A manager's obligation not to knowingly cause the corporation to violate the law has traditionally and properly been founded on the duty of good faith.[98] A corporate manager who knowingly causes the corporation to violate the law lacks honesty, because he knows that he is acting improperly and is violating generally accepted standards of decency applicable to the conduct of business. In addition, such a manager lacks fidelity to his office, because the organization in which his office is embedded is obliged to act within the boundaries set by the law and can reasonably expect its managers to act accordingly. In contrast, the obligation not to knowingly cause the corporation to violate the law cannot be founded on the duties of care and loyalty. A manager who knowingly causes the corporation to violate the law will seldom violate the duty of loyalty, because typically the manager does not engage in self-interested conduct, and will seldom violate the duty of care, because typically the manager rationally believes that the illegal conduct will serve the end of profit maximization.

To maintain his dyadic view, Vice Chancellor Strine asserted in *Guttman v. Jen-Hsun Huang*[99] that the obligation not to knowingly cause the corporation to violate the law was justified by, and fell within, the duty to act loyally. "[O]ne cannot," he said, "act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey." This argument, however, conflicts with both conventional legal usage and clear analysis. Why, and to whom, is a director or officer being disloyal if he causes the corporation to take an action that violates the law, when he is not self-interested in the action and the action is rationally calculated to increase corporate profit and shareholder gain? Trying to squeeze such conduct into the duty of loyalty is like trying to squeeze the foot of Cinderella's stepsister into Cinderella's glass slipper—an enterprise equally painful and fruitless.

B. *The Obligation of Candor*

Another set of obligations that are based on the duty of good faith consist of obligations of candor in various contexts not involving self-interest.[100] (I use the term *candor* in its broadest sense to mean the "state or quality of being frank, open, and sincere in speech or expression."[101]) For present purposes, the obligation of candor has two aspects. First,

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[98] *See supra* Part VI.A.

[99] 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

[100] *See* Sale, *supra* note 1, at 487-88.

[101] RANDOM HOUSE UNABRIDGED DICTIONARY, *supra* note 40, at 305.

managers have an obligation not to make intentionally or recklessly false or misleading statements in their managerial capacity. I will refer to this aspect of candor as the *obligation not to mislead.* Second, managers have an obligation not to intentionally or recklessly fail to inform other managers or corporate organs (including the body of shareholders) of information that is known by the manager to be material to those managers or corporate organs in making decisions or discharging their duties. I will refer to this aspect of candor as the *obligation to duly inform.* Although the obligations not to mislead and to duly inform shade into each other, they differ in an important way. The obligation not to mislead only addresses the issue of how a manager should act *if* he makes a statement. In contrast, the obligation to duly inform imposes a positive duty on managers to make certain statements. A manager's obligation of candor is not limited to ensuring that what he chooses to say is true. Rather, in appropriate cases a manager must step forward and say what ought to be said.

The obligation of candor even where self-interest is not involved will be discussed in three contexts: communication between the board and the shareholders, communication among members of the board, and communication by officers to the board and to other officers.

1. The Board's Obligation of Candor

a. *The Obligation Not to Mislead*

It has long been the law that when directors request shareholder action they may not knowingly make misleading statements concerning the action.[102] Suppose, however, that the directors knowingly make misleading statements to the shareholders without requesting shareholder action.

If the corporation is subject to reporting requirements under the Securities Exchange Act, and the statements are made by directors in an

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[102]*See, e.g.*, Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) ("This Court has held that a board of directors is under a fiduciary duty to disclose material information when seeking shareholder action."); Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 137 (Del. 1997) ("Delaware law of the fiduciary duties of directors . . . establishes a general duty . . . to disclose to stockholders all material information reasonably available when seeking stockholder action."); Arnold v. Soc'y for Sav. Bancorp., Inc., 650 A.2d 1270, 1277 (Del. 1994) (holding that a fiduciary disclosure "obligation attaches to proxy statements and any other disclosures in contemplation of shareholder action"); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (stating that "directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action"). *See also, e.g.*, Alessi v. Beracha, 849 A.2d 939 (Del. Ch. 2004) (sustaining a complaint of a shareholder who sold her shares in a buy-sell program for small shareholders and later brought a breach-of-fiduciary duty action against the directors for failing to disclose negotiations to sell the corporation).

SEC filing, the directors will have violated federal law.[103] Even if those conditions are not satisfied, a knowingly misleading statement may give rise to liability under Rule 10b-5, which makes it unlawful to make any untrue statement of a material fact, or to omit a material fact necessary to make statements not misleading, in connection with the purchase or sale of securities.[104] But Rule 10b-5 is hedged in a variety of ways, one of which is that only a purchaser or a seller may bring a private action under that Rule. The issue therefore arises whether shareholders who are not purchasers or sellers can bring suit under corporation law against directors who have knowingly made misleading statements to the shareholders, on the ground that the directors have thereby violated their fiduciary duty.

That issue was addressed in *Malone v. Brincat*,[105] decided by the Delaware Supreme Court in 1999. Mercury Finance was a publicly traded corporation. Plaintiffs, who had been Mercury shareholders since 1993, brought a class action against Mercury's directors on the ground that the directors had knowingly disseminated false information by overstating Mercury's earnings, financial performance, and shareholders' equity. For example, according to the complaint, in 1995, Mercury reported earnings of $99 million, when in fact earnings were only $78 million. In 1996, Mercury reported earnings of $121 million, when in fact earnings were only $57 million.[106] At year-end 1996, Mercury reported that shareholders' equity was $353 million, when in fact it was not more than $263 million. All of this inaccurate information was included in communications that Mercury's directors made to the shareholders.[107]

The directors moved to dismiss the complaint, arguing that under the circumstances alleged, they had not violated Delaware corporate law. Applying chancery court precedent, the Vice Chancellor granted the motion and dismissed the complaint with prejudice, on the ground that directors had no duty of candor under Delaware law except when they were requesting shareholder action. The Delaware Supreme Court, however, held that directors do have a duty to communicate honestly with shareholders even outside the context of a request for shareholder action:

> 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 tripartite fiduciary

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[103]*See* 15 U.S.C. § 77x (2005).

