

Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law

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The inability of Delaware's courts to identify what a corporate director's core fiduciary duties are, let alone what the scope of those duties might be, is one of the most pressing – and from a director's point of view, distressing – issues in corporate law today.

After the fall of Enron and WorldCom, and particularly since the passage of the Sarbanes-Oxley Act of 2002, lawmakers have only become more heavily reliant on the role of independent “outside directors” – that is, directors independent of the corporation and its management – to play what has effectively become a regulatory role. A centerpiece of the Sarbanes-Oxley reforms, for example, is the requirement that public companies have audit committees to oversee the work of outside auditors, and that all members of the audit committee be “independent” as defined in the Act.¹ Sarbanes-Oxley also requires the Securities and Exchange Commission (SEC) to direct the securities exchanges “to prohibit the listing of any security of an issuer that is not in compliance” with this requirement.² The New York Stock Exchange (NYSE) itself requires that listed companies' boards have an independent majority, who “must meet at regularly scheduled executive sessions without management,” and that the board have nominating/corporate governance and compensation committees composed solely

¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-77 (2002). Independence requires accepting no “consulting, advisory, or other compensatory fee from the issuer” and not being an “affiliated person” of the issuer or a subsidiary, other than by virtue of board membership. *Id.* For analysis of the Sarbanes-Oxley reforms aimed at corporate directors, see Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393 (2005), available at Lexis.

² Sarbanes-Oxley Act § 301.

of independent directors.³ Likewise, outside directors typically play a particularly important governance role under corporate law. For example, disinterested directors sometimes ratify CEO compensation (and that of the other board members) for a “measure of legal insulation,” and approval of a committee of disinterested independent directors can provide similar protection in the context of a controlled transaction between a corporate subsidiary and its parent, shifting the burden to the plaintiff to demonstrate the transaction’s unfairness.⁴

While all corporate directors are subject to fiduciary duties of care and loyalty (and, as discussed below, perhaps good faith) – requiring that they exercise their power over corporate affairs with reasonable diligence and in the best interests of the corporation – the fact that their role is effectively to invest on behalf of others has been thought to give rise to the potential for substantial risk aversion. Directors bear the downside costs of potential personal liability, but only see a very small portion of any upside flowing from the risks they direct the business to take.⁵ This problem is even more acute in the case of outside directors, whose “direct financial stake in the firm is commonly a small fraction of their net worth and a tiny fraction of the value of the firm,” and who typically “are busy people who are modestly compensated for serving as

³ NYSE, Inc., Listed Company Manual §§ 303A.01, 303A.03-303A.05 (2005), <http://www.nyse.com/Frameset.html?displayPage=/about/listed/1022221393251.html>. For the NYSE’s strict independence requirements, see *id.* at § 303A.02.

⁴ WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 321 (2003) (observing, however, that “compensation agreements are not subject to the ordinary law of director conflicts”); *id.* at 313-14.

⁵ *Id.* at 239-41.

directors relative to the opportunity cost of their time.”⁶ Thus the risk aversion that might simply have assumed the form of less willingness to take entrepreneurial risks could, in the case of candidates for outside director positions (who generally have day jobs, and for whom the gap between perceived downsides and upsides can be quite stark), take the form of declining the position in the first place.⁷

The historical development of U.S. corporate law, or at least corporate fiduciary duties, can be understood as an effort to establish and continually recalibrate this balance between providing a remedy for shareholders harmed by directors’ wrongdoing, while ensuring that qualified individuals will choose to fill corporate board positions and take appropriate risks for the benefit of those same shareholders. First and foremost, fiduciary duties of care and loyalty serve the important purpose of minimizing “agency costs” – that is, aligning the fiduciary’s interests with those of the

⁶ Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability* 5-6 (Stanford Law School, John M. Olin Program in Law and Economics, Working Paper No. 250, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=382422.

⁷ See, e.g., Michael Klausner, Bernard S. Black & Brian R. Cheffins, *Outside Directors’ Liability: Have WorldCom and Enron Changed the Rules?*, 71 STAN. LAW. 36 (2005), http://www.law.stanford.edu/publications/lawyer/issues/71/sl71_klausner.pdf; see also Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003), available at Lexis (“The wisdom of [using fiduciary duty law to increase director accountability] will depend, in part, on whether the risk of greater financial exposure will induce enhanced discharge of director responsibilities, to the advantage of share-holders, or dissuade capable prospective director candidates from service, to the detriment of shareholders.”).

It is widely accepted – and implicit here – that the presence of outside directors is beneficial. The optimal balance between outside and inside directors on a corporate board remains, however, an open question. See generally Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999), available at ABI/INFORM Global; Dawna L. Rhoades et al., *Board Composition And Financial Performance: A Meta-Analysis Of The Influence Of Outside Directors*, XII:1 J. MANAGERIAL ISSUES 76 (2000), available at ABI/INFORM Global; Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 IOWA J. CORP. L. 231 (2002), available at Lexis; Tod Perry & Anil Shivdasani, *Do Boards Affect Performance? Evidence from Corporate Restructuring*, 78:4 J. BUS. 1403 (2005), available at ProQuest.

individuals for whom they ultimately act⁸ (in a corporation, the shareholders) – through judicial scrutiny of the quality of *decisions* and the quality of *intentions*, respectively. The specter of liability for well-intentioned business decisions, however, resulting in the risk aversion described above, has given rise to the so-called “business judgment rule” (BJR). The BJR, formulations of which differ across jurisdictions, reflects universal judicial aversion to querying decisions made by disinterested, independent directors in good faith.⁹ In Delaware, the jurisdiction of incorporation for over half of U.S. public companies and almost 60 percent of the Fortune 500,¹⁰ the BJR has been formulated as “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹¹

In corporate law, this divergence between the standard of care and the standard of review for care breaches has rested on the straightforward policy rationale that the

⁸ See ALLEN & KRAAKMAN, *supra* note 4, at 31. For additional background on agency costs as a consequence of the division of corporate ownership and control, see generally Michael C. Jensen & William H. Meckling, *Theory of the firm: Managerial behavior, agency costs and ownership structure*, 3 J. FIN. ECON. 305 (1976); see also Mark J. Roe, *Political Preconditions to Separating Ownership from Control*, 53 STAN. L. REV. 539, 545-46 (2000); Douglas M. Branson, *The Very Uncertain Prospect of “Global” Convergence in Corporate Governance*, 34 CORNELL INT’L L.J. 321, 359-62 (2001).

I would not be understood to endorse as inevitable or appropriate the relatively pure shareholder-wealth-maximization norm that prevails in the United States; I employ the concept of agency costs to make a descriptive – rather than prescriptive – statement about governance of U.S. corporations. While the debate regarding whether corporate governance systems will “converge” upon a global set of best practices remains open, it is clear that other jurisdictions have settled upon perfectly coherent corporate legal systems emphasizing the interests of other stakeholders to varying degrees. See, e.g., Roe, *supra*; Branson, *supra*; Timothy L. Fort & Cindy A. Schipani, *Corporate Governance in a Global Environment: The Search for the Best of All Worlds*, 33 VAND. J. TRANSNAT’L L. 829 (2000); but see Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (arguing that there is “no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value”).

⁹ ALLEN & KRAAKMAN, *supra* note 4, at 248.

¹⁰ See *Division of Corporations*, <http://www.state.de.us/corp/default.shtml> (last visited Oct. 14, 2005).

¹¹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (applying the BJR in the context of demand futility analysis).

benefits (entrepreneurial risk taking) exceed the costs (a monetary remedy foregone).¹² In the 1980s, however, as the increasing prevalence of hostile corporate takeovers led to concerns that incumbent directors and officers of target companies might act to preserve their own power rather than to maximize shareholder value, the Delaware Supreme Court's jurisprudence began to incline toward greater liability exposure. Ultimately this resulted in the crafting of forms of judicial scrutiny specific to the takeover context, but in a notable 1985 opinion (*Smith v. Van Gorkom*¹³) now often described as a preamble to that takeover jurisprudence, it was held that disinterested directors could be held liable for monetary damages for breach of their duty of care – a holding that literally shocked the business community.¹⁴

Almost immediately, the Delaware legislature effectively overruled the decision by amending the Delaware General Corporation Law, in § 102(b)(7), to permit shareholders to include exculpatory provisions in their corporate charters limiting or eliminating directors' personal liability for duty of care breaches.¹⁵ The statute, however, does not actually refer explicitly to the duty of care; the drafters of § 102(b)(7) endeavored to achieve their end indirectly, by specifying what could not be exculpated, including (among other things) breaches of the duty of loyalty and acts not in "good faith."¹⁶ Notwithstanding the legislature's manifest desire to limit directors' exposure to monetary liability, the manner in which the statute was drafted essentially invited the

¹² See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny As a Standard of Review Problem*, 96 NW. U.L. REV. 449, 451 (2002), available at Lexis.

¹³ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

¹⁴ See ALLEN & KRAAKMAN, *supra* note 4, at 518.

¹⁵ DEL. CODE ANN. tit. 8, § 102(b)(7) (2005), available at Lexis.

¹⁶ See *infra* text accompanying notes 46-58.

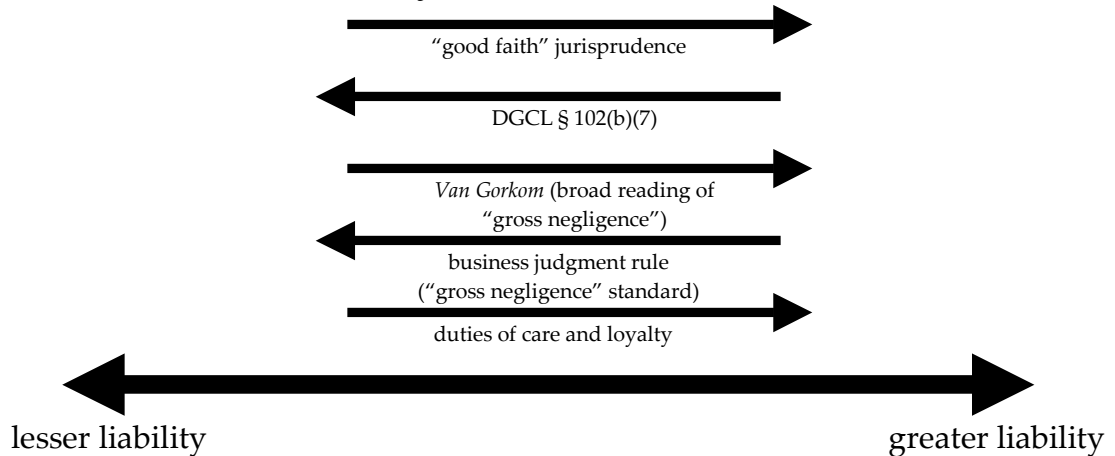
interpretation of good faith as a newly free-standing concept independent of the duty of loyalty, of which it was previously thought to be a component.¹⁷ The murky nature of the concept, and the difficulty courts have encountered in their efforts to imbue it with positive content unrelated to the concept of loyalty, will be discussed in detail below, but for the moment it will suffice to observe that plaintiffs' lawyers (and courts) looking for means through which to expand potential bases for director liability have had ample incentive to explore the good faith concept as a promising basis for monetary recovery where a company has an exculpatory charter provision and no financial conflict of interest appears to be involved. As a consequence, a case law exploring the meaning of good faith has emerged in Delaware that, in seeking to stake out for it an independent conceptual terrain not derivative of loyalty, has called into question the meaning and scope of the primary fiduciary duties of care and loyalty themselves.

This paper seeks to demonstrate that the Delaware courts and legislature have – at each turn in this process of calibrating the balance of directors' incentives – compounded complication upon complication, resulting today in a fiduciary duty framework under Delaware corporate law that is internally contradictory and essentially unworkable. As Figure 1 illustrates in stylized form (indicating the tendency of successive layers of the doctrine toward lesser or greater liability, respectively), the effort to calibrate and recalibrate directors' incentives and liability exposure has resulted in a five-layered framework for assessing disinterested board conduct. Doctrinal problems stemming from the ill-defined good faith concept represent only the latest

¹⁷ See *infra* text accompanying notes 59-67.

development in a corporate fiduciary duty doctrine that has grown by *ad hoc* accretion into an overly complex framework raising theoretical and practical problems out of all proportion to its benefits.

Figure 1: Director Liability for Fiduciary Breaches in Delaware

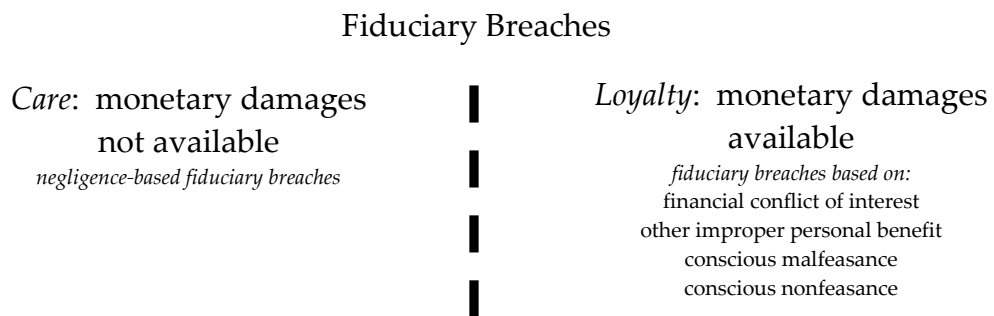


It is the task of this paper to diagnose the problems associated with this regime and to propose a remedy in the form of a statutory amendment that would eliminate the § 102(b)(7) exculpation provision, replacing it with a *provision permitting the imposition of monetary liability only for loyalty breaches, defined to include cases involving financial conflicts of interest, other improper personal benefits, conscious malfeasance, and conscious nonfeasance* – the latter category representing those cases recently styled by the Delaware courts as involving bad faith omissions.¹⁸ The proposed regime would, in essence, discard the

¹⁸ It bears emphasizing that in describing the proposed statutory provision in such terms, I speak abstractly. The language employed might take various acceptable forms, the intent being that the terminology differ from the exculpation exceptions in Delaware’s current § 102(b)(7) principally in the respects discussed in this paper. Thus, for example, while it is arguably subsumed conceptually by the other prongs of the proposed statute, a specific exception for unlawful distributions might nevertheless be included, though at least one Delaware jurist has expressed the view that this – like the other exceptions to Delaware’s §

convoluted damages rule represented by the several layers of doctrine presently superimposed on the core fiduciary duties – illustrated in Figure 1 – in favor of a more straightforward statutory provision representing their net effect – illustrated in Figure 2.

Figure 2: Director Liability for Fiduciary Breaches in Delaware, *Proposed* Regime



As I argue below, the proposed regime would track what Delaware case law, fairly read, already permits with regard to monetary liability for breaches of fiduciary duty, while offering substantial benefits associated with a logically coherent system both workable for courts and comprehensible by the market. It would also remain consistent with what I argue is, and has been, the functional distinction between duty of care analysis and duty of loyalty analysis: the minimization of agency costs through assessment of the quality of *decisions*, on the one hand, and the quality of *intentions*, on the other.

102(b)(7) – simply represents a form of disloyalty. See *infra* text accompanying note 112; see also DEL. CODE ANN. tit. 8, § 174 (2005), available at Lexis.

