MAKING SENSE OF GOOD FAITH
IN DELAWARE CORPORATE FIDUCIARY LAW:
A CONTRACTARIAN APPROACH

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ABSTRACT

Following the Delaware Supreme Court's momentous decision imposing a strict negligence standard on corporate directors in Smith v. Van Gorkom in 1985, the Delaware legislature passed Section 102(b)(7) of the state's General Corporation Law, allowing corporations to limit director liability for breach of fiduciary duty, but specifically not for breaches of the duties of loyalty or good faith. In the years since the statute was passed, Delaware courts have offered inconsistent definitions of these terms. While the supreme court has held that fiduciary duty consists of a "triad" of loyalty, care, and good faith, the court of chancery has repeatedly held that good faith is merely a "subsidiary" of loyalty and not a separate duty.

Because Delaware is the most contractarian jurisdiction (i.e., willing to allow parties to business organizations to craft the limits of their obligations), it is appropriate to inquire whether Delaware courts should interpret good faith in the corporate context in the same way that they use that term in the contractual context. Approaching the inconsistency from this perspective reveals that the director's duty of good faith encompasses both the duties of loyalty and care. Even in the corporate context, courts should use the term "good faith" to determine whether directors knowingly complied with the obligations (among them, loyalty and care) to which they willingly submitted themselves when they became corporate directors. By viewing good faith in this way, we can reconcile the competing language used by the supreme court, the court of chancery, and Section 102(b)(7).

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I leave it to the [Delaware] Supreme Court and to the academic community to distinguish the fiduciary duties of loyalty and "good faith."\(^1\)

I. INTRODUCTION

In the wake of the recent scandals involving apparent bad faith conduct by the leaders of American corporations, the legal basis for the fiduciary duties of corporate directors requires close examination. Clarification of the law governing the actions and liability of corporate directors will go a long way to restoring the public's confidence in America's business leaders. Because half of all large corporations in the United States are governed by Delaware law,\(^2\) commentators will doubtless look to the courts of Delaware for guidance. Delaware courts, however, currently offer no coherent framework for understanding the most fundamental duties imposed on corporate directors.

Over the last twenty years, many academics,\(^3\) legislatures,\(^4\) and

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\(^3\)The clearest explanations of this point of view in the corporate context are Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J.L. & Econ. 425 (1993); and Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 Wash. L. Rev. 1 (1990). Of course, the debate over modification or waiver of fiduciary duties extends far beyond corporations. Numerous other business organizations and legally recognized relationships carry with them fiduciary duties that many scholars and legislatures believe ought to be subject to elimination or modification. The Delaware Revised Uniform Limited Partnership Act, for example, allows the parties to a limited partnership to modify the statutory fiduciary duty of the general partners. David Rosenberg, Venture Capital Limited Partnerships: A Study in Freedom of Contract, 2002 Colum. Bus. L. Rev. 363. Some scholars have suggested that the arguments in favor of allowing the modification of fiduciary duties in other business entities are equally applicable to corporations. See, e.g., Larry E. Ribstein, Unlimited Contracting in the Delaware Limited Partnership and its Implications for Corporate Law, 17 J. Corp. L. 299 (1991).

\(^4\)Through the passage of such legislation as Section 102(b)(7), Delaware took the lead in allowing corporations to eliminate liability for some of the duties traditionally imposed on corporate directors. Del. Code Ann. tit. 8, § 102(b)(7) (2001). A majority of other states have adopted legislation similar to Section 102(b)(7). Eric Talley, Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine, 108 Yale L.J. 277, 287 n.20 (1998). Because of such laws, and the willingness of its courts to enforce them, Delaware is regarded as the state that comes closest to the model favored by contractarians. Mark J. Roe, Can Culture Constrain the Economic Model of Corporate Law, 69 U. Chi. L. Rev. 1251, 1252 (2002).
judges\textsuperscript{5} have adopted the view that the corporation is a collection of contractual relationships\textsuperscript{6} and that the duties imposed on the various parties in a corporation are largely indistinguishable from traditional contractual obligations. They contend, for example, that there is nothing special about corporate fiduciary duties that makes them different from other obligations to which people voluntarily agree to subject themselves through contract.\textsuperscript{7} The relationship between corporate directors and stockholders can be viewed, then, essentially as a contract, the terms of which may be crafted according to the parties' own understanding of what the market will bear.\textsuperscript{8} Most adherents to this line of thinking—let's call it the contractual view or contractarianism—further believe that the law should impose as few mandatory duties as possible on the parties to these relationships and that it should simply let market forces dictate the price and popularity of shares of the corporation in question. Opponents of this point of view believe that fiduciary duties originate from the unique ethical and moral implications of relationships in which one party entrusts his wealth or property to another. Further, they believe that the law must make these obligations unwaivable to protect potential victims from the misuse of the extraordinary degree of power entrusted to corporate directors.

Despite the vast disagreement on the origin and necessity of fiduciary duties, scholars, lawyers, judges, legislators, and businessmen generally agree about what obligations traditional fiduciary duties impose on corporate directors: they impose the dual duties of loyalty and care.\textsuperscript{9}

\textsuperscript{5}To the extent that judges are willing to enforce the terms of contracts that waive or modify traditional fiduciary duties, those judges could be described as contractarian. Of course, two of the leading contractarian scholars are themselves judges, Frank Easterbrook and Richard Posner of the United States Court of Appeals for the Seventh Circuit, although this view is not always reflected in their judicial opinions. See, e.g., Butler & Ribstein, supra note 3, at 30 n.129 (pointing out that Easterbrook took an apparently anti-contractarian position to resolve a case, while his colleague on the court, Posner, stuck to a contractual point of view).

\textsuperscript{6}This view is summarized nicely as "a three-player contract among shareholders, managers, and the board." Mark J. Roe, Can Culture Constrain the Economic Model of Corporate Law?, 69 U. CHI. L. REV. 1251, 1251 (2002).

\textsuperscript{7}This view is best exemplified by Easterbrook and Fischel's dictum that "[f]iduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings." Easterbrook & Fischel, supra note 3, at 427.

\textsuperscript{8}The value of shares in any corporation, public or private, will reflect the market's reaction to the terms of the corporation's charter. Companies that provide too much freedom for directors will presumably suffer in the market. Companies that take strategic advantage of Delaware's (or another state's) permissive laws regarding exculpation of directors will presumably benefit.

\textsuperscript{9}Easterbrook & Fischel, supra note 3, at 426 ("[T]he agent assumes a duty of loyalty in pursuit of the objective and a duty of care in performance."). The authors acknowledge, of course, that simply identifying the terms that we use for fiduciary duty begs the question: "This is the
While we know what these terms mean generally, we cannot say without the help of a judge what they mean in the context of complex relationships involving unprecedented facts. Fiduciary duties are, to contractarians, gap fillers; methods that people use because they cannot possibly describe every obligation they are demanding from other people. Once we are viewing the fiduciary duties of loyalty and care as simply terms of a contract, then we must have devices to interpret those terms. One such device is "good faith." When applied to a contract, good faith connotes taking action that conforms to the spirit of the contract, even if a literal interpretation of the contract would allow for a different course of action. As such, good faith in the contractual context is an interpretive device used by courts to decide whether a party has deliberately violated the obligations (both explicit and implicit) conferred by the contract. It makes sense then, to a contractarian, to analyze a corporate director's adherence to his fiduciary duties by asking whether the director acted in good faith with regard to the duties imposed on him.