[104]*Id.* § 240.10b-5.

[105]722 A.2d 5 (Del. 1998).

[106]All figures are rounded off.

[107]Malone v. Brincat, 722 A.2d 5 (Del. 1998).

> 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. . . .
>
> . . . . Whenever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows *a fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors' fiduciary duty to shareholders is honesty.
>
> The issue in this case is not whether Mercury's directors breached their duty of disclosure. It is whether they breached their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information about the financial condition of the company. The directors' fiduciary duties include the duty to deal with their stockholders honestly.[108]

Although the court in *Malone v. Brincat* referred to both loyalty and good faith—and earlier in its opinion referred to care—the board's obligation not to mislead shareholders through communications that do not involve a request for shareholder action is best explained by the duty of good faith. The duty of loyalty is not a satisfactory basis for the obligation because the board may violate the obligation not to mislead even if it is not self-interested. The duty of care is not a satisfactory basis for the obligation because under given circumstances the board may make a rational decision that lack of candor is profit-maximizing and best protects the wealth of existing shareholders. In contrast, the duty of good faith does provide a basis for the obligation. First, a board that knowingly makes false statements to the shareholders acts dishonestly. Second, in knowingly making false statements to the shareholders, directors lack fidelity to their office because shareholders have a reasonable expectation of truthful communication by the board.

This leaves the issue of remedy. In some cases, a board's misleading statements may cause injury to the corporation—for example, as the result of repercussions when the truth comes out. This would be especially true

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[108] *Id.* at 10 (footnotes omitted).

if the corporation transacts business in markets, such as credit markets, in which reputation is especially important. In *Malone v. Brincat*, the plaintiffs alleged that as a result of the board's misleading statements the corporation had lost $2 billion, comprising most or all of its value. The Delaware Supreme Court pointed out that such a loss would constitute an injury to the corporation. Therefore, a suit based on the loss would have to be brought as a derivative action, preceded by a demand on the board, and the plaintiffs had neither made a pre-suit demand nor shown why a demand should be excused. Accordingly, the court agreed that the complaint should be dismissed. However, the court held that the plaintiffs should be permitted to replead a derivative claim, together with a request for any damage or equitable remedy sought on behalf of the corporation. The court also held that the plaintiffs should have the opportunity to assert any individual cause of action and to articulate a remedy that was appropriate on behalf of either the named plaintiffs individually or a properly recognizable class. In this connection, the court referred to the possible remedies of injunctive relief, judicial removal of directors, or the disqualification of directors.[109] This range of remedies dramatically illustrates that violation of the duty of good faith can have significant consequences apart from the possibility of liability for damages.

b. *The Obligation to Duly Inform*

There is evidence of a recurring lack of candor by managers to investors. In particular, recent research strongly suggests that managers systematically withhold bad news from investors.[110] If a corporation's securities are registered under section 12 of the Securities Exchange Act, the corporation is required to make extensive periodic disclosure, and the Proxy Rules require the corporation to provide the shareholders with extensive information concerning major transactions that require shareholder approval.[111] However, the periodic-disclosure rules often will not require prompt disclosure of various kinds of bad news. Furthermore, the overwhelming bulk of corporations, including many publicly held corporations, are not registered under section 12 and not subject to the

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[109]The court stated that it was expressing no opinion whether these remedies could be asserted in *Malone* itself, because that relief had not been sought in the complaint. At least prior to *Malone v. Brincat*, the issue whether courts have the equitable power to remove directors in the absence of statutory authority was unclear and in conflict.

[110]*See* S.P. Kothari et al., *Do Managers Withhold Bad News?* (MIT School of Management Working Paper No. 4556-05, 2005), *available at* http://ssrn.com/abstract=803865 (last visited Feb. 20, 2006).

[111]15 U.S.C. § 78*l*; 240 C.F.R. § 14a-3 (2005).

Proxy Rules. Additionally, few, if any, state statutes require boards to provide investors with either material information, in general, or information concerning major transactions requiring shareholder approval, in particular.

The Delaware courts, at least, have filled part of the gap by making clear that the board has an obligation to duly inform the shareholders when the board requests a shareholder vote in such cases. Then Vice Chancellor (now Delaware Supreme Court Justice) Jacobs addressed this issue in *Turner v. Bernstein*,[112] which involved an arm's-length merger of unaffiliated corporations in which the shareholders of one corporation were provided with virtually no information. Drawing on a large number of decisions, Vice Chancellor Jacobs stated:

> The fiduciary duty of disclosure flows from the broader fiduciary duties of care and loyalty. That disclosure duty is triggered (*inter alia*) where directors . . . present to stockholders for their consideration a transaction that requires them to cast a vote and/or make an investment decision, such as whether or not to accept a merger or demand appraisal. Stockholders confronted with that choice are entitled to disclosure of the available material facts needed to make such an informed decision. Specifically in the merger context, the directors of a constituent corporation whose shareholders are to vote on a proposed merger, have a fiduciary duty to disclose to the shareholders the available material facts that would enable them to make an informed decision, pre-merger, whether to accept the merger consideration or demand appraisal.[113]

In a later decision in the case,[114] Vice Chancellor Strine said, "In his earlier opinion . . . , Vice Chancellor Jacobs succinctly stated the pertinent principles of law relevant to whether the defendant directors breached their fiduciary duties by providing the GenDerm stockholders with deficient disclosures."[115] Vice Chancellor Strine added:

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[112]No. 16,190, 1999 Del. Ch. LEXIS 18 (Del. Ch. Feb. 9, 1999), *reprinted in* 24 DEL. J. CORP. L. 1276 (1999).

[113]*Id.* at *19-20, *reprinted in* 24 DEL. J. CORP. L. at 1290 (footnotes omitted, emphasis added).

