for his personal use at $X property of the corporation worth $X when he knows the true valuation of the property is 10X. But more often, it is not the traditional duty of loyalty but rather structural bias or suspect motives that will be implicated. Consider directors depicting a decision that was a foregone conclusion—rejecting a takeover offer or offering a not-for-cause termination to a crony, for instance—as being extensively and critically considered. Or directors taking a problematic action, such as backdating options or paying a higher severance package than agreed upon to the shareholders, and either not disclosing it or perhaps even falsely depicting the action as appropriate or compliant.

79. 919 A.2d 563 (Del. Ch. 2007).
80. *Id.* at 597–98.
81. One interesting recent case involves the severance payment made to Carly Fiorina, former chief executive officer, when she left Hewlett Packard (HP). In *Indiana Elec. Workers Pension Trust Fund, IBEW v. Dunn*, HP was sued by shareholders who claimed that Fiorina’s severance payment was more than the 2.99-times-salary-and-bonus threshold above which HP’s severance policy stated HP would seek shareholder approval. No. C-06-01711 RMW, 2007 WL 1223220 (N.D. Cal. Mar. 1, 2007). One claim made by the shareholders rested on the duty of disclosure—that “defendants breached their fiduciary duty to disclose because HP did not disclose in its 2004, 2005, and 2006 proxy statements that it never intended to honor the Severance Policy or provisions of the Severance Program.” *Indiana Elec.* *Id.* at *11. The case was dismissed, but the plaintiffs were granted leave to amend their pleadings, and they have done so. *Id.* at *12.

Shareholders have also brought suits criticizing corporate disclosure alleging that the action at issue was disclosed but not properly characterized—paradigmatically, that directors took some questionable action and did not characterize it as such. Courts have rejected those sorts of claims, saying boards do not have to engage in self-flagellation. *See, e.g., In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998). In *Disney*, the Chancery Court stated, The Plaintiffs in this action attempt to convert their flawed derivative claim against Disney for paying Ovitz severance benefits to a disclosure claim. First, they claim that the information was germane to shareholder consideration of the five directors’ re-election because shareholders would consider important within the total mix the fact that these directors approved such extravagant waste. That assertion runs afoul of the rule against self-flagellation:

Delaware law does not, however, require a proxy statement to impugn a director’s character or draw negative inferences from his past business practices. It only requires a summary of his credentials and his
Our third category within the overall umbrella of good faith is "conduct involving illegality," a "culpable" lack of diligence to prevent illegal acts, such as was alleged in *Stone* itself and in *Caremark*, or actual commission of illegal acts, the most notable example of which is perhaps *Miller v. AT&T*. Here, unlike in all the cases discussed above, a stark divergence between directors' interests and those of shareholders is not in any obvious way what is at issue. Illegal behavior may very well maximize corporate profits; indeed, we would expect that it often would. Paying an illegal bribe in country Z is intended to get you more business in country Z. Often, a company's (non-U.S.) competitors are not subject to antibribery rules, and if the U.S. executive follows the rules, he will lose business to the competitor that can bribe without fear of legal sanction. In some cases, the executive may have made a bad decision in deciding on the illegal conduct—perhaps he underestimated the risk and cost of sanctions so that the ex ante return on the illegal conduct was less than he thought it would be or even negative. However, why should that not simply be treated as a judgment call given business judgment rule protection, as most other non-self-interested decisions are?83

There are several reasons why we might want to treat illegal behavior differently, with less legal deference. For one, the directors' willingness to tolerate or engage in illegal conduct may be a proxy for their willingness to engage in conduct that more directly diverges with the shareholders' interests. Someone who sets out to break the law often displays stealth and a willingness to pursue a more parochial interest over a competing more general interest: their own personal interest over the interests of others, their family or friends' interests over that of strangers, or their corporations' interests over more general social welfare.84 Those very traits also characterize those prone to steal from their corporations. Also, we may regard illegal acts as contrary to shareholders' interests notwithstanding that they might be in shareholders' pecuniary interests. Shareholders are also citizens, and insofar as laws advance the general social welfare, citizens care about that. A diversified shareholder with small stakes in any one corporation may well find that the public interest predominates over the