To traditional scholars of corporate law, fiduciary duties are mandatory constraints, the existence of which is necessary to curtail the possibility of abuse by directors. This point of view does not ask what the parties' understanding of their obligations was because it assumes that parties to corporate relationships all have—and ought to have—the same basic fiduciary obligations under law. Thus, use of the term good faith in the contractual sense seems misplaced in traditional corporate fiduciary jurisprudence.

'Tiduciary' package, but it is still empty. What do terms such as 'duty of loyalty' mean?" Id. Other, less ideological commentators, have used similar language: "Corporate case law frequently centers on the fiduciary duties of loyalty and care that corporate directors and officers are said to owe the firm and its shareholders . . . Yet what does it mean to owe a fiduciary duty?" Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. Pa. L. Rev. 1735, 1780-81 (2001). At least one important commentator limited his theoretical discussion of fiduciary duties to include only the duty of loyalty because the duty of care of fiduciaries is not necessarily different from the duty of care of those in purely contractual relationships, while the duty of loyalty is, in his opinion, fundamentally different in the fiduciary context because the nature of the opportunity for disloyalty is different. D. Gordon Smith, The Critical Resource Theory of Fiduciary Duty, 55 Vand. L. Rev. 1399, 1409 (2003). Smith is right for the most part, but in the meantime we are stuck with courts and legislatures who regularly define fiduciary duty to include both those components, and as we will see, sometimes conflate them.

The point is that, in the contractarian model, fiduciary duties stand for terms that the parties would have bargained for if they had the time and foresight: "The duty of loyalty replaces detailed contractual terms, and courts flesh out the duty of loyalty by prescribing the actions the parties themselves would have preferred if bargaining were cheap and all promises fully enforced." Easterbrook & Fischel, supra note 3, at 427.

Matthew G. Doré, The Duties and Liabilities of an Iowa Corporate Director, 50 Drake L. Rev. 207, 212 (2002).
Nonetheless, good faith has been part of fiduciary duty law well before the contractarians got into the business. For example, the business judgment rule requires that, before inquiring whether a director has breached his fiduciary duty toward a corporation, a court must presume "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 interest of the company." The business judgment rule requires the court to presume that the director acted with good faith regarding what he believed his obligations were as a director; that is, with good faith regarding his fiduciary duties and any other duties imposed on him by law or by the corporation's own rules.

Since the passage of Section 102(b)(7) of the Delaware General Corporation Law and its adoption in most other states, courts interpreting corporate charters in which the scope of fiduciary duty has been modified must continually adapt their own jurisprudence to take into account the trend towards treating such duties as contractual obligations. Because fiduciary duties and contractual obligations have, until recently, existed in separate areas of the law, it is not surprising that courts have struggled to define the precise nature of fiduciary duties once the extent of those duties becomes modifiable. This struggle is particularly apparent in the courts of Delaware, the state of majority incorporation. The Delaware Supreme Court has defined corporate fiduciary duty to consist of a "triad" of duties: loyalty, good faith and care. The Delaware Court of Chancery, which hears cases involving breaches of corporate duty, has recently chosen not to follow (and indeed to call into question) the supreme court's formulation, and has described good faith as a "subsidiary" of loyalty. The Delaware legislature seems to entertain a different definition altogether. This article will examine the current confusion in Delaware courts regarding the definition of good faith in the context of a corporate director's fiduciary duties. Using a contractarian approach to understand the relationship among parties in a corporation, it will attempt to clarify the meaning of

14Delaware has a justified reputation as a contractarian state. The Delaware Revised Uniform Limited Partnership Act, for example, allows the parties to a limited partnership agreement to expand or restrict the default duties, including fiduciary duties, imposed by law. Delaware courts routinely uphold modification of fiduciary duties in limited partnerships but appear unwilling to go so far as to allow their complete waiver. See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167-68 (Del. 2002).
15Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) [hereinafter Cede II]. A "triad" is defined as a "group of three." AMERICAN HERITAGE DICTIONARY 1908 (3d ed. 1992). There is no implication of a hierarchy among the three.

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good faith and loyalty and offer a more coherent analysis of corporate directors' adherence to their fiduciary obligations.

II. THE CONFUSION IN DELAWARE COURTS: IS GOOD FAITH A DISTINCT FIDUCIARY DUTY?

Delaware courts have long struggled with formulating a definition of fiduciary duties that is consistent with Delaware statutory and case law. Even now, however, after decades of litigation, Delaware courts still provide a confusing and inconsistent definition of the fiduciary obligations of corporate directors. This confusion is widely acknowledged both by academic commentators and Delaware courts themselves.\(^\text{16}\)

The modern history of Delaware corporate fiduciary jurisprudence begins with Aronson v. Lewis\(^\text{17}\) in which the Delaware Supreme Court stated its definition of the business judgment rule. The court defined the business judgment rule as a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."\(^\text{18}\) In order to rebut this presumption, the plaintiff must present evidence that the defendant did not act in accordance with those requirements. Importantly, regarding the degree to which corporate directors must make themselves "informed," Aronson said that directors will be held to a standard of "gross negligence."\(^\text{19}\)

The following year, the Delaware Supreme Court sent shockwaves through boardrooms and law offices across the country.\(^\text{20}\) In Smith v. Van Gorkom, the court held outside directors liable for an uninformed judgment, which, to the minds of most lawyers and business people, fell far

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\(^\text{16}\) In 1994, Cunningham and Yablon wrote of the lack of coherence and the "doctrinal fragmentation" of Delaware corporate fiduciary law. Lawrence A. Cunningham & Charles M. Yablon, Delaware Fiduciary Duty Law After QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?), 49 BUS. LAW. 1593, 1594-96 (1994). The authors predicted that two Delaware Supreme Court cases would signal a "trend toward a more unified conception of fiduciary law." Id. at 1596. See also Jackson Nat'l Life Ins. Co. v. Kennedy, 741 A.2d 377, 388 n.18 (Del. Ch. 1999) (citing Malone v. Brincat, 722 A.2d 5 (Del. 1998), and abrogating the task of distinguishing the fiduciary duties of loyalty and good faith).

\(^\text{17}\) 473 A.2d 805 (Del. 1984).

\(^\text{18}\) Id. at 812. The language of Aronson ("informed basis," "good faith," "best interests of the company") appears to signal the "triad" (care, good faith, and loyalty) laid out by subsequent courts and Section 102(b)(7), respectively.

\(^\text{19}\) Id.

\(^\text{20}\) Typical of the contemporary reaction to the decision was, "The Delaware Supreme Court in Van Gorkom exploded a bomb." Bayless Manning, Reflections and Practical Tips on Life in the Boardroom After Van Gorkom, 41 BUS. LAW. 1 (1985).
short of Aronson's standard of "gross negligence" and which appeared to better fit the definition of "ordinary negligence." This decision plainly did not sit well with the thousands of directors sitting on the boards of Delaware corporations because the lower standard of ordinary negligence would have left them open to potentially crippling lawsuits by shareholders eager to litigate at the slightest opportunity.

Delaware did not become the center of American corporate law by ignoring the needs and worries of corporate directors. In the wake of Smith v. Van Gorkom, the Delaware legislature passed Section 102(b)(7) of the Delaware General Corporation Law, which allows corporations and their shareholders to voluntarily limit the liability of corporate directors for certain breaches of duty. Specifically, the statute allows corporate charters to exempt directors from personal liability for breach of fiduciary duty as long as the provision does not eliminate or limit the director's liability: "(i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."

