THE CONVERGENCE OF GOOD FAITH AND OVERSIGHT

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In Stone ex rel. AmSouth Bancorporation v. Ritter, two important strands of Delaware corporate law converged; namely, the concept of good faith and the duty of directors to monitor the corporation’s employees for law compliance. As to the former, Stone put to rest any remaining question as to whether acting in bad faith is an independent basis of liability under Delaware corporate law, stating that “although good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.” Nevertheless, this holding may not matter much, because the Stone court made clear that acts taken in bad faith breach the duty of loyalty. As a result, instead of being recognized as a separate fiduciary duty, good faith has been subsumed by loyalty. In this sense, Stone looks like a compromise between those scholars and jurists who wanted to elevate good faith to being part of a triad of fiduciary duties and those who did not, with the former losing as a matter of form, and the latter losing as a matter of substance.

As to the duty of oversight, Stone confirmed former chancellor William Allen’s dicta in In re Caremark International Inc. Derivative Litigation that the fiduciary duty of care of corporate directors includes an obligation for directors to take some affirmative law compliance measures. In Stone, the Delaware Supreme Court confirmed “that Caremark articulates the necessary conditions for assessing director oversight liability.”

This Article argues that the convergence of good faith and oversight is one of those unfortunate marriages that leave both sides worse off. New and unnecessary doctrinal uncertainties have been created. This Article identifies those uncertainties and suggests how they should be resolved.

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INTRODUCTION

In Stone ex rel. AmSouth Bancorporation v. Ritter, the Delaware Supreme Court brought together two important strands of corporate governance jurisprudence. First, the emerging duty of good faith. Historically, a director’s duty of good faith was “subsumed in a court’s inquiry into the director’s satisfaction of her duties of care and loyalty.” In recent years, however, Delaware cases hinted that good faith was a freestanding fiduciary duty independent of and of equal dignity with the traditional care and loyalty duties. In Stone, the Delaware Supreme Court foreclosed that fledgling doctrinal development, holding that good faith merely constitutes a “subsidiary element” of director loyalty.

Second, Stone addressed longstanding issues surrounding a board of directors’ duty of oversight. Famed corporate lawyer Bayless Manning
observed that what boards do “does not consist of taking affirmative action on individual matters” but rather consists of “a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision.” Monitoring the performance of corporate management is not just one of the board’s three principal functions, it is, arguably, *prima inter pares.* It is thus well settled that the duty of care requires directors to pay ongoing attention to the business and affairs of the corporation.

Directors are not expected to know in minute detail everything that happens on a day-to-day basis. At the very least, however, Delaware law requires a director to have a rudimentary understanding of the firm’s business and how it works, keep informed about the firm’s activities, engage in a general monitoring of corporate affairs, attend board meetings regularly, and routinely review financial statements. Yet, beyond these obligations, the Delaware case law was unclear for many years as to whether boards have an obligation to monitor proactively the conduct of corporate subordinates. In particular, although the chancery court in *In re Caremark International Inc. Derivative Litigation* suggested in dictum that a board has an affirmative duty to ensure that the corporation complies with the law, the Delaware Supreme Court did not speak authoritatively on that issue for over a decade after *Caremark* was decided. In *Stone,* however, the court

7. See, e.g., Am. Bar Ass’n, *Corporate Director’s Guidebook: Third Edition,* 56 BUS. LAW. 1571, 1582 (2001) (stating that the duty of care expresses “the need to pay attention, to ask questions and to act diligently and reasonably to become and remain generally informed”).
9. See Grimes v. Donald, No. CIV.A. 133578, 1995 WL 54441, at *8 n.6 (Del. Ch. Jan. 11, 1995) (stating that a board meets “its management responsibilities by appropriately appointing and monitoring[,] corporate officers and exercising informed business judgment with respect to corporate goals and performance”), *aff’d en banc on other grounds,* 673 A.2d 1207 (Del. 1996); see also Am. Bar Ass’n, *supra* note 7, at 1582 (stating that the duty of care requires directors “to become and remain generally informed, including doing the ‘homework’ of reading materials and other preparation in advance of meetings in order to participate effectively in board deliberations”).
11. Id. at 970.
finally confirmed that the Caremark dictum is the law of Delaware, holding that “Caremark articulates the necessary conditions for assessing director oversight liability.”  

Considered individually, either of these developments would have been highly significant. Taken together, they make Stone one of the most consequential corporate governance decisions in recent years. This Article analyzes both aspects of Stone and then suggests that the conflation of oversight and good faith raises some interesting and troubling questions.

Part I of this Article reviews the origins of the purported duty of good faith. It argues that the prospect of creating an independent duty of good faith threatened the basic policies that underlie Delaware’s corporate governance jurisprudence. The Delaware courts long have endeavored to strike an appropriate balance between deference to director decisions and the need to hold directors accountable for misuses of their authority.  

Acknowledging good faith to be an independent fiduciary duty risked tipping that balance too far toward director accountability.

Part II turns to the duty of oversight. After examining the development of the law in this area both before and after Caremark, Part II turns to the relevant policy issues. As we shall see, there is a strong argument for limited director liability exposure with respect to alleged failures to exercise proper oversight.

Finally, Part III turns to the convergence of these lines of authority in Stone. It reviews Stone’s holdings on good faith and oversight. As to the former, it asks whether the Delaware Supreme Court struck an appropriate balance between authority and accountability. It then examines Stone’s analysis of a board’s oversight obligations, emphasizing Stone’s application to some common scenarios in which oversight issues arise. In sum, Part III argues that Stone unnecessarily complicated the law of director oversight.

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Oversight and Good Faith

I. GOOD FAITH IN DELAWARE LAW

The notion that directors ought to act in good faith pervades Delaware’s corporate governance jurisprudence. Only directors who, inter alia, act in good faith are entitled to indemnification of legal expenses. Only directors who, inter alia, rely in good faith on corporate books and records or reports from corporate officers or certain advisors are “fully protected” against shareholder claims. Related-party transactions are insulated from judicial review, inter alia, only if they are approved by the disinterested directors or shareholders in good faith. The business judgment rule presumes that directors acted, inter alia, in good faith. Despite these longstanding references to good faith, however, it is fair to

15. As Melvin Eisenberg has observed:
   The duty of good faith is well established in corporate law. To begin with, the
duty has long been established in statutes. Many or most corporate statutes
explicitly impose the duty of good faith on directors, officers, or both, and all or
virtually all statutes implicitly impose the duty of good faith under a variety of
provisions, such as those concerning indemnification. The duty of good faith also
has long been implicitly recognized in case law—for example, in the formulation
of the business judgment rule, and in fiduciary obligations that can only be explained
by that duty, such as the duty not to knowingly cause the corporation to violate the
law—and within the last fifteen years, the duty has been explicitly recognized in a
number of Delaware cases.

16. Delaware General Corporation Law (DGCL) section 145 permits indemnifi-
cation in suits brought against individual directors or officers. Del. Code Ann. tit. 8, § 145
(2001). Specifically, in suits brought by third parties or directly by shareholders, section
145(a) allows indemnification for expenses, “judgments, fines, and amounts paid in settlement,”
in connection with, brought by, or on behalf of the corporation. Id. § 145(a). Section
145(b) authorizes indemnity only with respect to expenses. Id. § 145(b). Both subsections
require, among other things, that the director have acted in good faith. Id. § 145(a)–(b). Only
under section 145(c) must the corporation indemnify a director or officer who “has been
successful on the merits or otherwise,” without regard to whether the director acted in good
faith or not. Id. § 145(c); see also Waltuch v. Conticommodity Servs., 88 F.3d 87, 96 (2d Cir.
1996) (interpreting Delaware law).

18. Id. § 144(a)(1)–(2).
   judgment rule as “a presumption that in making a business decision the directors of a
corporation acted on an informed basis, in good faith and in the honest belief that the
action taken was in the best interests of the company”). For a court to apply the business
judgment rule, no fraud, illegality, or conflict of interest may exist. See, e.g., Smith v. Van
Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (en banc). The board also must have acted in
good faith as disinterested directors. In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52
(Del. 2006) (en banc). Furthermore, the business judgment rule will not apply in cases in
which the board acted irrationally by way of an uninformed or wasteful decision. See, e.g.,
Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).
say that the concept remained essentially undefined until quite recently.\textsuperscript{20} This Part proceeds to trace the history of the good faith principle as it gradually emerged in the Delaware case law.

A. The Origins of the Duty of Good Faith

Good faith is not a new concept in corporate law. It has been called an “immutable ingredient” of the business judgment rule, for example, setting forth the law’s expectation that directors will take honest and prudent business risks in the best interests of the company and its shareholders.\textsuperscript{21} Historically, however, good faith was a concept that had rarely been analyzed. Instead, a director’s obligation to act in good faith traditionally was “subsumed in a court’s inquiry into the director’s satisfaction of her duties of care and loyalty.”\textsuperscript{22} If there was no breach of either of those duties, it was uncommon for courts to perform a separate inquiry on the issue of good faith.\textsuperscript{23}

The process of giving content to good faith began in 1993 with Justice Horsey’s opinion for the Delaware Supreme Court in \textit{Cede & Co. v. Technicolor, Inc.}\textsuperscript{24} Horsey opined:

> [A] shareholder plaintiff challenging a board decision has the burden at the outset to rebut the rule’s presumption. To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess

\textsuperscript{20} See Sean J. Griffith, \textit{Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence}, 55 DUKE L.J. 1, 15–16 (2005) ("The mystery of good faith . . . was unexplored for almost two decades, until the chancery court’s development of good faith jurisprudence in 2003."); \textit{see also id. at 13 ("[N]either the functional meaning of good faith nor its potential relationship to other corporate law doctrines has ever been specified."). But cf. Myron T. Steele, Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 DEL. J. CORP. L. 1, 29 (2007) (suggesting that earlier cases had treated “bad faith as tantamount to fraud or an absence of rationality or a decision so far beyond the bounds of reasonable judgment that it established a bad faith act or omission” (internal quotation marks omitted) (footnote omitted)).}


\textsuperscript{22} Fleischer & Sussman, supra note 2, at 918.

\textsuperscript{23} \textit{Id.} at 985 app. 3.

\textsuperscript{24} 634 A.2d 345 (Del. 1993).
these business judgments. If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the entire fairness of the transaction to the shareholder plaintiff.\(^{25}\)

One of us elsewhere has sharply criticized this formulation of the business judgment rule.\(^{26}\) For present purposes, however, it suffices to note that Horsey’s use of the term “triad” signaled the then-novel proposition that good faith was a freestanding fiduciary obligation having equal dignity with the traditional concepts of care and loyalty.\(^{27}\) As Delaware Supreme Court Chief Justice Steele explained in a recent article, pre-Technicolor cases touching “on the phrase ‘good faith’” had done so “without elevating it to an independent fiduciary duty.”\(^{28}\)

The Technicolor innovation generated considerable academic interest,\(^{29}\) but initially had a somewhat rocky treatment in Delaware cases.\(^{30}\) As one commentator explained, “references to the so-called triad of fiduciary

\(^{25}\) Id. at 361 (emphasis added) (citations omitted) (internal quotation marks omitted).