[114]Turner v. Bernstein, 776 A.2d 530 (Del. Ch. 2000).

[115]*Id.* at 541.

In *Skeen v. Jo-Ann Stores, Inc.*, the Supreme Court recently confirmed Vice Chancellor Jacobs's view of the applicable standard, stating:

> In this appeal we consider the adequacy of corporate disclosures to minority stockholders who were "cashed out" in a merger approved by the majority stockholder. The minority stockholders complain that they were not given enough financial information to decide whether to accept the merger consideration or seek appraisal. They say, in essence, that the settled law governing disclosure requirements for mergers does not apply, and that far more valuation data must be disclosed where, as here, the merger decision has been made and the only decision for the minority is whether so seek appraisal. *We hold that there is no different standard for appraisal decisions. Directors must disclose all material facts within their control that a reasonable stockholder would consider important in deciding how to respond to the pending transaction.*[116]

Although Vice Chancellor Jacobs rested the board's obligation to duly inform in such cases on the duties of care and loyalty, those duties do not adequately explain that obligation, at least as they are traditionally understood. The duty of loyalty does not explain the obligation to duly inform, because that obligation applies even if the directors are not self-interested in the proposed transaction. The duty of care does not explain the obligation, because a failure to duly inform the shareholders does not necessarily run counter to the idea of profit-maximization. (It is true that when an obligation exists, a failure to duly perform the obligation may be a breach of the duty of care, but the existence of an obligation must precede

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[116] *Id.* at 542 (emphasis added by Vice Chancellor Strine) (citing Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170 (Del. 2000)). *See also, e.g.*, Frank v. Arnelle, 725 A.2d 441 (Del. 1999) (noting the obligation of directors to disclose material information to stockholders regarding a decision to sell). Although the Delaware cases concerning transactional disclosure to the shareholders are sometimes framed in terms of the exercise of appraisal rights, for present purposes there is no reason in principle to distinguish between the exercise of appraisal rights and voting rights, and in *Turner*, Vice Chancellor Jacobs explicitly stated that disclosure was required in connection with both voting and appraisal rights.

the duty to perform it carefully.) The duty of good faith, on the other hand, does explain the board's obligation to duly inform, because fidelity to office requires the board to satisfy the shareholders' reasonable expectations that the board will provide them with information that is known by the board to be material to a decision that the board requests the shareholders to make.

Of course, not every failure to duly inform violates the duty of good faith, just as not every noncompliance with law violates the duty of good faith.[117] A failure to inform, like noncompliance with law, will violate the duty of good faith only if it is intentional or reckless.[118]

2. Communication among Directors

Another context in which candor is required concerns communication by an individual director to the whole board. In this section, I will take it as a premise that individual directors, when communicating to the board, have an obligation not to mislead, and will focus instead on an individual director's obligation to duly inform.

In the case of individual directors, the rule that should—and almost certainly would—be applied is that a director must duly inform the board of all material facts that he knows are relevant to the board's decision-making and monitoring responsibilities, even when he is not self-interested. This rule has now been explicitly embodied in section 8.31(c) of the Model Business Corporation Act: "In discharging board or committee duties a director shall disclose, or cause to be disclosed, to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions . . . ."

Again, the obligation to duly inform in this context is not explained by the duty of loyalty, because a director who withholds information may

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[117] *See, e.g.*, Arnold v. Soc'y for Sav. Bancorp., Inc., 650 A.2d 1270, 1288 (Del. 1994) (directors did not lose protection of a shield provision on the ground of faulty disclosure where the single disclosure violation "was consistent only with a good faith omission").

[118] *See* Zirn v. VLI Corp., 681 A.2d 1050, 1061-62 (Del. 1996) ("The record reveals that any misstatements or omissions that occurred were made in good faith. . . . 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."); Johnson v. Wagner, No. 17,651, 2003 Del. Ch. LEXIS 45, at *34 (Del. Ch. Apr. 10, 2003), *reprinted in* 28 DEL. J. CORP. L. 1109, 1125 (2003) ("If [Wagner had knowledge of the buyout proposal] and intentionally or recklessly failed to disclose such information Wagner would have breached his fiduciary duties."); Johnson v. Shapiro, No. 17,651, 2002 Del. Ch. LEXIS 122, at *30-31 (Del. Ch. Oct. 18, 2002), *reprinted in* 28 DEL. J. CORP. L. 361, 374 (2003) ("If Wagner intentionally failed to disclose, or was reckless in his failure not to disclose, material information known on or before September 28, 1999 about the buyout proposal to Garden Ridge stockholders, then § 102(b)(7) does not save him as a matter of law.").

not act for reasons of self-interest. It is also not explained by the duty of care, because a director may withhold information in the reasonable belief that if he provides the information it might lead the board to make a decision that is not profit-maximizing. In contrast, the obligation to duly inform in this context *is* explained by the duty of good faith, because it springs from the requirement of fidelity to the director's office. The board is a collegial body, and the office of director entails an obligation to promote the board's decision making and monitoring functions by duly informing the director's colleagues of facts that the director knows are relevant to the discharge of those functions.

3. Communication by Officers

A particularly important aspect of the obligation of candor concerns communication by officers. One context in which officers have an obligation of candor involves the provision, by officers to the board, of information that bears on a proposed corporate action. When board approval is needed for a corporate action, the nonmanagement directors will be almost wholly dependent on the corporation's officers for the information on which their decision should be based. The officers, however, may spin the information they provide, to push the board toward a decision that the officers believe to be best for the corporation.