I. Delaware's Business Judgment Rule and Fiduciary Duty Analysis

Broadly speaking, the business judgment rule (BJR) reflects substantial reluctance on the part of judges to substitute their own business judgment for that of corporate boards. Notwithstanding that corporate directors owe a duty of care to the corporation, typically expressed in the standard negligence terminology of reasonable prudence under the circumstances, the BJR has historically operated to remove the specter of liability for damages resulting from business decisions made by disinterested directors in "good faith." As a first approximation it is probably fair to define the latter term as requiring "an honest judgment seeking to advance the corporation's interests"¹⁹ (bearing in mind that its evolving meaning under Delaware case law is a matter of considerable controversy, and will constitute the principle subject of the latter portion of this paper).

Though formulations of the BJR differ across jurisdictions, the Delaware Supreme Court has described it as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."²⁰ In *Aronson v. Lewis*, the court explained (in 1984) that the BJR protects only disinterested directors and that it applies only to directors' actions, not "where directors have either abdicated their

¹⁹ See generally ALLEN & KRAAKMAN, *supra* note 4, at 248-53; see also, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 889 (Del. 1985) (characterizing the issue of "good faith" in BJR analysis as whether the board made "an honest exercise of business judgment").

²⁰ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (applying the BJR in the context of demand futility analysis).

functions, or absent a conscious decision, failed to act.”²¹ However, a director’s disinterestedness with respect to board action would not be enough to ensure insulation from liability. The court further stated that “to invoke the rule’s protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them,” and then to “act with requisite care in the discharge of their duties.”²² That is, the BJR could be overcome – at least in theory – solely by reference to the care exercised by the board in informing itself and arriving at a decision.

As to the actual standard for overcoming the BJR in this manner, however, the *Aronson* court found the cases to be less than clear. Interestingly, while a couple of the cases cited by the court drew the line at “grossly negligent” conduct or “reckless indifference,” most of the cases cited by the court used verbal formulae pointing toward a more culpable mental state, such as “fraud,” “gross overreaching,” “bad faith,” “misconduct,” and the like.²³ Nevertheless, the court took from this authority only that “director liability is predicated on a standard which is less exacting than simple negligence,” and concluded that “under the business judgment rule director liability is predicated upon concepts of gross negligence.”²⁴ In other words, the *Aronson* court in 1984 resolved the preexisting ambiguity by setting the bar for overcoming the BJR relatively lower, styling the choice as between simple negligence or a “less exacting”

²¹ *Id.* at 812-13.

²² *Id.* at 812.

²³ *Id.* at 812 n. 6 (citations and internal quotation marks omitted).

²⁴ *Id.* at 812 and n.6.

standard, without asking whether this case law had in fact permitted the BJR to be overcome by a showing of anything short of disloyalty.²⁵

In essence the court had simply traded one form of ambiguity for another; while a single articulation of the standard might have seemed like a step in the right direction, the formulation chosen was itself a highly ambiguous one. Setting aside whether gross negligence adequately summarizes the range of prior formulations identified by the court, the range of conduct intended to be captured by the gross negligence concept is, at the margin, notoriously difficult to identify even in abstract terms. *Black's*, for example, offers the following insights: “It is materially more want of care than constitutes simple inadvertence.... The element of culpability which characterizes all negligence is in gross negligence magnified to a high degree as compared with that present in ordinary negligence.”²⁶ Put differently, gross negligence is negligence that is gross.²⁷ The BJR’s gross negligence standard has been interpreted as allowing courts to “articulate a duty of ‘reasonable care’ but enforce a more director protective standard.”²⁸ That may be correct, but as would become clear within a year of the court’s restyling of the doctrine in *Aronson*, this blurring of the distinction between the duty itself and the liability standard²⁹ would also obscure the very purpose of the BJR by suggesting that negligence

²⁵ See *infra* notes 35 and 158.

²⁶ *Black's Law Dictionary* 1033 (6th ed. 1990). See also text accompanying note 33.

²⁷ See, e.g., *Guttman v. Huang*, 823 A.2d 492, 508 n.39 (Del. Ch. 2003) (Strine, Vice Chancellor, unable to confirm, as of 2003, “[i]f gross negligence means something other than negligence”).

²⁸ ALLEN & KRAAKMAN, *supra* note 4, at 254 n. 17.

²⁹ *Id.* at 253.

– if only the gross variety (whatever that might come to mean) – could, alone, give rise to monetary liability for a director’s breach of the duty of care.³⁰

A. *Van Gorkom*, D&O Insurance, and Market Perception

The story of Trans Union’s ill-fated dealings with takeover artist Jay Pritzker is a fascinating one, though a lengthy one. It is sufficient for present purposes to observe that the manner in which Trans Union’s board approved its merger into a Pritzker-controlled entity hardly reflected ideal corporate governance practice. Without copies of the proposed merger agreement available, and based principally on a twenty-minute presentation by Trans Union Chairman and CEO Jerome Van Gorkom, the board approved the merger. Van Gorkom – who was a shareholder fast approaching retirement, had not read the agreement himself, and was an acquaintance of Pritzker – had negotiated largely without board or management knowledge. The \$55 per share price agreed upon (representing a substantial premium over Trans Union’s market price, which had ranged from \$24¼ to \$39½ per share over the prior five years) had been suggested by Van Gorkom to Pritzker (not vice versa), and Van Gorkom had arrived at the price not by reference to any valuation study, but based on the feasibility of a leveraged buyout at that price (a fact not disclosed to the board). The agreement purported to provide for a 90-day market test to confirm price validity, though it placed onerous restrictions on Trans Union’s capacity to negotiate with others.³¹

³⁰ Cf. Allen, Jacobs & Strine, *supra* note 12, at 458-60 (arguing that the court subsequently applied a simple negligence standard rather than the gross negligence standard announced in *Aronson*).

³¹ *Smith v. Van Gorkom*, 488 A.2d 858, 863-70 (Del. 1985).

The ensuing shareholder class action suit came before the Delaware Supreme Court on appeal from the Court of Chancery's determination that the board's actions were protected by the BJR. In its own opinion, which came down in January 1985, the Delaware Supreme Court began with the observation that "there were no allegations of fraud, bad faith, or self-dealing," such that "considerations of motive are irrelevant to the issue before us." The BJR analysis would focus solely on the issue of care, and the court reiterated its view that gross negligence was the applicable standard.³² Little illumination of the meaning of gross negligence was offered, save additional citations to Chancery opinions stating the standard as being whether the board acted "without the bounds of reason and recklessly" or "so far without information that they can be said to have passed an unintelligent and unadvised judgment."³³

The Delaware Supreme Court found that the board had, in fact, been grossly negligent in approving the merger; that subsequent amendments to the agreement were not helpful (as they only tended further to lock Trans Union into the deal); that subsequent board consideration of the deal did not cure the problem (as the board lacked the ability to withdraw from the agreement by that point); and that shareholder approval of the merger likewise was unavailing (as the vote was uninformed – particularly with respect to information on price).³⁴

³² *Id.* at 870-73.

³³ *Id.* at 873 n. 13 (citing standards articulated in *Mitchell v. Highland-Western Glass Co.*, 167 A. 831, 833 (Del. Ch. 1933) and *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599, 615 (Del. Ch. 1974), respectively, evidently in support of its conclusion that "the concept of gross negligence is ... the proper standard for determining whether a business judgment reached by a board of directors was an informed one") (internal quotation marks omitted).

³⁴ *Id.* at 874-93.

The business community – and perhaps more pertinently, their insurers – were shocked by the outcome in *Van Gorkom*. Notwithstanding the ambiguities that Aronson had introduced into the doctrine and the haste with which the Trans Union board had acted, commentators at the time simply did not, by and large, view Delaware’s BJR as permitting the imposition of board liability for damages solely by reference to the *quality* of decisionmaking.³⁵ In this light, *Van Gorkom* appeared not to have applied the BJR so much as to have eviscerated it.³⁶ The decision’s formalism was widely criticized, particularly in light of the prominence of Trans Union’s board members, their depth of background knowledge on the company, the substantial premium involved, and the low probability that an investment bank opinion to the effect that \$55 per share was a fair price could not have been procured.³⁷ The case accordingly “provoked intense concern

³⁵ William Allen and Reinier Kraakman indicate that they have identified no pre-*Van Gorkom* case (outside the banking context) “in which directors who have no conflicting interests and who attend meetings and deliberate before authorizing a transaction are held personally liable for breach of a duty of care, let alone a case in which they are held liable for approving a sale of the company at a 50 percent premium to market price.” ALLEN & KRAAKMAN, *supra* note 4, at 518 n. 17.

³⁶ See, e.g., Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985), available at Westlaw (discussing “the rejection of the business judgment rule as the proper standard of judicial review in the *Trans Union* case”); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985), available at Westlaw (describing *Van Gorkom* as having “pierced the business judgment rule”); cf. DAVID A. DREXLER ET AL., 1-15 DELAWARE CORPORATION LAW AND PRACTICE § 15.06 (2004), available at Lexis (observing that liability was imposed “for conduct which to many observers seemed wholly undeserving of the characterization ‘gross negligence,’” the dissent arguing that their conduct did not amount even to simple negligence).

³⁷ See, e.g., Fischel, *supra* note 36 (quipping, “I wish someone would pay me several hundred thousand dollars to state that \$55 is greater than \$35”); Leo Herzel & Leo Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986), available at Westlaw (arguing that *Van Gorkom* would result in “greater formalism on the part of the board, as it goes about the business of cultivating an aura of care, diligence, thoroughness, and circumspection,” and that this would “mean more reliance on and more fees for lawyers, investment bankers, accountants,” and others). Herzel’s law firm had in fact played a role in the acquisition at issue in *Van Gorkom*, representing the lenders involved. See Kirk Victor, *Rhetoric Is Hot When the Topic Is Takeovers*, LEGAL TIMES, Dec. 23/30, 1985, at 2, available at Lexis.

in many corporate boardrooms,”³⁸ the “corporate bar generally view[ed] the decision as atrocious,” and “[c]ommentators predict[ed] dire consequences as directors [came] to realize how exposed they [had] become.”³⁹ Corporate lawyers decried the “much greater randomness and unpredictability on the part of future courts passing on future board decisions,”⁴⁰ and carriers of directors and officers (D&O) insurance found themselves surveying a landscape in which “the perceived rules of the game” had changed.⁴¹

Indeed, the D&O insurance industry⁴² had already been lapsing into a crisis. In the early 1980s, increased M&A activity, IPO activity, and business failure had together resulted in a spike in shareholder litigation against corporate boards. The costs of claims increased significantly, and by late 1984 the D&O insurance industry had fallen into “severe dislocation” reflected in significantly higher premia, higher deductibles, lower policy limits, and narrower scope of coverage. Some insurers simply left the market, and “[a]s market capacity declined, some corporations claimed to be unable to obtain the coverage they desired at any price.”⁴³ Enter *Van Gorkom*, which “exemplifie[d] the legal

³⁸ John F. Olson & J. Keith Morgan, *D&O Exclusions Extend To Takeover Context*, LEGAL TIMES, Mar. 10, 1986, at 23, available at Westlaw.

³⁹ Manning, *supra* note 36.

⁴⁰ See, e.g., Herzel & Katz, *supra* note 37.

⁴¹ Olson & Morgan, *supra* note 38.

⁴² Delaware’s corporate law permits companies to purchase insurance for its directors, officers, employees and agents “against any liability ... arising out of such person’s status as such, whether or not the corporation would have the power to indemnify such person against such liability.” DEL. CODE ANN. tit. 8, § 145(g) (2005), available at Lexis. The latter clause is important, among other reasons, in light of § 145’s preclusion of indemnification for judgments in derivative suits. See DEL. CODE ANN. tit. 8, § 145(b). See also *infra* note 172 and accompanying text.

⁴³ Roberta Romano, *Corporate Governance In the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1158 (1990), available at Lexis. See also Olson & Morgan, *supra* note 38, for a detailed discussion of specific changes in D&O coverage, including the use of “a new hostile takeover exclusion,” and the corporate response to these developments.

uncertainty that contributed to the insurance crisis; most practitioners, like the lower court, would have predicted that the facts in *Van Gorkom* would not constitute gross negligence under Delaware's duty of care standard."⁴⁴ Matters only looked worse when, following remand, the case settled for \$23.5 million, \$13.5 million beyond Trans Union's \$10 million D&O policy limit.⁴⁵

B. Politics and the Delaware General Assembly: § 102(b)(7)

As of late 1985, pressure was mounting on Delaware's legislature to intervene. One commentator observed that Delaware's recent corporate governance jurisprudence had resulted in "almost complete frustration among those who search the decisions for consistency and predictability," that the Delaware legislature was not taking action to cope with the "near chaos in corporate legal policy," and that the business community should "reconsider anew alternatives to our American corporate Ruritania."⁴⁶ By late March 1986, the Delaware Bar Association's influential corporate law section was "seriously considering making recommendations to amend the state corporate law" – perhaps prompted by a new Indiana statute (effective April 1, 1986) expressly limiting director liability to cases involving recklessness or willful misconduct.⁴⁷ Consensus with

⁴⁴ Romano, *supra* note 43, at 1160. At least one commentator suggested that the outcome in *Van Gorkom* was even more difficult to comprehend in light of the fact that the BJR had been found to apply to the *Aronson* facts, "even though the directors were elected by a control person and their decisions were to grant him compensation he desired in excess of all perceptible reason." See Michael R. Klein, *Delaware's Corporate Citadel: We Could Do Better*, LEGAL TIMES, Dec. 16, 1985, at 9, available at Westlaw.

⁴⁵ See Olson & Morgan, *supra* note 38; Mary Ann Galante, *Corporate Boardroom Woes Grow; The D&O Crisis*, NAT'L L.J., Aug. 4, 1986, at 1, available at Westlaw. While most of the \$13.5 million beyond the policy limit was actually paid by the Pritzkers, some was paid by the directors themselves. See Victor, *supra* note 37.

⁴⁶ Klein, *supra* note 44.

⁴⁷ Kirk Victor, *Statutory Response to D&O Crisis Studied*, LEGAL TIMES, Mar. 31, 1986, at 1, available at Lexis; Leo Herzog & Daniel Harris, *Uninsured Boards Mount Weak Defense*, NAT'L L.J., Apr. 21, 1986, at 19, available at Westlaw. See also IND. CODE ANN. § 23-1-35-1(e) (West 2005). In 1989, Indiana's statute was amended to

respect to action in Delaware was difficult to reach, however, as lawyers within and without the state variously advocated differing liability caps and forms of exculpation. Corporate law section chairman Gilchrist Sparks, unsure whether consensus could be achieved in time to get a proposal to the Delaware legislature before the end of its session in June 1986, observed that “[w]e don’t want to destroy the efficacy of the derivative suit, but on the other hand, we want directors to continue to sit on boards and take appropriate risks.”⁴⁸

By mid-May, however, the Delaware Bar Association reportedly was close to settling on “proposed amendments [that would] allow shareholders to place a ceiling on their directors’ personal financial exposure in lawsuits by shareholders and other parties.” According to one press account (citing a “prominent Wilmington corporate attorney”), once the Bar Association approved the amendment, it would make its way to the Delaware legislature and, if “customary practice” were any indication, it would “pass easily.”⁴⁹ Ultimately it did pass, the new § 102(b)(7) of the Delaware General Corporation Law being signed by the governor on June 18, 1986 and going effective July

1st.⁵⁰

reject explicitly the Delaware court’s BJR jurisprudence as “inconsistent with the proper application of the business judgment rule under this article.” IND. CODE ANN. § 23-1-35-1(f), Historical and Statutory Notes.