Since adoption of the statute, most Delaware corporations have amended their corporate charters to shield their directors from liability wherever possible. Superficially, the statute appears to do nothing to change the definitions of loyalty, care, or good faith under Delaware law, however ambiguous those terms might already have been. The standard remains the one laid out in Aronson. Rather than change that standard, Section 102(b)(7) simply permits incorporators more freedom of contract than was earlier allowed. Instead of having no option but to impose liability on directors for breaches of unwaivable fiduciary duties, corporate charters could now exempt directors from liability for such breaches as long they


22How it did get to be the center of American corporate jurisprudence is still a hotly debated topic. For a recent contribution, see Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. REV. 1559, 1560-61 (2002).


25A plain reading of the law suggests that the legislature understood that a director could breach his duty of loyalty while still acting in good faith or that a director could act in bad faith in a way that does not necessarily implicate his duty of loyalty. Nothing in the statute implies that a breach of loyalty must necessarily include a breach of good faith or vice versa.

26Plaintiffs must show that directors did not act "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson, 473 A.2d at 812.
remained liable for any breach of loyalty or good faith. The courts have widely interpreted the rule to mean that directors are not liable for good faith breaches of the duty of care.\textsuperscript{27} Further, Section 102(b)(7) also appears to allow exemption of directors from liability for other kinds of breaches of fiduciary obligations besides loyalty (whatever they might be—102(b)(7) does not say what they are) as long as those violations were made in good faith.

In the meantime, Delaware courts began to formulate definitions of fiduciary duty that broke away from the traditional bifurcation of loyalty and care that had long dominated both Delaware and American law. In\textit{ Cede & Co. v. Technicolor, Inc.}, the nebulous concept of good faith became a separate duty, apparently on equal footing with loyalty and care.\textsuperscript{28} The case addressed whether a board of directors' decision to approve a merger was protected by the business judgment rule. The Delaware Supreme Court redefined the component parts of directors' fiduciary duties by creating "the triads [sic] of their fiduciary duty: good faith, loyalty or due care."\textsuperscript{29} None of the three cases the court cites for this formulation used the term "triad," and all simply used the standard laid out in\textit{ Aronson}: That the directors "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."\textsuperscript{30} In establishing the triad, the court must have thought that it was simply clarifying\textit{ Aronson}'s somewhat hazy formulation by laying out in clear language the rule that

\textsuperscript{27}O'Reilly v. Transworld Healthcare, Inc., 745 A.2d 902, 914 (Del. Ch. 1999) ("It is settled that 8 Del. C. [section] 102(b)(7) . . . and provisions tracking its language exculpate directors from liability where the factual basis for a claim for breach of fiduciary duty against the directors solely implicates a violation of the duty of care made in good faith."). The Delaware Supreme Court has held that Section 102(b)(7) allows for exculpation of a fairly narrow range of behavior: "only an unambiguous, residual due care claim and nothing else." Malpiede v. Townson, 780 A.2d 1075, 1094 (Del. 2001). Breaches of the duties of loyalty and good faith cover the range of action that could not be exempted from liability by Section 102(b)(7) under a literal reading of the statute.

\textsuperscript{28}See 634 A.2d 345 (Del. 1993).

\textsuperscript{29}Id. at 361. At least one later court suggests that the triad arose because Section 102(b)(7) "appear[s] to depict 'breach[e]s of the director's duty of loyalty' and 'acts or omissions not in good faith' as separate categories of conduct." Emerald Partners v. Berlin, No. 9700, 2001 Del. Ch. LEXIS 20, at *87 n.63 (Del. Ch. Feb. 7, 2001). \textit{Cede I} does not mention 102(b)(7) as the source of the triad though. In fact, the incident in question in \textit{Cede I} predated passage of Section 102(b)(7). See William T. Allen et al., Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem, 96 NW. U. L. REV. 449, 463 n.45 (2002). It is possible, though, that the court in \textit{Cede I} was influenced by the recent enactment of the law and its apparent elevation of good faith, although the court does not say so.

\textsuperscript{30}Aronson, 473 A.2d at 812.
corporate directors have three separate duties. The case does not address the issues of overlap or over-inclusiveness among these three duties, nor does it attempt to provide any substance to the content of the duty of good faith. Indeed, *Cede II* discusses the duty of loyalty and duty of care claims separately with hardly a mention of the good faith element of the triad as a separate duty. The inclusion of good faith in the triad of fiduciary duties was not pivotal to the disposition of the case because the appellant did not raise the issue of good faith. Adding further confusion to its new formulation, the court quoted, without full explanation, its earlier opinion in *Barkan v. Amsted Industries, Inc.*, in which it clearly equated good faith with loyalty.

Rather than clarifying the rigid and seemingly contradictory triad laid out in *Cede II*, a subsequent Delaware Supreme Court opinion reinforced it in almost Cardozian language in *Malone v. Brincat*:

The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That triparte fiduciary duty does not operate intermittently but is the constant compass by which all director actions for the corporation and interactions with its shareholders must be guided.

In *Malone*, the court addressed the question of whether the directors' fiduciary duties include the duty to deal honestly with their stockholders.

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31The court does, for example, interpret *Aronson*'s language to be a clear definition of the duty of care: "The duty of the directors of a company to act on an informed basis, as that term has been defined by this Court numerous times, forms the duty of care element of the business judgment rule." *Cede II*, 634 A.2d at 367 (emphasis added). But in the next sentence, the court seems to forget the three elements of the "triad": "Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders. Each of these duties is of equal and independent significance." *Id.* (citation omitted).

32But, the opinion does seem to take good faith into account in its analysis of the duty of care claim:

Applying the [business judgment] rule, a trial court will not find a board to have breached its duty of care unless the directors individually and the board collectively have failed to inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company. *Id.* at 368 (emphasis added).

3367 A.2d 1279 (Del. 1989).

34See *id.* at 368 n.36. Lower courts have not ignored this contradiction. *See infra* text and accompanying notes 38-64.

 Asserting that the "duty of directors to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty and good faith," the court rather unhelpfully noted that "[d]issemination of false information could violate one or more of those duties." 36 The decision provided little guidance on the content of a separate duty of good faith.