Essentially, this is a special case of the more general problem presented by asymmetric information within a hierarchal organization. The problem is well described by Milgrom and Roberts:

> We take it as given that some of the information that is important for the organization to make good decisions is not directly available to those charged with making the decisions. Instead, it is lodged with or producible only by other individuals or groups that are not empowered to make the decisions but may have a direct interest in the resulting outcomes. . . .
>
> In such situations, the members of the organization may have an incentive to try to manipulate the information they develop and provide in order to influence decisions to their benefits. Such manipulation can take many forms, . . . [including] presenting the information in a way that accentuates the points supporting the interested party's preferred decision and then insisting on these points at every

opportunity.[119]

The concern here is not necessarily, nor even usually, that officers will exploit informational asymmetry to benefit themselves by lining their own pockets in self-dealing transactions. Rather, the concern is that officers will attempt to herd the board toward action that the officers believe is in the corporation's best interests. As Milgrom and Roberts point out, "The directors of a firm may have the final say on whether a new plant will be built, but only the division whose products will be made in the plant can generate important parts of the relevant information on the likely profitability of the new facility."[120]

An officer who provides some information while knowingly holding back other information, or who spins information, violates the obligation not to mislead. An officer also has an obligation to duly inform. Officers are a special class of agents, and the rule has long been established in agency law that agents have a duty to duly inform their principals. *Restatement (Second) of Agency* § 381 provides that an agent must "give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have."[121] Similarly, *Restatement (Third) of Agency* § 8.11 provides that "[a]n agent has a duty to use reasonable effort to provide the principal with facts that the agent know[s] . . . when . . . the agent knows or has reason to know that the principal would wish to have the facts."[122] The corporate law counterpart of this rule has now been explicitly adopted in section 8.42(b)(1) of the Model Business Corporation Act:

> (b) The duty of an officer includes the obligation:
>
> (1) to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the

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[119]Paul Milgrom & John Roberts, *An Economic Approach to Influence Activities in Organizations*, 94 AM. J. SOC. S154, S156-57 (Supp. 1988) (footnote omitted).

[120]*Id.* at S156.

[121]RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

[122]RESTATEMENT (THIRD) OF AGENCY § 8.11 (Tent. Draft No. 6, 2005). *Restatement Third* was approved at the ALI's 2005 annual meeting, but has not yet been published.

For a leading analysis of the duty of candor in corporate law, see Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187 (2003).

> scope of the officer's functions, and known to the officer to be material to such superior officer, board or committee . . . .

This rule should—and undoubtedly would—be applied to corporate officers even by courts in non-Model Act jurisdictions. Indeed, one explanation of the result in *Smith v. Van Gorkom*[123]—or more accurately, one explanation of the imposition of liability on Van Gorkom, the CEO of Trans Union, the corporation in that case—is that Van Gorkom violated his obligation of candor by withholding important information from the board in connection with a cash-out merger. For example, Van Gorkom did not disclose to the board the shaky methodology by which he had arrived at a price of $55 per share for the corporation or the fact that Trans Union's CFO had concluded that in a leveraged buyout the price range for Trans Union's stock would be $55-$65 per share.

There are other important contexts, besides board decision making, in which officers owe an obligation to duly inform—for example, providing the board with material information that is relevant to the board's duty to monitor. A related context, emphasized by Donald Langevoort, concerns providing the board with material information about important risk factors in the corporation's business:

> Extraordinary forms of risk-taking are, by black-letter corporate law doctrine, for the board in any event. But even to carry out its monitoring function, the board must gain a fair sense of the aggregate level of risk assumed by the firm. Especially in today's business environment, where sophisticated tools for both hedging and assuming risk abound, there is a temptation to assume greater risk in order to satisfy perceived pressures—whether from the marketplace or the board itself—to generate high returns. Thus it is risk-related information that is the underdeveloped substance of the duty of candor we are describing. When risk is hidden, CEOs can play out "last period" strategies—taking more aggressive steps as the company's performance lags (or more likely, as the CEO fears that it is about to lag) because he or she fears that termination is a real possibility once that subpar performance becomes clear to the board. Risk-related information is also important to the board because it allows

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[123]488 A.2d 858 (Del. 1985).

> board members to second-guess the CEO's risk perceptions, which are likely to be colored by an optimistic bias.[124]

An officer's obligation to duly inform the board of material information that he knows or has reason to know the board would desire to have is paralleled by an obligation to duly inform his superiors of such information. An officer also has an obligation to duly inform appropriate superior officers or corporate organs of material violations of law or breaches of duty by other officers, or by employees or agents of the corporation, which the officer believes have occurred or are likely to occur. The obligation to duly inform in this context is explicitly imposed by the Model Business Corporation Act:

> (b) The duty of an officer includes the obligation
>
> . . . .
>
> (2) to inform his or her superior officer, or another appropriate person within the corporation, or the board of directors, or a committee thereof, or any actual or probable material violation of law involving the corporation or material breach of duty to the corporation by an officer, employee, or agent of the corporation, that the officer believes had occurred or is likely to occur.[125]

In agency law, the agent's obligation of candor is not categorized as part of either the agent's duty of care or duty of loyalty.[126] Neither can it be so characterized in corporate law. An officer's obligation of candor is not based on the duty of loyalty, because an officer typically will have no pecuniary self-interest in providing or withholding information. The duty of care also does not provide a basis for this obligation, because an officer who violates this obligation typically does so because he reasonably believes that doing so is in the corporation's best interest. For example, in the Milgrom & Roberts new-plant hypothetical, the officers may reasonably believe that building the new plant is the best decision, but that if all the material information was given to the board, the board might erroneously

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[124]Langevoort, *supra* note 122, at 1201 (footnotes omitted).

[125]MODEL BUS. CORP. ACT § 8.42(b)(2) (2004).

[126]*See* RESTATEMENT (SECOND) OF AGENCY § 378 (2005); RESTATEMENT (THIRD) OF AGENCY § 8.12 (2005).

decide not to build the plant. Similarly, in the case of risk elements, an officer might withhold information from the board because he reasonably believes that the board is unduly risk-averse. In the case of a failure to report violations of law and breaches of duty, an officer might withhold information because he reasonably believes that the wrongdoer was motivated by his perception of the corporation's best interests and did not harm the corporation, and that disciplining the wrongdoer would itself harm the corporation.