⁴⁸ See Victor, *supra* note 47 (internal quotation marks omitted); see also R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 4.29, pp. 4-110-4-111 (3d ed. 2004 supp.) (outlining various proposals considered).

⁴⁹ Michael A. Hiltzik, *In Tiny Delaware, Major Corporations Find a Refuge Away From Home*, L.A. TIMES, May 19, 1986, at pt. 4, p. 1, available at Lexis. Roberta Romano has cited this story as the “first story referring to the limited liability provision after it became clear that it would be recommended.” Romano, *supra* note 43, at 1185 n.50.

⁵⁰ Francine Schwadel, *Delaware Law Might Let Firms Avoid Liability Insurance Woes for Directors*, WALL ST. J., June 19, 1986, at 1, available at ProQuest. See also DEL. CODE ANN. tit. 8, § 102(b)(7).

While it would come to be described colloquially as permitting exculpation of director liability for breaches of the duty of care, the operation of the new statute was not so straightforward as that. The language of § 102(b)(7) provided that a Delaware corporation’s charter could include a “provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty,” except that exculpation would not be permitted for certain enumerated types of conduct. Those exceptions included (1) “any breach of the director’s duty of loyalty”; (2) “acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law”; (3) unlawful distributions; and (4) transactions from which a director derives “improper personal benefit.”⁵¹ That the statute is intended to permit exculpation of care violations is obvious; care is not among the exceptions to exculpation. Beyond that, however, the relative meanings of, and interrelationship among, the various exceptions is far from clear – a problem that, given Delaware’s influence in the field of corporate law, has propagated itself elsewhere. (The Appendix provides summary tables reflecting both the prevalence of statutory exculpation, and the role of Delaware’s § 102(b)(7) as a model, across the United States.⁵²) Notably, as one Vice Chancellor would later put it, “its subparts all illustrate

⁵¹ DEL. CODE ANN. tit. 8, § 102(b)(7).

⁵² As the Appendix tables reflect, the vast majority of states permit exculpation. The problematic bifurcation of “loyalty” and “good faith” into separate categories appears in the statutes of 18 other states, while most of the remaining states permitting exculpation appear generally to have followed the Revised Model Business Corporation Act (the pertinent provision of which does not distinguish between loyalty and good faith). See Appendix: Exculpation Statutes by Type, *infra*; see also 1984 MODEL BUS. CORP. ACT § 2.02(b)(4) (incorporating changes through November 2004), *available at* Lexis. There is considerable variation with respect to the form and substance of the remaining exculpation statutes not falling into these two broad categories. Most differ in the phrasing and scope of their exceptions, though some differ more structurally. Connecticut’s statute, for instance, permits the limitation of liability “to an amount not less than the

conduct that is disloyal,” as that term has traditionally been understood,⁵³ rendering it difficult to ascribe distinct conceptual content to each of the exculpation exceptions.

The legislative history confirms that § 102(b)(7) “represent[ed] a legislative response to recent changes in the market for directors’ liability insurance.” Such coverage had “become a relatively standard condition of employment for directors,” and in the legislature’s view, the lack of coverage had “threatened the quality and stability of the governance of Delaware corporations because directors [had] become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions.” Statutory exculpation would permit corporations to “provide substitute protection.”⁵⁴ Neither the statute nor the legislative comment, however, offers any interpretive guidance with respect to the exceptions.⁵⁵

compensation received” from the corporation that year, while under New Mexico’s statute the level of culpability required to trigger the exculpation exception decreases as a director’s ownership interest and remuneration increase. See *infra* Appendix: Exculpation Statutes by Type, Table 3. Most of the states not permitting exculpation have statutory provisions limiting director liability, though the statutes of Nevada and Ohio permit corporations to increase liability exposure through their charters. See *id.*, Table 4.

⁵³ Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) (Strine, Vice Chancellor); see also Allen, Jacobs & Strine, *supra* note 12, at 463 n. 46 (“The statutory examples of conduct that cannot be exculpated under 102(b)(7) are all, in our opinion, examples of loyalty violations.”).

⁵⁴ Chapter 289, Laws of 1986: § 102. Contents of certificate of incorporation, Comment (Del. 1986), reprinted in 2 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS I-12 (3d ed. 2005 supp.); see also Schwadel, *supra* note 50 (reporting that Sparks, “who helped draft the bill,” had indicated that the intent was to ensure retention of outside directors); Galante, *supra* note 45 (quoting Sparks’ remark that the “main idea” of § 102(b)(7) was “to put directors back in the position they were in” before the D&O crisis) (internal quotations marks omitted).

Empirical studies regarding the effects of liability limitation report mixed results. See, e.g., Vahan Janjigian & Paul Bolster, *The Elimination of Director Liability and Stockholder Returns: An Empirical Investigation*, XIII:1 J. FIN. RES. 53 (1990), available at Econlit (concluding that “liability elimination does not have a significant impact upon shareholder wealth”); Yaron Brook & Ramesh K.S. Rao, *Shareholder Wealth Effects of Directors’ Liability Limitation Provisions*, 29:3 J. FIN. & QUANTITATIVE ANALYSIS 481 (1994), available at JSTOR (concluding that “adoption of liability limitation provisions ... is associated with insignificant stock price reactions for all firms, but with positive stock price reactions for poorly performing firms”); Randall A. Heron & Wilbur G. Lewellen, *An Empirical Analysis of the Reincorporation Decision*, 33:4 J. FIN. &

Section 102(b)(7)'s exceptions appear even less coherent before the backdrop of available alternatives proposed at the time. Indiana's statute, for example, had simply revised the standard of care, a move not requiring the expense and complication of one-off corporate charter amendments.⁵⁶ (By contrast, in Delaware more than 90 percent of corporations would, within a single year of § 102(b)(7)'s adoption, opt into the exculpation regime – by amending their charters, one at a time.⁵⁷) With respect to exculpation, the Restatement (Second) of Trusts approach had also been identified as a potential model. Trustees could – under the terms of the trust – “be relieved of liability for breach of trust,” save only where the breach was “committed in bad faith or intentionally or with reckless indifference to the interest of the beneficiary,” or where involving “liability for any profit which the trustee has derived from a breach of trust.”⁵⁸ Though superficially similar to § 102(b)(7) in structure, there is a crucial difference: The

QUANTITATIVE ANALYSIS 549 (1998), available at JSTOR (concluding that “shareholder wealth ... is increased by reincorporations that establish limits on director liability”).

⁵⁵ See John L. Reed & Matt Neiderman, “Good Faith” and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law As a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 DEL. J. CORP. L. 111, 119 (2004), available at Lexis; Sean J. Griffith, *The Good Faith Thaumatrope: A Model of Rhetoric in Corporate Law Jurisprudence* 3, 13 (Dec. 17, 2004) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=571121.

⁵⁶ IND. CODE ANN. § 23-1-35-1(e).

⁵⁷ Romano, *supra* note 43, at 1160-61 (citing data from “a random sample of 180 Delaware firms”); see also DREXLER ET AL., *supra* note 36, at § 6.02 n. 58 (reporting that during “the one-year period from September 1, 1986 through August 31, 1987, 4,206 charter amendments or restated certificates of incorporation containing director liability provisions were filed by the Secretary of State,” and that “13,697 new certificates of incorporation with director liability provisions” were filed). Romano further notes that within two years, 41 states had amended their corporate law statutes “to reduce directors’ liability exposure,” many following the Delaware approach. Romano, *supra* note 43, at 1160. By 2003, all fifty states had done so. See Fairfax, *supra* note 1, at 412 and n. 105; see also Appendix: Exculpation Statutes by Type, *infra*.

⁵⁸ RESTATEMENT (SECOND) OF TRUSTS § 222 (1959), available at Westlaw. See also Herzel & Harris, *supra* note 47 (identifying this Restatement provision in April 1986 as a useful model for exculpation under Delaware corporate law). Herzel and Harris also point to an interesting Delaware Chancery case from 1910 establishing the acceptability of an exculpatory charter provision that simply eliminates director and officer liability except where arising “through his own dishonesty.” See *id.*; *In re Brazilian Rubber Plantations & Estates, Ltd.*, [1911] 1 Ch. 425, 1910 WL 15606 (Ch D) (Del. Ch. 1910).

trust law approach presents bad faith, reckless, and intentional misconduct as forms of breach of trust generally evocative of disloyalty, whereas the structure ultimately adopted in § 102(b)(7) tends to characterize such forms of conduct as their own categories of fiduciary breach somehow *distinct from* the concept of disloyalty.

C. Fiduciary Duties in the Post-*Van Gorkom*, Pre-§ 102(b)(7) Window

Meanwhile, in the 18 month period between the *Van Gorkom* decision (January 1985) and the passage of § 102(b)(7) (June 1986), the Delaware Supreme Court turned its attention to the increasingly controversial hostile takeover context. Two cases, in particular, are of interest for purposes of this discussion because they shed light on the court's conception of the framework of corporate fiduciary duty law in Delaware on the eve of § 102(b)(7)'s passage in 1986.

Even though *Van Gorkom* involved a corporate takeover, it purported to be a duty of care case.⁵⁹ In its June 1985 *Unocal* opinion, however, the Delaware Supreme Court began to fashion a framework for the analysis of fiduciary breaches specific to the takeover context. The case involved a coercive two-tier tender offer, and the primary legal issue was “the validity of [Unocal’s] self-tender for its own shares which exclude[d] from participation [the] stockholder making [the] hostile tender offer.”⁶⁰ The court found that the board in fact could take such action, but in so doing articulated a new test. While the BJR applies in the takeover context, “the omnipresent specter that a board may be acting primarily in its own interests” – given the threat to the incumbents’ positions – gives rise to “an enhanced duty which calls for judicial examination at the

⁵⁹ ALLEN & KRAAKMAN, *supra* note 4, at 518.

⁶⁰ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985).

threshold before the protections of the [BJR] may be conferred.” Specifically, the board “may not have acted solely or primarily out of a desire to perpetuate themselves in office,” and the “defensive measure ... must be reasonable in relation to the threat posed.”⁶¹

Though the court presents its new test specifically as a response to the conflict directors inevitably face when their control is challenged, it is worth observing that the court clearly linked the notion of good faith with the demonstration of loyalty. The court observed that “directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person’s stock ownership,” and that “they satisfy that burden ‘by showing good faith and reasonable investigation.’”⁶² Though the court leaves the term undefined, it clearly conceptualizes good faith as distinct from the reasonableness of the investigation – which would go to care – and as evincing the actuality of the belief in a danger to corporate policy required to demonstrate loyalty under these circumstances.

The court’s March 1986 *Revlon* opinion⁶³ addressed the validity of defensive measures aimed at preventing Pantry Pride, Inc. from acquiring Revlon – while aiding rival suitor Forstmann Little & Co. – in the midst of what had become a bidding war for Revlon.⁶⁴ Citing *Aronson* and *Unocal* as the basis for its analysis,⁶⁵ the court determined that once bidding was underway and it became clear that the company “was for sale,”

⁶¹ *Id.* at 954-56. See also *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995) (restyling the standard as being whether a defensive measure is “preclusive or coercive,” and if not, whether it falls within a “range of reasonableness”).

⁶² *Unocal*, 493 A.2d at 955 (citation omitted).

⁶³ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

⁶⁴ *Id.* at 175.

⁶⁵ *Id.* at 180.

such that “the break-up of the company was inevitable,” the board’s responsibility under *Unocal* “changed from the preservation of Revlon as a corporate entity to the maximization of the company’s value at a sale for the stockholders’ benefit.” In this light, the court found that a lock-up agreement entered with Forstmann, which involved waiving restrictive covenants in certain outstanding debt securities but then bolstering their market price to prevent litigation (even though there was no suggestion that the terms of the debt had been violated), constituted a breach of the board’s duty of loyalty – by calling into question the board’s good faith under *Unocal*. The court observed 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.... [W]hen the Revlon board entered into an auction-ending lock-up agreement with Forstmann *on the basis of impermissible considerations* at the expense of the shareholders, the directors breached their primary duty of loyalty.” Thus the Delaware Supreme Court, on the eve of § 102(b)(7)’s passage, essentially treats failure to demonstrate good faith – here, in the form of *intent actively to pursue* the best interests of shareholders by maximizing sale price in a bidding war – as tantamount to a failure to establish compliance with the board’s “primary duty of loyalty.”⁶⁶

⁶⁶ *Id.* at 182 (emphasis added). Revlon’s defensive actions had included an exchange offer, in which notes and convertible preferred stock were issued in exchange for common stock. The notes “contained covenants which limited Revlon’s ability to incur additional debt, sell assets, or pay dividends unless otherwise approved by the ‘independent’ (non-management) members of the board” – a move that “stymied Pantry Pride’s attempted takeover,” which required external financing. Following the announcement of a leveraged buyout by Forstmann, however, under which Revlon would “waive the Notes covenants for Forstmann,” the market value of the notes fell and “threats of litigation by these creditors” was reported in *The Wall Street Journal*. In a subsequent offer, then, “[i]n return” for various concessions by Revlon’s board, “Forstmann agreed to support the par value of the Notes ... by an exchange of new notes.” *Id.* at 177-79.

The court did find a breach of the director's duty of care (citing *Van Gorkom*) to have resulted from the lock-up agreement as well – namely, in “follow[ing] a course that ended the auction for Revlon ... to the ultimate detriment of shareholders.”⁶⁷ This finding occasions two observations. First, in this opinion coming down just months before the passage of § 102(b)(7), the Delaware Supreme Court identifies two core fiduciary duties – loyalty and care. Second, though the loyalty and care violations both arise from the same conduct, there is an important (if subtle) distinction between the two. Whereas the loyalty violation, as described above, clearly flows from the directors' state of mind – i.e. basing their decision on “impermissible considerations” and thereby failing to demonstrate their good faith vis-à-vis the shareholders' interests – the care violation flows from the decision itself – i.e. “follow[ing] a course” that in fact redounds to the benefit of non-shareholders, at the shareholders' expense.

This distinction is not rendered semantic simply by virtue of the fact that both ultimately aim for the maximization of shareholder value. It is a straightforward reflection of the fact that loyalty and care are two analytical means toward that same end, the former operating through assessment of the fiduciary's *subjective* state of mind when the relevant act or omission occurred, and the latter operating through assessment of the *objective* characteristics of the decision taken. They only appear to conflate in *Revlon* because the board essentially announces that it is acting in the interests of a non-shareholder constituency. Indeed, that the court would have bothered to draw the distinction at all in such a case – rather than simply referring generically to a breach of

⁶⁷ *Id.* at 185.

fiduciary duty – is itself an indication of the degree to which this analytical structure was embedded in the court’s jurisprudence as late as March 1986.

II. Fiduciary Duties in the Post-§ 102(b)(7) World

Notwithstanding the Delaware Supreme Court’s fiduciary duty jurisprudence, however, § 102(b)(7) was drafted in a manner suggesting that, according to the Delaware legislature, “breach of the director’s duty of loyalty” must consist of something other than “acts or omissions not in good faith,” “intentional misconduct,” “knowing violations of law,” improper declaration of dividends, and transactions involving “an improper personal benefit” to the director.⁶⁸ As discussed above, it is quite difficult to imagine how the duty of loyalty might be defined to include none of these forms of wrongdoing, but in any event the statute remains in place, the vast majority of Delaware corporations have adopted exculpatory charter provisions pursuant to the authority it grants, and courts must deal with it as best they can.