\(^{26}\) Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 VAND. L. REV. 83, 94–95 (2004) (“Notice how the court puts the cart before the horse. Directors who violate their duty of care do not get the protections of the business judgment rule; indeed, the rule is rebutted by a showing that the directors violated their fiduciary duty of ‘due care.’ This is exactly backwards. . . . [T]he whole point of the business judgment rule is to prevent courts from even asking the question: did the board breach its duty of care?” (footnotes omitted)).

\(^{27}\) See Steele, supra note 20, at 29 (“Delaware courts first recognized the duty of good faith as a freestanding fiduciary duty, with no discussion about why, in the Delaware Supreme Court’s opinion in Cede & Co. v. Technicolor Inc.”). 

\(^{28}\) Id.


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. 31 Virtually all of the cases adopting the triad formulation came from the supreme court, with the chancery court viewing “the intellectual bona fides of the good faith concept with considerably greater skepticism.” 32 Moreover, virtually all of the post-Technicolor decisions adopting the triad formulation were written by Justice Holland. 33 The triad formulation was notable by its omission from important fiduciary duty decisions penned by other jurists, such as Chief Justice Veasey’s opinion in Brehm v. Eisner. 34 In a coauthored law review article, Veasey noted that the triad formulation “has not been universally embraced. Some members of the judiciary have . . . [suggested] that there really are only two fiduciary duties—loyalty and care.” 35 Indeed, one of those skeptics disparagingly dismissed Horsey’s formulation as the “so-called ‘triad[ ]’.” 36

31. Id. at 1152.
32. Id. at 1155.
34. 746 A.2d 244 (Del. 2000) (en banc).
35. Veasey & Di Guglielmo, supra note 21, at 1449–50. E. Norman Veasey and Christine Di Guglielmo include Jack Jacobs and Leo Strine among the triad’s judicial skeptics. See id. at 1450 n.191 (analyzing cases).
36. Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003). Up until 2006, the triad formulation and the corollary proposition that good faith is a freestanding duty thus appeared to be an example of the cycling phenomenon identified by David Skeel. See generally David A. Skeel, Jr., The Unanimity Norm in Delaware Corporate Law, 83 Va. L. Rev. 127 (1997). Until quite recently, the Delaware Supreme Court heard most corporate governance cases not en banc but rather using three-justice panels. Cf. Randy J. Holland & David A. Skeel, Jr., Deciding Cases Without Controversy, 5 Del. L. Rev. 115, 121 (2002) (“[T]he Delaware Supreme Court continues to generally hear all but capital cases initially in three-justice panels . . . .”). In addition, the court has a longstanding unanimity norm making split decisions very rare. See Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 n.90 (Del. 2003) (en banc) (Veasey, C.J., dissenting) (“Split decisions by this Court, especially in the field of corporation law, are few and far between.”). The formulations adopted in any given opinion thus depend on the composition of the panel and the identity of the jurist assigned to write the opinion. As a result, even sharp differences among the members of the court can be masked, while Delaware law cycles between competing doctrinal approaches to the same problem depending on which jurist wrote the most recent opinion. See, e.g., Skeel, supra, at 147–48. As one of us has demonstrated elsewhere, Delaware’s business judgment rule jurisprudence demonstrates just such a pattern of cycling. See Stephen M. Bainbridge, Corporation Law and Economics 249–51 (2002) (discussing relevant precedents).
B. The Threat Posed by the Triad

The differences between the competing formulations of a board of directors' duties are not just semantic. To the contrary, they go to the core of corporation law. Compared to earlier formulations, the triad threatened the sensitive balance Delaware courts had traditionally struck.

At the heart of corporate governance law lies the tension between the competing values of authority and accountability. On the one hand, efficient decisionmaking requires that a board of directors be free to take action without the specter of judicial second-guessing hovering over them. Otherwise, innovation and risk taking would be stifled. In addition, market constraints, including the capital, product, and employment market forces, already encourage directors and managers to exercise care in their business decisions. Thus, judicial intervention in cases dealing with poor business judgment would prove redundant and undermine the board's decisionmaking discretion.

Reflecting this imperative, Delaware case law consistently indicates a regime of director primacy.

37. Bainbridge, supra note 26, at 84. For a much more detailed first principles–based argument for a presumption of judicial deference to board of director decisions absent self-dealing, see id. at 102–29.
38. See id. at 102–09.
41. See generally Bainbridge, supra note 26, at 109–29 (explaining costs that would be imposed by active judicial oversight of board decisions).
42. See, e.g., Hollinger Inc. v. Hollinger Int'l, Inc., 858 A.2d 342, 374 (Del. Ch. 2004) (“[T]he director-centered nature of our law, which leaves directors with wide managerial freedom subject to the strictures of equity, including entire fairness review of interested transactions. It is through this centralized management that stockholder wealth is largely created, or so much thinking goes.”). As a general matter, the board of directors acts on behalf of the corporation by collective decisionmaking. Delaware defines an act of the board of directors as “[t]he vote of the majority of the directors present at a meeting at which a quorum is present.” DEL. CODE ANN. tit. 8, § 141(b) (Supp. 2006). In contrast, an individual director cannot unilaterally bind the corporation. RESTATEMENT (SECOND) OF AGENCY § 14C cmt. b (1958).
Courts generally abstain from intervening in the affairs of corporate decisionmaking, typically by invoking the business judgment rule. On the other hand, however, the vast grant of authority vested in boards of directors comes with extensive obligations. Courts recognize that market forces may fail to sufficiently constrain self-interested behavior among directors and managers. In addition, self-dealing often leads to inefficiencies that undermine intra-board relationships and successful control of corporate operations. Hence, courts actively intervene to review alleged breaches of director loyalty.

Breach of a director’s duty of loyalty thus long has been recognized as differing in kind and not just in degree from a violation of the fiduciary duty of care. As a New York court explained, the business judgment rule “yields to the rule of undivided loyalty. This great rule of law is designed ‘to avoid the possibility of fraud and to avoid the temptation of self-interest.’” Yet, despite the rhetoric of enhanced scrutiny, we find evidence of the importance that Delaware corporate law places on deference to director decisions, even in cases implicating loyalty claims.

43. See, e.g., Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) (“We have held that when a court reviews a board action, challenged as a breach of duty, it should decline to evaluate the wisdom and merits of a business decision unless sufficient facts are alleged with particularity, or the record otherwise demonstrates, that the decision was not the product of an informed, disinterested, and independent board.”); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (“Ordinarily when a court is required to review the propriety of a corporate transaction challenged as constituting a breach of duty or is asked to enjoin a proposed transaction on that ground, it will, in effect, decline to evaluate the merits of wisdom of the transaction once it is shown that the decision to accomplish the transaction was made by directors with no financial interest in the transaction adverse to the corporation and that in reaching the decision the directors followed an appropriately deliberative process.”).

44. See Gilson, supra note 40, at 840.


46. See, e.g., Mills, 559 A.2d at 1279 (holding that “judicial reluctance to assess the merits of a business decision ends in the face of illicit manipulation of a board’s deliberative processes by self-interested corporate fiduciaries”). Because “[a] business corporation is organized and carried on primarily for the profit of the stockholders,” Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919), directors of the board have a fiduciary duty to take action that first and foremost serves the interest of the corporation and its shareholders, see, e.g., Broc v. Cellular Info. Sys., 673 A.2d 148, 154 (Del. 1996) (“A corporate fiduciary agrees to place the interests of the corporation before his or her own in appropriate circumstances.”). When boards of directors take self-interested action to the disadvantage of the corporation, they will be found to have breached their fiduciary duty of loyalty, unless they are able to bear the burden of proof in establishing the transaction’s fairness to the corporation. Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987).

We observe rules designed to require judicial deference to the board of directors, for example, in the statutory provisions governing interested director transactions, which effectively insulate such transactions from meaningful judicial review if they have been properly approved by disinterested directors. 48 Similar rules also are found in the context of management buyouts. Because such transactions involve a significant conflict of interest, they tend to get close judicial scrutiny, but will receive substantial judicial deference where the transaction is approved by disinterested directors. 49 As a final example, the Delaware courts allow the target’s board of directors a substantial gate-keeping role in unsolicited tender offers, despite the obvious conflict of interest inherent in such transactions, which again is attributable to the courts’ recognition of the importance of preserving the board’s authority. 50

Even if a plaintiff were positioned to surmount these substantive obstacles, the procedural limitations on derivative litigation further insulate boards of directors from judicial review. 51 Moreover, as the New York Court of Appeals seemingly recognized, these limitations follow precisely because corporate law must strive to balance authority and accountability:

By their very nature, shareholder derivative actions infringe upon the managerial discretion of corporate boards. . . . Consequently, we have historically been reluctant to permit shareholder derivative

48. Even when a director’s decision may be tainted by self-interest, title 8, section 144(a)(1) of the DGCL, effectively shields such self-interested transactions from judicial review if a majority of the disinterested directors approved the transaction. See Marciano, 535 A.2d at 405 n.3 (explaining that “approval by fully-informed disinterested directors under section 144(a)(1) . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction”).


51. See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 46–47 (2004) (criticizing the rules governing derivative litigation as preventing shareholders from holding directors accountable). When the cause of action belongs to individual shareholders, shareholders may individually file suit in their own names. In contrast, if the board’s conduct harms the corporation, shareholders may merely bring a derivative suit on the corporation’s behalf. See e.g., Grimes v. Donald, 673 A.2d 1207, 1213 (Del. 1996) (en banc) (finding that shareholders may bring a direct suit if the directors relinquish their authority to the corporation’s officers).
suits, noting that the power of courts to direct the management of a corporation's affairs should be "exercised with restraint."52

In sum, we observe throughout corporate law rules that recognize the need to strike a balance between authority and accountability but nevertheless are biased toward deference to the board's authority rather than accountability.53 Courts leave corporate decisionmaking to the board of directors and refuse to intervene when the board simply makes an inferior business decision.

Delaware judges thus recognize that someone's decision must be final. After all, the power to review is the power to decide.54 The question then is a simple one: "[W]ho is better suited to be vested with the mantle of infallibility that comes by virtue of being final—directors or judges?"55 Judges necessarily have less information about the needs of a particular firm than do that firm's directors. Thus, judges inevitably will make poorer decisions than the firm's board. As one court put it:

[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.56

52. Marx v. Akers, 666 N.E. 2d 1034, 1037 (N.Y. 1996). The court further noted the need to strike "a balance between preserving the discretion of directors to manage a corporation without undue interference, through the demand requirement, and permitting shareholders to bring claims on behalf of the corporation when it is evident that directors will wrongfully refuse to bring such claims," id., which is precisely the balance between authority and accountability our analysis predicts. See also Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (noting that "the derivative action impinges on the managerial freedom of directors").

53. One of us elsewhere advanced this point in the context of analyzing the business judgment rule. See Bainbridge, supra note 26, at 107–09. Former Delaware Supreme Court Chief Justice Veasey subsequently cited that article's analysis, deeming it to be "consistent with the Delaware doctrine that the rule is a presumption that courts will not interfere with, or second-guess, decision making by directors." Veasey & Di Guglielmo, supra note 21, at 1422.

54. See KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 78 (1974) ("If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.").

55. Bainbridge, supra note 26, at 121; cf. Brown v. Allen, 344 U.S. 443, 540 (1953) (Jackson, J., concurring) ("We are not final because we are infallible, but we are infallible only because we are final.").