Subsequent Delaware Court of Chancery cases have not only failed to follow the supreme court's triad, they have called into question its usefulness. In In re Gaylord Container Corp. Shareholders Litigation, 37 a case involving directors' use of a "poison pill" defense against a corporate takeover, Vice Chancellor Leo E. Strine pointed out the inherent contradictions in the Cede II opinion. The lower court noted that, while Cede II breaks fiduciary duties into a triad, it also plainly equates loyalty with good faith elsewhere in the same opinion. 38 In overtly rejecting the triad, the court said that, in earlier opinions, the supreme court's use of "good faith" was simply a "fresh way of referring to the 'fundamental duties of care and loyalty.'" 39 In returning to the more traditional formulation of fiduciary duties as a duality of care and loyalty, the court explained its view on the proper place of "good faith": within the duty of loyalty "would logically rest the subsidiary requirement to act in good, rather than bad, faith toward the company and its stockholders." 40 Because the decision in Gaylord hinged on an interpretation of the reasonableness 41 of a poison pill defense to a hostile takeover, the court did not need to explain further how good faith functions as a subsidiary of loyalty. But the court acknowledges that had the plaintiff been able to show bad faith, this would have been persuasive evidence of disloyalty and would have "fatally undercut" the board's ability to show that its poison pill was reasonable under the existing standard. 42

While the Delaware Supreme Court has continued to return to its "triad" formulation, 43 the court of chancery seems to favor Cede II's

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36 Id. 11-12.
37 753 A.2d 462 (Del. Ch. 2000).
38 Id. at 476 n.41 ("Indeed, the very Supreme Court opinion that refers to a board's 'triads [sic] of fiduciary duty [sic]—good faith, loyalty [and] due care,' Cede II, equates good faith with loyalty.")
39 Id.
40 Id. at 475 n.41 (emphasis added).
41 That is the standard set out by the supreme court to judge the validity of defensive measures taken by corporate directors to prevent hostile takeovers. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).
42 Gaylord, 753 A.2d at 476.
definition of good faith as a subsidiary or subset of loyalty. In both *Emerald Partners v. Berlin*44 (one of many rulings in a much litigated and appealed dispute) and *Orman v. Cullman,*45 Vice Chancellor Jacobs and Chancellor Chandler noted their preference for the subsidiary view and wrote opinions that attempted to explain why that view makes more sense. In both cases, the court essentially ruled that its resolution of the issue of breach of loyalty is sufficient to resolve a plaintiff's argument of bad faith as well. In both opinions the court noted, in language plainly critical of the supreme court's "triad," that good faith is really just a subsidiary of loyalty.

In *Emerald Partners,* Vice Chancellor (now Justice) Jacobs ruled against plaintiff shareholders who had claimed that defendant directors had violated their fiduciary duties by approving a merger that was, according to the plaintiffs, unfair to minority shareholders. Vice Chancellor Jacobs disposed of the breach of the duty of loyalty claim by noting that the directors "honestly believed that the merger was in the best interests" of stockholders.46 If they were wrong in that honest belief, then, the court points out, that might implicate the directors' duty of care, a claim for which, as Section 102(b)(7) permits, they would have been exculpated.47

This left the court to review plaintiff's final claim: that the directors acted in bad faith.48 Plaintiff claimed, among other things, that "defendants' conduct was 'sufficiently lacking in rational business basis as to lack good faith.'"49 In rejecting the claim, the court cited *Gaylord* and notes:

> Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty. Rather, it is a subset or "subsidiary requirement" that is subsumed within the duty of loyalty, as distinguished from being a

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45794 A.2d 5 (Del. Ch. 2002).
46*Emerald Partners,* 2001 Del. Ch. LEXIS 20, at *81.
47Id. at *85. A paraphrase of *Emerald*'s logic might go as follows: A good faith failure to act loyally is no breach of the duty of loyalty. An action made in the good faith belief that it was in the best interests of the corporation may be a breach of the duty of care if the directors acted negligently in arriving at the conclusion that the action so benefitted the corporation.
48It appears in this case that plaintiff's lawyers were simply doing what lawyers do: trying every argument that might work based on a broad interpretation of the law. Because the Delaware Supreme Court had indicated that a duty of good faith exists separate from the duty of loyalty, it made sense to give the argument a try.
49Id. at *86.
compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care.  

Nonetheless, the court addressed the good faith claim separately because the corporation's articles of incorporation and Section 102(b)(7) discussed them separately. The court rejected the claim of a failure by the directors to act with a "rational business basis," by explaining that the directors could not have possibly survived the breach of loyalty claim if they had acted in bad faith or "any other pejorative state of mind." Therefore, according to the court, once a duty of loyalty claim has been disposed of, the duty of good faith claim has gone with it:

Accordingly, the "bad faith" argument reduces to the assertion that the non-affiliated directors' behavior was so lacking in business rationality that the only conclusion one can reach is that the defendants were acting in bad faith. To assert that, however, is merely to argue in a different form that the challenged decisions fell outside the boundary of conduct that is protected by the business judgment rule.

So, the court found no use for a duty of good faith because any violation of that duty would entail a violation of another duty, loyalty. The supreme court's triad appears here ready for the dustbin, at least as far as the court of chancery is concerned.

More recently, in Orman v. Cullman, the court of chancery disposed of a bad faith claim regarding a corporate merger by directly applying the logic of Emerald Partners. The court declined to address the good faith and loyalty claims separately because "good faith is merely a subset of a director's duty of loyalty, . . . [and] consideration of [plaintiff's] duty of loyalty allegations necessarily includes a consideration of whether the facts pled suggest the defendants did not act in good faith with regard to their duty of loyalty to the Company." This plainly suggests that the duty of good faith applies only to the duty of loyalty and is not applicable to the duty of care or to other duties that a director might have. As such, the court is treating good faith consistently with its own definition as "merely a

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50 Emerald Partners, 2001 Del. Ch. LEXIS 20, at *87 n.63.
51 Id. at *88-*89.
52 Id. at *89-*90.
53 Orman v. Cullman, 794 A.2d 5, 14 n.3 (Del. Ch. 2002).
54 Id.
subset of a director's duty of loyalty."\textsuperscript{55} In denying the defendant's motion to dismiss the fiduciary duty claim, the court simply held that the plaintiff pled facts which gave rise to a claim that the accused directors breached their duty of loyalty, a duty of which good faith is merely a subset. In \textit{Orman}, the court of chancery completely ignored the supreme court's triad, neither invoking nor criticizing that formulation.

In two nearly simultaneous opinions issued in spring 2003, Vice Chancellors Jacobs and Strine renewed the court of chancery's criticism of the triad in even starker terms than before. In the most recent iteration of the \textit{Emerald Partners} litigation, Vice Chancellor Jacobs attributed the blame for the confusion in Delaware courts regarding the elements of fiduciary duty "(in my view and the view of other members of this Court) to the way that Section 102(b)(7) \textsuperscript{(i)} was drafted."\textsuperscript{56} He explains:

\begin{quote}
The structure of Section 102(b)(7) balkanizes the fiduciary duty of loyalty into various fragments, thereby creating unnecessary conceptual confusion. For example, subsection (i) of Section 102(b)(7) excludes conduct violative of the "duty of loyalty" from exculpatory protection, but then goes on, in other subsections, to carve out conduct that amounts to different examples of quintessentially disloyal conduct.\textsuperscript{57}
\end{quote}

Section 102(b)(7)(i) specifically states that directors cannot be exculpated from liability for disloyal conduct even if the corporate charter so allows. The section also specifically states that directors cannot be exculpated from liability for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."\textsuperscript{58} As Vice Chancellor Jacobs explained, subsection 102(b)(7)(iv) prohibits exculpation from liability for transactions from which the director gains "an improper personal benefit," conduct that would clearly already violate subsection (i). Vice Chancellor Jacobs explained that the Delaware Supreme Court has confusingly interpreted Section 102(b)(7) as a whole to mean that loyalty and good faith are separate duties;\textsuperscript{59} hence the triad dividing fiduciary obligations into three duties (loyalty, good faith, and care) rather than two (loyalty and care).