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82. 507 F.2d 759 (3d Cir. 1974).
84. Note that whether the corporation's interest is parochial or general depends on the context and what it is being compared to: it is more general than one individual's interest but more parochial than society's interests.
corporate interest. The other possible account, rather less neat from a doctrinal perspective, is that, because corporations are chartered by the state, they owe a duty to the public, which may include the shareholders, not to act illegally. This reason moves us away from the agency account that underlies the rest of this Essay and most current scholarly thinking about corporate law. Since the second reason for caring about illegal action provided above blends into this third reason, we do not need to draw too fine a line as to which better explains why the law has developed as it has.

These reasons are probably enough to explain why directors acting in deliberately illegal ways violate their duty of good faith. However, they do not help us nearly as much in explaining why and when directors who fail to monitor for illegal behavior are violating their duty of good faith. Our best account is this: directors are shirking their responsibility to be vigilant when they, on some metric, "ought" to know what their lack of vigilance might permit; hence, the violation of the duty of good faith. This description seems to fit the allegations made in Caremark and Stone, and the standards for liability enunciated therein. The Disney Chancery Court opinion in 2005 quoted Nagy v. Bistricer, as follows:

If it is useful at all as an independent concept, [good faith’s] utility may rest in its constant reminder . . . that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes [even if for a reason] other than personal pecuniary interest.

Perhaps another justification for the Caremark line of cases is that internal control systems that monitor illegal behavior tend to overlap with internal control systems that monitor fraudulent behavior. A board that leaves its corporation open to subordinates breaking the law is also likely to be vulnerable to top officers who choose to steal from the corporation.

85. A related reason could be that fiduciaries are classically supposed to be honest and honorable, and simply breaking the law could be seen as running afool of that characterization. See Frankel, supra note 55, at 129 ("Fiduciary law vests in entrustors the legal right to rely on the honesty of their fiduciaries by imposing on fiduciaries a corresponding duty of loyalty and other specific duties to deter dishonesty.").

86. There is one line of cases suggesting that damages from illegal conduct would only be the amount by which the company suffered from the conduct net of what it gained. But that damage formula is based on a New York decision that has subsequently been criticized. See Principles of Corporate Governance: Analysis and Recommendations § 7.18(c) cmt. e (1994) ("In effect, derivative actions seeking to hold corporate officials accountable for fines imposed on the corporation as a result of knowing criminal antitrust violations were dismissed because the plaintiff could not prove that the crime did not pay. The continued authority of these decisions is questionable after the New York Court of Appeals’ subsequent decision in Diamond v. Oreamuno, 24 N.Y.2d 494 (1969), which stressed that the deterrent role of the derivative action excused the necessity of proving a loss to the corporation and also held that an intangible loss to the corporation might arise from adverse publicity and stigmatization.").

87. 770 A.2d 43, 48 n.2 (Del. Ch. 2000).

Thus, there is at least a hint of structural bias and suspect motives present if one considers, again, why the board might not have had appropriate monitoring systems in place. These considerations combined with those in the previous paragraph may be enough to justify somewhat more judicial scrutiny than applies in duty of care cases. However, they do not seem to justify much more scrutiny, and indeed that is precisely what we find. Stone may have located Caremark on the loyalty side of the loyalty/care divide, but it is very near the border with care. As we have already seen, and emphasize more in the next part, not all cases on the loyalty side of the divide are treated equally—not by a long shot. Some cases within the good faith zone of loyalty receive weak judicial scrutiny, while others receive much more searching scrutiny. Caremark is very much on the weak end of the continuum. Indeed, the categorization of a fact pattern as a Caremark case is almost as good a piece of news for defendants as its categorization as a care case would be: it is very hard for defendants to be held liable in a Caremark case.