The duty of good faith does explain an officer's obligation of candor.[127] An officer who makes misleading or skewed statements is insincere, dishonest, and lacks fidelity to his office. The board is entitled to have all material information that is relevant to its monitoring obligation and to any decisions that the board is either required or chooses to make. The role of officers in such cases is to present the material facts and to present them fairly, not to spin the facts with the objective of leading the board in a certain direction that the officers believe is in the corporation's best interest. The officers may properly seek to achieve that objective only by reasoned persuasion. The board has the right to make decisions that the officers believe are wrong. This is also true of an officer's superiors.

An officer who fails to duly inform also violates the duty of good faith. Generally accepted basic corporate norms require officers to duly inform others within the corporation of information that is known to be material to the discharge of the others' duties and responsibilities. Fidelity to office requires an officer to be forthcoming with facts that come to his knowledge and that his office obliges him to pass on. Failure to duly inform may also be viewed as a lack of sincerity, because an actor who is charged with a duty to speak, and does not do so, acts insincerely.

Again, this leaves the issue of remedy. If the board is led to make a bad decision by an officer's breach of the obligation of candor, in principle the officer could be made liable for any losses resulting from the decision. In practice, however, causation in such cases would often, perhaps invariably, be difficult to prove. Alternative remedies are suggested by the comment to section 8.42 of the Model Business Corporation Act, which

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[127] *Cf.* Langevoort, *supra* note 122, at 1203:

> [W]hat is the categorical basis for the duty of candor? Clearly, it is not part of the duty of care, which deals with negligent or unintentional misconduct. Nor is it really the duty of loyalty.... The intracorporate duty of candor is a separate and distinct kind of obligation, and ought to be recognized as such. At the same time, however, those wanting to stay within convention could make a good argument that it is an integral part of the duty of good faith, which is often mentioned as one of the three kinds of fiduciary obligations officers and directors owe under Delaware law.

points out that "deficient performance of duties by an officer, depending on the facts and circumstances, will normally be dealt with through intracorporate disciplinary procedures, such as reprimand, adjustment of compensation, delayed promotion, demotion, or discharge."[128]

C. *Obtaining Action by a Corporate Organ Through the Use of a Manipulative Process that Violates Generally Accepted Basic Corporate Norms*

A manager also violates the duty of good faith if he obtains action by a corporate organ through the use of a manipulative process that violates generally accepted basic corporate norms. Usually, this principle operates as a condition, rather than as a liability rule, because where this principle is applicable, its main effect is to render an action of the corporate organ ineffective. If the action is ineffective, a manager's violation of the principle will usually not cause damage to the corporation, and therefore will not result in liability.

This principle is well exemplified by three Delaware cases: *Koch v. Stearn* (*Koch*),[129] *VGS, Inc. v. Castiel* (*VGS*),[130] and *Adlerstein v. Wertheimer* (*Adlerstein*).[131] In each of these cases, an enterprise was in serious business difficulty, and the managers caused the board to take action that seemed to be in the best interests of the enterprise. Nevertheless, the board's action was held to be ineffective because the managers obtained the action by using a manipulative process that violated generally accepted basic corporate norms.

In *Koch*, the board of Showcase Communications Network consisted of four directors: Stearn, Koch, Ginsberg, and Bunn. Stearn was the founder and CEO; Koch was a major investor; Ginsberg was Stearn's designee; and Bunn was Koch's designee. By late March 1992, Showcase was running out of funds and approaching insolvency. Koch offered to invest an additional $2 million, subject to several conditions, including Stearn's resignation as CEO. A third party, Shapiro, had offered to provide $250,000 in interim financing, but the directors other than Stearn believed that Koch's offer was the most attractive possibility available to Showcase,

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[128]MODEL BUS. CORP. ACT § 8.42 cmt. (2005).

[129]No. 12,515, 1992 Del. Ch. LEXIS 163 (Del. Ch. July 28, 1992), *reprinted in* 18 DEL. J. CORP. L. 730 (1993).

[130]No. 17,995, 2000 Del. Ch. LEXIS 122 (Del. Ch. Aug. 31, 2000), *reprinted in* 27 DEL. J. CORP. L. 454 (2002), *aff'd*, 781 A.2d 696 (Del. 2001) (table), No. 564, 2000 (Del. May 23, 2001).

[131]No. 19,101, 2002 Del. Ch. LEXIS 13 (Del. Ch. Jan. 25, 2002).

and that Stearn should be removed as CEO if he would not resign.[132]

Koch's offer was open until April 2. That day passed without the offer having been accepted. The next day, Koch and Bunn discussed holding a board meeting at which Stearn would be removed from office. On April 6, Bunn faxed a letter to Showcase's counsel, Levy, requesting that Stearn and Levy attend a board meeting the following morning. The letter stated:

> In view of the pending offer from Shapiro, and the dire financial condition of Showcase, David [Koch], Jerry [Ginsberg] and I hope that you and Leathem [Stearn] can attend a meeting at David's office at 9:00 a.m. tomorrow morning to review the situation. David has asked Mr. Shapiro to extend his offer until we have had a chance to discuss the situation. Since there is no time for formal notice, the four directors would waive notice at the 9:00 a.m. meeting tomorrow. Please advise immediately.[133]

Later that day, Bunn sent Koch and Ginsberg drafts of board resolutions to remove Stearn as CEO. These resolutions were not circulated to either Stearn or Levy. On April 7, Showcase's board held a meeting at which Stearn was removed as CEO and replaced by Ginsberg, his own designee. The Court set aside the action of the board because Stearn had been tricked into attending the meeting:

> The letter to Levy suggested that the board would be considering the revised Shapiro offer. It was silent as to any possible consideration of the Koch offer, which had technically expired. Moreover, the outside directors had an agenda, which included removing Stearn from office if he did not cooperate and step down voluntarily. I cannot help but conclude that Bunn's failure to inform Stearn of this agenda item was intentional.[134]

VGS concerned an action by the board of managers of an LLC, rather than by a corporation's board of directors, but the applicable principles were the same. The LLC, Virtual Geosatellite, had been formed by David Castiel. It had three members: Holdings and Ellipso, which were

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[132]*Koch*, 1992 Del. Ch. LEXIS 163, at *7.