\textsuperscript{55}Id.
\textsuperscript{57}Id.
\textsuperscript{59}Id. § 102(b)(7)(ii).
Less than one week later, in Gutman v. Huang, Vice Chancellor Strine expressed his utter dissatisfaction with the supreme court's "so called triad[]" of fiduciary duty. He explained that good faith is an essential element of the duty of loyalty and that while it is possible to act in good faith and not be loyal, "there is no case in which a director can act in subjective bad faith towards the corporation and act loyal." Going a step further than Vice Chancellor Jacobs, Vice Chancellor Strine suggested that the Delaware legislature might want to consider rewriting Section 102(b)(7) to "end[] the balkanization of the duty of loyalty."

Taken together, the court of chancery cases represent a marginalization of the concept of good faith in Delaware corporate fiduciary law, however prominent that duty might be in the state's statutory law. The court of chancery has sent the message that as long as a director's conduct is loyal, he will receive the full protection of Section 102(b)(7). Directors who are worried about their potential personal liability for dubious decision-making will focus on pure questions of disloyalty rather than bad faith.

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60823 A.2d 492, 506 n.34 (Del. Ch. 2003).

61Using an example similar to the one suggested by Vice Chancellor Jacobs in Emerald Partners, he says, "e.g., if the director is interested in a transaction subject to the entire fairness standard and cannot prove financial fairness." Id. This seems right. A director might in good faith believe that a self-interested transaction is not a breach of the duty of loyalty because he believes (incorrectly, as it turns out) that the transaction was in the best interests of the corporation. The Delaware Supreme Court has made coherent rulings in an analogous context. The court has ruled that good faith errors in judgment as to the duty of disclosure are not violations of the duty of loyalty, but rather violations of the duty of care, and therefore potentially protected under Section 102(b)(7). See Zirn v. VLI Corp., 681 A2d 1050, 1062 (Del. 1996) ("A good faith erroneous judgment as to the proper scope or content of required disclosure implicates the duty of care rather than the duty of loyalty. Thus, the disclosure violations at issue here fall within the ambit of the protection of section 102(b)(7).") (citation omitted).

62Gutman, 823 A.2d at 506 n.34.

63The interplay between these two opinions is also strange. First, they both use the term "balkanize," without footnote to refer to the splitting up of fiduciary duties although the term seems inappropriate and appears not to have been used before in reference to Delaware's definition of fiduciary duty. The word is usually meant to imply a division into separate hostile groups, something that is plainly missing here. Further, in Emerald, Chancellor Jacobs made reference to the fact that his opinion is shared by "other members of this Court," again without citation, although, per the rules and procedures of the court of chancery, his opinion has no concurrence. Emerald Partners, 2003 Del. Ch. LEXIS 42, at *138 n.133. It is as if Gutman has relied on Emerald without citation. Of course Strine knows the opinion of at least one of his colleagues on the court. Strine and Jacobs wrote an article together (along with a co-author, no longer a judge in the Court of Chancery) in which they assert that good faith "is a 'subsidiary requirement' that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care." Allen et al., supra note 29, at 464 n.49.
Clearly, what we have here is a true judicial schism. The Delaware Supreme Court has repeatedly ruled that the fiduciary duty of corporate directors consists of three elements: loyalty, good faith, and care. While the court acknowledges that there is overlap among the three elements, it nonetheless appears to be holding that corporate directors must follow these three separate duties. This rule arises not only from longstanding precedent, but also from a common-sense interpretation of an important statute designed to make Delaware corporate law more accommodating to the thousands of American corporations that use Delaware as their governing jurisdiction. Delaware's Court of Chancery is in open revolt against this rule, holding that fiduciary duty should properly be defined as consisting of care and loyalty, with good faith simply a necessary element of loyalty.

III. APPLYING CONTRACTUAL GOOD FAITH TO CORPORATE FIDUCIARY DUTIES

When the supreme court of America's most important corporate law jurisdiction and the most active court in defining corporate law are in open disagreement about the definition of the fiduciary obligations of corporate directors to shareholders, any attempt to clarify the issue ought to be worthwhile. The tension between Delaware's Supreme Court and

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64 While the Delaware Supreme Court appears to give little credence to the possibility that its "triad" is confusing, the Chief Justice has acknowledged, in an outside discussion, that further clarification is needed. In his Keynote Address to the Journal of Corporation Law on March 6, 2003, Chief Justice Veasey said: "Because the jurisprudence on good faith is unresolved, I express no opinion whether or when a separate duty of good faith that is not subsumed in the duty of loyalty should apply upon court review." E. Norman Veasey, State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors, Keynote Address to the Journal of Corporation Law at the University of Iowa College of Law (Mar. 6, 2003), in 28 J. CORP. L. 441, 448 (2003). Earlier in the talk, however, Veasey adhered to the supreme court's view that good faith and loyalty are separate: "In my view, therefore, it seems that there is a separate duty of good faith, not only arising out of our case law, but also as a matter of statutory construction." Id. at 447 (referring to 102(b)(7)).

65 The website of the court of chancery notes:
The Delaware Court of Chancery is widely recognized as the nation's preeminent forum for the determination of disputes involving the internal affairs of the thousands upon thousands of Delaware corporations and other business entities through which a vast amount of the world's commercial affairs is conducted. Its unique competence in and exposure to issues of business law are unmatched. http://courts.state.de.us/chancery.

66 Some other scholars have noticed the problems presented by the supreme court's triad. For example, Ellen Taylor pointed out the contradictions in the court's approach:
Although the Delaware courts frequently include the duty of good faith in the litany of fiduciary duties alongside the duties of loyalty and care, they have not
Court of Chancery appears to arise from the fact that Delaware corporate law is in a transition stage between two views of corporate law: (1) the traditional view of corporate law as an area separate from that governing other types of non-corporate commercial entities and contractual agreements, and (2) the view of the corporation and corporate duties generally as arising under contract. The court of chancery's more restrictive understanding of good faith represents an attempt to reconcile an apparent contradiction in the language of Section 102(b)(7), a contractarian statute, the illogic of which demands correction by the legislature itself.\(^{67}\) While the statute itself uses the phrase "good faith" to suggest that fiduciary duties are contractual duties, the court of chancery has interpreted it to be merely a subset of the duty of loyalty. The result is the current confusion in Delaware law.

The assertion that Section 102(b)(7) is a plainly contractarian law requires explanation.\(^ {68}\) The Delaware legislature passed the rule in response to widespread public displeasure with a court ruling regarding the bounds of the duty of care. The drafters of the law did not choose simply

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described or explained this duty in nearly as much detail as the others . . . . At least one court has suggested that good faith is equivalent to honesty in fact, a subjective standard requiring directors to act in accordance with what they believe to be true. But another court suggests that good faith is more closely associated with diligence, or the duty of care.


Further, "good faith" is one of the triad of a director's fiduciary duties and the statute [102(b)(7)] does not permit exculpation for its breach. This has focused the attention of the plaintiff's bar, and therefore of the courts, on the meaning of good faith (although more attention has not resulted in greater clarity).

*Id.* at 72 n.79 (citation omitted). See also J. Robert Brown, Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 HASTINGS L.J. 641, 645 n.13 (2003) ("The [Delaware] Supreme Court has provided little content to an independent duty of good faith. Moreover, the lower courts have largely ignored it, treating it as a subcategory of loyalty."); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 463 (2004) ("The good faith element [of the duties of a Delaware fiduciary] ha[ve] not been explored in much detail, either by the courts or the academics.").

\(^ {67}\) And at least one member of the court of chancery has "respectfully" called for legislative action to correct this contradiction. See *supra* note 63 and accompanying text.