It seems, then, that the doctrine of good faith can help us articulate the breach at issue for cases that fall in the middle of the care/loyalty continuum that we have previously hypothesized. Its status as a presumption has worked well at the care end of the continuum. In principle, we do want to make sure that directors are working hard enough and well enough, but we do not want to encourage constant ex post second-guessing of directors by the shareholders. Where plaintiffs cannot articulate anything other than a problematic decision made after what seems to them like less-than-thorough process, good faith should indeed be presumed, especially given the incentives plaintiffs have to bring suits whenever a decision turns out badly whatever the merits at issue. While, as we have noted, not working hard or well enough constitutes a taking of leisure to which one is not entitled, and hence could be characterized as a breach of the duty of loyalty, the situations are sufficiently distinct that a different label—care rather than loyalty—seems appropriate, as does, of course, a deferential doctrine, with its substantive backstop for truly egregious decisions, namely, waste. But—and this is key—until recently, many cases couched as care cases in fact implicated something else—not loyalty as loyalty had traditionally been characterized, but something culpable nevertheless, often because of structural bias or suspect motives. Consider in this regard the following quote from the Disney Chancery Court opinion in 2005:

It is precisely in this context—an imperial CEO or controlling shareholder with a supine or passive board—that the concept of good faith may prove

89. Lyman Johnson also suggests that good faith can provide doctrinal support for the duty to affirmatively devote oneself to the corporation’s interest, something Johnson calls the “affirmative” or “devotion” side of loyalty. See Johnson, supra note 58, at 69 n.245.

highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect.91

In addition to the other benefits discussed above, the good faith doctrine also potentially allows us to expand and rationalize the class of intermediate standards—now consisting principally of Unocal, regarding takeover threats; Revlon, regarding corporations that have been put up for sale; and Zapata, regarding decisions not to pursue a derivative suit92—into a more coherent framework.

We should address here two criticisms of this increased judicial use of the good faith concept in corporate law. One criticism is that the scope of good faith liability is uncertain, and will thus increase litigation and litigation costs.93 That is true, but we do not see it as a decisive objection. The increase in uncertainty is limited by two factors. First, as we shall argue in the next part, the courts have already articulated more fine-tuned and precise standards of review for a variety of specific situations that would be encompassed within the good faith framework, reducing uncertainty in those situations. Second, the Disney definition of good faith is of relatively limited scope and draws on intent language that is common in many areas of law. It thus does not provide much comfort for plaintiffs who want to go too far in expanding the scope of the law, and the long history of similar language imports a fair amount of guidance for lawyers interpreting the cases. Moreover, any sort of legal standard can be criticized as yielding greater uncertainty and litigation costs than would a precise rule. However, sometimes standards make sense as a way to give courts flexibility to respond to complicated fact patterns and new circumstances. We argue in the next part that this is one of those times. All this being said, we should be clear at this juncture that our conception of good faith may very well go beyond that used by the Disney court. As we discuss in the next part, the good faith cases closest to the care end of the continuum may contemplate less intentionality than is suggested in the Disney case. But the jurisprudence still likely will, and should, develop in a sufficiently cautious and incremental manner that defendants should not have to see their burdens in defending against derivative cases suddenly increase appreciably.

91. Disney, 907 A.2d at 760 n.487.
92. See supra notes 8–10 and accompanying text.
93. See Bainbridge et al., supra note 83, at 34; see also Andrew S. Gold, A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty, 66 Md. L. Rev. 398 (2007).
Stephen Bainbridge has raised another objection to *Stone*, based on the remedy rule that results from the doctrinal placement of good faith.\(^94\) He argues that stripping away ill-gotten gains is the traditional remedy for loyalty violations, but by extending the duty of loyalty to cases where the defendants have not received any material pecuniary gain at the expense of the corporation, this remedy will become unavailable. This will create "a conceptually difficult task of crafting appropriate remedies"\(^95\) and also create a doctrinal conflict with *Cede*’s holding that harm causation is not a required element.\(^96\) We are not convinced by this objection. Although it is true that rescission or rescissionary damages are the standard form of remedy in standard loyalty cases, the Delaware Supreme Court has already held that in loyalty cases the court may "fashion any form of equitable and monetary relief as may be appropriate."\(^97\) Thus, rescissionary damages are not the exclusive remedy available. Compensatory damages may also be used, as appropriate. Indeed, in the general law of agency, both compensatory damages and recovery of the value received wrongfully by the principal are valid remedies.\(^98\) Thus, if there is no ill-gotten gain in any particular case, that simply means that one of several possible damage measures is not available in that case. The other measures may still be used.