In this section I argue that the Delaware Supreme Court has bent over backward since the early 1990s to accommodate the common law to the statute’s internally contradictory language, and that the court’s effort to cram fiduciary concepts into the ill-fitting statutory boxes (aided by creative pleading practices among the plaintiffs’ bar⁶⁹) has left Delaware’s fiduciary duty framework analytically incoherent and practically unworkable.

⁶⁸ DEL. CODE ANN. tit. 8, § 102(b)(7).

⁶⁹ Roberta Romano observed in 1990 that “the plaintiffs’ bar did not oppose the new legislation” passed in Delaware and elsewhere, and that “the statutes’ effectiveness will depend on how courts interpret them.” She presciently speculated that plaintiffs would “be careful to bring their complaints within the included liability categories and will allege recklessness or willful misconduct rather than negligence.” Romano, *supra* note 43, at 1161-62.

A. Delaware's "Triad" Framework

As of the late 1980s the court continued to employ the good faith concept in tandem with the duty of loyalty, while beginning to refer to it in a manner that might arguably tend to imbue it with the status of an independent duty. In *Citron v. Fairchild Camera & Instrument Corp.*, for example, several of Fairchild's directors were "charged with breach of their fiduciary duties of good faith and due care and with gross negligence" in recommending acceptance of a tender offer made by a party allegedly favored by interested management, rather than the offer of another bidder.⁷⁰ Whether the reference to a duty of good faith is intended simply as a synonym for loyalty, or to indicate that it is a self-standing duty, is never made clear, though the court's analysis would tend to indicate the former. In its BJR analysis the court never contrasts good faith with the duty of loyalty in a manner that would indicate self-standing duty status; the court explains that to overcome the BJR, for instance, the plaintiff must "introduc[e] evidence either of director self-interest, if not self-dealing, or that the directors either lacked good faith or failed to exercise due care."⁷¹ Here, bad faith could simply be understood as another form of loyalty violation apart from self-interest. Indeed, with respect to the specific allegation in *Citron*, the court links the two when it explains that "plaintiff obliquely asserts a claim of good faith by Fairchild's board for its alleged failure to act independently of interested management" (a claim plaintiff fails to establish on the facts).⁷²

⁷⁰ 569 A.2d 53, 54 (Del. 1989). The events described in the case occurred prior to the passage of § 102(b)(7).

⁷¹ *Id.* at 64.

⁷² *Id.*

Any doubts that Justice Horsey may have harbored regarding the status of good faith at the time of writing his 1989 *Citron* opinion, however, were gone by 1993. In *Cede & Co. v. Technicolor, Inc.*, also written by Justice Horsey, the court explains:

.... To rebut the [BJR], a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* [sic] of their fiduciary duty – good faith, loyalty or due care.⁷³

The court never explains, however, what this duty of good faith amounts to in concrete terms. In fact, the court cites “abdication of directorial duty” as an example of disloyal conduct⁷⁴ (that is, the very type of conduct alleged in *Citron* to have demonstrated bad faith), and later remarks that the “[d]uty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders.”⁷⁵ The court even equates “good faith” and “loyalty” – by inserting the latter in brackets following the former in quoted language from another case – presumably indicating that the two essentially meant the same thing.⁷⁶ Ultimately it is impossible to discern from *Cede* what meaning good faith might have apart from loyalty, but it is equally impossible to deny that the Delaware Supreme Court had elevated it (at least nominally) to the status of a core fiduciary duty, as part of the new triad with care and loyalty.

⁷³ 634 A.2d 345, 361 (Del. 1993) (citing *Citron*, *Van Gorkom*, and *Aronson*, without explanation).

⁷⁴ *Id.* at 363.

⁷⁵ *Id.* at 367.

⁷⁶ *Id.* at 368 n.36 (inserting bracketed word “loyalty” following the words “good faith” in quotation from *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989)); *see also* *Reed & Neiderman*, *supra* note 55, at 120 (“In *Barkan* itself, it is clear that the Supreme Court used the terms ‘due diligence’ and ‘good faith’ as a fresh way of referring to the ‘fundamental duties of care and loyalty’ it discussed three sentences earlier in the same paragraph.”).

References to the so-called triad of fiduciary duties would continue to pop up in subsequent opinions, though never, unfortunately, accompanied by anything approaching a coherent description of what positive content could be ascribed to the duty of good faith. For example, in *Malone v. Brincat*, a case addressing directors' disclosure obligations under state corporate law, the court invokes the triad but applies it in a manner that renders the distinction between good faith and loyalty indiscernible.⁷⁷ The court observes that the general "duty of directors to observe proper disclosure requirements [when shareholder action is sought] derives from the combination of the fiduciary duties of care, loyalty and good faith,"⁷⁸ but that "knowingly" misleading shareholders (regardless of whether shareholder action is sought) requires a different analysis. In such instance, the court explains, the issue is "whether [the directors] breached their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information."⁷⁹ The court does not, however, explain what the difference between loyalty and good faith amounts to in the analysis of knowing misstatements. The singular reference to a duty of loyalty and good faith, together with their application in tandem to a case involving the directors' state of mind at the time of the alleged misconduct, may itself be telling.

⁷⁷ 722 A.2d 5, 10 (Del. 1998). The court has also invoked the "triad," without explanation, in other contexts. See, e.g., *Emerald Partners v. Berlin*, 726 A.2d 1215 (Del. 1999); *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) (making numerous unexplained references to the "triad" in analysis of the effects of a § 102(b)(7) exculpatory charter provision).

⁷⁸ *Malone*, 722 A.2d at 11.

⁷⁹ *Id.* at 10.

A rare and somewhat illuminating comment on the nature of good faith would come in *Brehm v. Eisner*⁸⁰ – a 2000 opinion by Chief Justice Veasey that, interestingly, never invokes the triad or refers to a duty of good faith. This shareholder derivative litigation followed Disney’s hiring and termination of Michael Ovitz (of which more later), who allegedly walked away with total compensation worth \$140 million after a year’s mediocre service as Disney’s president.⁸¹ The issues before the court at this stage of the litigation included whether pre-suit demand on the directors should be excused, an analysis turning, in the instant case, on whether “the particularized facts in the complaint create[d] a reasonable doubt that the informational component of the directors’ decisionmaking process, *measured by concepts of gross negligence*, included consideration of all material information reasonably available.”⁸² In response to an argument made by the plaintiffs to the effect that the director defendants had failed to exercise not only procedural due care, but also “substantive due care,” the court explained that “such a concept is foreign to the business judgment rule,” and offered the following explanation of the BJR standard:

.... Courts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.⁸³

⁸⁰ 746 A.2d 244 (Del. 2000).

⁸¹ *Id.* at 248-53.

⁸² *Id.* at 259 (emphasis in original). Ordinarily plaintiffs seeking to advance a derivative claim on the corporation’s behalf must seek action by the board first, unless the plaintiff can allege facts creating a reasonable doubt as to director disinterestedness or as to whether the transaction would be protected by the BJR. *Id.* at 256.

⁸³ *Id.* at 264 (internal quotation marks omitted).

Veasey here suggests that, as a practical matter, the analysis by which a court arrives at a finding of gross negligence overcoming the BJR – which the court makes clear has literally nothing to do with the reasonableness of the decision itself – may effectively require so flawed a decisionmaking process that it calls into question whether the board even intended to discharge its obligations. Veasey’s description could reasonably lead one to conclude that, in his view, the BJR *completely* insulates the board from liability in all instances not calling into question the propriety of the directors’ state of mind.⁸⁴ And in this light, one might reasonably further query whether there is in fact any meaningful difference whatsoever between grossly negligent conduct – exculpable – and bad faith conduct – not exculpable under § 102(b)(7).

In any event, by 2001, the court was back to its triad talk. In *Emerald Partners v. Berlin*, an opinion by Justice Holland addressing the pre-trial effects of a § 102(b)(7) exculpatory charter provision, the court referred again to the directors’ “triad of primary fiduciary duties.”⁸⁵ Here, however, the triad concept appears to figure more saliently in the court’s portrayal of the fiduciary duty landscape, which clearly endeavors to reconcile the disparate frameworks of the primary fiduciary duties, *Aronson’s* articulation of the BJR, and § 102(b)(7)’s exceptions.

⁸⁴ Such a conclusion would not be inconsistent with Veasey’s reference to “waste,” which allegations the court had earlier explained could be overcome by the minimal showing of “*any substantial* consideration received by the corporation, and ... a *good faith judgment* that in the circumstances the transaction is worthwhile.” *Id.* at 263 (emphasis in original, internal quotation marks and citation omitted). Given the unlikelihood that there would be literally nothing that could be called consideration, it would appear that waste analysis – at least according to this formulation – is itself really about the “good faith” of the decisionmaker.

⁸⁵ *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

Starting with the triad concept of fiduciary duties, the court proceeds to describe the BJR and § 102(b)(7) through that lens. Following a recitation of *Aronson's* BJR formulation, the court explains that a rebuttal of its presumption requires the plaintiff to show that “the board of directors, in reaching its challenged decision, violated any one of its triad of fiduciary duties: due care, loyalty, or good faith.”⁸⁶ Section 102(b)(7), the court likewise explains, was intended to permit shareholders to exculpate “breaches of their duty of care, but not ... duty of loyalty violations, good faith violations and” – as if to avoid emphasizing other exceptions not fitting the model – “certain other conduct.”⁸⁷ This depiction of § 102(b)(7) in triad terms – i.e. precluding damages for breaches of the duty of care, but not for breaches of the duty of loyalty or the duty of good faith – continues throughout the opinion.⁸⁸ The court even goes so far as to say the following:

When the General Assembly enacted Section 102(b)(7), ... it not only recognized but reinforced ... a venerable and fundamental principle of our common law corporate fiduciary jurisprudence: “there is no ‘safe harbor’ for ... divided loyalties in Delaware.” The fact that Section 102(b)(7) does not permit shareholders to exculpate directors for violations of loyalty or good faith reflects that the provision was a thoughtfully crafted legislative response to our holding in *Van Gorkom* and, simultaneously, reflected the General Assembly’s own expression of support for our assertion ... that when the standard of review is entire fairness [because loyalty or good faith breaches are alleged] “the requirement of fairness is unflinching in its demand”⁸⁹

Though this opinion, like those employing the triad concept that came before it, never explains what the difference between loyalty and good faith is supposed to be, the passage quoted above renders the triad’s rhetorical function eminently clear. The triad

⁸⁶ *Id.* at 91.

⁸⁷ *Id.* at 90.

⁸⁸ *Id.* at 92, 94.

⁸⁹ *Id.* at 96 (citations omitted, ellipses in internal quotations in original).

permits the court to bring the framework of primary fiduciary duties, *Aronson's* articulation of the BJR, and § 102(b)(7)'s exceptions (read loosely) into focus with one another – at least nominally, if not in substance. So far as the Delaware Supreme Court is concerned, the doctrine is of a whole, and § 102(b)(7) – far from being an internally contradictory botch job – represents a “thoughtfully crafted” response to pre-existing fiduciary duty jurisprudence.

B. Life in Chancery

Notwithstanding the evolution of the Delaware Supreme Court's thinking described above, life in Chancery pursued its own course. Indeed, it would be fair to say that a parallel evolution of thinking unfolded in the Court of Chancery over this period that, while certainly impacted by the higher court's statements regarding good faith, was far from consistent with them. Ultimately the trial court would come to view the intellectual bona fides of the good faith concept with considerably greater skepticism, take a much dimmer view of the quality of drafting exhibited by § 102(b)(7), and decry as effectively unworkable the triad framework set out by the Delaware Supreme Court.

1. The Good Faith State of Mind

The Chancery's own (unreported) opinion in *Citron v. Fairchild Camera & Instrument Corp.*,⁹⁰ in contrast with the Delaware Supreme Court's subsequent opinion affirming it (discussed above), quite clearly links good faith with the duty of loyalty. In connection with BJR analysis of a challenged merger under *Aronson*, Chancellor Allen

⁹⁰ No. 6085, 1988 Del. Ch. LEXIS 67 (Del. Ch. May 19, 1988) (unreported).

explained that although “the absence of significant financial adverse interest” – the paradigmatic loyalty issue – “creates a presumption of good faith, or a prima facie showing of it, ... the question of bona fides may not be finally determined on that basis alone.” Analysis of good faith “call[ed] for an ad hoc determination of the board’s motives in the particular instance” – an “inquiry into a subjective *state of mind*” that would “require inferences to be drawn from overt conduct,” including “the quality of the decision made.”⁹¹ In the case at hand, “the board’s decision to act and its decision to accept the ... proposal [that plaintiff had alleged it had improperly favored] may not be viewed as so beyond the bounds of reasonable judgment as to support an inference that the board was acting in bad faith in accepting that offer.”⁹²

As of 1988, then, the Court of Chancery essentially understood good faith to be fundamentally bound up with questions of loyalty (to the degree that the absence of adverse financial interest could itself be viewed as “a prima facie showing” of good faith), and specifically concerned with whether the directors exhibited “a subjective state of mind” indicating intent to discharge their responsibilities.⁹³ Though the board’s exercise of care would be analyzed separately by reference to process, the substantive “quality of the decision made” could nevertheless still support an inference of improper motivation (apart from adverse financial interest) implicating loyalty. Indeed, in the midst of his care analysis, Chancellor Allen even refers back to the foregoing good faith

⁹¹ *Id.* at *46 (citations omitted, emphasis added).

⁹² *Id.* at *51.

⁹³ See also Reed & Neiderman, *supra* note 55, at 121-22 (“[F]ollowing the reasoning of Citron, misconduct otherwise implicating due care could be so egregious as to create an inference of bad faith, even absent an improper financial benefit.”).

analysis as having held that the board's conduct "does not, on these facts, constitute a breach of the duty of loyalty."⁹⁴

2. Good Faith and the BJR

By the time of his famous 1996 opinion in the *Caremark* case,⁹⁵ however, coming after the Delaware Supreme Court's articulation of the triad concept in *Cede & Co.*, Chancellor Allen formulated the role of good faith in fiduciary duty analysis somewhat differently. In an opinion approving a settlement of a derivative action that involved allegations of care (but not loyalty) breaches in failing to implement systems to ensure the company's compliance with applicable health care laws, Allen invokes good faith in a manner that is difficult to square either with his own view in *Citron* or with the Delaware Supreme Court's jurisprudence – though for reasons, I argue, that only reinforce the fundamental link between concepts of good faith and loyalty.

Allen states that "a breach of the duty to exercise appropriate attention" will not be found "so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests."⁹⁶ He then further ties the concept of good faith to due care analysis, stating that "[w]here 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." He then cites to a Learned Hand opinion in the tort context that "correctly identifie[d], in [Allen's] opinion, the core

⁹⁴ *Citron v. Fairchild Camera & Instrument Corp.*, No. 6085, 1988 Del. Ch. LEXIS 67, at *53.