Put another way, judges are no less subject to bounded rationality than any other decisionmakers. Just as the limits on cognitive competence impede decisionmaking by boards of directors, those same limits necessarily impede judicial review. Only with the benefit of hindsight will judges be able to make better decisions than boards, but hindsight review is always problematic. While market forces work a sort of Darwinian selection on corporate decisionmakers, moreover, no such forces constrain erring judges.

As we have seen, Delaware courts historically were willing to acknowledge their limitations vis-à-vis boards of directors, and to defer to the latter as the appropriate final decisionmaker, so long as there was no evidence that the decision in question was tainted by self-dealing. In doing so, Delaware courts drew a sharp line between what the law requires and what might constitute best practice. As the supreme court stated:

> Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.

It was precisely this line insulating directors from liability for failure to comply with best practice standards that proponents of creating an independent duty of good faith hoped to erase.

At the turn of the millennium, a number of corporate scandals broke out, including such prominent firms as Enron, WorldCom, Qwest, Global Crossing, and Tyco, which collectively cost shareholders $460 billion. In general, these scandals involved fraudulent accounting transactions designed by corrupt managers to make financial statements appear healthier than they really were. In their wake, a prominent Delaware jurist who favors the principle of deference opined that “the main corporate

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governance failure [has been] the lassitude and indifference of some boards of directors who were not pro-active in their oversight and strategic roles.\footnote{62}{E. Norman Veasey, Policy and Legal Overview of Best Corporate Governance Principles, 56 SMU L. REV. 2135, 2136 (2003) (alteration in original).}

The public outrage triggered by the corporate scandals prompted a number of regulatory responses intended to prevent a recurrence of such “lassitude and indifference.” At the federal level, the Sarbanes-Oxley Act of 2002 (SOX)\footnote{63}{Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18, and 28 U.S.C.).} expanded disclosure and governance rules. Among other things, SOX requires publicly traded companies to establish independent audit committees.\footnote{64}{For an overview, see Stephen M. Bainbridge, The Complete Guide to Sarbanes-Oxley: Understanding How Sarbanes-Oxley Affects Your Business (2007).} SOX also eliminated auditors’ conflicts of interest by prohibiting auditors from performing any nonaudit business services for their audit clients.\footnote{65}{Ribstein, supra note 61, at 14.}

In addition, the New York Stock Exchange (NYSE) and NASDAQ imposed more stringent listing standards on corporations.\footnote{66}{See id. at 176–78.} For example, listed companies on the NYSE must now have a majority of independent directors,\footnote{67}{See NYSE Euronext, Listed Company Manual § 303A.01, available at http://www.nyse.com/lcm/lcm_section.html (follow “Section 3 Corporate Responsibility” hyperlink; then follow “303A.00 Corporate Governance Standards” hyperlink; then follow “303A.01 Independent Directors” hyperlink) (last visited Dec. 6, 2007).} an independent audit committee,\footnote{68}{See NYSE Euronext, Listed Company Manual § 303A.06, available at http://www.nyse.com/lcm/lcm_section.html (follow “Section 3 Corporate Responsibility” hyperlink; then follow “303A.00 Corporate Governance Standards” hyperlink; then follow “303A.06 Audit Committee” hyperlink) (last visited Dec. 6, 2007).} and shareholder approval of equity compensation plans.\footnote{69}{See NYSE Euronext, Listed Company Manual § 303A.08, available at http://www.nyse.com/lcm/lcm_section.html (follow “Section 3 Corporate Responsibility” hyperlink; then follow “303A.00 Corporate Governance Standards” hyperlink; then follow “303A.08 Shareholder Approval of Equity Compensation Plans” hyperlink) (last visited Dec. 6, 2007).} These new listing standards are intended to enhance corporate accountability by increasing director oversight.\footnote{70}{See Deborah Solomon, SEC to Approve Governance Rules by NYSE, Nasdaq, WALL ST. J., Oct. 13, 2003, at C5.}

A number of prominent corporate law academics argued that state corporate law also needed to address the “lassitude and indifference” of corporate directors purportedly exposed by the Enron scandal and its ilk. For many, creating an independent duty of good faith seemed an
ideal vehicle for carrying out such a reform. Melvin Eisenberg, for example, opined that

the duty of good faith provides the courts with a principled basis for articulating new specific fiduciary obligations that come to be seen as appropriate in response to changes in social and business norms, and in the general understanding of efficiency and other policy considerations, but that cannot be easily accommodated within the duties of care and loyalty. 72

Similarly, Hillary Sale argued that “a freestanding duty of good faith is potentially more expansive [than the duties of loyalty and care], requiring fiduciary compliance in its own right and encouraging fiduciary parties to comply with their obligations, thereby avoiding the related shame for noncompliance.” 73 In her view, a freestanding duty of good faith would create “its own incentives for fiduciaries to make thoughtful decisions ex ante” and prevent “abdication of the fiduciary’s role”—in other words, it would create “incentives to instill effective corporate governance and preventing the kind of fiduciary abdication that has occurred.” 74

Not only was a freestanding duty of good faith to be created, but that duty was to be shorn of the rules applicable to care and loyalty that skew judicial review in favor of deference to director decisions. Eisenberg, for example, argued:

[V]arious rules limit a manager’s accountability under the duties of care and loyalty. These include the business judgment rule; rules that make harm or unfairness to the corporation, or profit to the manager, elements of a breach of those duties; and rules that allow “disinterested” directors who are friends and colleagues of a self-interested director to insulate that director from liability for self-interested transactions. These accountability-limiting rules should be and are inapplicable to conduct that violates the duty of good faith. 75

If this view were adopted, good faith would become “a loose rhetorical device that courts can wield to find liability or enjoin actions that do not quite fit within established doctrinal categories.” 76

74. Id. at 469.
75. Id. at 462.
76. Eisenberg, supra note 15, at 5.
77. Griffith, supra note 20, at 34.
In sum, the proponents of creating a freestanding duty of good faith saw it as mechanism by which Delaware law could respond at the state level to the same set of concerns that had motivated SOX and the stock exchange listing standards. According to their critique, “Delaware’s basic policy choice—a robust vision of the business judgment rule and maximum respect for the principle of board authority—was suddenly less tenable.”

The traditional balance between authority and accountability needed to shift significantly in the direction of accountability, and the duty of good faith was to be the doctrinal vehicle by which that outcome was achieved. If one believes, as one of us elsewhere opined, that the virtues of board discretion are such that “one must not lightly interfere with management or the board’s decisionmaking authority in the name of accountability,” the emergence of a freestanding duty of good faith thus posed a serious challenge to the fundamental policy animating corporate governance law.

II. THE EVOLVING DUTY OF OVERSIGHT

Delaware law requires directors to exercise “that amount of care which ordinarily careful and prudent men would use in similar circumstances,” which sounds like a negligence standard. Yet, as Joseph Bishop famously observed, “[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of

78. *Id.* at 47.
79. Sean Griffith has suggested that even a prominent Delaware jurist was considering such a shift:
   
   Good faith, Veasey then suggested, might be usefully employed as a doctrinal hook to incorporate the emerging consensus on best corporate governance practices. Stating first that “the utter failure to follow the minimum expectations of the evolving standards of director conduct, the minimum expectations of Sarbanes-Oxley, or the NYSE or NASDAQ Rules . . . might . . . raise a good faith issue,” Veasey later repeated that “it is arguable—but not settled—that the issue of good faith may be measured . . . against the backdrop of Sarbanes-Oxley and the SRO requirements.”

needles in a very large haystack." A recent survey found only thirteen cases imposing liability on directors for negligence in the absence of a concurrent breach of the duty of loyalty or other conflict of interest.

The paucity of such cases doubtless owes much to the business judgment rule. However, it also reflects a fundamental reluctance to impose liability on directors even in cases in which the business judgment rule does not apply. One of the most important classes of cases to which the rule is inapplicable is that involving allegations that the board of directors failed adequately to monitor management. This exception exists because the business judgment rule applies only where the board has exercised business judgment, while most oversight cases arise precisely because the board has failed to act.

The duty of care requires directors to pay ongoing attention to the business and affairs of the corporation. But does the duty of care require directors to monitor proactively the conduct of corporate subordinates? The Delaware Supreme Court first took up this issue in *Graham v. Allis-Chalmers Manufacturing Co.*

In 1937, Allis-Chalmers had entered into two consent decrees with the Federal Trade Commission in connection with alleged antitrust violations. In the 1950s, the firm settled unrelated federal antitrust charges of price-fixing by mid-level employees. After the 1950s settlement, shareholders derivatively sued the board of directors for having failed to install a law compliance program to prevent antitrust violations. Because the plaintiffs’ claim rested on an alleged failure to act, the business judgment rule did not apply, so...
the supreme court focused solely on the question of whether the directors had satisfied their duty of care.92

The plaintiffs argued that the directors knew or were on notice of the 1950s price-fixing violations.93 The court rejected that argument, however, because there was no credible evidence any of the directors actually knew of the 1950s-era violations until the federal government commenced grand jury proceedings.94 The plaintiffs then argued that, by virtue of the 1937 consent decrees, the directors were on notice that they had to take steps to prevent future violations and that they had failed to do so.95 The court also rejected that argument.96 Only a few of the inside directors had actual knowledge of the 1930s consent decrees.97 Moreover, the few directors who did know of them had reviewed the consent decrees and reasonably concluded that the corporation had done nothing wrong in the 1930s.98 The company had settled the case simply to avoid litigation.99 Accordingly, the court held that the directors were not on notice of the possibility of future illegal price-fixing.100

The Graham court also rejected the plaintiffs’ claim of lack of oversight.101 The court held that directors are entitled to rely on the honesty of their subordinates until something occurs to put them on notice that misconduct is taking place.102 If they are put on notice and then fail to act, or if they recklessly repose confidence in an obviously untrust-

92. See Marc I. Steinberg, The Role of Inside Counsel in the 1990s: A View From Outside, 49 SMU L. REV. 483, 487 n.21 (1996) (“[B]ecause the board of directors never focused on the issue [in Graham], the business judgment analysis was not applied.” (second alteration in original)).
93. Graham, 188 A.2d at 127.
94. Id. at 129–30.
95. Id. at 129.
96. See id. (“Plaintiffs have wholly failed to establish either actual notice or imputed notice to the Board of Directors of facts which should have put them on guard, and have caused them to take steps to prevent the future possibility of illegal price fixing and bid rigging.”).
97. Id.
98. See id.
99. Id.
100. Id.
101. See id. at 130 (“The precise charge made against these director defendants is that, even though they had no knowledge of any suspicion of wrongdoing on the part of the company’s employees, they still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end.”).
102. Id.
Oversight and Good Faith

worthy employee, liability may follow. But there is no duty to install a compliance program from the outset, absent such red flags.

Graham is routinely criticized these days. The Delaware Supreme Court itself, in Cede & Co. v. Technicolor, Inc., described it as “quite confusing and unhelpful.” Some commentators have suggested that firms should be required to maintain compliance programs designed to prevent misconduct by employees, a position embraced by the American Law Institute’s 1994 Principles of Corporate Governance.