We now turn to a discussion of our framework.

IV. OUR PROPOSAL

*Stone v. Ritter* forges a path to what we think is the right answer. The terminology does not line up completely with ours, but we think analytically the framework and result are the same.

Director duties, and breaches thereof, fall along a continuum. There are stylized cases at both ends, where the procedures have been well developed. Care, with its very strong deference, which essentially translates into "plaintiff loses" (and even if he did not lose, there would be exculpation), is at one extreme. Traditional loyalty, where the defendant has to show good process (in the form of approval by disinterested and fully informed directors, shareholders, or both) or, failing that, very good substance (that is, "entire" or "intrinsic" fairness), is at the other extreme. Of most interest here are the cases that fall between these extremes, where we think good faith will increasingly become part of the doctrinal story.

In dividing up the cases along this continuum, we can think at varying levels of abstraction (see Figure 1). At the very highest level, there is just one fiduciary duty—to pursue faithfully and diligently the best interests of the corporation and its shareholders. Below this level of abstraction, we

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\(^94\) Bainbridge et al., *supra* note 83, at 28–31.

\(^95\) *Id.* at 31.

\(^96\) *Id.* at 28–31.


\(^98\) Restatement (Second) of Agency § 407 (1957).
can see the continuum of cases as divided into the two traditional categories, care and loyalty. Why divide the cases this way? As we discuss above and below, we put into the care category circumstances where we want courts to largely avoid scrutinizing board behavior, such that it is extremely unlikely that directors will ever be held personally liable. \textsuperscript{99} Loyalty cases deserve at least a bit of (and sometimes quite a bit of) a closer look from courts.

One level of abstraction below that, we divide the loyalty category into two parts. One part, at the extreme end, is traditional loyalty cases, where directors or officers have a pecuniary material interest that conflicts with the interests of the corporation. The other part is good faith. This includes the intermediate cases that fall between traditional care and traditional loyalty. Why is this division of the broad loyalty category useful? Cases presenting facts that fall in the traditional loyalty category clearly deserve close scrutiny from some sort of independent decision maker, be it independent directors, shareholders, or the courts. We have well-established rules for these sorts of cases. Good faith is a more nebulous category. It includes many different kinds of factual circumstances, united by the fact that we have some reason to be concerned about director objectivity (hence, they are not care cases), but the stark concerns of traditional conflicts of interest are not present (hence, they are not traditional loyalty cases). It is thus useful to distinguish good faith from traditional loyalty.

If we then descend one more level of abstraction, we find that the good faith region in turn subdivides at present into a variety of different factual circumstances and related standards of review. The more specific standards of review give structured guidance to courts, corporations, and their counselors where the facts fall within the scope of those specific standards. The general backdrop of good faith gives courts flexibility to deal with new circumstances that do not fit within better defined standards of review, and to develop new specific standards for other sorts of cases where appropriate. \textsuperscript{100}

Let us look more closely at each part of this continuum. At one end is generic inattentiveness: The directors did not give the attention that was due, for no purposive or intentional reason. The directors are taking from the corporation something that belongs to the corporation—their due consideration and time. Still, given the ever-present concern that directors might become too risk averse and too tied up in ex post shareholder second-guessing, and, given the broad grant of authority to the board, the present regime seems appropriate in cases where nothing more can be shown.