⁹⁵ *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

⁹⁶ *Id.* at 967 (court's emphasis).

element of any corporate law duty of care inquiry: whether there was a good faith effort to be informed and exercise judgment.”⁹⁷

This doctrinal move raises at least two important questions. First, why would Allen characterize good faith as a component of the duty of care, having previously (in *Citron*) characterized it as a component of the duty of loyalty (to which evidence of actual conduct could, to be sure, be relevant)? Second, why would Allen ground his desired care standard in a 1924 tort case,⁹⁸ when his own effort to apply that very case and its standard to BJR analysis (including its requirement of proof of injury)⁹⁹ had been roundly rejected by the Delaware Supreme Court just a few years earlier?¹⁰⁰

Chancellor Allen makes clear in *Caremark* that, in his view, there should be no exposure to monetary liability for pure duty of care violations, end-stop. “[O]ne wonders,” Allen remarks at one point, “on what moral basis might shareholders attack a *good faith* business decision of a director as ‘unreasonable’ or ‘irrational.’”¹⁰¹ Clearly Allen’s answer to that question, in light of the standard he urges in *Caremark*, is never.¹⁰² It is interesting in this light to note the depth of Allen’s obvious distaste for the outcome in *Van Gorkom*, to which he refers only once in this due care opinion – and there only to

⁹⁷ *Id.* at 968 (court’s emphasis).

⁹⁸ *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924).

⁹⁹ See *Cinerama, Inc. v. Technicolor, Inc.*, 1991 Del. Ch. LEXIS 105 (Del. Ch. 1991).

¹⁰⁰ See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368, 370 (Del. 1993) (the Delaware Supreme Court describing *Barnes* as “an obscure seventy-year-old decision,” and stating that “*Barnes*, a tort action, does not control a claim for breach of fiduciary duty”).

¹⁰¹ *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996).

¹⁰² See also ALLEN & KRAAKMAN, *supra* note 4, at 252 (“[I]f a director has no conflicting interest, is reasonably informed, and makes a good-faith judgment (by which we mean an honest judgment seeking to advance the corporation’s interests), what possible basis for liability exists? The answer, we think, is that there is none – not because the business judgment rule exists but because there is no breach of directorial duty.”). For an argument that a duty of care bereft of monetary damages for its breach remains an important component of corporate law, see *infra* note 159.

dismiss it as part of the Delaware Supreme Court’s “jurisprudence concerning takeovers.”¹⁰³ Indeed, Allen adopts a virtually intent-based test for the exercise of due care in the monitoring/oversight context – under which “the lack of good faith that is a necessary condition to liability” is established by “a sustained or systemic failure of the board to exercise oversight”¹⁰⁴ – notwithstanding the Delaware Supreme Court having made clear in *Van Gorkom* that issues of motive are irrelevant to due care analysis.¹⁰⁵ The clear upshot is that Allen simply does not believe that there should be any potential whatsoever for monetary liability in pure due care cases, but of course he cannot go so far as to say that because *Van Gorkom* – which by its terms is a due care case not limited to the takeover context – made clear that there *is* potential liability exposure for pure due care violations. Allen end-runs *Van Gorkom* essentially by carving off part of what he himself had called a component of loyalty in *Citron* and simply restyling it as a component of due care analysis in the monitoring/oversight context. Indeed, Allen comes close to conceding as much in a 2002 article appearing in the *Northwestern University Law Review* (with then-Vice Chancellor, now-Justice Jack Jacobs and Vice Chancellor Leo Strine, Jr.), which includes the following in a footnote:

.... In [the duty to monitor] context it has been held that corporate directors will not be held liable unless their dereliction of duty is in bad faith.... “Bad faith” is an element of the duty of loyalty, not the duty of care, which suggests that “duty to monitor” cases may be remediable

¹⁰³ *Caremark*, 698 A.2d at 970.

¹⁰⁴ *Id.* at 971.

¹⁰⁵ *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (“[A] director’s duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. Here, there were no allegations of fraud, bad faith, or self-dealing, or proof thereof. Hence, it is presumed that the directors reached their business judgment in good faith, ... and considerations of motive are irrelevant to the issue before us.”) (citation omitted).

only if the board's conduct violates the duty of loyalty, as distinguished from the duty of care.

The note continues, "[t]he Caremark standard can be viewed as consistent with the traditional approach in due care cases decided *before* Van Gorkom."¹⁰⁶

3. Bad Faith as Disloyalty

Leo Strine, Jr., who became a Vice Chancellor in 1998,¹⁰⁷ has missed few opportunities to criticize the Delaware Supreme Court's triad concept, and specifically the notion that good faith can have any coherent meaning independent of loyalty.

In an opinion addressing a challenged merger, in which a minority shareholder was provided very little information about that merger and in which the total consideration was in fact left to the surviving entity's board to determine (albeit comprised of the same individuals who were the controlling shareholders of the target), Vice Chancellor Strine explicitly rejects the notion that good faith could be its own fiduciary duty. Strine observes in a footnote that plaintiff's "complaint ... refers to the so-called 'duty of good faith,'" and explains that "[b]y definition, a director cannot simultaneously act in bad faith and loyally towards the corporation and its stockholders."¹⁰⁸ He continues:

.... If it is useful at all as an independent concept, the good faith iteration's utility may rest in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary

¹⁰⁶ Allen, Jacobs & Strine, *supra* note 12, at 457 n.31 (citation to *Caremark* omitted, emphasis added); *see also* Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003) (Strine, Vice Chancellor). *See also* text accompanying note 111.

¹⁰⁷ *Judges*, http://courts.delaware.gov/Courts/Court%20of%20Chancery/?jud_off.htm (last visited Oct. 13, 2005).

¹⁰⁸ Hillary Sale argues otherwise, but only by defining loyalty to reach only issues of independence and disinterestedness. *See* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 484, 488 (2004), available at Lexis.

interest; and (2) 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.¹⁰⁹

Despite the fact that the Delaware Supreme Court had, for seven years, maintained that there was such thing as an independent fiduciary duty of good faith under Delaware corporate law, Vice Chancellor Strine simply refuses to hear anything of it, and implicitly criticizes plaintiff's counsel for having accepted the invitation to include such an allegation in the complaint. Strine's approach, indeed, is broadly consistent with that taken by Chancellor Allen in his *Citron* opinion over a decade earlier; good faith is essentially a subset of the duty of loyalty addressing forms of disloyalty other than financial interest, and specifically cases in which a fiduciary lacks – in some sense “consciously” – the affirmative intent to discharge the duties flowing from his or her status as a director.¹¹⁰

A few years later, in *Guttman v. Huang*, Strine would further develop this position (in a similarly gratuitous footnote), effectively declaring war on both the triad concept and § 102(b)(7)'s framework. Strine explains in the text of his opinion that *Caremark*, though “rightly seen as a prod towards the greater exercise of care,” in fact “articulates a standard for liability for failures of oversight that requires a showing that

¹⁰⁹ *Nagy v. Bistricher*, 770 A.2d 43, 48-49 n.2 (Del. Ch. 2000). In the instant case the court determines that in “the absence of evidence that the defendant directors made any attempt to comply with their disclosure obligations, it is clear that a due care violation has been demonstrated even under the exacting gross negligence standard,” rendering unnecessary the production of evidence regarding whether “the failure of disclosure was purposeful or otherwise indicative of disloyalty.” *Id.* at 59. This does not, however, contradict the statement quoted above, which categorizes *conscious* disregard of duties as a loyalty violation.

¹¹⁰ See also Allen, Jacobs & Strine, *supra* note 12, at 464 n. 49 (“We use the term ‘disloyally’ in the broad sense of encompassing breaches of the duty of loyalty, including conduct that is in bad faith, or that constitutes intentional misconduct or results in the director receiving an improper benefit.”).

the directors breached their duty of loyalty by failing to attend to their duties in good faith.”¹¹¹

Having thus thrown down the gauntlet by placing good faith squarely within the realm of loyalty, Strine proceeds in a footnote to blast the *Cede & Co.* opinion in which the Delaware Supreme Court coined the triad concept. Observing that the same opinion “also defined good faith as loyalty” – inevitably in Strine’s view, since a “director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s interests” – Strine comes to his larger point:

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. interested transactions], but there is no case in which a director can act in subjective bad faith towards the corporation and act loyally.

Perhaps in recognition, however, of the degree to which the Delaware Supreme Court’s fiduciary duty jurisprudence had been driven by a desire to render it consistent with the statutory exculpation regime, as argued above, Strine reserves a few choice words for the Delaware legislature:

The General Assembly could contribute usefully to ending the balkanization of the duty of loyalty by rewriting § 102(b)(7) to make clear that its subparts all illustrate conduct that is disloyal. For example, one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.... But it would add no substance to our law to iterate a “quartet” of fiduciary duties, expanded to include the duty of “legal fidelity,” because that requirement is already a subsidiary element of the fundamental duty of loyalty. The so-called

¹¹¹ *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003).

expanded “triad[.]” created by [*Cede & Co.*], I respectfully submit, is of no great utility.¹¹²

So there we are. By 2003, with respect to the place of good faith in the pantheon of primary fiduciary duties, the Delaware Supreme Court and the Court of Chancery could not have seen things more differently. What to the Delaware Supreme Court looked like a coherent system, in which common law fiduciary duties and the statutory exculpation regime worked together in harmony by the same terminology, looked to the Court of Chancery like an intellectually broken framework in which the liability rules and the very nature of directors’ duties to the corporation were confusing and confused, to say the least.

4. The Ambiguous Ontology of Good Faith

Within a few weeks of Vice Chancellor Strine’s decision in *Guttman v. Huang*, Chancellor Chandler addressed a motion to dismiss the plaintiffs’ second amended complaint in the on-going Disney derivative litigation, which alleged that “the defendant directors breached their fiduciary duties when they blindly approved an employment agreement with defendant Michael Ovitz and then, again without any review or deliberation, ignored defendant Michael Eisner’s dealings with Ovitz regarding his non-fault termination.”¹¹³ In finding that plaintiffs’ allegations survived the motion to dismiss, the court declined to weigh in on the crucial question of the status of good faith vis-à-vis care and loyalty, but did introduce what has already become an

¹¹² *Id.* at 506 n.34. Observe also that Strine’s hypothetical “quartet” of fiduciary duties exposes the strained logic implicit in the Delaware Supreme Court’s attempt, in *Emerald Partners v. Berlin* (2001), to render the core fiduciary duties, the BJR, and § 102(b)(7)’s exceptions consistent with one another by use of the triad. See *supra* text accompanying notes 86-89.

¹¹³ *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 277-78 (Del. Ch. 2003).

influential statement of a generically fiduciary duty-based cause of action for lack of good faith in cases involving board nonfeasance.¹¹⁴

Defendants argued that plaintiffs' allegations "cannot be read reasonably to allege any fiduciary duty violation other than, at most, a breach of the directors' duty of care" – a violation for which no damages would be available given Disney's § 102(b)(7) exculpatory charter provision.¹¹⁵ Chandler, however – consistent with the spirit of Chancellor Allen's opinion in *Citron* 15 years earlier (and, incidentally, with Vice Chancellor Strine's position that the good faith component of loyalty could reach conscious disregard of duty¹¹⁶) – determined that a board's failure to act could amount to something more than mere negligence or gross negligence:

[The alleged] facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged ... suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company....¹¹⁷

Thus casting doubt on the consistency of the board's actions with the BJR, Chandler found that demand was excused under the *Aronson* test,¹¹⁸ and found further that the alleged conduct would "fall *outside* the liability waiver provided under Disney's

¹¹⁴ See, e.g., Official Comm. of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *44-*46 (Del. Ch. Aug. 24, 2004) (reciting what had already come to be called the "Disney Standard").

¹¹⁵ In re The Walt Disney Co. Derivative Litig., 825 A.2d at 286.

¹¹⁶ See text accompanying note 109.

¹¹⁷ In re The Walt Disney Co. Derivative Litig., 825 A.2d at 289.

¹¹⁸ See *supra* note 82.

[charter]" because "[w]here a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct.'"¹¹⁹

Chandler's 2003 *Disney* opinion never refers to the triad of fiduciary duties and does not explicitly address whether good faith in fact constitutes a distinct fiduciary duty, and confusion over this fundamental doctrinal issue has not abated. Justice Jacobs (sitting as a Vice Chancellor in a case assigned while he was still on the Court of Chancery) employed the *Disney* standard in a very different context a year later, explicitly highlighting the lack of clarity in this area. The *Emerging Communications* case involved a freeze-out merger in which minority shareholders were forced to accept about one-quarter of what Jacobs ultimately determined to be the fair value of their stock.¹²⁰ In light of the company's § 102(b)(7) charter provision, Jacobs ultimately had to identify the nature of any fiduciary breaches by a given director in order to determine whether monetary damages could be imposed.¹²¹ One individual who assisted with the transaction, but did not directly benefit from it, was found to have "breach[ed] his fiduciary duty of loyalty and/or good faith" because his loyalties had run to the controlling shareholder rather than to the minority shareholders. Jacobs explains in a footnote that he "employs the 'and/or' phraseology because the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and of

¹¹⁹ In re The Walt Disney Co. Derivative Litig., 825 A.2d at 289-90.

¹²⁰ In re Emerging Communications, Inc. S'holders Litig., 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004, revised June 4, 2004).

¹²¹ *Id.* at *137-38.

good faith” (and specifically whether loyalty breaches extend beyond self-dealing), but that in any event this director’s conduct could not be exculpated.¹²²

Another director was also found liable for violations of “loyalty and/or good faith” solely for having voted for the transaction when (unlike otherwise similarly situated directors) he “was in a unique position to know” that the price was unfair by virtue of his financial and industry-specific expertise. For Jacobs, this special expertise was relevant precisely for the inferences concerning state of mind that it permitted. Conceding that “divining the operations of a person’s mind is an inherently elusive endeavor,” Jacobs nevertheless concluded that the expert director’s conduct was “explainable in terms of only one of two possible mindsets.” Either he “made a deliberate judgment that to further his personal business interests, it was of paramount importance for him to exhibit his primary loyalty to [the controlling shareholder],” or, “for whatever reason, [he] ‘consciously and intentionally disregarded’ his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair.” That is, either he was indirectly self-interested, or he violated the *Disney* standard – hence violating “his duty of loyalty and/or good faith” (again, non-exculpable in either event).¹²³ While clearly cognizant of the unresolved issue regarding its doctrinal status, Jacobs nevertheless emphasizes the subjective nature of good faith, its close relationship with the loyalty concept, and the manner in which the requisite state of mind may be inferred from concrete conduct and circumstances.

¹²² *Id.* at *142 and n. 184.

¹²³ *Id.* at *143-47.

In his 2004 *Integrated Health Services* opinion, a compensation case, Vice Chancellor Noble also applied *Disney's* good faith standard for overcoming a § 102(b)(7) provision, offering further interpretation of the nature of that standard. Quoting an amusing passage from a hearing transcript in which counsel for certain of the defendants expresses utter confusion regarding whether bad faith would violate the duty of care or the duty of loyalty,¹²⁴ the court simply observes that the *Disney* standard could be read either way.¹²⁵ Though the court can be read to have taken on the question for purposes of its analysis,¹²⁶ it never actually answers it. It does, however, explore fruitfully the subjective nature of good faith.

Having observed that the *Disney* standard “moves beyond gross negligence,”¹²⁷ the court explains that “[a]s long as the Board engaged in action that can lead the Court to conclude it did not act in knowing and deliberate indifference to its fiduciary duties, the inquiry of this nature ends. The Court does not look at the *reasonableness* of a Board’s

¹²⁴ Official Comm. of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *32, n.33 (Del. Ch. Aug. 24, 2004). In counsel’s words:

What could be confusing in the cases is that there’s language – and I don’t believe that it’s subtle – as to whether the bad-faith claim is a subset of the duty of loyalty or not. For this argument, I don’t care, okay, frankly. The tests are there. We should apply the test. Prior to the *Disney* decision, the cases lined up in saying “Bad faith is a subset of the duty of loyalty and here’s the test.” After the recent *Disney* decision, we have a bad-faith claim under a duty-of-care theory. I’m prepared on this complaint to apply either standard. It doesn’t matter; okay?