As one of us has observed elsewhere, however, there is an interesting analogy between Graham and the well-known aphorism “every dog gets one bite.” At common law, of course, the one-bite rule actually was somewhat more complicated. When a dog bit someone, the master could be held liable only if the master knew or had reason to know the dog had a propensity to bite. A prior bite would constitute the requisite

103. Delaware law generally invokes gross negligence as the standard of review in duty of care cases. See, e.g., McMullin v. Beran, 765 A.2d 910, 921 (Del. 2000) (“Director liability for breaching the duty of care is predicated upon concepts of gross negligence.”); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (en banc) (“[G]ross negligence is . . . the proper standard for determining whether a business judgment . . . was an informed one.”); see also Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1986) (defining gross negligence for this purpose as “reckless indifference to or a deliberate disregard of the stockholders” or conduct outside the “bounds of reason,” and suggesting that that standard created a higher threshold for liability than the usual tort concept of gross negligence (citations omitted)).

Oddly, however, it is not entirely clear whether the Graham court reviewed the plaintiffs’ claims under an ordinary or gross negligence standard. On the one hand, the court suggested the directors could make “themselves liable for failure to exercise proper control” over the company’s employees “by neglect.” Graham, 188 A.2d at 130. On the other hand, the court also used such terms as “recklessly” and “neglected cavalierly,” id., both of which suggest a standard higher than ordinary negligence.

Some subsequent chancery court opinions expressly adopted the gross negligence standard in oversight cases. See, e.g., Seminaris v. Landa, 662 A.2d 1350, 1355 (Del. Ch. 1995) (“In order to hold the directors liable, plaintiff will have to demonstrate that they were grossly negligent in failing to supervise these subordinates.”). In the Rabkin decision, however, the chancery court split the baby, holding that the gross negligence standard is limited to situations in which the board has rendered a decision, but that ordinary negligence is the appropriate standard when directors fail to act. Rabkin v. Philip A. Hunt Chemical Corp., 1987 WL 28436, at *3 (Del. Ch. Dec. 17, 1987).

104. See Graham, 188 A.2d at 130 (holding that “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists”).

105. 634 A.2d 345 (Del. 1993).

106. Id. at 364 n.31.

107. See 1 AM. LAW INST., supra note 39, § 4.01(a) cmt. d.

108. See BAINBRIDGE, supra note 36, at 293–94, on which the following paragraphs draw.

knowledge, thus giving rise to the colloquial name for the rule, but the requisite knowledge also could be based on the breed’s inherently violent propensities.\footnote{110. See Collier v. Zambito, 807 N.E.2d 254, 256 (N.Y. 2004) (noting that even in the absence of a prior bite, a triable issue of fact regarding knowledge of vicious propensities may be raised by other evidence of the dog’s aggressive behaviors).}

The common law rule had a sound cost-benefit rationale. Preventing dog bites is not costless; to the contrary, it requires precautions such as leashes, fences, and the like. If the likelihood of a bite is low, the costs of such precautions outweigh their benefits.

The analogy to cases like \emph{Graham} should be readily apparent. Just as a dog’s master is not liable unless the master knew ex ante that the dog has a propensity to bite, directors are liable under \emph{Graham} only if they are on notice that firm employees have a propensity for misconduct. Just as a prior bite puts a dog’s master on such notice, prior criminal violations or breaches of fiduciary duty can put directors on notice. Just as masters have an affirmative duty to control dogs of an inherently vicious breed, moreover, directors will be held liable when they recklessly fail to monitor an obviously untrustworthy employee.

As with the dog bite rule, there is a strong cost-benefit justification for \emph{Graham}. Compliance programs are expensive. Programs with real teeth require substantial high-level commitment and review, frequent and meaningful communication to employees, serious monitoring and auditing, and appropriate discipline when violations are discovered.\footnote{111. See H.J. Aibel, \emph{Corporate Counsel and Business Ethics: A Personal Review}, 59 Mo. L. Rev. 427, 437–38 (1994) (listing the elements of an effective program).} By analogy to the one-bite rule, one thus would expect a firm to take such precautions only when the board of directors is on notice of a past violation.\footnote{112. To be sure, in some areas the law has long required that directors maintain internal controls to guard against wrongdoing. In particular, directors have an obligation to ensure that basic accounting practices are followed in preparing and auditing the firm’s financial records. See, e.g., Atherton v. Anderson, 99 F.2d 883, 889 (6th Cir. 1938). Such precautions are relatively inexpensive. The company already may hire outside accountants to prepare the books, so it is relatively inexpensive also to require them to report on their procedures and findings to the board.}

Despite \emph{Graham}'s clear holding, in \emph{In re Caremark International Inc. Derivative Litigation},\footnote{113. 698 A.2d 959 (Del. Ch. 1996).} Chancellor Allen nevertheless opined that a board of directors does have an obligation to take affirmative compliance measures:

\begin{quote}
[I]t would, in my opinion, be a mistake to conclude that our Supreme Court’s statement in \emph{Graham} concerning “espionage” means that corporate boards may satisfy their obligation to be reasonably
\end{quote}
informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.

Thus, I am of the view that a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards. 114

Caremark was a health industry company that provided patients with a variety of managed care services. 115 Much of Caremark’s revenue came from federal government health programs. 116 Under the federal Anti-Referral Payments Law (ARPL), Caremark was prohibited from paying doctors to refer patients to it. 117 Caremark could, however, legally hire doctors under consulting agreements and research grants. 118

In 1994, the federal government prosecuted Caremark for criminal violations of the ARPL. 119 The government argued that some of Caremark’s consulting agreements and research grants with doctors were disguised kickbacks for patient referrals. 112 In 1995, Caremark settled, paying fines and reimbursement of about $250 million. 121 A group of shareholders thereafter filed derivative suits against Caremark directors. 122 Those suits were settled pursuant to an agreement under which the directors paid nothing, Caremark agreed to make some cosmetic changes in the way it ran its business, and the plaintiffs’ attorneys collected a fee of $1 million from Caremark. 123 As with all derivative suit settlements, the agreement

114. Id. at 970.
115. Id. at 961.
116. Id.
117. Id. at 961–62.
118. Id. at 962.
119. Id. at 963–64.
120. See id. at 964.
121. Id. at 960–61.
122. Id. at 964.
123. See id. at 966 (summarizing the proposed settlement terms); see also id. at 972 (“The proposed settlement provides very modest benefits.”).
required judicial approval. Chancellor Allen approved the settlement (although he cut the plaintiffs' attorneys' fee to $869,000). Because of the procedural posture, the case dealt only indirectly with the real issue of whether Caremark's directors had an obligation to create effective compliance programs. In the dicta quoted above, however, Allen indicated that the duty of care does require such programs.

Allen's analysis began by distinguishing two scenarios in which directors might be sued with respect to the firm's law compliance:

Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent." Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.

In the former class of cases, in which the directors made an ill-advised decision, the business judgment rule will insulate that decision from judicial review, "assuming the decision made was the product of a process that was either deliberately considered in good faith or was otherwise rational."

As to the latter class of cases, the relevant question is whether the "directors breached their duty of care by failing adequately to control [the corporation's] employees." Allen acknowledged that much of what the corporation does never comes to the board's attention. Allen contended, however, that decisions made deep in the interior of the corporation by relatively junior employees can have devastating consequences. Allen also noted two concurrent regulatory trends. On the one hand, federal law increasingly used criminal sanctions to ensure corporate compliance with various regulatory regimes. On the other, the federal criminal sentencing guidelines mitigated sanctions where

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124. See id. at 961 (noting that the court was obliged "to assess the strengths and weaknesses of the claims asserted in light of the discovery record and to evaluate the fairness and adequacy of the consideration offered to the corporation in exchange for the release of all claims made or arising from the facts alleged"); BAINBRIDGE, supra note 36, at 381 (discussing the judicial approval requirement).
125. Caremark, 698 A.2d at 972.
126. See supra text accompanying note 114.
127. Caremark, 698 A.2d at 967.
128. Id.
129. Id. at 971 (alteration in original).
130. See id. at 968.
131. See, e.g., id. at 968–69.
132. Id. at 969.
the corporate defendant had compliance programs in place. In light of these considerations, Allen held that Graham no longer could be interpreted as meaning that a corporate board has no obligation to create information-gathering and monitoring mechanisms designed to ensure corporate law compliance.

Allen undoubtedly was correct that decisions made by subordinates can have substantial and often multiplicative effects throughout the corporation. Yet, Caremark threatens to open the door to expansive directorial liability. Because a board’s exercise of its oversight function so often falls outside the business judgment rule, most of what directors actually do becomes subject to second-guessing by courts. As a matter of sound policy, it would have been preferable for Allen to reaffirm Graham’s replication of the dog bite rule.

Even though Allen’s opinion in Caremark was dicta and arguably inconsistent with supreme court precedent, it quickly became well accepted by the chancery court as good law. Yet, for over a decade, the Delaware Supreme Court found no occasion on which to address squarely Caremark’s validity.

III. THE CONVERGENCE

That occasion came in Stone ex rel. AmSouth Bancorporation v. Ritter, in which shareholders of AmSouth Bancorporation brought a derivative suit against AmSouth’s directors alleging a “classic Caremark claim.” In 2004, AmSouth had paid $50 million in fines and penalties
to the federal government to settle criminal and civil charges that the
bank had failed to file reports of suspicious activity required by the federal
anti-money-laundering regulations. The plaintiffs thereafter brought
a derivative claim, seeking to recover the $50 million from the directors.
The plaintiffs alleged that the “defendants had utterly failed to implement
any sort of statutorily required monitoring, reporting or information
controls that would have enabled them to learn of problems requiring
their attention.”

The plaintiffs failed to make demand on the board of directors prior
to filing their lawsuit, claiming that demand should be excused as futile.
The chancery court disagreed, dismissing the suit on the ground that
demand was required.

In an en banc opinion authored by Justice Holland, the supreme court affirmed.

This Part begins with a review of Stone’s impact on the good faith
obligation. It demonstrates that the court subsumed good faith into the
duty of loyalty, a marriage we believe will prove most unwise. The Part
then turns to Stone’s implications for the duty of oversight. In our view,
by situating that duty in the category of good faith obligations and, accord-
ingly, the duty of loyalty, Stone badly misread Caremark and unwisely
complicated the analysis of oversight cases.

A. Good Faith

1. The Backdrop to Stone

Just a few months prior to the decision in Stone, the Delaware Supreme
Court had finally resolved the long-running shareholder litigation over
the termination of Michael Ovitz as president of the Walt Disney Company
in what still looks likely to be a landmark decision.

In In re Walt Disney Co. Derivative Litigation, shareholders claimed
that the board of directors had violated its duties of care and good faith

139. See id. at 365.
140. See id. at 364.
141. Id. at 367, 370. For discussion of the demand requirement in derivative litigation, see
BAINBRIDGE, supra note 36, at 385–94.
143. Stone, 911 A.2d 362.
144. In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006). In August 1995,
Michael Ovitz was hired by the Walt Disney Company to serve as president for five years.
Id. at 35. Ovitz had been the leading partner and one of the founders of Creative Artists
Agency, which had generated an annual income of over $20 million for Ovitz. Id. at 36.
145. 906 A.2d 27.
in setting the terms of Ovitz’s compensation and in deciding to terminate him. In hiring Ovitz, the board approved an employment agreement that included a generous nonfault termination provision. When Ovitz failed to perform up to expectations in his new position, the board terminated his employment without cause fourteen months into his five-year term, resulting in a severance payout of approximately $130 million. The Disney case set important standards as to the minimum care and good faith required for boards to avoid liability in setting executive compensation, and offered important guidance as to best practice in this regard. For present purposes, however, the court’s doctrinal statements on the role and nature of good faith are of principal import.