\textsuperscript{99} See generally Bainbridge, supra note 90.
Consider in this regard *Kamin v. American Express Co.*\(^{101}\) *Kamin* involved a substantive decision to forego $8 million in tax savings in order to avoid $25 million in accounting losses.\(^{102}\) Tax savings are real monetary savings; accounting losses or gains are merely paper losses or gains. A robust debate exists as to whether markets value accounting earnings; the best academic findings indicate that the answer is no, but market practitioners typically say and apparently believe the answer is yes.\(^{103}\) Indeed, there is considerable evidence that they "put their money where their mouths are," paying considerable amounts (admittedly, of others' money, but certainly, of their own time) to structure transactions to obtain the more desirable accounting treatment.\(^{104}\) The directors in *Kamin* listened, in good faith, to the market practitioners, who told them the market would react very badly to a $25 million loss and not nearly so badly to a decision not to save $8 million in taxes.\(^{105}\) This seems like precisely the sort of decision directors should not be second-guessed on: good faith here was appropriately presumed and, apparently, present.\(^{106}\)

Another reason exists for favoring considerable deference in cases of simple generic inattention. The main result of imposing liability would probably not be more diligent decisions. Rather, it would probably be a full employment act for lawyers and other advisers (and, as is commonly observed, perhaps a smaller contingent of people willing to serve as directors), as proper process was painstakingly documented. Telling directors to work harder and better—and face liability if they do not—scarcely seems to provide sensible incentives.

At the other end of the continuum is traditional loyalty, where one or more directors, officers, or controlling shareholders has a material pecuniary interest in a decision that conflicts with the interests of the corporation and its shareholders in that decision. Here, a transaction involving a conflict of interest is presumptively invalid, unless it is validated through one of three methods. A defendant in a loyalty case must show that (1) the transaction was approved by disinterested and independent directors; (2) the transaction was approved by disinterested shareholders; or (3) the transaction was entirely fair to the corporation.\(^{107}\)

\(^{102}\) Id. at 809.
\(^{104}\) Id. at 145-46 n.12 (discussing the AT&T/NCR transaction).
\(^{105}\) *Kamin*, 383 N.Y.S.2d at 811-12.
\(^{106}\) This being said, we should note that, in Hill & McDonnell, *supra* note 54, at 860 n.135, we argue that *Kamin* may not actually have been a straightforward care case. The alternative explanation invokes structural bias, suspect motives, and/or even straightforward self-interest: the directors were motivated by a compensation measure, applicable to the compensation of four of the twenty-member board, based on accounting earnings rather than the report by market experts as to the likely effect of the accounting loss.
Any of these prongs involves a fair degree of scrutiny by the court of the process by which a transaction was approved, and at least some scrutiny of the substance of the transaction as well, albeit usually only minimal substantive scrutiny in the first two prongs.

In between, there is a vast middle ground. In our earlier paper, we located structural bias within a middle ground between traditional loyalty and care. We also discussed certain stylized types of cases in which courts had adopted procedures that were intermediate, neither at the "pure care" end nor at the "pure loyalty" end. Here, we propose that the middle ground actually is lack of good faith. At one end of the middle ground itself is simple lack of good faith; at the other is affirmative bad faith.

The best formulation to date for this middle ground is the analysis in the Disney cases described above. However, if some recurring set of circumstances is important and unique enough, courts may elaborate the general good faith analysis into a more specific doctrine for those circumstances. Moreover, articulation of the broad contours of the doctrine may very well change, especially as the role of differing levels of intentionality becomes more developed in the jurisprudence. Thus, over time the broad good faith part of the continuum becomes more complicated and highly elaborated.