Id. Although Noble would explain in *Integrated Health Services* decision that the *Disney* decision in fact had not made clear the precise nature of its bad faith cause of action, counsel here expresses the widespread doctrinal confusion – and impatience at the failure of Delaware courts to address it – that has resulted from the dynamics discussed in this paper.

¹²⁵ *See id.* at *33-*34, nn.36-37.

¹²⁶ *Id.* at *33. Specifically, the court states that it “must determine whether the Plaintiff’s well-pleaded allegations, taken as true, amount to a violation of the fiduciary duty of loyalty or the fiduciary duty of care.” This task could be read either as requiring that the court specify the nature of a good faith claim, or that it simply determine whether the conduct amounts to a violation of fiduciary duty more generically under *Disney's* good faith standard. I argue here that the court in fact answers the latter question, not the former.

¹²⁷ *Id.* at *46.

actions in this context, as long as the Board exercised *some* business judgment.”¹²⁸ Lest this begin to look like an objective standard, however, the court makes clear that in its view,

... the *Disney* standard is scienter-based. Thus, the Court will generally be required to look to the Board’s actions as circumstantial evidence of state mind. The Court, in analyzing whether an action was taken with intentional and conscious disregard of a board’s duties, must determine that the action is beyond unreasonable; it must determine that the action was irrational.¹²⁹

Though it may not be accurate to call the *Disney* standard “scienter-based” in that it appears not to capture conduct that is merely reckless (as most articulations of the scienter standard for purposes of federal Rule 10b-5 securities litigation do),¹³⁰ there are larger doctrinal points upon which to focus for the moment. Had Vice Chancellor Noble wanted to come out and identify good faith as fundamentally linked either with the duty of care or the duty of loyalty he could easily have done so, but he does not (at least not in any clear way). But likewise, had he been comfortable calling it an independent fiduciary duty, he could have done that even more easily; indeed, this would require nothing beyond citation to the triad – a move never made in his opinion. Thus the doctrinal nature of good faith remains a mystery, though Noble has further emphasized

¹²⁸ *Id.* at *52.

¹²⁹ *Id.* at *64, n.92.

¹³⁰ THOMAS LEE HAZEN, 3 LAW OF SECURITIES REGULATION § 12.8 (5th ed. updated by July 2005 Pocket Part), available at Westlaw (observing that the Supreme Court has not determined “whether a showing of reckless conduct would satisfy the scienter requirement,” but that “the vast majority of the circuit and district court decisions have found that recklessness is sufficient to state a claim under 10b-5”); see also Sale, *supra* note 108, at 489-93 (advocating that Delaware courts adopt a scienter-based standard for analysis of bad faith conduct, under which “a breach of good faith need not be intentional or conscious,” extending also to cases involving “some sort of obvious, deliberate, or egregious failure” short of consciousness or intentionality). It is argued below that there are substantial problems associated with this approach to the good faith concept. See *infra* text accompanying notes 164-169.

its subjective nature in a manner that is, once again, reminiscent of the view Allen advances in *Citron* – *intent* to perform one’s duties as evidenced by what one actually did or did not do. Additionally, Noble emphasizes that both *Disney* and *Integrated Health Services* “involve Board approval of compensation packages for corporate officers and directors,” a context in which board “deference” – which one might reasonably expect would often express itself through *inaction* – is simply inappropriate. “The board must exercise its own business judgment in approving an executive compensation transaction,” and in this light the utility of a concept like good faith – understood as being concerned with intent to perform one’s duties – becomes eminently clear.

More recently, Chancellor Chandler would have another bite at the apple in his August 2005 *Disney* opinion following trial (*Disney 2005*). In a lengthy opinion drawing from over 9,000 pages of transcript, Chandler found that the defendants had in no way violated their fiduciary duties, though the opinion reads like a *how-not-to* guide for directors with respect to corporate governance.¹³¹ Like Justice Jacobs’ opinion in *Emerging Communications* and Vice Chancellor Noble’s opinion in *Integrated Health Services*, *Disney 2005* leaves the fundamental question open, essentially laying out the mushrooming diversity of perspectives on it – including those of scholars recently taking up the question.

Perhaps hoping to evoke a sense of doctrinal continuity, Chandler states from the outset that “[u]nlike ideals of corporate governance, a fiduciary’s duties do not change

¹³¹ In re The Walt Disney Co. Derivative Litig., 2005 WL 2056651, at *1, *39 (Del. Ch. Aug. 9, 2005) (“For the future, many lessons of what not to do can be learned from defendants’ conduct here.”).

over time.”¹³² Then, in his description of the applicable legal standards, he comes to the doctrinal issue:

The fiduciary duties owed by directors of a Delaware corporation are the duties of due care and loyalty. Of late, much discussion among the bench, bar, and academics alike, has surrounded a so-called third fiduciary duty, that of good faith. Of primary importance in this case are the fiduciary duty of due care and the duty of a director to act in good faith. Other than to the extent that the duty of loyalty is implicated by a lack of good faith, the only remaining issues to be decided herein with respect to the duty of loyalty are those relating to Ovitz’s actions in connection with his own termination. These considerations will be addressed seriatim, although issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty, as well as a principal reason the distinctness of these duties make a difference – namely [section] 102(b)(7) of the Delaware General Corporation Law.¹³³

Taken at face value, Chandler would appear to be saying that good faith is either an expression of loyalty, or some type of subsidiary duty derivative of the primary duties of care and loyalty (appearing dismissive of the “so-called third fiduciary duty” and never citing the triad concept). In footnotes, then, he pauses for a sidelong glance at the Delaware Supreme Court’s jurisprudence on the issue, observing that the court “has been clear that outside the recognized fiduciary duties of care and loyalty (and *perhaps* good faith), there are not other fiduciary duties,” and quoting at length from recent work by Sean Griffith suggesting that rigid distinctions between care and loyalty may be conceptually illusory (of which more later).¹³⁴

Chandler backpedals somewhat when he states that Delaware case law is “far from clear with respect to whether there is a separate fiduciary duty of good faith,”

¹³² *Id.*

¹³³ *Id.* at *31.

¹³⁴ *Id.* at *31, nn. 400, 402 (emphasis added). See also *infra* note 175.

though he cites to and quotes at length Vice Chancellor Strine's argument from *Guttman v. Huang* that good faith can have no meaning apart from loyalty.¹³⁵ Chandler writes that "[i]t is unclear, based upon existing jurisprudence, whether motive is a necessary element for a successful claim that a director has acted in bad faith, and, if so, whether that motive must be shown explicitly or whether it can be inferred from the directors' conduct."¹³⁶ Upon consideration, however, of what he aptly calls the "hazy jurisprudence" on good faith, he reiterates commitment to the standard articulated in his 2003 *Disney* opinion, but goes further by explicitly styling it as a form of disloyalty:

Upon long and careful consideration, I am of the opinion that the 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. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.¹³⁷

Had Chandler stopped here, we might have (at least in the Chancery's view) a more clear answer to the doctrinal question: Good faith is a component of loyalty. However, Chandler did not stop here. In an attempt to identify good faith with some sort of über-fiduciary concept, he writes that loyalty and care "are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary," and that the "good faith required of a corporate fiduciary includes not simply the duties of care and loyalty ... but all actions required by a true faithfulness and devotion to the interests of the corporation and its

¹³⁵ *Id.* at *35 and n. 447.

¹³⁶ *Id.* at *35.

¹³⁷ *Id.* at *35-*36.

shareholders.”¹³⁸ The practical difference between calling good faith a third fiduciary duty, as the Delaware Supreme Court had, and calling it a catch-all category for fiduciary duty breaches not addressable (in Chandler’s view) through care and loyalty concepts, is utterly unclear. The obvious question for Chandler is: What type of action or inaction are we actually talking about here that cannot be addressed through the duties of care and loyalty? Tellingly, Chandler has no answer to this question. The “most salient” examples he can identify of conduct to which the good faith concept is peculiarly suited are “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.”¹³⁹ Then, however, buried in a footnote, Chandler concedes that the “first two of these examples seem to sound in the fiduciary duty of loyalty, whereas the last appears to be an extension, or rather, an example of, severe violations of the fiduciary duty of care.”¹⁴⁰ Setting aside that Chandler has just styled the third of these examples a *loyalty* breach as well (on the very same page, in fact),¹⁴¹ his concession makes clear that the notion of

¹³⁸ *Id.* at *36.

¹³⁹ *Id.*

¹⁴⁰ *Id.* at *36 n.463.

¹⁴¹ *Id.* at *36 (“Deliberate indifference and inaction in the face of a duty to act is, in my opinion, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.”). Chandler later observes that “[i]t is precisely in this context – an imperial CEO [Eisner] or controlling shareholder with a supine or passive board – that the concept of good faith may prove highly meaningful.” Chandler grounds this claim in his suspicion that care and loyalty, “as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, it is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest,” and that good faith could “fill this gap.” This claim rests, however, by its own terms, on how these duties are defined, and no explanation as to why “care” and “loyalty” – representing very broad and adaptable principles of conduct – could not reach such situations.

good faith as an über-fiduciary concept serves only to confuse what had been a relatively clear analytical framework already capable of addressing such misconduct. In a resigned tone reminiscent of the defense counsel quoted in *Integrated Health Services*, Chandler essentially throws up his hands, concluding that “[i]n the end, so long as the role of good faith is understood, it makes no difference whether the words ‘fiduciary duty of’ are placed in front of ‘good faith,’ because acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable because they are disloyal to the corporation.”¹⁴²

On the contrary, as the next section of this paper argues, doctrinal coherence in fact makes quite a bit of difference.

III. Good Faith and the Market for Corporate Directors Post-Enron/WorldCom

As late as 2003 it could fairly be said that outside directors of U.S. public companies greatly overestimated the likelihood that they would ever face out-of-pocket liability for breaches of the duty of care. Although *Van Gorkom* had precipitated (or at least exacerbated) a true crisis among corporate directors and insurers who had assumed that the BJR simply meant no liability for care breaches, that case was a one-off – quite literally. The diligent efforts of Bernard Black, Brian Cheffins, and Michael Klausner unearthed just one single case between the years 1968 and 2003 “in which an

¹⁴² *Id.* at *36, n.463. While the Disney case has been appealed to Delaware’s Supreme Court, at least one prominent legal scholar has predicted affirmance from the outset. See Posting of Larry Ribstein to Conglomerate Blog, http://www.theconglomerate.org/conglomerate_forum_disney/index.html (Aug. 11, 2005). Plaintiff-appellants’ heavy emphasis on the facts (as opposed to the law) during oral arguments on January 25, 2006 has led others to predict the same. See, e.g., Posting of Elizabeth Nowicki to Conglomerate Blog, http://www.theconglomerate.org/conglomerate_forum_disney/index.html (Jan. 25, 2006); cf. Posting of Gordon Smith to Conglomerate Blog, http://www.theconglomerate.org/conglomerate_forum_disney/index.html (Jan. 26, 2006).

outside director of a public company [had] paid out-of-pocket for either damages or legal expenses, under any source of law” – *Van Gorkom*¹⁴³ (with which the Delaware legislature dealt swiftly). This finding was all the more striking in light of what these authors describe as the “conventional wisdom in the U.S.” that “being an outside director is often too risky,” as well as the fact that “[f]ear of liability is a leading reason why potential candidates turn down board positions.”¹⁴⁴

How do we explain this? Black, Cheffins, and Klausner begin by observing that “how directors respond to liability” in the real world is of the essence. Directors by and large “do not know in detail their liability risk under particular laws. They operate instead with a general sense of how likely they are to be found liable for *something*, under *some law* . . . , and how likely it is that nominal liability, if found, will result in actual liability.”¹⁴⁵ The authors add, incidentally, that “lawyers, the trade press, and D&O insurers,” upon whom directors tend to be heavily reliant for their information, “tell directors that they must be careful and vigilant and that standards are tougher than ever,” stressing “nominal liability, not the factors that limit actual liability”¹⁴⁶ (e.g. insurance, indemnification, exculpation, liability standards, settlement dynamics). In light of all this, it comes as no surprise that “outside directors’ incentives are skewed

¹⁴³ Black, Cheffins & Klausner, *supra* note 6, at 6.

¹⁴⁴ *Id.* at 1 (internal quotation marks and citation omitted).

¹⁴⁵ *Id.* at 2.

¹⁴⁶ *Id.* at 50.

enormously toward risk aversion”; they “face unknown but potentially bankrupting liability risk,” which could easily outweigh “modest financial and reputational gains.”¹⁴⁷

Following the Enron and WorldCom disasters, however, the world arguably looks quite different, and risk aversion – particularly with respect to outside director positions – appears perhaps more understandable. Indeed, some of the recent high-profile settlements involving alleged board wrongdoing have explicitly required some form of out-of-pocket payment by directors. By 2004 the Securities and Exchange Commission had adopted a policy for insider trading cases “requiring settling parties to forgo any rights they may have to indemnification, reimbursement by insurers, or favorable tax treatment of penalties.”¹⁴⁸ And the Enron and WorldCom securities class-action settlements (in early 2005) themselves required substantial out-of-pocket payments by directors (\$13 million of a total \$168 million settlement in the case of Enron, and \$18 million of a total \$54 million settlement in the case of WorldCom). These developments were described as representing “a backlash against corporate wrongdoing in which board members are being pushed to bear much higher personal costs for failures in supervision.” In the case of WorldCom the lead plaintiff “insisted that the former ... directors pay a significant portion themselves in order to send a message to other directors,” and the \$18 million to be paid by them reportedly amounted to about

¹⁴⁷ *Id.* at 51-52 (though warning that while this “director-error story is surely partly right,” liability is just one factor identified by directors as reasons to turn down offered board positions).

¹⁴⁸ Stephen M. Cutler, Dir., Div. of Enforcement, Sec. & Exch. Comm’n, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), <http://www.sec.gov/news/speech/spch042904smc.htm> (last visited Sept. 29, 2005); *see also* Press Release, Sec. & Exch. Comm’n, SEC Sues Tyson Foods and Former Chairman Don Tyson For Misleading Disclosure of Perquisites, 2005-68 (Apr. 28, 2005), <http://www.sec.gov/news/press/2005-68.htm> (last visited Sept. 29, 2005) (settlement of charges alleging misleading proxy disclosures of “perquisites and personal benefits” requiring payment of \$1.5 million by Tyson Foods and \$700,000 by Don Tyson, former Chairman and CEO).