In Disney, the court defined good faith as encompassing all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

The court held that a plaintiff could rebut the business judgment rule by showing that the board of directors acted in bad faith. The court

146. See id. at 35.
147. Id. at 41, 45–46. Ovitz’s employment agreement provided for a base salary of $1.25 million, a discretionary bonus, and two sets of stock options that would collectively enable Ovitz to purchase five million shares of Disney common stock. Id. at 37, 40. The agreement also provided for two ways in which Ovitz could be fired. Id. Before the end of the employment term, Disney could fire Ovitz for “good cause” only if Ovitz resigned voluntarily or if Ovitz committed gross negligence or malfeasance. Brehm v. Eisner, 746 A.2d 244, 250 (Del 2000). Disney would owe Ovitz no additional compensation if it terminated him for “good cause.” Id. Termination without cause (no-fault termination) would entitle Ovitz to the present value of his remaining salary payments through September 30, 2000, a $10 million severance payment, an additional $7.5 million for each fiscal year remaining under the agreement, and the immediate vesting of the first three million stock options. Id.
148. Disney, 906 A.2d at 35.
149. See Sarah Helene Duggin & Stephen M. Goldman, Restoring Trust in Corporate Directors: The Disney Standard and the “New” Good Faith, 56 Am. U. L. Rev. 211 (2006) (stating that in “Disney V the court had the wisdom to provide guidance to the bar, and to the corporate world by shining a light on a duty ‘shrouded in the fog of . . . hazy jurisprudence’” (quoting Disney, 906 A.2d at 63 n.98)).
150. 906 A.2d at 67. The court made clear that these three categories of conduct were merely the “most salient” forms of bad faith, but did not constitute an exclusive definition of bad faith. Id.
151. Id. at 52.
declined to decide, however, whether good faith was an independent fiduciary duty whose breach would give rise to liability absent a breach of the duty of care or loyalty.\footnote{152}

2. Stone and the Status of Good Faith

In \textit{Stone}, Justice Holland's opinion for the court resolved the issue left open in \textit{Disney}.\footnote{153} In doing so, Holland oddly recast the triad formulation, to which he previously had been faithful,\footnote{154} as a mere colloquialism.\footnote{155} Following Vice Chancellor Strine's influential decision in \textit{Guttman v. Huang},\footnote{156} Justice Holland held that “the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”\footnote{157} Instead, he concluded that the obligation to act in good faith is subsumed within the duty of loyalty:

[T]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in \textit{Guttman}, “[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.”\footnote{158}

This formulation appears to be a compromise between those who wanted to elevate good faith to being part of a triad of duties and those who did not, with the former losing as a matter of form, and the latter losing as a matter of substance.

On close examination, this formulation makes little sense.\footnote{159} First, the court took some pains to emphasize that a failure to act in good faith was

\begin{footnotes}
\footnote{152. \textit{Id.} at 67 n.112.}
\footnote{153. \textit{Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369 n.29 (Del. 2006).}}
\footnote{154. See supra text accompanying note 33.}
\footnote{155. \textit{Stone}, 911 A.2d at 370 (stating that “good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty”).}
\footnote{156. \textit{823 A.2d 492 (Del. Ch. 2003).}}
\footnote{157. \textit{Stone}, 911 A.2d at 370.}
\footnote{158. \textit{Id.} (quoting \textit{Guttman}, 823 A.2d at 506 n.34).}
\footnote{159. To be sure, subsuming good faith into loyalty is logical in the limited sense that the set of cases in which one acts in bad faith as defined by the court without being motivated by conflicted interests is likely to be empty or nearly so. As Larry Ribstein observed: It follows that the only way a board is going to be held liable for breach of fiduciary duty when it isn't self-dealing is to (1) really not have any idea what it is doing; and (2) not have a 102(b)(7) clause in the charter; or (3) have such a clause but proceed in conscious disregard of the board's responsibility, which would be truly.}
\end{footnotes}
a "necessary condition to liability." Are there other conditions that must be satisfied in order for a bad faith act to constitute a breach of the duty of loyalty? The court leaves this question unanswered.

Second, and more important, the doctrinal consequences of subsuming good faith into loyalty are quite odd. The duty of loyalty traditionally focused on cases in which the defendant fiduciary received an improper financial benefit. Accordingly, the traditional remedy was to strip that benefit away from the defendant. In related-party transactions whose terms are unfair to the corporation, for example, the transaction may be voided. Where a defendant usurps a corporate opportunity, the corporation gets a constructive trust on the opportunity.

By subsuming good faith into the duty of loyalty, however, Stone extended the domain of the duty of loyalty to cases in which the defendant received no financial benefit. In such cases, the traditional remedy is inapt. There is neither a transaction to be voided nor a res to be seized. Liability for acts in bad faith thus will look a lot more like that imposed in cases involving a breach of the duty of care than the duty of loyalty. If someone “intentionally acts with a purpose other than that of advancing the best interests of the corporation,” for example, it makes no sense to ask whether the action was fair to the corporation.

puzzling in the absence of self-dealing. In other words, the board will be liable for non-self-dealing conduct on a cold day in August in Miami under a blue moon.


160. Stone, 911 A.2d at 369 (quoting In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996)).

161. See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 346, 363 (Del. 1993) (holding that “a shareholder plaintiff, to establish a breach of duty of loyalty, must present evidence that the director either was on both sides of the transaction or ‘derive[d] any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally’” (citation omitted) (emphasis omitted) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))).

162. See, e.g., Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (“If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit.”).

163. See generally Marciano v. Nakash, 535 A.2d 400, 403–04 (Del. 1987) (discussing the conditions under which an interested director transaction may be voidable).


165. Indeed, the court did so explicitly. See supra note 159.

166. See, e.g., Oliver v. Boston Univ., 2006 WL 1064169 (Del. Ch. 2006) (“If corporate fiduciaries stand on both sides of a challenged transaction, an instance where the directors’ loyalty has been called into question, the burden shifts to the fiduciaries to demonstrate the ‘entire fairness’ of the transaction.”).
Instead, the relevant question is whether the corporation was harmed and, if so, by what amount.

Good faith thus raises the issue of causation in a way that traditional loyalty concerns do not. After all, if the plaintiffs are setting out to recover the amount by which the defendant harmed the corporation, presumably they need to show that the defendant’s conduct in fact harmed the corporation. Indeed, it would be unfair to impose liability without a showing of causation.167

To be sure, in Cede & Co. v. Technicolor, Inc.,168 the Delaware Supreme Court held that causation was not an element of the duty of care claim169 (a ruling that the court presumably will extend to the good faith context), but that decision made no sense. At one point in that Jarndyce-like saga, Chancellor Allen ruled that plaintiff Cinerama could not prevail on its duty of care claims because it had failed to prove a financial injury caused by the Technicolor board’s alleged misfeasances.170 In so holding, Allen relied on Barnes v. Andrews,171 which held that a shareholder-plaintiff suing over a breach of the duty of care must prove that the loss would have been avoided if the director had carried out his duties.172 In effect, the shareholder-plaintiff must establish causation.

In reversing Allen, the Delaware Supreme Court claimed it was “a ‘mystery’ how the [chancery] court discovered the Barnes case and then based its decision on Barnes.”173 In fact, however, the real mystery is how the Delaware Supreme Court could have been unaware of Barnes. The Barnes decision was (and still is) routinely cited as the leading authority for the proposition that “the undoubted negligence of directors may not result in liability if the plaintiff cannot show that the negligence proximately caused damages to the corporation.”174 The proposition was so

167. Christopher Robinette explained:
Because corrective justice seeks to right moral imbalances, it is first necessary to determine that such imbalances exist. If a defendant has not caused harm to a plaintiff, no moral imbalance exists; no wrong has been done by the defendant to the plaintiff. Thus, the causation requirement is a necessary part of corrective justice.


168. 634 A.2d 345 (Del. 1993).

169. See id. at 367–69.


171. 298 F. 614 (S.D.N.Y. 1924). See generally BAINBRIDGE, supra note 36, at 288–90, on which the following paragraphs draw.


173. Technicolor, 634 A.2d at 370 n.38.

well accepted that both the Emanuel’s law outline\(^\text{175}\) and the corporation law nutshell\(^\text{176}\) in print at the time cited Barnes for the proposition that, as the former stated, “the traditional tort notions of cause in fact and proximate cause apply in [the duty of care] context.”\(^\text{177}\)

*Technicolor’s* rejection of Barnes had the odd result of effectively conflating the duties of care and loyalty. This is so because, under *Technicolor*, once a plaintiff rebuts the business judgment rule by proving a breach of the duty of care (which itself puts the cart before the horse\(^\text{176}\)), the defendants have the burden of establishing “entire fairness.”\(^\text{179}\)

The entire fairness standard makes sense in self-dealing cases. Corporate law’s “overarching normative constraint” is that directors should “exercise their authority with the intention of benefiting the shareholders and not themselves.”\(^\text{180}\) Where directors put their personal interests ahead of those of the shareholders, the need to hold directors accountable for their actions necessarily trumps the principle of deference to board decisions; consequently, courts review loyalty claims under a most exacting standard.\(^\text{181}\)

The concept of entire fairness, however, has little relevance to either a duty of care case or one involving bad faith.\(^\text{182}\) First, as noted above, the relevant factual issues go not to fairness but to errors of judgment and resulting damages. Second, invocation of entire fairness carries with it important remedial implications. In entire fairness cases, the court may impose “any form of equitable or monetary relief as may be appropriate, including rescissory damages.”\(^\text{183}\) By conflating the loyalty and care analyses, *Technicolor* extended this broad grant of remedial authority to care claims, with bizarre consequences. Rescissory damages make sense in a self-dealing case because the wrongdoer personally benefited.

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177. Emanuel, supra note 175, at 128 (emphasis omitted).
178. See supra note 26.
179. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the court described the entire fairness standard as placing on the director-defendants the burden of proving, subject to “careful scrutiny by the courts,” “their utmost good faith and the most scrupulous inherent fairness of the bargain.” Id. at 710.
181. See supra notes 46–47 and accompanying text.
182. See generally Dooley, supra note 180, at 249–54 (criticizing *Technicolor*). For a careful demonstration that *Technicolor*’s importation of entire fairness into the duty of care was a doctrinal novelty, see Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 Del. J. Corp. L. 787, 799–01 (1999). Johnson concluded there is “no clear and reasoned prior authority” supporting *Technicolor* in this respect. Id. at 801.
from the breach of duty. In such cases, the remedial goal should be to ensure that the wrongdoer retains neither its ill-gotten gains nor their tainted fruits. In a case, however, an award of rescissory damages would have the effect of ordering the director-defendants to return a benefit that they never received. By definition, there are no ill-gotten gains to be recouped.