Figure 1, at the lowest level of abstraction, locates some of the key cases within the good faith middle ground. Cases closer to the care end of the continuum receive less scrutiny from courts; cases closer to the loyalty end receive more scrutiny. This continuum is not necessarily smooth everywhere; there are notches and bumps. A big bump occurs at the boundary between care and loyalty, where a notably higher degree of judicial scrutiny kicks in. The placement of a case on this continuum reflects the courts' rough judgment as to how much risk of biased decision making is present within a given type of circumstance. The three categories we considered in Part III all enter into this analysis. The more structural bias that is present, the further toward the loyalty end a fact pattern will tend to fall. Similarly, the more suspect motives appear to be present, the further toward the loyalty end one will find a case. The subcategory of other culpable conduct, conduct involving illegality, also moves a case toward the loyalty end, much more so where the illegality reflects intentional behavior by directors or officers. That being said, even a failure to monitor as in Caremark moves the case toward the loyalty end—after all, it moves the case from care to loyalty, given Stone. Weighed against these factors is the need to allow corporations to choose freely whether or not to enter into certain kinds of transactions. We do not claim the considerations

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110. See supra notes 27–30 and accompanying text.
we have mentioned occupy the field completely; there may currently be more, or there may come to be more. That said, let us consider the range of cases within the good faith portion of the continuum.

On the left, closest to the duty of care, is *Caremark*, i.e., cases where the board allegedly failed to put in place adequate systems to monitor illegal behavior by subordinate employees. As long as the board has put something in place, courts are almost certain to defer to the board in such cases, absent further suspicious facts. In *Caremark* cases there is just a whiff of structural bias and suspect motives, and while there is illegal behavior, it is by subordinates, not by the board or top officers; hence, there is little reason for concern about biased decision making in such cases.

Moving a bit toward the loyalty end, we have placed *Levine v. Smith*. *Levine* deals with judicial review of decisions by boards to reject a demand made by plaintiffs prior to instituting a derivative action. Such cases involve greater concern about structural bias and suspect motives, insofar as directors are making a decision about whether a case against themselves and/or their fellow directors should continue. Indeed, one might well argue that this situation should be placed further toward the loyalty end of the continuum than we have put it here. In this regard, some states' courts impose a high level of scrutiny for such decisions because of the structural bias concerns. However, Delaware has chosen to extend business judgment rule protection to such cases, although the board's decision can still be scrutinized for good faith. In our earlier article, we suggest that Delaware's review of such decisions can and should be stiffened somewhat through the use of good faith analysis.

Moving again toward the loyalty end in Figure 1, but still relatively close to the care end, we find *Disney*. *Disney* articulates a general standard for good faith, but it also deals with a recurring and important fact pattern, namely, executive compensation decisions. Executive compensation is receiving a great deal of attention, and the Delaware courts are seeing more

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111. Bainbridge voices concern about the consequences of *Stone* in instances where a board has adopted no compliance system whatsoever. He believes it may inappropriately let boards off where they are unaware of the duty to have such a system, and that it may inappropriately find boards liable where they have carefully weighed the costs and benefits and decided such a system is not worth it. Bainbridge et al., * supra* note 83, at 42–48. We doubt that in this day and age any public corporation board can plausibly fit into the former, uninformed category—the duty to have a compliance system is simply too pervasive, particularly post–Sarbanes-Oxley. As for the latter category, a consequence of *Stone* is indeed that any board will feel it must have some sort of legal compliance system in place—and that is presumably an intended effect, and one that is defensible, as we argued above. *See supra* notes 82–90 and accompanying text. Moreover, the need for intentional behavior may be muted as the good faith doctrine develops; an additional ground for finding the totally unaware board liable may therefore come to exist.


compensation cases.\textsuperscript{116} We expect that, as the courts see more such cases, they will develop more specific guidance. This may take the form of articulating a specific standard of review, but even if not, the courts through accumulated cases will give more guidance as to what sorts of procedure are likely to insulate compensation decisions, and what sorts of procedure will raise red flags. Executive compensation implicates significant concern about structural bias, which is why a fair degree of scrutiny is warranted. On the other hand, compensation decisions are unavoidable, frequent, and recurrent, so an overly strict standard of judicial scrutiny would be too much of an intrusion into board decision making; hence, Disney remains not far from the care end of the continuum.