[133]*Id.* at *8.

[134]*Id.* at *13.

corporations controlled by Castiel, and Sahagen Satellite, an LLC controlled by Peter Sahagen. Castiel, through Holdings and Ellipso, owned 75% of Virtual's equity. Sahagen, through Sahagen Satellite, owned 25%. The management of Virtual was vested in a board of managers. As the majority owner, Castiel had the power to appoint, remove, and replace two of the three members of the board of managers, and therefore had the power to prevent any board decision with which he disagreed. Castiel named himself and Tom Quinn to the board of managers. Sahagen named himself as the third member of the board.[135]

Not long after the formation of Virtual, Castiel and Sahagen fell out.[136] Sahagen ultimately convinced Quinn—Castiel's nominee—that for Virtual to prosper, Castiel had to be ousted from leadership. Many of Virtual's employees, and even some of Castiel's lieutenants, believed that such an action was in Virtual's best interest.[137]

Virtual's LLC Agreement allowed Virtual to merge by a majority vote of the board of managers. Quinn covertly defected from Castiel to Sahagen's camp, and Sahagen and Quinn decided to wrest control of Virtual from Castiel. Under the Delaware LLC statute, on any matter that is to be voted on by managers, the managers may take action without prior notice, a vote, or a meeting, through means of a written consent signed by managers having the number of votes that would be necessary to authorize the action at a meeting. Sahagen and Quinn, acting by written consent, without notice to Castiel, merged Virtual into a new corporation, VGS. VGS's board of directors was comprised of Sahagen, Quinn, and Neel Howard. On the day of the merger, Sahagen executed a $10 million promissory note to VGS in exchange for two million shares of VGS preferred stock. Upon consummation of the merger, Sahagen's interest in the Virtual enterprise went from 25% to 62.5% and Castiel's interest went from 75% to 37.5%.[138]

The Delaware Court of Chancery,[139] in an opinion affirmed by the Delaware Supreme Court,[140] set these actions aside on the ground that they involved improper manipulative conduct:

> There can be no doubt why Sahagen and Quinn, acting

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[135] *VGS*, 2000 Del. Ch. LEXIS 122, at *4, *reprinted in* 27 DEL. J. CORP. L. at 456.

[136] *Id.*

[137] *Id.* at *5, *reprinted in* 27 DEL. J. CORP. L. at 456.

[138] *Id.* at *5-6, *reprinted in* 27 DEL. J. CORP. L. at 457.

[139] VGS, Inc. v. Castiel, No. 17,995, 2000 Del. Ch. LEXIS 122 (Del. Ch. Aug. 31, 2000), *reprinted in* 27 DEL. J. CORP. L. 454 (2002).

[140] VGS, Inc. v. Castiel, 781 A.2d 696 (Del. 2001).

as a majority of the LLC's board of managers did not notify Castiel of the merger plan. Notice to Castiel would have immediately resulted in Quinn's removal from the board and a newly constituted majority which would thwart the effort to strip Castiel of control. Had he known in advance, Castiel surely would have attempted to replace Quinn with someone loyal to Castiel who would agree with his views. Clandestine machinations were, therefore, essential to the success of Quinn and Sahagen's plan. . . .

. . . . [T]he LLC Act, read literally, does not require notice to Castiel before Sahagen and Quinn could act by written consent. The LLC Agreement does not purport to modify the statute in this regard.

Those observations can not complete the analysis of Sahagen and Quinn's actions, however. Sahagen and Quinn knew what would happen if they notified Castiel of their intention to act by written consent to merge the LLC into VGS, Inc. Castiel would have attempted to remove Quinn, and block the planned action. . . .

. . . . Nothing in the statute suggests that this court of equity should blind its eyes to a shallow, too clever by half, manipulative attempt to restructure an enterprise through an action taken by a "majority" that existed only so long as it could act in secrecy.

. . . . The majority investor [in Virtual] protected his equity interest in the LLC through the mechanism of appointment to the board rather than by the statutorily sanctioned mechanism of approval by members owning a majority of the LLC's equity interests. . . . Instead the drafters [of the LLC Agreement] made the critical assumption, known to all the players here, that the holder of the majority equity interest has the right to appoint and remove two managers, ostensibly guaranteeing control over a three member board. When Sahagen and Quinn, fully recognizing that this was Castiel's protection against actions adverse to his majority interest, acted in secret, without notice, they failed to discharge their duty of loyalty to him in good faith. They owed Castiel a duty to give him prior notice even if he would

> have interfered with a plan that they conscientiously believed to be in the best interest of the LLC.[141]

In *Adlerstein*, Joseph Adlerstein was the founder and CEO of SpectruMedix and owned a majority of the corporation's voting power. In early 2000, Adlerstein elected Steven Wertheimer and Judy Mencher to join him on the SpectruMedix board. By late 2000, SpectruMedix's cash position had become perilous. A business consultant recommended various restructuring measures. These measures were supported by most of the corporation's department heads, and put into place, but Adlerstein tried to undo them. The consultant also concluded that Adlerstein was the central problem at SpectruMedix, because he was totally lacking in managerial and business competence, and that for SpectruMedix to have any chance to succeed, Adlerstein had to be removed from any operating influence.