The same considerations apply to claims alleging a breach of the “duty” of good faith that do not involve an improper benefit to the defendant. Barnes thus should govern such cases. By subsuming good faith into the duty of loyalty, however, Stone makes it doctrinally even more difficult to require causation, while simultaneously creating a conceptually difficult task of crafting appropriate remedies.

3. Stone and the Definition of Good Faith

In Stone, the Delaware Supreme Court approvingly quoted the Disney definition of good faith, along with Disney’s qualification that the three identified categories are not exclusive. In Disney, Justice Jacobs identified three broad categories of conduct that were candidates for being defined as bad faith:

1. Conduct “motivated by an actual intent to do harm.”
2. Conduct involving an “intentional dereliction of duty” or taken with “conscious disregard for [the fiduciary’s] responsibilities.”
3. Conduct constituting negligence or gross negligence on the part of a corporate fiduciary.

Only the first and second categories were held to constitute bad faith.

a. The Role of Section 102(b)(7)

Justice Jacobs’s analysis in Disney rested in part on the exculpation clause provision in section 102(b)(7) of the Delaware General Corporation Law (DGCL). This provision originated in the mid-1980s, when “the insurance market for directors and officers was very tight, and it was

184. DOOLEY, supra note 180, at 256.
186. In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 64 (Del. 2006).
187. Id. at 66.
188. Id. at 64.
189. Id. at 64–66.
difficult to attract persons willing to serve as directors. Consequent-
ly, the Delaware legislature adopted section 102(b)(7), which permits 
the articles of incorporation to include an exculpation clause exonerating 
directors from personal liability for breaching the duty of care. As 
such, “proving the existence of a valid exculpatory provision in a corpo-
rate charter entitles directors to dismissal of any claims for money 
damages against them that are based solely on alleged breaches of the 
board’s duty of care.” Put another way, “actions against the directors 
of Delaware corporations with a § 102(b)(7) charter provision, a share-
holder’s complaint must allege well-pled facts that, if true, implicate 
breaches of loyalty or good faith.”

Section 102(b)(7) thus brought the issue of good faith to the forefront 
in defining the conduct for which corporate directors will be liable. 
Indeed, in Jacobs’s view, the structure of section 102(b)(7) precludes 
treating negligence or gross negligence as bad faith:

The exculpatory provision affords significant protection to direc-
tors of Delaware corporations. The statute carves out several 
exceptions, however, including most relevantly, “for acts or 
omissions not in good faith . . . .” Thus, a corporation can exculpate 
its directors from monetary liability for a breach of the duty of care, 
but not for conduct that is not in good faith. To adopt a definition 
of bad faith that would cause a violation of the duty of care 
automatically to become an act or omission not in good faith, would 
eviscerate the protections accorded to directors by the General 
Assembly’s adoption of Section 102(b)(7).

Accordingly, Jacobs held, “in the pragmatic, conduct-regulating legal 
realm which calls for more precise conceptual line drawing,” good faith 
and care “are and must remain quite distinct.”

The reliance on section 102(b)(7) to define good faith seems 
misplaced. To be sure, the rules of statutory interpretation “suggest that 
the concept, because it appears as a separate numbered item, has some 
meaning distinct from loyalty and self-interest and that this meaning, 
judging by nearby words in the series, may have something to do with

196. Id.
‘intentional misconduct’ or ‘knowing violations.’” As Delaware Chief Justice Steele recently observed, “we can’t overlook the fact that good faith is mentioned by our legislature in our statutes.” The trouble with this argument is that it requires the court to overlook the serious flaws in section 102(b)(7). Although one commentator has argued otherwise, section 102(b)(7) is “an internally contradictory botch job,” and the court should have realized it.

Justice Jacobs could have followed Vice Chancellor Strine’s argument that section 102(b)(7)’s “subparts all illustrate conduct that is disloyal.” If he had done so, there would have been no statutory necessity to carve out a separate doctrine of good faith. Instead, however, Disney allowed the section 102(b)(7) tail to wag the dog.

b. Intent to Violate Applicable Positive Law

We saw earlier that the emergence of good faith as a distinct concept threatened to shift the balance between authority and accountability in favor of the latter, significantly increasing director liability exposure. At first glance, by defining good faith in ways that emphasize intentional misconduct, Disney and Stone may appear to have limited that risk. Indeed, Chief Justice Steele has acknowledged the need for Delaware courts to “keep the bigger picture in mind, the balance of authority and accountability, whether good faith is intuitively known to all of us or not, or whether it’s simply a rhetorical device.”

197. Griffith, supra note 20, at 14 (footnotes omitted). Accord Bruner, supra note 30, at 1147 (stating that “the structure ultimately adopted in section 102(b)(7) tends to characterize [bad faith, reckless, and intentional misconduct] as their own categories of fiduciary breach somehow distinct from the concept of disloyalty” (emphasis omitted)).


  if good faith truly is the absence of intentional wrongdoing, the absence of bad faith, which we probably could all agree is intentional wrongdoing, or intentional acts of omission that cause harm, how do we deal with the language in 102(b)(7) that seems to say that intentional conduct is something different than the exercise of good faith?

Id. at 6–7.

199. See Bruner, supra note 30, at 1155.

200. Id.


202. See supra Part I.B.

203. Steele, supra note 198, at 13.
Unfortunately, even under the Disney definition, good faith still threatens to expand the extent to which courts will review the substance of director decisions and, concomitantly, the liability exposure of corporate directors. First, recall that the Disney and Stone courts both took pains to emphasize that the three-pronged definition of good faith is not exclusive.\textsuperscript{204} Instead, good faith is broadly defined as a “doctrinal vehicle” for addressing any conduct that “does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence.”\textsuperscript{205} As a result, the definition of good faith is potentially open ended. The resulting uncertainty leaves room for courts to subject additional classes of decisions to substantive review. This not only is inconsistent with the basic principle of judicial deference to boards, but also encourages litigation challenging such decisions. Uncertainty as to whether conduct will be deemed bad faith and thus a nonexculpable source of liability uninsulated by the business judgment rule will invite shareholder-plaintiffs to test the boundaries of the concept. It may also make it less likely that director-defendants will be able to prevail on a motion to dismiss, which will raise the settlement value of litigation.

Second, even under the seemingly limited Disney formulation, good faith will still restrict boards’ decisionmaking discretion. Consider, for example, that conduct intended “to violate applicable positive law” now constitutes bad faith.\textsuperscript{206} Given the importance section 102(b)(7) appears to have played in driving the creation and the definition of the good faith concept,\textsuperscript{207} including such conduct within the definition of good faith seems odd. It was not necessary for the court to do so in order to ensure that such conduct was nonexculpable, because section 102(b)(7) already disallowed exculpation of “a knowing violation of law.”\textsuperscript{208} To the contrary, given the logic of the Delaware Supreme Court’s analyses in Disney and Stone, the fact that “a knowing violation of law” is a separately listed item suggests that it should be distinguished from “acts or omissions not in good faith.”\textsuperscript{209}

In any case, the more important point for present purposes is the impact of the court’s decision on the freedom of directors to manage a corporation. To be sure, pre-Disney, the business judgment rule did not

\textsuperscript{204} See supra text accompanying note 185.
\textsuperscript{205} In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 65 (Del. 2006).
\textsuperscript{206} See supra text accompanying note 150.
\textsuperscript{207} See supra Part III.A.3.a.
\textsuperscript{208} DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2001).
\textsuperscript{209} Id.; see supra text accompanying note 197.
insulate illegal conduct from judicial review.\textsuperscript{210} The business judgment rule, however, is not a standard of liability.\textsuperscript{211} Instead, it is a presumption against judicial review of business decisions. Where the business judgment rule is inapplicable, courts therefore must go on to ask whether the duty of care or of loyalty was violated before imposing liability.\textsuperscript{212}

As one of us has written elsewhere,\textsuperscript{213} if a package delivery firm told its drivers to illegally double-park so as to speed up the delivery process, for example, it is hardly clear that the decision should be deemed a breach of the duty of care. The criminal law has long distinguished between crimes that are malum in se and those that are merely malum prohibitum. The latter are acts that are criminal merely because they are prohibited by statute, not because they violate natural law. It is said that “misdemeanors such as jaywalking and running a stoplight are mala prohibita, as are most securities-law violations.”\textsuperscript{214} Individuals routinely make cost-benefit analyses before deciding to comply with some malum prohibitum law, such as when deciding to violate the speed limit. Is it self-evident that the directors of a corporation should be barred from engaging in similar cost-benefit analyses? A negative answer to that question is suggested by the so-called net loss rule, under which directors cannot be held monetarily liable if the overall gains to the

\textsuperscript{210} See, e.g., Lewis v. Aronson, 466 A.2d 375, 384 (Del. Ch. 1983) (holding that “the rule is a presumption that a rational business decision of the officers or directors of a corporation is proper unless there exists facts which remove the decision from the protection of the rule—such as self-dealing, conflict of interest, fraudulent, illegal or reckless decisions, waste of corporate assets, etc.”), rev’d on other grounds, 473 A.2d 805 (Del. 1984).

\textsuperscript{211} See Bainbridge, supra note 26, at 95–100 (arguing that the business judgment rule is not properly understood as a standard of liability).

\textsuperscript{212} Cf. 1 AM. LAW INST., supra note 39, § 4.01 cmt. d (“To be successful in a duty of care action involving noncompliance with law, a plaintiff is required to prove two violations: first, the plaintiff must establish a corporation's violation of the law, and second, the plaintiff must establish that the defendant director or officer failed to comply with the standards of § 4.01 [the duty of care] with respect to the violation.”).

For this reason, the fact that section 102(b)(7) excludes exculpation of knowing violations of law, DEL. CODE ANN. tit. 8, § 102(b)(7)(ii), does not mandate adoption of a per se rule of director liability in connection with such acts. Section 102(b)(7) was not intended to create a standard of liability, but rather to ensure that liability arising out of the duty of care could be exculpated. See supra notes 192–196 and accompanying text (discussing the purpose behind section 102(b)(7)). If conduct involving a knowing violation of law does not breach the duty of care, the exculpation provisions authorized by section 102(b)(7) should not come into play. By treating such conduct as bad faith, however, the court effectively adopted a rule of per se liability. See infra text accompanying notes 222–223.

\textsuperscript{213} The following analysis is taken from BAINBRIDGE, supra note 36, at 272–73.