Moving further along in Figure 1, we find the two main change of control categories, \textit{Unocal} and \textit{Revlon}.\textsuperscript{117} Changes in corporate control inherently raise structural bias and suspect motive concerns, as directors and officers want to protect their positions (and each others’ positions) within the corporation. This is why the Delaware courts give more scrutiny in such cases than they would if they were using business judgment deference. However, changes in corporate control and defenses against such changes both have strong justifications in some circumstances. Courts are not very good at distinguishing where control changes should be encouraged or discouraged, and to whom control should be transferred if there is to be a change. It is therefore inadvisable for courts to very closely scrutinize a board’s decision in these matters. The courts have tried to strike a balance between these competing considerations, crafting standards of review that put such cases in the middle of the continuum.

Getting close to the loyalty end, we find \textit{Zapata}.\textsuperscript{118} Recall that \textit{Zapata} involves derivative suits where shareholder demand was excused, the board set up a special litigation committee to review the merits of the suit, and the committee recommended dismissal.\textsuperscript{119} Here, the structural bias concerns are very strong, the ability of the court to judge the wisdom of the committee’s decision is better than usual, and the business needs to use such committees are relatively weak. Hence, there is not much reason to defer to such decisions, and Delaware courts do not.

Closest to the loyalty end of the continuum is \textit{Blasius Industries, Inc. v. Atlas Corp.}\textsuperscript{120} This case, as later described by the Chancery Court, involves board actions taken with the intent of precluding shareholder action: “[T]he incumbent board attempted to appoint new members at the eleventh hour to preclude shareholders from filling those seats by electing a

\textsuperscript{116} See, e.g., Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007); In re Tyson Foods Consol. Shareholder Litig., 919 A.2d 563 (Del. Ch. 2007); Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007).

\textsuperscript{117} See supra notes 8–9 and accompanying text.

\textsuperscript{118} See supra note 10 and accompanying text.

\textsuperscript{119} See supra note 10 and accompanying text.

\textsuperscript{120} 564 A.2d 651 (Del. Ch. 1988).
hostile acquirer's candidates.”

State of Wisconsin Investment Board v. Peerless, a subsequent case applying Blasius, involved a board's adjournment of a shareholder meeting when it became clear that a shareholder vote would approve a measure that management opposed. Once Blasius is invoked, the judicial scrutiny is no less searching than in traditional loyalty cases themselves—perhaps even more searching.

We think this structure tracks fairly closely the Delaware case law on fiduciary duty as it has developed. The structure is of course not perfect; however, it does succeed in giving the courts flexibility to address new situations as they arise while still providing corporations and their counsel a fair degree of guidance in many kinds of recurring situations. It also does, we think, a sensible job of singling out for greater judicial scrutiny those kinds of cases that are likely to be more problematic.

Our structure and its conceptual underpinnings also serve another important function. Extralegal forces—norms and reputation—play a very strong role in the behavior of corporate actors. Delaware courts are clearly aware of this function, and employ it to encourage behavior they find desirable but that would be difficult to address more directly through law itself. Consider in this regard much of the language in Caremark. In approving the settlement in that case, Chancellor Allen expressly acknowledged that the plaintiffs almost certainly would have lost. Still, he took the occasion to articulate what directors ought to be doing in cases presenting Caremark-type issues. Similarly, consider the language in the Chancery Court opinion in Disney. The court takes pains to describe the deficiencies in the board of directors’ process, characterizing it as “fall[ing] far short of what shareholders expect and demand from those entrusted with a fiduciary position,” while nevertheless ruling in their favor. Finally, consider also the case of Kahn v. Sullivan, where the court approved a settlement of an action against Occidental Petroleum for having built a museum with corporate funds to house the art collection of the CEO and


122. Id. at *1.

123. A recent case refines, and arguably somewhat alters, the Blasius standard. See Mercier v. Inter-Tel., 929 A.2d 786 (Del. Ch. 2007). Blasius seemed to suggest that it would be very hard to postpone a shareholder vote to stop a result the management did not like; Mercier suggests that such a postponement may be not quite so hard.

124. Johnson also stresses the interplay between the judicial loyalty rhetorical and extrajudicial norms. See Johnson, supra note 58, at 29.