At the beginning of July 2001, if not earlier, SpectruMedix was either insolvent or operating on the brink of insolvency; Adlerstein was not communicating with creditors; key vendors were refusing to make deliveries unless paid in cash; SpectruMedix did not have sufficient cash to make its next payroll; and a complaint of sexual harassment had been filed against Adlerstein.[142] Against the background of these actual and impending conditions, Wertheimer had contacted Ilan Reich to invest in and help manage SpectruMedix. Reich was willing to invest, but only if he was put in charge. Wertheimer and Mencher concluded that it was essential to bring Reich on board, and concomitantly to remove Adlerstein. Without Adlerstein's knowledge, they negotiated with Reich to that end. The deal they negotiated with Reich provided that subject to board approval, Reich would invest $1 million in SpectruMedix and would assume active management of the corporation, and SpectruMedix would issue to Reich preferred stock carrying voting control of the corporation. The documents necessary for a transaction with Reich were in draft form by July 6, 2001. They were sent to Wertheimer, Mencher, and Reich, but not to Adlerstein, who was deliberately kept unaware that Reich had made a proposal.

Wertheimer and Mencher then asked Adlerstein to convene a board meeting on July 9, without telling him that they intended to effectuate their plan at that meeting. The SpectruMedix bylaws had no requirement of prior notice of agenda items for meetings of the board of directors, nor was there a hard-and-fast legal rule that directors be given advance notice of all

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[141] *VGS*, 2000 Del. Ch. LEXIS 122, at *6, 10-11, 13, *reprinted in* 27 DEL. J. CORP. L. at 457, 459-60.

[142] *Adlerstein*, 2002 Del. Ch. LEXIS 13, at *3-11.

matters to be considered at a meeting.[143] Adlerstein convened the meeting. The deal with Reich, including the discharge of Adlerstein, was adopted by majority vote, over Adlerstein's objection.

The court set aside the board's action. It pointed out that the decision to keep Adlerstein in the dark about the Reich proposal was significant, because Adlerstein possessed power to prevent the issuance of the preferred stock by executing a written consent removing Wertheimer and Mencher from the board. Had Adlerstein known beforehand that Wertheimer and Mencher intended to approve the Reich deal and to remove Adlerstein from office at the July 9 meeting, Adlerstein could have exercised his legal right to remove one or both of them. The court concluded:

> [I]n the context of the set of legal rights that existed within SpectruMedix at the time of the July 9 meeting, Adlerstein was entitled to know ahead of time of the plan to issue new Series C Preferred Stock with the purposeful effect of destroying his voting control over the Company. This right to advance notice derives from a basic requirement of our corporation law that boards of directors conduct their affairs in a manner that satisfies minimum standards of fairness.[144]

The results in these cases are best explained by the duty of good faith. The duty of care does not explain these results, because the managers in all three cases could have rationally—indeed, reasonably—believed that they were acting in the best interests of the enterprise. It is true that in *VGS* the court referred to the duty of loyalty, but that reference is ambiguous because the court stated that the directors had "failed to discharge their duty of loyalty . . . *in good faith*,"[145] so that the reference to loyalty seems to be surplusage. Furthermore, the elements of wrongfulness that all three cases refer to—elements such as trickery, being "too clever by half,"[146] and failure to conduct the board's affairs in a manner that meets minimum standards of fairness—all sound in good faith, rather than loyalty.

Even apart from the language of the opinions, there are two reasons why the obligation not to achieve results through the use of manipulative processes that fail to satisfy generally accepted basic corporate norms is better understood as part of the duty of good faith than as part of the duties

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[143] *Id.* at *28.

[144] *Id.* at *28-29.

[145] *VGS*, 2000 Del. Ch. LEXIS 122, at *13, *reprinted in* 27 DEL. J. CORP. L. at 460 (emphasis added).

[146] *Id.* at *11, *reprinted in* 27 DEL. J. CORP. L. at 460.

of care or loyalty. First, this obligation applies even when, as in *Adlerstein*, the result that is achieved does not involve self-interest. Second, conduct that results in a benefit to the enterprise might not be deemed to violate the duty of loyalty, just for that reason. In contrast, the obligation not to achieve action by a corporate organ through the use of a manipulative process that violates generally accepted basic corporate norms applies even when the result benefits the enterprise, as seems to have been the case in *Koch*, *VGS*, and *Adlerstein*. It is never proper—never in good faith—to achieve desirable objectives through improper methods.

D. *Impermissible Nonpecuniary Motives*

Occasionally, a corporate manager engages in conduct in his managerial capacity that is based on a motive that, although not pecuniary, is self-regarding (hereinafter an "impermissible motive"). Conduct based on such a motive violates the duty of good faith. As Chancellor Allen stated in *In re RJR Nabisco, Inc. Shareholders Litigation*,[147] a manager does not act in good faith if he is motivated by "hatred, lust, envy, revenge, or . . . shame or pride."[148] Hatred, envy, and revenge may not often figure as managerial motives in publicly held corporations, but may frequently figure in closely held corporations. Lust or love may occasionally figure even in publicly held corporations, as where an executive hires or promotes a lover.

The prohibition against acting on the basis of impermissible motives provides still another way to explain the liability of Van Gorkom in *Smith v. Van Gorkom*.[149] Some of Van Gorkom's conduct seems best explained by the premise that he did not want to jeopardize his social position in Chicago generally, and with his negotiating counterparty, Jay Pritzker, in particular, by failing to deliver on a transaction that he had negotiated with Pritzker, who was one of the most prominent figures in Chicago. This could explain, for example, Van Gorkom's apparent lack of candor, which was likely aimed at getting the board to approve the transaction that Van Gorkom had arranged with Pritzker, rather than to negotiate that transaction more aggressively or explore alternative transactions.

A manager's obligation not to act on the basis of impermissible motives differs from the obligations considered in the first three sections of this Part. Because the conduct is self-regarding, the obligation might be explained, even without the duty of good faith, by the duty of loyalty.

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[147]No. 10,389, 1989 Del. Ch. LEXIS 9, at *46 (Del. Ch. Jan. 31, 1989), *reprinted in* 14 DEL. J. CORP. L. 1132, 1159 (1989).

[148]*Id.*

[149]*See supra* text accompanying note 123.

However, there are several reasons why it is important to place, or also place, the prohibition on such conduct within the duty of good faith.