\(^ {68}\) Some scholars regard Section 102(b)(7) as a classic example of contractarian legislation because it makes liability for the breach of fiduciary duties the default rule rather than the mandatory rule. Blair & Stout, *supra* note 9, at 1781-82. While contractarians believe that parties to corporate charters ought to have maximum freedom to negotiate away default rules, at least one scholar in the field has persuasively argued that support for the contractual view of the corporation does not automatically translate into support for minimal mandatory rules. Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1408-09 (1989) ("Accepting the contractual view does not entail accepting any particular position on mandatory rules.").
to change the bounds of that duty by, for example, passing a law stating a
clearer definition of "gross negligence," the standard at issue in Smith v.
Van Gorkom. Rather, the rule permits incorporators to mold their
corporations' rules and to allocate liability as they choose as long as they
stay within specified boundaries—boundaries that are now much wider.
It allows the marketplace—rather than mandatory rules—to determine the
extent to which corporate directors must take personal risks when they
agree to make decisions on behalf of corporations and shareholders. The
language of Section 102(b)(7) does not go nearly as far as other Delaware
laws embracing a contractarian view, but it nonetheless allows for the
voluntary elimination of liability for violation of a duty that is
fundamental to American corporate law: the duty of care.

Viewing Section 102(b)(7) through a contractarian lens reveals a
puzzling contradiction: The law allows a corporation's charter to exempt
directors from personal liability for breaches of fiduciary duty except: "(i)
for any breach of the director's duty of loyalty to the corporation or its
stockholders, [or] (ii) for acts or omissions not in good faith." It is easy
to come up with sensible arguments for the inclusion of the first provision.
Just as the advocacy of freedom of contract is limited by even the most
contractarian among us at the point at which a contract becomes "uncon-
scionable," the Delaware legislature has decided to limit the freedom to
create a corporate structure at the point at which a director is not personally
liable for actions that are plainly disloyal to the interests of the corporation
or its shareholders. The Delaware legislature, as well as countless

69 For example, Section 17-1101 of the Delaware Revised Uniform Limited Partnership
Act (DRULPA) wears its contractarian pedigree on its sleeve: "It is the policy of this chapter to
give maximum effect to the principle of freedom of contract and to the enforceability of
partnership agreements." Del. Code Ann. tit. 6, § 17-1101(c) (1999). The state has identical
provisions regarding partnerships and limited liability companies.

70 By contrast, the DRULPA allows only for the expansion or restriction of default duties.
Id. § 17-1101(d)(2). For a brief discussion in dicta of the precise language of DRULPA, see
There is, of course, a big difference between eliminating liability and allowing waiver of that duty
altogether. See Blair & Stout, supra note 9, at 1781-82.

71 It requires some interpretation to arrive at the conclusion (universally accepted in the
courts) that Section 102(b)(7) allows directors to be exculpated for breaches of the duty of care
although the statute itself does not even mention that duty. We know that the rule allows for such
exculpation because, after allowing for the exceptions listed in the rule, (loyalty and good faith)
care is all that remains.

72 Del. Code Ann. tit. 8, § 102(b)(7) (2001). The other exceptions have been omitted
because they do not seem to have contributed to confusion over the definition of fiduciary duty.

73 This debate is perhaps analogous to similar debates regarding the limits of freedom of
contract. Just as an advocate of the sale of body organs might believe that such sales are not
unconscionable, a contractarian might believe that the law should not forbid the creation of
legislatures and courts throughout the history of corporate law, has decided that waiver of liability for a director's breach of the duty of loyalty is, in effect, unconscionable. 74 It is purely a question of public policy, and the legislature has made the call.

The confusion in the Delaware courts arises from the implication in Section 102(b)(7)(ii) that liability for breach of the duty of good faith could somehow be waived in a way that does not defy logic. The rule prohibits exculpating directors from bad faith breaches of fiduciary duty, presumably because, for policy reasons, the Delaware legislature did not want corporations to exist in which the directors would be free from liability for taking actions that deliberately violate obligations to which the directors have voluntarily submitted themselves. Taking the phrase "good faith" to mean what it does in the contractual context, 75 we have a paradoxical proposition. Good faith in that context requires a party to adhere to the terms of the contract without knowingly attempting to evade those obligations to which he has voluntarily submitted himself. The focus of good faith in the contractual context is the terms of the contract. We use good faith to ensure that both parties act according to the other parties' expectations even when the contract itself does not explicitly dictate whether certain behavior is permissible. 76 It would be paradoxical to allow a corporate director to be free from liability for deliberately engaging in action that he knows he is obligated not to engage in.

In an article representing the first serious scholarly attempt to explain the meaning of good faith in contemporary Delaware law, Hillary Sale

corporations in which no duty of loyalty exists. These debates are most easily settled by legislatures, which (as here) pass laws limiting the freedom of persons to enter into certain kind of commercial relationships.

74Victor Brudney seems to be saying the same thing in his discussion of mandatory duties: "The conditions that generate state-imposed fiduciary restrictions not only impel limits on the fiduciary's power, but they impel limits on the beneficiary's power (both procedurally and substantively) to consent to departure from those restrictions." Victor Brudney, Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. REV. 595, 598 (1997).

75It is, in fact, very difficult to find a useful definition of good faith in the corporate context that does not begin to sound like the definition that prevails in the contractual context.

76This definition spans the ideological spectrum. Writing strictly about good faith in contracts (in an influential article published in 1980), Steven J. Burton wrote: "The good faith performance doctrine establishes a standard for contract interpretation and a covenant that is implied in every contract. . . . [T]he courts employ the good faith performance doctrine to effectuate the intentions of parties, or to protect their reasonable expectations." Steven J. Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 HARV. L. REV. 369, 371 (1980). Larry Ribstein, a leading contractarian, writes, "[G]ood faith is a general principle of interpreting contracts that conserves drafting costs by precluding parties from acting opportunistically according to the letter, but contrary to the spirit, of the contract." Larry E. Ribstein, Fiduciary Duty Contracts in Unincorporated Firms, 54 WASH. & LEE L. REV. 537, 583 (1997).
endorsed the Supreme Court's view of good faith as a separate duty on par with the duties of loyalty and care. Yet her definition of good faith seems to depend wholly on the content of the duties of loyalty and care. For example, in arguing that the court of chancery puts forth good faith as "an emerging and independent doctrine" in In re Caremark International Inc. Derivative Litigation, Sale states that "a failure to attempt to comply with one's fiduciary duties is likely to result in a breach of good faith." While Delaware courts may indeed be moving towards a strict enforcement of the duty of good faith, Sale does not provide a definition of that duty that is independent from the fiduciary duties of loyalty and care.

Sale summarizes several other cases in which the Delaware Supreme Court used the duty of good faith to determine whether corporate directors had violated their fiduciary duties. But in the cases she discusses, the breaches essentially amounted to bad faith breaches of the duty of care: actions by directors in which the directors themselves knew that they were not acting with the requisite care. Sale refers to such bad faith behavior as "irresponsible" or as "resulting from abdication, subversion, or deliberate indifference," but these merely seem to be proxies for the accusation that directors knowingly acted without due care. Her examples contradict the court of chancery's definition of good faith as a subsidiary of loyalty because, in the cases she discusses, the defendants were not accused of disloyalty. But she does not fully illustrate how the "emerging" duty of good faith exists separate from the duties of loyalty and care.