127. Id. at 763.

one percent shareholder. Approving the settlement, the court nevertheless noted its displeasure with the board:

[T]he Settlement in the Court’s opinion leaves much to be desired.

The Court’s role in reviewing the proposed Settlement, however, is quite restricted. If the Court was a stockholder of Occidental it might vote for new directors, if it was on the Board it might vote for new management and if it was a member of the Special Committee it might vote against the Museum project. But its options are limited . . . .

The court is telling corporate actors how it thinks they should behave—and corporate actors listen. Consider in this regard the rush to abide by “Caremark duties” after the case was decided. Corporations employ well-paid advisers to tell them how to avoid conduct that might trigger liability. Activist shareholders publicize their corporations’ deviations from what the activists view as best practices, and bring shareholder resolutions to advance their views. Indeed, as jurisprudence on good faith develops, we would expect norms of conduct to develop as well, which will almost certainly contain a penumbra beyond what law can directly reach.

CONCLUSION

In the classic formulation of the duty of loyalty, when a director breaches her duty of loyalty, she takes for herself or her relations or affiliates what should otherwise be the corporation’s. Classic duty of loyalty cases paradigmatically involve a conveyance of money or assets between the director or officer and the corporation. It is clear, given that the director or officer can have a role in setting the terms of the conveyance, that the terms could be biased in favor of the director or officer. Thus, once there is such a conveyance, the terms are necessarily scrutinized, as is the process by which the terms were reached.

Classic duty of care cases also involve a director taking for herself something which should otherwise be the corporation’s: her attention and diligence. But clearly, we cannot apply the same level of scrutiny to all corporate decisions as we are willing to apply to decisions where the director or officer had a clear opportunity to benefit herself at the expense of the corporation. Thus, the duty of care jurisprudence has developed with considerable deference to directors and officers.

The difficulty has been, though, that, as a general matter, if a case did not fall under the narrow loyalty definition, it too often was treated as invoking only the duty of care—notwithstanding some indication that the directors were not properly doing their jobs, and that the omission was not simple neglect. Consider why directors might not have given adequate attention to

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129. Id. at 51–52.
a decision. In many, and perhaps most, cases, inadequate attention will
mean something in the family of rubber stamping on account of structural
bias, something that does essentially implicate loyalty concerns.

Thus, we have had a class of cases in which the directors are somehow
culpable—but how were we to characterize that culpability in the context of
existing fiduciary duty jurisprudence? The issue always mattered, but came
to matter even more after the enactment of section 102(b)(7). Before,
liability for breach of duty of care was simply exceedingly unlikely. After
section 102(b)(7), it became impossible. Something clearly needed to
occur—a recognition and delineation of a middle-ground category of
culpable act or omission, as has now occurred in Stone v. Ritter.

That middle ground is the realm of good faith. Cases that fall into this
realm will get greater judicial scrutiny than care cases, and create some risk
of liability. How much more scrutiny and risk will depend on how much
risk of director misbehavior is present in a particular kind of context. For
frequently recurring contexts—takeover defenses, derivative actions,
executive compensation, and so on—the courts will continue to develop
more specialized rules that respond to the challenges arising within each
context. Beyond that, the courts will, and should, continue to use good faith
to address new sorts of corporate governance issues that arise with evolving
business practices that raise questions of structural bias, suspect motivation,
or other sorts of concerns. Courts should continue as well to use their
“bully pulpit” to set forth and encourage the development of norms and best
practices that may effectively influence directors as much as, or more than,
the fear of legal liability.

Figure 1:
A Continuum of Cases

<table>
<thead>
<tr>
<th>Most Abstract</th>
<th>Caremark Levine Disney Unocal Revlon Zapata Blasius</th>
</tr>
</thead>
<tbody>
<tr>
<td>Least Abstract</td>
<td>Traditional Loyalty</td>
</tr>
<tr>
<td>Care</td>
<td>Good Faith</td>
</tr>
</tbody>
</table>