\textsuperscript{214} BLACK'S LAW DICTIONARY 401 (pocket ed. 1996).
corporation from the violation exceed the losses directly attributable thereto, such as fines or legal expenses. 215

The point is not that corporations should be allowed to break the law. They should not. If a corporation breaks the law, criminal sanctions should follow for the entity or the responsible individuals.216 The point is only that fiduciary obligation and the duty to act lawfully make a bad fit. If the question is one of reconciling authority and accountability, it is not obvious that corporate law should hold directors accountable simply for deciding that the corporation's interests are served by violating a particular statute. After all, the point of the business judgment rule is that shareholders should not be allowed to recover monetary damages simply because the directors made the wrong decision.217

This argument is further supported by the realities of shareholder litigation. Shareholder lawsuits alleging that directors violated the purported duty to act lawfully will be brought as derivative actions. The real party in interest in derivative litigation is the plaintiff's attorney, not the nominal shareholder-plaintiff.218 In most cases, the bulk of any monetary benefits go to the plaintiffs' lawyers rather than the corporation or its shareholders.219 In practice, such litigation is more likely to be a mere wealth transfer (from corporations and their managers to the plaintiffs' bar) than a significant deterrent to corporate criminality.220 Accordingly, the illegality of a board decision—standing alone—should not result in director liability.221

216. There is an active debate over the appropriateness of corporate criminal liability, but that debate is beyond the scope of this Article. For commentary on that issue, see, for example, Norwood P. Beveridge, Does the Corporate Director Have a Duty Always to Obey the Law?, 45 DEPAUL L. REV. 729 (1996); V.S. Khanna, Corporate Criminal Liability: What Purpose Does It Serve?, 109 HARV. L. REV. 1477 (1996); William S. Laufer, Corporate Liability, Risk Shifting, and the Paradox of Compliance, 52 VAND. L. REV. 1343 (1999).
217. See, e.g., Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (“Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context.”).
218. BAINBRIDGE, supra note 36, at 367.
219. Id. at 403.
220. Id.
221. There is an analogy here to the tort law doctrine of negligence per se. In tort law, many courts hold that the presumption of negligence made when the defendant violated some statute can be rebutted by a showing that the defendant acted reasonably under the circumstances despite the violation. See, e.g., W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 230 (5th ed. 1984); see id. at 231 (“The arbitrary classification of all breaches of statute as negligence per se or no negligence at all leaves too little flexibility for the standard of reasonable care.”).
Yet, post-Disney, deciding to cause the corporation to commit an illegal act will automatically result in liability. Because such a decision is one made in bad faith by definition, it now appears to be a per se violation of the duty of loyalty. In light of the remedial aspects of the good faith doctrine discussed above, moreover, liability will be imposed even in circumstances in which the corporation affirmatively benefited from the decision in question.

This may seem a trivial complaint. Given the highly regulated nature of the U.S. economy and the growing use of criminal law to regulate corporate conduct, however, the adoption of a per se rule of liability lacking even an exception for de minimis violations of laws malum prohibitum in fact is a significant restriction on the discretionary powers of boards of directors. This result also may set an unfortunate precedent for converting issues traditionally analyzed on a case-by-case rule of reason under the duty of care into per se violations.

B. Oversight

As we have seen, in In re Caremark International Inc. Derivative Litigation, former Delaware Chancellor Allen stated in dicta that the fiduciary duty of care of corporate directors included an obligation for directors to take some affirmative law compliance measures. Specifically, a

222. See supra notes 167–184 and accompanying text.
223. In a post-Stone decision, Vice Chancellor Strine held:

In short, by consciously causing the corporation to violate the law, a director would be disloyal to the corporation and could be forced to answer for the harm he has caused. Although directors have wide authority to take lawful action on behalf of the corporation, they have no authority knowingly to cause the corporation to become a rogue, exposing the corporation to penalties from criminal and civil regulators. Delaware corporate law has long been clear on this rather obvious notion; namely, that it is utterly inconsistent with one’s duty of fidelity to the corporation to consciously cause the corporation to act unlawfully. The knowing use of illegal means to pursue profit for the corporation is director misconduct.

225. The American Law Institute’s 1994 Principles of Corporate Governance state that the de minimis principle applies here as elsewhere in the law. Similarly, there may be isolated cases in which it is widely understood that liability is properly viewed as a price of noncompliance. In general, knowing noncompliance by a corporation should be treated no differently than knowing noncompliance by a natural person.
1 AM. LAW INST., supra note 39, § 2.01 cmt. g.
226. See supra notes 113–136 and accompanying text.
board has a “responsibility to assure that appropriate information and
reporting systems are established by management” to ensure that the
company complies with the key regulatory regimes under which it
operates.\textsuperscript{228} In Stone, the Delaware Supreme Court confirmed that the
Caremark dicta is now the law of Delaware, holding that “Caremark articu-
lates the necessary conditions for assessing director oversight liability.”\textsuperscript{229}

1. Reinterpreting Caremark

In Stone, the Delaware Supreme Court described Caremark as a case
in which the operative standards are good faith and loyalty rather than
care, stating that

the Caremark standard for so-called “oversight” liability draws
heavily upon the concept of director failure to act in good faith.
That is consistent with the definition(s) of bad faith recently
approved by this Court in its recent Disney decision, where we held
that a failure to act in good faith requires conduct that is
qualitatively different from, and more culpable than, the conduct
giving rise to a violation of the fiduciary duty of care (i.e., gross
negligence). In Disney, we identified the following examples of
conduct that would establish a failure to act in good faith: . . . “where
the fiduciary intentionally fails to act in the face of a known duty
to act, demonstrating a conscious disregard for his duties.”\textsuperscript{230}

The court further explained that such an intentional failure “describes, and
is fully consistent with, the lack of good faith conduct that the Caremark
court held was a ‘necessary condition’ for director oversight liability.”\textsuperscript{231}

In finally adopting Caremark, however, the Delaware Supreme Court
radically reinterpreted that decision. To be sure, there are several refer-
ces to good faith in Caremark, the most notable of which is Allen’s
statement that “only a sustained or systematic failure of the board to
exercise oversight—such as an utter failure to attempt to assure a reason-
able information and reporting system exists—will establish the lack of
good faith that is a necessary condition to liability.”\textsuperscript{232} Nevertheless, even

\textsuperscript{228} Id. at 969–70.
\textsuperscript{230} Id. at 369 (quoting In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006)).
\textsuperscript{231} Id.
\textsuperscript{232} Caremark, 698 A.2d at 971.
the most cursory reading of Caremark demonstrates that Allen viewed oversight liability as a species of the duty of care:

- “The complaint charges the director defendants with breach of their duty of attention or care in connection with the on-going operation of the corporation’s business.”
- “[There are] good policy reasons why it is so difficult to charge directors with responsibility for corporate losses for an alleged breach of care, where there is no conflict of interest or no facts suggesting suspect motivation involved . . . .”
- “Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts.”
- “What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director’s duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed.”
- “[T]he core element of any corporate law duty of care inquiry” is “whether there was good faith effort to be informed and exercise judgment.”
- “I now turn to an analysis of the claims asserted with this concept of the directors duty of care, as a duty satisfied in part by assurance of adequate information flows to the board, in mind.”
- “In order to show that the Caremark directors breached their duty of care by failing adequately to control Caremark’s employees, plaintiffs would have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of . . . .”

233. Id. at 967 (emphasis added).
234. Id. (emphasis added).
235. Id. (emphasis added).
236. Id. (emphasis added) (emphasis omitted) (footnote omitted). Notice, by the way, how Disney’s decision to give good faith substantive content departs from Allen’s emphasis on process. Likewise, the decision to do so flies in the face of Brehm’s command that “substantive due care” is a concept “foreign to the business judgment rule. . . . Due care in the decisionmaking context is process due care only.” Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).
237. Caremark, 698 A.2d at 968 (emphasis added).
238. Id. at 970 (emphasis added).
239. Id. at 971 (emphasis added).
In light of these passages, especially when read in their full context, it is clear that the Caremark duties arise out of the duty of care. Indeed, Allen explicitly distinguished a board’s failure to monitor proactively corporate performance from charges of self-dealing and “loyalty type problems arising from cases of suspect director motivation.”

To now subsume the Caremark duties into good faith and, thereby, the duty of loyalty is thus simply shoddy.

Why did the Delaware Supreme Court so brazenly misinterpret Caremark? One possibility is that the court was seeking to limit the potential liability exposure of corporate directors. By focusing on the duty of care, Caremark permits imposition of liability where directors are grossly negligent in exercising their oversight responsibilities. In contrast, Stone imposes a higher state of mind requirement by holding that “imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”

On the other hand, this is another case in which section 102(b)(7) seems to be driving the analysis. By subsuming Caremark into good faith, the court makes a violation of the Caremark duties nonexcusable. Hence, there is the potential for Stone to expand the scope of director liability.

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240. Id. at 967.
241. There was no pressing doctrinal need to create a new analytical category for such conduct as “conscious disregard of a known duty,” which could have been analyzed under the existing duty of care. By way of analogy, in tort law, willful and wanton conduct is treated as a species of negligence. KEeton et al., supra note 221, at 212. In other words, such conduct is a violation of the tort law duty of care.

Similarly, in the punitive damage context, courts sometimes use the term “gross negligence” to refer to “conduct that is sufficiently outrageous to support an inference of conscious disregard of a duty.” Mary Jane Morrison, Getting a Rule Right and Writing a Wrong Rule: The IRS Demands a Return on All Punitive Damages, 17 CONN. L. REV. 39, 62 (1984). Of course, gross negligence is the Delaware standard for duty of care in corporate law. See supra note 103.

As a final example, in insurance law, to show that the insurer acted in bad faith, one must show that the insurer’s actions were “willful, wanton and in conscious disregard of [its] duty to pay plaintiff’s insurance claim.” Von Hagel v. Blue Cross & Blue Shield, 370 S.E.2d 695, 699 (N.C. Ct. App. 1988). Note again how conscious disregard of duty is linked to willful and wanton conduct rather than personal benefit.

All of these examples show that the conduct at issue in Caremark properly could have been analyzed under the existing duty of care doctrines. There was no doctrinal need to reinvent those duties as a species of good faith or to subsume them into the ill-fitting duty of loyalty.

244. See supra Part III.A.3.a (discussing the role of section 102(b)(7) in the evolution of the good faith doctrine).
The process of common law adjudication is one of creative destruction. Courts constantly rethink and rework the law. When a court changes the law by overturning prior precedent, however, it ought to do so clearly and for a good reason that is well stated. Unfortunately, Stone’s reinterpretation of Caremark failed both to advance a convincing explanation for why seemingly well-settled doctrine should be overturned and to set forth clearly the new rules of the game.  

2. Applying Stone  

There are four basic scenarios in which the duties created by Caremark and modified by Stone come into play. First, the board of directors adopts a compliance program that prevents violations. Here, of course, all is well. Second, the board of directors adopts a compliance program that fails to prevent violations. Here, under Stone, liability would arise only if the board “consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”

245. Admittedly, there had been pre-Stone signals in the case law suggesting that a convergence of good faith, loyalty, and oversight might be impending. In Disney, for example, Chancellor Chandler cited an influential article by Lyman Johnson situating noncare breaches of good faith in the loyalty domain:

It is precisely in this context—an imperial CEO or controlling shareholder with a supine or passive board—that the concept of good faith may prove highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect. In a thoughtful article, Professor Lyman Johnson has written about the richer historical and literary understanding of loyalty and care, beyond their more narrow “non-betrayal” and “process” uses in contemporary jurisprudence. Professor Johnson’s description of a more expansive duty of loyalty to encompass affirmative attention and devotion may, in my opinion, fit comfortably within the concept of good faith (or vice versa) as a constituent element of the overarching concept of faithfulness.

In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 760 n.487 (Del. Ch. 2005) (citing Lyman P.Q. Johnson, After Enron: Remembering Loyalty Discourse in Corporate Law, 28 DEL. J. CORP. LAW 27 (2003)). Likewise, in Gutman v. Huang, 823 A.2d 492 (Del. Ch. 2003), Vice Chancellor Strine indicated that “there is no case in which a director can act in subjective bad faith towards the corporation and act loyally.” Id. at 506 n.34. For the reasons set forth in this Article, however, we believe that these cases suffer from the same problems as Stone.