20 percent of their aggregate net worth (not including residences and retirement accounts).¹⁴⁹

Similarly, in the Delaware courts, Vice Chancellor Strine made news in May 2005 when he refused to approve settlement of a shareholder lawsuit alleging excessive pay in a family controlled company. The proposed settlement, with a monetary value of about \$2.9 million (in the form of a retirement plan advance and salary cuts), amounted in Strine's view to a "cosmetic whimper" in light of the protection shareholders required from the "grotesque lack of controls in a company that also has no profits." John Coffee observed of the move that courts in Delaware and elsewhere have "a long history of settlements that look cosmetic and illusory but are accompanied by the corporation paying a generous award of attorneys' fees," and that in this instance Strine had gone "to the heart of the problem."¹⁵⁰

To be clear, it is not my intention to argue that these settlements (or in the case of the latter example, the rejection thereof) are substantively unfair or inappropriate. Enron and WorldCom, in particular, were disasters of a magnitude difficult to comprehend, and they occurred on these former directors' watch. I raise them, rather, to make a much more modest point: They change the lay of the land with respect to risk analysis in a fundamental way, including for outside directors who, though diligently

¹⁴⁹ Ben White, *Former Directors Agree To Settle Class Actions: Enron, WorldCom Officials to Pay Out of Pocket*, WASH. POST, Jan. 8, 2005, at E01, available at <http://www.washingtonpost.com/ac2/wp-dyn/A57696-2005Jan7?language=printer> (last visited Sept. 29, 2005); see also Klausner, Black & Cheffins, *supra* note 7, at 36, 38. According to the WorldCom lead plaintiff, "one of the [former WorldCom directors] has filed for bankruptcy and will not pay." White, *supra*.

¹⁵⁰ David S. Hilzenrath, *Fairchild Executives' Settlement Rejected; Judge Says Allegations Call for Better Terms For Investor Plaintiffs*, WASH. POST, May 19, 2005, at E01, available at Lexis (internal quotation marks omitted); see also Iveth P. Durbin & Katherine A. VanYe, *Delaware Court Rejects Settlement in Executive Compensation and Corporate Waste Case*, 19:8 INSIGHTS 23 (2005), available at Lexis.

pursuing the best interests of their corporations, might nevertheless fear that such settlement tactics could conceivably be turned against them in far less egregious cases and differing legal contexts.

Delaware's corporate law judges have, to be sure, taken pains to emphasize the low risk of out-of-pocket liability faced by corporate directors, notwithstanding recent events and the muddle of Delaware's fiduciary duty law. As Norman Veasey, former Delaware Chief Justice, has endeavored to explain, while the "tactic by lead institutional plaintiffs and the plaintiffs' bar in the WorldCom and Enron settlements to require out-of-pocket payments as a condition of settlement changes the risk analysis," its use is likely to be confined, he guesses, to "those aberrational cases in which the likelihood of director liability is high and exposure of personal wealth is already considerable" – a situation most directors are unlikely to encounter.¹⁵¹ He claims that "[t]here has been no change in Delaware law in the time-honored business judgment rule," though he acknowledges "the emergence of 'good faith' as an issue" that has "not been authoritatively resolved" and concedes, at least implicitly, that it has resulted in some degree of increased liability exposure for corporate directors.¹⁵² In a similar spirit, Vice Chancellor Strine remarked in a speech that "[i]ndependent directors who apply themselves to their duties in good faith have a trivial risk of legal liability. Let me repeat

¹⁵¹ Klausner, Black and Cheffins are less sure of this, urging pension funds to clarify their stance on demanding out-of-pocket payments by directors in settlements, and particularly to limit this approach to "cases of deliberate self-dealing or egregious failure of oversight." Klausner, Black & Cheffins, *supra* note 7, at 39.

¹⁵² E. Norman Veasey, *A Perspective on Liability Risks to Directors in Light of Current Events*, 19:2 INSIGHTS 9 (2005), available at Lexis ("[I]t is my view that the legal exposure to liability of directors has not been ratcheted up significantly, as a matter of Delaware law."); see also Fairfax, *supra* note 1, at 415-20 (arguing that good faith claims are repackaged care claims, reflecting post-Sarbanes-Oxley fears of federalization of corporate law); Sale, *supra* note 108, at 459-60; Griffith, *supra* note 55, at 49-60.

that: If you do your job as a director with integrity and attentiveness, your risk of damages liability is minuscule.”¹⁵³

Accepting these statements as correct for purposes of my analysis, it is nevertheless “the perception of liability risk that affects directors’ willingness to serve,”¹⁵⁴ not the objective reality, and all things being equal (including actual liability risks), we are far better off with a damages rule that is at least theoretically coherent and comprehensible by market actors subject to it. It remains the case that outside directors routinely overestimate out-of-pocket liability exposure, and developments like those described above can be expected to “increase liability fears among outside directors”¹⁵⁵ – market actors upon whom we continue to place increasing regulatory reliance following Sarbanes-Oxley. Obviously Delaware’s legislature and judiciary are not answerable for settlement dynamics in federal securities litigation, but as Veasey acknowledges, the issue of good faith under Delaware’s corporate law is itself a source of confusion and anxiety for corporate directors. As I have argued in this paper, the incoherence of Delaware’s fiduciary duty doctrine resulting from the interaction of the bench and the legislature over the course of decades has resulted in a doctrinal framework that is self-contradictory and that, as a practical matter, utterly sacrifices the “clarity” and “predictability” upon which Delaware’s corporate establishment has long prided

¹⁵³ Veasey, *supra* note 152 (quoting Strine, internal quotation marks omitted).

¹⁵⁴ Klausner, Black & Cheffins, *supra* note 7, at 39.

¹⁵⁵ *Id.*; see also Fairfax, *supra* note 1, at 450-55 (acknowledging these costs and suggesting that regulatory reliance on outside directors may need to be reconsidered).

itself.¹⁵⁶ The last thing this system needs is more of the very type of tinkering that has slowly accreted into the morass we face today. It is a system sorely in need of overhaul, and recent events in corporate America have only heightened the urgency of this need.

IV. Cutting Losses and Moving On: Reforming Delaware's Fiduciary Duty Framework

The reform advocated here is straightforward, and in fact flows quite directly from the shortcomings in the current regime identified in this paper: *The Delaware legislature should establish by statute that monetary liability may not be imposed on corporate directors for breach of the "duty of care," but that monetary liability may be imposed for breach of the "duty of loyalty," defined to include cases involving financial conflicts of interest, other improper personal benefits, conscious malfeasance, and conscious nonfeasance.*¹⁵⁷ Such a regime would effectively track what Delaware case law, fairly read, already permits with respect to imposition of monetary liability for breaches of fiduciary duty – including the relatively recent line of cases recognizing a cause of action for what have been styled bad faith omissions (i.e. conscious nonfeasance).

In contrast, the statutory approach advocated here avoids these difficulties and offers substantial benefits over the current system. First, this system would eliminate the need for a BJR in the imposition of monetary damages for fiduciary breaches, as well as the various problems associated with the vague gross negligence standard for

¹⁵⁶ See, e.g., Lewis S. Black Jr., *A National Law of Takeovers Evolves in Delaware*, LEGAL TIMES, Nov. 25, 1985, at 6, available at Westlaw ("The national prominence of its corporation law is a source of pride (and revenue) to Delaware, and Delaware lawyers, judges, and legislators work to maintain the law's importance. The Delaware legislature considers proposed improvements from lawyers all over the country. The statute is fine-tuned frequently, but its clarity and predictability are carefully guarded. Major changes in direction are rare.").

¹⁵⁷ Again, recall that the language employed might take various acceptable forms, and that an explicit exception for unlawful distributions could obviously be included. See *supra* note 18.

overcoming it (adopted by *Aronson*). Ever-murky distinctions between gross negligence and negligence, on one end of the spectrum, and between exculpable gross negligence and non-exculpable bad faith, on the other – distinctions that are virtually impossible to draw in abstract, let alone in concrete, terms – would be rendered entirely moot. The notion that well-intentioned directors applying themselves to their work could be found liable for monetary damages based solely on an *ex post* determination that they had not done the job well – almost without exception, a fiction¹⁵⁸ – would be dispelled once and for all by making clear that pure due care violations simply cannot give rise to monetary damages. Equitable remedies (i.e. injunctions) would remain available for pure due care violations by reference solely to the quality of a decision taken by the board, but the perception that monetary damages could be on the table for such breaches would be much more effectively combated than could ever be achieved through piecemeal changes to the current system.¹⁵⁹

¹⁵⁸ See Allen, Jacobs & Strine, *supra* note 12, at 450 (“[I]t is arguable that the pre-Van Gorkom case law reflected a judicial aversion to reviewing director action for any purpose other than identifying (and remedying) breaches of the duty of loyalty.”).

¹⁵⁹ One might reasonably ask, in response to the reform advocated in this paper: Why retain a duty of care at all if damages for its breach would in all circumstances remain off the table? Indeed, one might point to the example of Virginia, which effectively has defined the duty of care out of existence by statute. See VA. CODE ANN. § 13.1-690(A) (2005), *available at* Lexis (“A director shall discharge his duties as a director ... in accordance with his good faith business judgment of the best interests of the corporation.”); see also VA. CODE ANN. § 13.1-692.1 (2005), *available at* Lexis (permitting exculpation, but otherwise capping damages at the greater of \$100,000 or the director’s cash compensation over the prior year, except in cases of “willful misconduct” and knowing violations of criminal or securities laws).

Aside from the fact that care-related analysis would remain necessary in other contexts (such as where injunctive relief is sought, or where a derivative plaintiff seeks to demonstrate demand futility), there is almost certainly – as Allen and Kraakman have argued – “social value to announcing a standard that is not enforced with a liability rule,” which among other things serves “the pedagogic function of informing [directors] just what ‘doing the right thing’ means under the circumstances.” ALLEN & KRAAKMAN, *supra* note 4, at 253; *cf.* In re The Walt Disney Co. Derivative Litig., 2005 WL 2056651, at *1, *39 (Del. Ch. Aug. 9, 2005) (Chancellor Chandler observing, in an opinion absolving Disney’s directors of all alleged fiduciary breaches, that nevertheless “[f]or the future, many lessons of what not to do can be learned from defendants’ conduct here”). This observation carries perhaps greater force in the post-Enron/WorldCom environment;

Second, and related to the prior point, the statutory reform envisioned would definitively cast aside the objectionable doctrinal aspects of the *Van Gorkom* holding while preserving its spirit. Even though the vast majority of Delaware corporations have availed themselves of § 102(b)(7) exculpation, the fact that it remains an optional regime means that by default, under *Van Gorkom*, monetary liability could (in theory) be imposed for pure due care violations. The statutory amendment proposed in this paper would eliminate that entirely theoretical possibility. It would not, however, eliminate the courts' ability to address the truly problematic facts in a case like *Van Gorkom*, were they to arise today. Though I do not agree with those who claim that *Van Gorkom* can be treated, under the current regime, as a takeover case (pertinent only to those cases for which takeover-specific standards were subsequently developed)¹⁶⁰ rather than the broader due care case that it purports to be, I do accept the implicit point that we now have a takeover-specific regime to deal with just this type of factual scenario. Put differently, the regime that I propose, which would leave current takeover jurisprudence (built to address loyalty concerns) untouched, would in no way preclude a finding of monetary liability on *Van Gorkom*-like facts, because such a case arising today simply would not be viewed as a due care case.¹⁶¹

Third, by phrasing the statute solely in terms of care and loyalty, the Delaware legislature could simply foreclose further fruitless debate about whether another

eliminating the duty of care outright would send entirely the wrong normative message at a time when corporate America is struggling to articulate and reinforce effective corporate governance standards.

¹⁶⁰ See, e.g., ALLEN & KRAAKMAN, *supra* note 4, at 518-19.

¹⁶¹ Cf. Allen, Jacobs & Strine, *supra* note 12, at 459 n.39 (“[I]f decided consistent with the ‘enhanced scrutiny’ analysis mandated by Revlon, with its emphasis upon immediate value maximization, rather than as a ‘due care’ case, *Van Gorkom* would not be viewed as remarkable.”).

primary fiduciary duty of good faith exists – a duty and concept which, despite having over a decade in which to do so, no jurist or commentator has ever been able to imbue with a coherent set of positive content not redundant with the concept of loyalty.¹⁶² The cases described in this paper, in practical terms, appear to have said little more about the concept of good faith than that it is implicated in cases involving conscious nonfeasance – that is, inaction in the face of a known duty to act – by corporate directors. The cause of action for monetary damages that has evolved through the line of cases including the *Disney* opinions would be preserved under this new regime; nothing in the statutory amendment proposed here would foreclose it (or prevent looking to actual conduct as circumstantial evidence of state of mind).¹⁶³ In fact, the formulation of “conscious nonfeasance” practically paraphrases the *Disney* standard. It would come with the substantial benefit, however, of clarifying that monetary liability can follow *only* where

¹⁶² Cf. Faith Stevelman Kahn, *Fiduciary Duty, Limited Liability, and the Law of Delaware: Transparency and Accountability: Rethinking Corporate Fiduciary Law’s Relevance to Corporate Disclosure*, 34 GA. L. REV. 505, 509 n. 18 (2000) (arguing, in the corporate disclosure context, that “it is analytically superior for courts and commentators to affirm that a norm of honesty applies to directors’ public communications ... as a matter of fiduciary loyalty doctrine, instead of searching for firm conceptual ground in the notoriously murky world of ‘good faith’”); see also *id.* at 525 (observing that “managers’ duty of loyalty to shareholders does, of course, encompass a commitment to further the prescribed objectives of the corporate fiduciary enterprise”).

¹⁶³ Cf. Johnson, *supra* note 7, at 38-40, 61-72 (advocating a “due loyalty” concept representing “the affirmative thrust of loyalty”). The fact that a finding of conscious nonfeasance would typically turn on circumstantial evidence drawn from actual conduct does not render this mode of analysis identical to a care inquiry any more than does the fact that director conflicts – widely acknowledged as falling within the realm of loyalty – are identified by objective criteria. As the Delaware Supreme Court observed in *Guth v. Loft, Inc.*, a case articulating a widely observed test for the corporate opportunity doctrine, that “rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.” 5 A.2d 503, 510 (Del. 1939) (emphasis added). That suspect circumstances are identified by objective criteria does not alter the fact that concern with subjective bad intent – including preventing it from coalescing in the first place by “removing all temptation” – motivates such manifestations of the duty of loyalty.

loyalty is called into question, which in all cases turns on state of mind, not the quality of board decision-making as an end of analysis in itself.

Fourth, the regime advocated here would avoid substantial – and inevitable – problems associated with the “scienter”-based approach that has been offered as an alternative. Professor Sale has conceded that adoption of a scienter-based standard “[w]ithout an appropriate line between the grossly negligent duty of care violations and those that are more deliberate and egregious” would “raise the same concerns as those that followed *Smith v. Van Gorkom*” in the mid-1980s. The “key question” under such a regime would thus be “how to define ‘egregious.’”¹⁶⁴ Sale argues that federal securities case law “provide[s] guidance on what is simply gross negligence and what amounts to severely reckless or egregious behavior in the context of scienter,” perceiving “a line based on a connection between the defendants’ knowledge and their misstatements or omissions.” However, the only case cited in support of this assertion appears to define recklessness principally by reference to the level of care exercised: “an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”¹⁶⁵ This would appear to contradict the plain language of the *Disney* standard, which requires not merely some degree of departure from ordinary care, but utter disregard of and indifference toward a duty to act. Furthermore, once imported from the specific context of shareholder communications to the broader context of a discharge of a director’s supervisory duties, it is difficult to

¹⁶⁴ Sale, *supra* note 108, at 488-89.