While little other scholarship exists on the meaning of good faith in the corporate context, the subject has been addressed in the partnership context. Larry Ribstein, for example, has noted that the good faith principle "means that the courts interpret contracts by assuming that the parties agreed to act as would a reasonable contracting party having consented to the explicit contract terms, rather than seizing opportunistically on the contract's literal language." This definition can be adapted to the corporate context: good faith for a corporate director means not doing anything that he knows violates the spirit of the obligations to which he has submitted himself by agreeing to act as a corporate director. Such

77 Sale, supra note 66.
78 698 A.2d 959 (Del. Ch. 1996).
79 Sale, supra note 66, at 469.
80 Id. at 487.
81 Id. at 488.
obligations exist either as default rules under Delaware statute or common law, or as duties enumerated in the corporate charter itself.

It is virtually impossible to imagine a corporate charter that would allow directors to evade liability for failure to act in good faith. Such a charter would essentially exculpate directors from liability for knowingly engaging in activities that they had agreed not to engage in when they assumed their responsibilities as directors under the corporate charter. Just as a party to a contract cannot waive the obligation to adhere to that contract in good faith, it would be paradoxical for a director to be free from liability for deliberately failing to honor his obligations as a director. After all, a corporate director's duty of good faith is really the obligation to try to perform his duties according to his understanding of what the corporate charter and existing law demand from him.

In a recent study of fiduciary duties, D. Gordon Smith distinguishes between good faith in the contractual context and fiduciary duty in the corporate context. In his analysis, the duties appear to be different only because the nature of corporate relationships is different from that of contractual relationships. In comparing fiduciary duty and the contractual duty of good faith, Smith writes:

Fiduciary duty is typically more expansive than contractual duty. While fiduciary duty is determined by the structure of the relationship, the obligation of good faith and fair dealing emanates from the terms of the contract. The varying intensity of these obligations is attributable to the range of opportunistic behavior possible in each context. As noted above, the intensity of fiduciary duty should depend on the likelihood of harm and the potential magnitude of the harm.

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83These would plainly include the duties of loyalty and care. The author will resist the temptation to speculate on the obligation to carry out the duty of good faith in good faith.

84It is easy though to imagine drafting a corporate charter that would exculpate directors for breaches of the duty of loyalty. Many contractarians support the right of incorporators to do just that. See, e.g., Ribstein, supra note 3. Further, Delaware allows the parties to limited partnerships and limited liability companies to "restrict," though not completely eliminate, fiduciary duties of directors of those entities. See Del. Code Ann. tit. 6, § 17-1101(d)(2) (1999); Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 168 (Del. 2002). No one, however, seriously makes the argument that true freedom of contract requires allowing directors to be free from liability for breaches of good faith.

85Burton, supra note 76, at 371 n.14. Also, Ribstein has pointed out the inherent contradiction of waiving good faith in a context that is closer to a corporation than to a regular contract, the partnership. In discussing potential modifications to the Revised Uniform Partnership Act, he says: "Because this principle [of good faith] ensures that the parties' conduct conforms to their underlying deal, the parties obviously cannot contract out of it ...." Ribstein, supra note 82, at 55-56.
Both the likelihood of harm and the potential magnitude of the harm are often less in an arm's length contract than in a fiduciary relationship because the allocation of residual control over the relevant resources provides fewer opportunities for self-serving behavior. As a result, the duty of good faith is typically weaker than fiduciary duty.86

Essentially, Smith is saying that corporate relationships present a wide range of potentially opportunistic behavior on the part of directors, wider than in the typical contract; therefore, people who enter into corporate relationships demand that directors have an obligation towards them that includes undivided loyalty. To act in good faith as a corporate director would simply mean deliberately acting in accordance with that obligation and all other obligations to which the director has submitted himself. To say that the fiduciary duty of corporate directors is more intense than the duty of good faith is simply to acknowledge that corporate directors routinely agree to adhere to a set of obligations that is more intense than the set of obligations typically agreed to by parties to a contract.87 Whether or not you choose to call a corporate director's obligations "contractual," those obligations are more intense than most contractual obligations, because being a corporate director requires the acceptance of certain responsibilities as well as the abandonment of the right to engage in a large number of otherwise permissible activities because they would implicate the director's duty of loyalty.

Ribstein appears to be saying the same thing when he states the paradigmatic contractarian position that "[f]iduciary duties are a specific type of contractual term, namely a duty of unselfishness"88 and later explains that the basic distinction between fiduciary duties and good faith is that fiduciary duties proscribe a specific category of self-interested conduct in any fiduciary relationship, while the content of good faith entirely depends on the specific contract to which the principle is applied.89

86Smith, supra note 9, at 1488-89.
87One would not argue that the meaning of "good faith" is different in an employment contract for a dishwasher than in an employment contract for a CEO. Rather, one would simply say that the nature of the duties to which the employee has agreed are different.
What Ribstein is really saying is that fiduciary duties are obligations that arise in fiduciary relationships, in which the law mandates that those duties exist. The only real difference between fiduciary obligations and contractual obligations is that a body of law dictates what those fiduciary obligations are, whereas an individual contract dictates the content of contractual obligations. The duty to honor those obligations in good faith is identical in both cases because, as Ribstein puts it, "good faith is an interpretation rule . . . its application in a particular case ultimately depends on the terms of the parties' contract." In the corporate case, the application of good faith depends on the corporate charter and the existing default rules to the extent that they are still applicable. Just as the good faith duty in a contract depends on the substance of the contract, the content of the good faith duties of corporate directors depends on the substance of the duties (among them, fiduciary duties) that the directors have voluntarily assumed under law and under the corporate charter. Good faith is merely the requirement that they adhere to those obligations honestly.

Fiduciary duties are substantive obligations which must be honored in good faith in the same way that contractual obligations must be honored in good faith. If the intensity of that obligation is stronger in a corporate relationship, it is not because the notion of good faith is different, it is because the loyalty demanded from a fiduciary is different from the loyalty demanded from a party to a "garden-variety" contractual agreement. Thus, the descriptions of good faith and fiduciary duty as existing on a "continuum" or, as Ribstein puts it, "blur[ring] at the edges," do not paint quite the right picture.

90Ribstein, supra note 89, at 17.

91This point seems to be lost in the debate regarding the difference between fiduciary and contractual duties. For example, Brudney says:

[R]estrictions on self-dealing imposed by courts in fiduciary terms in the corporate context are increasingly slack. But their terms may be somewhat tighter than the restrictions that are imposed under classic contract doctrine or might be imposed under contract doctrine that either requires "good faith" by parties in performing contracts, particularly contracts infected with touches of duress or adhesion, or prohibits results that are unconscionable. Brudney, supra note 74, at 629. Such an observation, it seems, does not suggest a fundamental difference between contractual and corporate duties other than that the typical obligations imposed on the parties in corporate contracts and regular contracts are different and that good faith adherence to the terms of each means something different because the obligations are different. In any case, what if two parties entered into a contract which called for a duty of loyalty and care identical to that found in corporations? Would not good faith adherence to that contractual obligation be identical to the corporate notion of fiduciary duty?


93Ribstein, supra note 89, at 17.
There is no line connecting good faith and fiduciary duties. Rather, good faith is a circle around which all duties, corporate or contractual, are surrounded. A director who agrees to adhere to the terms of a corporate charter must do so in good faith: he must honestly try to be loyal; he must do his best to use care; and he must honestly try to carry out any other promise he has made to those who have entrusted him with control of their corporation. Good faith is merely a way of interpreting whether the parties adhered to the duties imposed upon them by the corporate charter or by contractual agreement.