246. Stone, 911 A.2d at 370. Here, liability likely will arise only where there are alleged “red flags” that are “either waived [sic] in one’s face or displayed so that they are visible to the careful observer.” Rattner v. Bidzos, No. CIV.A.19700, 2003 WL 22284323,
Third, the board of directors may have simply been unaware of the need for a compliance program. Fourth, the board of directors may have considered adopting a compliance program but opted not to do so. These latter scenarios are more interesting for our purposes, because they require examination of the ambiguities in the Stone approach.

a. The Board Asleep at the Switch

As originally understood, Caremark was a case about whether “unconsidered inaction” on the part of the board of directors gives rise to liability. Allen concluded that “liability to the corporation for a loss” could indeed “arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.” Apropos of the earlier discussion of causation, however, he qualified the scope of liability by suggesting that “[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause, since, for reasons that I take to be obvious, it could never be assumed that an adequate information system would be a system that would prevent all losses.”

The paradigm case for director liability under Caremark thus would seem to be a board that over a sustained period of time simply failed even to consider whether a compliance program was necessary. One would need to show that the board’s failure to do so amounted to gross negligence. One would also need to show causation. If one carried out the four-pronged standard established by Caremark, which encompasses these two principal components, however, a board that was asleep at the switch for an extended period of time could be held liable.

As suggested by the dog bite analogy advanced above, liability in this situation is perfectly appropriate. A dog owner who knows or should know that his animal is dangerous, yet fails even to consider the most basic of precautions, should face liability. Such a rule sends a signal to dog owners to evaluate whether their animal has a sufficiently vicious personality as to suggest a propensity to bite. For precisely the same reason,

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248. Id. at 967 (emphasis omitted).
249. Id. at 970 n.27.
250. See supra text accompanying note 242.
251. See supra text accompanying note 239.
252. See supra text accompanying notes 109–110.
a board of directors that fails even to evaluate the trustworthiness of its employees should face liability.

Yet, the Stone court arguably would allow such a board to escape liability. To be sure, the court stated that liability would arise where, inter alia, the board “utterly failed to implement any reporting or information system or controls.” The court immediately qualified that statement, however, by requiring “a showing that the directors knew that they were not discharging their fiduciary obligations.” The court then referred to a failure to “act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities.” Again, there is the implication that a clueless board that just drifted along for years with unconsidered inaction will escape liability. Perhaps ignorance really is bliss.

This analysis reveals one set of ambiguities inherent in Stone. It seems absurd that directors asleep at the compliance program switch should per se escape liability, although Stone plausibly can be read to reach that result. Conversely, however, it would be equally absurd to hold that directors who are asleep at the switch are per se acting in bad faith and are therefore liable without regard even to whether their failure to act caused harm to the corporation. Yet, because Stone’s approach to good faith creates precisely such rules, Stone lacks the flexibility this scenario requires. It would have been far preferable to retain Allen’s duty of care analysis, as outlined above, which permits a much more nuanced analysis.

b. The Board That Weighs Costs and Benefits

Suppose that the board of directors determined that the nature of the company’s business created a risk that company employees might violate a certain federal regulation. The board of directors met extensively with both internal and external advisors, including legal and other relevant experts. After carefully gathering and evaluating all “material information

254. Id. (emphasis added).
255. Id.
256. See supra text accompanying notes 232–239.
257. The hypothetical thus suggests the potential application of DGCL section 141(e), which provides that directors shall be “fully protected” when they properly rely on certain internal or external advisors. DEL. CODE ANN. tit. 8, § 141(e) (2001). The potential application of that defense to the problem at hand, however, is beyond the scope of this Article.
reasonably available” to them, the board concluded that the costs associated with creating and maintaining an effective compliance program outweighed the benefits such a program offered. Company employees subsequently violate the regulation, as a result of which the company is indicted and later convicted. The company is required to pay a substantial fine that has a materially adverse impact on its earnings.

Caremark made clear that boards have substantial discretion in designing compliance programs. Although Allen did not expressly address the somewhat different question of whether a board could opt not to have such a program, the logic of his opinion mandates an affirmative answer to that question. Recall that Allen identified two basic scenarios in which director liability arises. In the prior Subpart, we dealt with the case of unconsidered inaction. In this Subpart, we are concerned with the other scenario; that is, where the directors made an allegedly ill-advised decision. According to Allen, the business judgment rule will insulate that decision from judicial review “assuming the decision made was the product of a process that was either deliberately considered in good faith or was otherwise rational.” Allen went on to explain:

What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director’s duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational,” provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule—one that permitted an “objective” evaluation of the decision—would expose directors to substantive second guessing by

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258. Where a plaintiff can show that the board of directors was grossly negligent in failing to inform itself of all “material information reasonably available to [it],” the business judgment rule will not protect the decision. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).
259. In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (“Obviously the level of detail that is appropriate for such an information system is a question of business judgment.”).
260. See supra text accompanying note 127.
261. See supra Part III.B.2.a.
262. Caremark, 698 A.2d at 967 (emphasis omitted).
ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.263

Nothing in Allen’s decision suggests that these principles do not apply to a decision against adopting a compliance program. After all, a decision not to act does not differ from a decision to take action. Accordingly, the thrust of Allen’s opinion suggests that the business judgment rule ought to protect directors who rationally elect against adopting a compliance program after weighing the costs against the benefits.264

As was the case with our analysis of board decisions to cause the corporation to violate the law,265 this is another illustration of why the business judgment rule is properly understood as a rule of abstention rather than a standard of liability. Caremark establishes that directors have a duty to create law compliance programs.266 In appropriate cases, however, the business judgment rule will preclude courts from reviewing a board decision not to do so.

Notice the analogy thus suggested to judicial review of disinterested director approval of a conflicted interest transaction. As we saw earlier, even in cases implicating loyalty claims, Delaware corporate law places great emphasis on deference to director decisions. Under DGCL section 144(a), approval by a majority of fully informed and disinterested directors effectively immunizes a related-party transaction from meaningful judicial review.267 Per Puma v. Marriott,268 approval by disinterested directors invokes the business judgment rule as the standard of review for conflicted-interest transactions.269 Likewise, in Marciano v. Nakash,270 the Delaware Supreme Court held that “approval by fully-informed disinterested directors

263. Id. at 967–68 (emphasis omitted) (footnotes omitted).
265. See supra Part III.A.3.b. Apropos of that discussion, if the board has discretion to violate the law in appropriate cases, it would follow a fortiori that the board has discretion in appropriate cases to not adopt programs intended to promote law compliance.
266. See supra text accompanying note 11.
267. See supra note 48.
268. 283 A.2d 693 (Del. Ch. 1971).
269. In Puma v. Marriott, the five disinterested directors of Marriott Corporation unanimously approved the purchase of six other companies owned by the majority shareholder of Marriott Corporation, the Marriott family. Id. at 694. In light of their approval, the court applied the business judgment rule to the self-interested transaction. Id. at 696.
270. 535 A.2d 400 (Del. 1987).
under section 144(a)(1) . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction. If fully informed and disinterested directors thus receive the benefit of the business judgment rule even when passing on a transaction involving a colleague with a conflict of interest, thereby insulating a transaction potentially involving self-dealing from judicial review, there is no obvious reason that a decision by fully informed and disinterested directors that the costs of a compliance program outweigh the benefits should not also receive such protection.

Under Stone, however, it seems possible that a conscious decision by a board of directors that the costs of a law compliance program outweigh the benefits no longer will be protected by the business judgment rule. Instead of Allen’s focus on process, the new standard of good faith focuses on the substantive merits of a board’s decision. As already noted, this is a significant departure that threatens to tilt the balance between authority and accountability substantially toward the latter.

The Stone court stated that “[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.” Caremark created the requisite known duty to act, by imposing “a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists.” Worse yet, by defining such a failure as bad faith, Stone made liability arising in connection with such a decision nonexculpable. In addition, for the reasons discussed above, liability would appear to be per se and no causation would need to be shown.

In a post-Stone decision, Vice Chancellor Strine rejected this concern:

I do not read Stone as undercuts the discretion given to corporations to address law compliance in a manner that takes into account the precise circumstances facing the corporation. Rather, I read it as reaffirming the protection given by Caremark to directors who make good faith judgments about how their corporations should

271. Id. at 405 n.3.
272. See supra note 236 (discussing how the definition of good faith is inconsistent with prior Delaware precedent emphasizing that courts do review the merits of most board decisions).
275. See supra notes 167–184 and accompanying text.
address law compliance, approaches that will obviously vary because of the different circumstances corporations confront.\textsuperscript{276} Although this is reassuring, the basis for Strine's reading is unclear. Perhaps Strine read the phrase “known duty to act” as being limited to situations in which positive law affirmatively mandates compliance programs, such as the compliance programs required of certain financial institutions by the USA Patriot Act.\textsuperscript{277} Under this reading, the \textit{Caremark} obligation does not give rise to the requisite duty. Yet, nothing in \textit{Stone} compels this result. Allen’s application of the business judgment rule, moreover, would have led to this result far more effectively.

\textbf{CONCLUSION}

\textit{Stone} likely will prove to be one of the most consequential decisions in recent corporate law jurisprudence. It addressed long open questions in two important areas of the law. Unfortunately, while the Delaware Supreme Court seemingly set out to solve some doctrinal puzzles, in doing so it made things worse in many respects.

As for the concept of good faith, the extent to which it exposes directors to new sources of liability remains unresolved. Because categorizing conduct as bad faith seemingly results in per se liability, unconstrained by questions of causation, which is nonexculpable under section 102(b)(7), this uncertainty is quite troubling. As we have seen, Delaware law properly strives to create a balance between holding directors accountable and allowing directors managerial authority to operate the corporation as they see fit. The uncertain extent to which a good faith requirement tips that balance toward accountability may chill directors from taking risks.

As to oversight liability, in \textit{Caremark}, Chancellor Allen recognized the need to balance authority and accountability, observing that a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.\textsuperscript{278}

Curiously, however, the \textit{Stone} decision arguably gets that balance wrong in two distinct respects. First, a conscious decision by the board of directors

\begin{itemize}
\item \textsuperscript{276} Desimone v. Barrows, 924 A.2d 908, 935 n.95 (Del. Ch. 2007).
\item \textsuperscript{277} 31 U.S.C. § 5318(h) (2003).
\item \textsuperscript{278} \textit{Caremark}, 698 A.2d at 971 (emphasis omitted).
\end{itemize}
that the costs of a law compliance program outweigh the benefits may no longer be protected by the business judgment rule. To the contrary, such a decision might result in per se liability. Second, and even more curiously, by requiring “a showing that the directors knew that they were not discharging their fiduciary obligations,” the Stone court arguably disallows director liability in the paradigm case in which a board over a sustained period of time simply failed to even consider whether a law compliance program was necessary.

The convergence of good faith and oversight thus is one of those unfortunate marriages that leaves both sides worse off. New and unnecessary doctrinal uncertainties have been created. As a result, Stone is unlikely to be Delaware's last word.