¹⁶⁵ *Id.* at 490 and n. 266 (citing *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719 (W.D. Okla. 1976)).

imagine what the relevant “danger” would be (of which the actor’s knowledge would be germane under the scienter standard) other than perhaps whether the act or omission could conceivably have some negative wealth effect upon shareholders¹⁶⁶ – a “danger” present in essentially all board decision-making. The scienter-based standard would thereby collapse into just another strata of negligence (perhaps “super”-gross negligence), an outcome practically invited by defining the standard by reference to “care.” We would move from two forms of negligence to three – each with starkly different legal consequences, yet with no principled means of distinguishing them.¹⁶⁷ We would have simple negligence, a showing of which would overcome *neither* the BJR nor § 102(b)(7); gross negligence, a showing of which would overcome the BJR *but not* § 102(b)(7); and finally bad faith, a showing of which would overcome *both* the BJR and § 102(b)(7). In light of the murkiness of these concepts and terminology, one might reasonably predict a slippery slope back into monetary damages for lesser forms of negligence – an outcome that both the BJR and § 102(b)(7) were devised to prevent.¹⁶⁸ In my view, the *Disney* standard does well to steer clear of these problems by requiring that one “consciously and intentionally” disregard one’s duties for monetary damages to

¹⁶⁶ Unlike the *Disney* standard, the knowledge aspect of which clearly relates to the existence of a duty to act, precisely because it calls into question whether the director intended to discharge his or her responsibilities, the scienter standard cited by Professor Sale would appear to focus on knowledge of some specific potential outcome – presumably manifestation of the alleged care lapse.

¹⁶⁷ See *Guttman v. Huang*, 823 A.2d 492, 508 n.39 (Del. Ch. 2003) (Strine, Vice Chancellor, unable to confirm, as of 2003, “[i]f gross negligence means something other than negligence”); cf. DREXLER ET AL., *supra* note 36, at § 15.06 (arguing that unlike in tort, “where a jury must be instructed by the court on the standards to apply in its deliberations, the characterizations of the standard of care in corporate cases often amounts to little more than affixing a label to a course of conduct in an opinion written after the court itself has heard and analyzed the facts and formed a judgment on culpability”).

¹⁶⁸ See, e.g., DREXLER ET AL., *supra* note 36, at § 6.02 (arguing that “to the extent that [future] decisions reflect a greater readiness on the part of courts to impute bad faith to allegations of careless, but non-self-interested, directorial behavior, the public policy embodied in Section 102(b)(7), which is, after all, expressly intended to protect directors from the consequences of their own lapses of duty, will have been significantly eroded”).

become available (even if that intent is inferred from actual acts or omissions) – a much clearer and more coherent standard effectively codified by the reform advocated in this paper through its recognition as a component of the broader loyalty concept.¹⁶⁹

Fifth, the reform advocated here recognizes the fact that exculpation of liability for care breaches is already (and long has been) the *de facto* rule in Delaware, eliminating the additional costs associated with drafting exculpatory charter provisions¹⁷⁰ (admittedly modest) and any traps for the unwary, and – most importantly – excising misleading and contradictory language from the Delaware General Corporation Law. Should additional protections be required – for example, among entrepreneurs going into business together (e.g. in small, partnership-like close corporations¹⁷¹) – presumably they could contract for them; the contracting costs incurred in such limited cases would, I would be willing to assume, be more than outweighed by the savings associated with the far simpler and more comprehensible regime advocated here. And in any event,

¹⁶⁹ While some federal cases applying Delaware law apparently have concluded that “reckless” conduct represents non-exculpable bad faith, the consistency of their analyses with Delaware’s case law is questionable. See *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001) (federal court applying Delaware law, holding that “intentional or reckless breach of the duty of care” cannot be exculpated); *In re Abbott Lab. Derivative S’holders Litig.*, 325 F.3d 795 (7th Cir. 2003) (federal court applying Illinois law, following Delaware law, and citing *McCall v. Scott* regarding exculpability of reckless conduct); Reed & Neiderman, *supra* note 55, at 132-38 and n. 104 (discussing *McCall v. Scott* and *In re Abbott Laboratories*, and arguing that “[n]o Delaware court has expressly held that ‘recklessness’ is the equivalent of ‘bad faith’”).

¹⁷⁰ See BALOTTI & FINKELSTEIN, *supra* note 48, at 4-112 (observing that § 102(b)(7) “is an enabling provision only”).

¹⁷¹ See DEL. CODE ANN. tit. 8, §§ 341 et seq. (2005), available at Lexis. Section 354, in particular, provides that [n]o written agreement among stockholders of a close corporation, nor any provision of the certificate of incorporation or of the bylaws of the corporation, which agreement or provision relates to any phase of the affairs of such corporation, ... shall be invalid on the ground that it is an attempt ... to treat the corporation as if it were a partnership or to arrange relations among the stockholders or between the stockholders and the corporation in a manner that would be appropriate only among partners.

DEL. CODE ANN. tit. 8, § 354.

such parties would still benefit from the loyalty-based causes of action explicitly recognized by the new statute, including for conscious nonfeasance.

Sixth, the proposed reform should clearly eliminate the need for D&O insurance coverage for potential liability stemming from breaches of the duty of care – an expense borne under the current regime by shareholders to protect against a largely theoretical (and therefore unquantifiable) risk.¹⁷²

It must be borne in mind that fiduciary doctrines of corporate law – though drawing upon larger cultural norms, to be sure¹⁷³ – are not really employed by the law as ends in themselves; they are different means to the minimization of agency costs and therefore the maximization of shareholder wealth. In the lives of investors and corporate directors, they are practical duties that exist for practical purposes.¹⁷⁴ This fact has been lost (or at least deemphasized) in recent case law and scholarship speaking about these concepts as if their true nature, for purposes of legal doctrine, were out there to be discovered.¹⁷⁵ When approached in this way, we lose sight of the fact that as

¹⁷² See DEL. CODE ANN. tit. 8, § 145(g) (giving the “corporation” the power to purchase D&O insurance). It should be observed, however, that “[m]any traditional D&O insurance policies intended to protect officers and directors do not cover damages resulting from intentionally dishonest or criminal acts, willful violations of law, or profit gained by a person who is not legally entitled to receive it,” broadly understood to represent “insurance-speak for acts taken in bad faith or breaches of the duty of loyalty.” Mark R. High, *Disney directors survive attack on Magic Kingdom: Learning from the trial court’s opinion*, 15:3 BUS. L. TODAY 18, 21 (2006). Whether D&O policies covering bad faith omissions might emerge in response to the conscious nonfeasance prong of the statutory reform advocated here (were it adopted) lies well beyond the scope of this paper.

¹⁷³ For an insightful discussion of larger social and cultural conceptions of “care” and “loyalty” and associated norms of conduct, see Johnson, *supra* note 7.

¹⁷⁴ See, e.g., Allen, Jacobs & Strine, *supra* note 12, at 451.

¹⁷⁵ See, e.g., *In re The Walt Disney Co. Derivative Litig.*, 2005 WL 2056651, at *36 (describing loyalty and care as “but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary,” and eschewing attempts to define “good faith” specifically, as it

analytical means toward a practical end, their significance in the hands of courts plying them should be as distinct modes of analysis – that is, distinct ways of reaching that end. This is where recent arguments focusing heavily on the interconnected nature of these duties, in my view, veer off in less fruitful directions; to argue that care and loyalty are in fact the same thing (or even that the distinction is highly blurred) based on the fact that they both have the same ultimate aim is simply to mistake the means for the end itself. Of course they have the same end, but this does not render the mode of analysis that each represents identical to the other. As I have argued, and consistent with the proposed reform to Delaware corporate law that I advocate, fiduciary duty doctrine would be rendered substantially more comprehensible and workable if the line between care and loyalty were understood functionally as an analytical distinction between minimizing agency costs through assessment of the quality of objective *decisions*, on the one hand, and the quality of subjective *intentions*, on the other. Beneath the surface of the doctrine and the terminology employed, this has always in fact been the difference between the duties of care and loyalty, and there is no reason to think that we can identify a better line for the imposition of monetary liability.

“includes not simply the duties of care and loyalty ... but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders”); Johnson, *supra* note 7, at 27 (“[U]nderstanding the affirmative facet of both the social norm of loyalty and the legal duty of loyalty raises deeper questions such as whether the supposed conceptual distinction between ‘care’ and ‘loyalty’ is as clear as widely believed and whether corporate law fiduciary discourse should continue to be conducted in moral-sounding terms at all.”); Griffith, *supra* note 55, at 39-47 (arguing that care and loyalty are “nested oppositions,” each containing aspects of the other, that the “fundamental question” underlying both “of whether a particular decision ... is likely to be beneficial to the corporation” is really the “good faith” question stated broadly as whether directors are “doing their best in acting for someone else,” and that in this light “good faith” cases represent “situations in which one can answer the fundamental question without checking all of the boxes for liability under either analytic standard”).

Appendix: Exculpation Statutes by Type¹⁷⁶

Table 1: Exculpation Statutes Resembling Delaware's § 102(b)(7)	
State	Statute
Alaska	ALASKA STAT. § 10.06.210(1)(N) (2005), <i>available at Lexis</i>
Arkansas	ARK CODE ANN. § 4-27- 202(b)(3) (2005), <i>available at Lexis</i>
Colorado	COLO. REV. STAT. §7-108- 402(1) (2005), <i>available at Lexis</i>
Delaware	DEL. CODE. ANN. tit. 8, § 102(b)(7) (2005), <i>available at Lexis</i>
Illinois	805 ILL. COMP. STAT. 5/2.10(b)(3) (2005), <i>available at Lexis</i>
Kansas	KAN. STAT. ANN. § 17-6002(b)(8) (2005) <i>available at Lexis</i>
Louisiana	LA. REV. STAT. ANN. § 12:24.C(4) (2005), <i>available at Lexis</i>
Massachusetts	MASS. GEN. LAWS ch. 156B, § 13(b)(1 ½) (2005), <i>available at Lexis</i>
Minnesota	MINN. STAT. § 302A.251.4 (2005), <i>available at Lexis</i>
Missouri	MO. REV. STAT. § 351.055.2(3) (2005), <i>available at Lexis</i>
New Jersey ¹⁷⁷	N.J. STAT. ANN. § 14A:2-7(3) (2005), <i>available at Lexis</i>
North Dakota	N.D. CENT. CODE § 10-19.1-50.5 (2005), <i>available at Lexis</i>
Oklahoma	OKLA. STAT. tit. 18, § 1006.B.7 (2004), <i>available at Lexis</i>
Oregon	OR. REV. STAT. § 60.047(2)(d) (2003), <i>available at Lexis</i>
Rhode Island	R.I. GEN LAWS § 7-1.2-202(b)(3) (2005), <i>available at Lexis</i>
South Carolina ¹⁷⁸	S.C. CODE ANN. § 33-2-102(e) (2005), <i>available at Lexis</i>
Tennessee ¹⁷⁹	TENN. CODE ANN. § 48-12-102(b)(3) (2005), <i>available at Lexis</i>
Texas	TEX. REV. CIV. STAT. art. 1302-7.06.B (2005), <i>available at Lexis</i>
West Virginia	W. VA. CODE ANN. § 31D-2-202(b)(4) (2005), <i>available at Lexis</i>

¹⁷⁶ For discussion, see *supra* note 52 and accompanying text.

¹⁷⁷ New Jersey's statute includes no explicit exception for unlawful distributions, and defines disloyalty as knowingly acting "contrary to the best interests of the corporation or its shareholders" where there is "a material conflict of interest."

¹⁷⁸ South Carolina's statute applies only to larger corporations, and includes an exception for "gross negligence."

¹⁷⁹ Tennessee's statute includes no exception for "improper personal benefit."

Table 2: Exculpation Statutes Resembling RMBCA § 2.02(b)(4)	
State	Statute
Alabama ¹⁸⁰	ALA. CODE § 10-2B- 2.02(b)(3) (2005), <i>available at Lexis</i>
Arizona	ARIZ. REV. STAT. § 10-202.B.1 (2005), <i>available at Lexis</i>
Hawaii	HAW. REV. STAT. ANN. § 414-222 (2004), <i>available at Lexis</i>
Idaho	IDAHO CODE ANN. § 30-1-202(2)(d) (2005), <i>available at Lexis</i>
Iowa	IOWA CODE § 490.202(2)(d) (2004), <i>available at Lexis</i>
Maine	ME. REV. STAT. ANN. tit. 13-C, § 202.2.D (2005), <i>available at Lexis</i>
Michigan	MICH. COMP. LAWS SERV. § 450.1209(1)(c) (2005), <i>available at Lexis</i>
Mississippi	MISS. CODE ANN. § 79-4-2.02(b)(4) (2005), <i>available at Lexis</i>
Montana	MONT. CODE ANN. § 35-1-216(2)(d) (2005), <i>available at Lexis</i>
Nebraska	NEB. REV. STAT. ANN. § 21-2018(2)(d) (2005), <i>available at Lexis</i>
New Hampshire	N. H. REV. STAT. ANN. § 293- A:2.02(b)(4) (2005), <i>available at Lexis</i>
South Dakota	S.D. CODIFIED LAWS § 47-1A-202.1(4) (2006), <i>available at Lexis</i>
Utah	UTAH CODE ANN. § 16-10a-841(1) (2005), <i>available at Lexis</i>
Vermont	VT. STAT. ANN. tit. 11A, § 2.02(b)(4) (2005), <i>available at Lexis</i>
Wyoming	WYO. STAT. ANN. § 17-16-202(b)(iv) (2005), <i>available at Lexis</i>

¹⁸⁰ Alabama’s statute adds an exception for “loyalty” breaches.

Table 3: Other Exculpation Statutes	
State	Statute
California	CAL. CORP. CODE § 204(a)(10) (2005), <i>available at Lexis</i>
Connecticut	CONN. GEN. STAT. § 33-636(b)(4) (2004), <i>available at Lexis</i>
Georgia	GA. CODE ANN. § 14-2- 202(b)(4) (2005), <i>available at Lexis</i>
Kentucky	KY. REV. STAT. ANN. § 271B.2-020(2)(d) (2005), <i>available at Lexis</i>
New Mexico	N.M. STAT. ANN. § 53-12-2.E (2005), <i>available at Lexis</i>
New York	N.Y. BUS. CORP. LAW § 402(b) (2005), <i>available at Lexis</i>
North Carolina	N.C. GEN. STAT. § 55-2-02(b)(3) (2005), <i>available at Lexis</i>
Pennsylvania	15 PA. CONS. STAT. § 1713 (2005), <i>available at Lexis</i>
Washington	WASH REV. CODE ANN. § 23B.08.320 (2005), <i>available at Lexis</i>

Table 4: States Not Permitting Exculpation¹⁸¹	
State	Statute
Florida	FLA. STAT. ANN. § 607.0831(1) (2005), <i>available at Lexis</i>
Indiana	IND. CODE ANN. § 23-1-35-1(e) (2005), <i>available at Lexis</i>
Maryland	MD. CODE ANN. CORPS. & ASS'NS § 2- 405.1(c) (2005), <i>available at Lexis</i>
Nevada	NEV. REV. STAT. ANN. § 78.138.7 (2005), <i>available at Lexis</i>
Ohio	OHIO REV. CODE ANN. § 1701.59(D) (2005), <i>available at Lexis</i>
Virginia	VA. CODE ANN. § 13.1-692.1 (2005), <i>available at Lexis</i>
Wisconsin	WIS. STAT. ANN. § 180.0828 (2005), <i>available at Lexis</i>

¹⁸¹ Citations are provided to statutory requirements for the imposition of monetary damages.