In an article which tries to find a middle ground between the contractarian and traditionalist scholars, John C. Coffee says that the difference between good faith and fiduciary duty is that "a contracting party may seek to advance his own interests in good faith while a fiduciary may not." But the contractarian view, which Coffee restates nicely, explains this difference without requiring an abandonment of the notion that corporate duties are not fundamentally different from contractual duties. Corporate fiduciaries may not advance their own interests above those of others because to do so would be to fail to act in good faith regarding the fiduciaries' obligations. Whether we view those obligations as contractual or not, the meaning of good faith is the same: the corporate fiduciary cannot act knowingly against the interests of the stockholders.

Viewed as a device for interpreting contracts or other kinds of obligations, the duty of good faith seems not to be a subsidiary or subset of loyalty as the Delaware Court of Chancery would have made it. Rather, the duty to act in good faith is broader than the duty of loyalty. The obligation to act in good faith applies to all the obligations imposed on a corporate director, including the fiduciary duties of loyalty and care, as

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94 Violations of the duty of care usually do not involve "bad faith." They are often acts of omission committed with no intention of undermining the welfare of the corporation. At least one court, however, has held that it is possible to act with such a lack of care that it implicates the duty of good faith. McCall v. Scott, 239 F.3d 808, 817-19 (6th Cir. 2001). Such lack of care can be different from disloyalty because the inaction might not be designed to benefit the person failing to act.

95 The duty of good faith extends to every obligation from loyalty to the most mundane directive. A director who knowingly parks his car in a space designated for someone else in the company parking lot violates his duty of good faith in the same way as does a director who deliberately acts against the corporation's best interest. The first example is not very interesting, but it is still a violation of good faith.


97 "Suppose one were to start with a devil's advocate assertion that the core fiduciary duties of corporate law are essentially context-specific applications of contract law's duty of good faith . . . ." Id. at 1653.

98 See supra notes 38-42 and accompanying text.
well as any other duties to which the director has agreed. The court of
chancery has, on at least one occasion, determined that a director’s breach
of the duty of care could result in liability for the director where the breach
involved conduct that was not merely negligent, but actually rose to the
level of bad faith. 99 For example, in the Walt Disney decision, involving
massive compensation offered to a well-known corporate executive, the
court allowed a claim for breach of the fiduciary duty of care, despite the
use of the exculpatory provisions allowed by Section 102(b)(7) because the
plaintiffs had claimed that directors "consciously and intentionally
disregarded their responsibilities, adopting a ‘we don’t care about the risks’
attitude concerning a material corporate decision." 100 There was no
implication, however, that the directors acted disloyally. A federal court
has also held that Section 102(b)(7) might exclude from protection reckless
(though not disloyal) acts by corporate directors if such acts amounted to
bad faith. 101

Delaware courts have already shown themselves to be ready to use
good faith to interpret adherence to fiduciary duties in non-corporate
business organizations. In its limited partnership jurisprudence, Delaware
courts will apply the default fiduciary duty rule if the parties to the limited
partnership have not modified that rule. If they have modified the rule,
however, as they are permitted to do by Section 17-1101 of DRULPA, a
court immediately asks whether the party acted in "good faith reliance on
the provisions of such partnership agreement." 102 Unlike Section 102(b)(7),
which seems to place good faith alongside the duty of loyalty, Section 17-
1101 makes good faith a necessary element of any action that falls within
the statute’s protection. While a court interpreting Section 102(b)(7) might
confusingly make two inquiries (i.e., was he disloyal and did he act in good
faith?), a court interpreting Section 17-1101 will simply ask whether the
defendant acted in good faith compliance with his obligations under the
limited partnership agreement, which might include fiduciary duties in
modified form.

Because many Delaware limited partnerships now take advantage of
the flexibility allowed by 17-1101 and modify the fiduciary duties of the
general partners, the courts now use "good faith" in interpreting whether

99 See, e.g., In re Walt Disney Co. Derivative Litig., 825 A2d 275 (Del. Ch. 2003).
100 Id. at 289. The court went on to say: "Put differently, all of the alleged facts, if true,
imply that the defendant directors knew that they were making material decisions without
adequate information and without adequate deliberation, and that they simply did not care if the
decisions caused the corporation and its stockholders to suffer injury or loss." Id. Not caring in
bad faith is therefore plainly different from disloyalty in bad faith.
101 McCall, 239 F.3d at 818-19.
limited partnership fiduciaries have adhered to their duties. Because the fiduciary duty provisions in limited partnerships are simply contractual terms (because a limited partnership agreement is explicitly a "contract" under Delaware law\textsuperscript{103}), courts address allegations of breach of fiduciary duty by a general partner by asking if the general partner acted in good faith, i.e., whether the general partner believed he was acting disloyally or carelessly as those terms are defined under the limited partnership agreement.\textsuperscript{104} Under DRULPA, good faith is simply a way of interpreting whether certain action violates the terms of a contract.

Like Section 17-1101, Section 102(b)(7) represented a step forward in allowing business organizations to create legal relationships best suited to the nature of their businesses. Although not as purely contractarian as its limited partnership counterpart, the law was plainly designed to give parties to corporate relationships the ability to free themselves from the default restrictions imposed under Delaware law. The duty of good faith should apply to all the obligations of a corporate director, and not just to the duty of loyalty as the court of chancery has held. Nor does it exist side by side with the duties of care and loyalty as the Delaware Supreme Court has held. Rather, a corporate director's duty of good faith encompasses his adherence to all of his duties as director in the same way that good faith encompasses all of the duties imposed by a contract.

IV. CONCLUSION

The current schism between the Delaware Supreme Court and the Delaware Court of Chancery arises from both courts' misuse of the term "good faith" in cases involving allegations of violation of fiduciary duty by corporate directors. Properly construed, good faith is not itself a fiduciary duty, nor is it a subset of a specific fiduciary duty. Rather, good faith is an interpretive device which can be used to determine whether directors have adhered to their traditional fiduciary duties of loyalty and care. This application of the term is analogous to its use in interpreting adherence to contractual duties. By recognizing that the interpretation of adherence to

\textsuperscript{103}Section 17-1101(c) of DRULPA states: "It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." Delaware courts recognize that in this context, contractual obligations have taken the place of fiduciary duties: "It is a correct statement of law that principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain." Sonet v. Timber Co., L.P., 722 A.2d 319, 322 (Del. Ch. 1998).

\textsuperscript{104}For a discussion of contractually created fiduciary duties in the specific context of venture capital funds, see David Rosenberg, The Two "Cycles" of Venture Capital, 28 J. CORP. L. 419, 431-35 (2003).
corporate fiduciary duties is not fundamentally different from the interpretation of adherence to contractual duties, Delaware courts could more coherently carry out their task of enforcing the obligations assumed by corporate directors. Either the Delaware Supreme Court must seize the next opportunity to clarify its understanding of the good faith provisions of Section 102(b)(7), or the Delaware legislature should amend the statute to repair its fundamental contradictions. Such an amendment should recognize the inherently contractual nature of the corporation and treat "good faith" as a contractual obligation which encompasses all the obligations of a corporate director, including, but not limited to, the fiduciary duties of care and loyalty.