To begin with, although such conduct *could* fall within the duty of loyalty, because it is self-regarding, it is not clear as a matter of positive law that it *does* fall within that duty because, as shown in Part V, traditionally that duty applied only to conduct that is motivated by direct or indirect *financial* self-interest. Locating the prohibition against conduct based on an impermissible, although non-pecuniary, motive under the duty of good faith makes clear that such conduct is improper even though it may not violate the duty of loyalty as traditionally conceived.[150]

Another reason for locating this prohibition under the duty of good faith concerns the nature of the prohibition. Over a wide range of cases, the duty of loyalty does not prohibit self-interested transactions, but only requires that such transactions be fair.[151] In contrast, the duty of good faith involves absolute prohibitions. So, for example, a manager may not properly take an action based on spite even though the same action would be unobjectionable if engaged in for proper reasons. Locating the prohibition on conduct based on impermissible motives under the duty of good faith underlines that such conduct is prohibited without regard to the outcome, although the outcome may affect the extent of liability, if any. Finally, locating this prohibition under the duty of good faith has the consequence that a manager cannot be shielded from accountability for such conduct.

An important and recurring case in which the possibility of impermissible motivation plays a central role concerns actions by directors to effectively preclude the liability of a colleague. Such actions occur in two contexts. First, some states, such as Delaware, have statutes that are interpreted to allow "disinterested" directors to approve a colleague's self-interested transaction and thereby preclude the normal judicial review of the fairness of such a transaction.[152] Second, many states allow the board to form a special litigation committee composed of "disinterested" directors, which has the effective power to preclude a judicial determination whether a derivative action against one or more colleagues of the directors is meritorious.

I put the term "disinterested" in quotes, because it is highly unlikely

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[150] *Cf.* E. Norman Veasey with Christine T. Di Gugliemo, *What Happened to Delaware Corporate Law and Governance from 1992-2004?*, 153 U. PA. L. REV. 1399, 1451 (2005) ("Arguably, it is analytically preferable to treat good faith and loyalty as separate duties, in part because self-dealing is not required for a good faith violation.").

[151] *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a)(3) (2004).

[152] *Id.* § 144.

that directors are impartial when deciding whether to preclude the liability of a friend and colleague. This is yet another case where "interestedness" is narrowly defined to mean only financial self-interest. Lately, the Delaware courts have expanded the test of disinterestedness, both by adding a test of independence and by determining financial disinterestedness and independence in a more expansive manner.[153] Nevertheless, even the Delaware courts have stopped well short of requiring impartiality. For example, in *Beam v. Stewart*,[154] the Delaware Supreme Court held that allegations that Martha Stewart and directors who took action to insulate her from suit "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' even when coupled with Stewart's 94% voting power, are insufficient, without more, to rebut the presumption of independence."[155] Would not a Delaware judge who had those same kinds of relationships with Martha Stewart believe that he was obliged to recuse himself from deciding a case in which Martha Stewart was a party? If those kinds of relationships would render a judge not impartial, how could they fail to render a director not impartial?

It is true, of course, that the action of the "disinterested" directors, like any other directorial action, is potentially subject to judicial review. However, the duty of loyalty is typically inapplicable to these directors, because by hypothesis they have no material financial ties to either the director whose transaction or conduct is at issue or to the transaction or conduct itself. And as a result of the business judgment rule, typically it is also very difficult to prove that the directors have violated the duty of care.

The best way to address these problems would be to adopt a special rule of review in these contexts. Many states do just that, either by providing that a self-interested transaction is subject to judicial review for fairness even if approved by "disinterested" directors, or by adopting rules that require a much higher level of scrutiny of the recommendations of special litigation committees than would be normally applied under the business judgment rule. The next-best alternative is to apply the duty of good faith to determine whether the approving directors have acted with the impermissible motive of favoring their colleague. As Chancellor Chandler pointed out in *Disney IV*:

> Another example of how the concept of good faith may operate in a situation where ensuring director compliance with

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[153] *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

[154] 845 A.2d 1040 (Del. 2004).

[155] *Id.* at 1051.

> the fiduciary duties of care and loyalty (as we have traditionally defined those duties) may be insufficient to protect shareholders' interests, is found in . . . § 144(a). Under § 144(a), a transaction between a corporation and its directors or officers will be deemed valid if approved by a majority of the independent directors, assuming three criteria are met: 1) the approving directors were aware of the conflict inherent in the transaction; 2) the approving directors were aware of all the facts material to the transaction; and 3) the approving directors acted in good faith. In other words, the inside transaction is valid where the independent and disinterested (loyal) directors understood that the transaction would benefit a colleague (factor 1), but they considered the transaction in light of the material facts (factor 2—due care) mindful of their duty to act in the interests of the corporation, unswayed by loyalty to the interests of their colleagues or cronies (factor 3—good faith). On the other hand, where the evidence shows that a majority of the independent directors were aware of the conflict and all material facts, in satisfaction of factors 1 and 2 (as well as the duties or loyalty and care), but acted to reward a colleague rather than for the benefit of the shareholder, the Court will find that the directors failed to act in good faith and, thus, that the transaction is voidable. In such a case, the duties of care and loyalty, as traditionally defined, might be insufficient to protect the equitable interests of the shareholders, and the matter would turn on the good faith of the directors.[156]

A similar position was taken in *Desaigoudar v. Meyercord.*[157] Here the court stated:

> [T]he business judgment rule . . . does not apply in the case of bad faith. . . . "The policy reasons for keeping a court from evaluating after the fact the wisdom of a particular business decision do not apply when the issue is whether a party to that decision acted fraudulently or in bad faith. . . ."[158]

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[156]*Disney IV*, 2005 Del. Ch. LEXIS 113, at *177 n.464, *reprinted in* 31 DEL. J. CORP. L. at 425 n.464 (citing DEL. CODE ANN. tit. 8, § 144(a) (2004)).

[157]133 Cal. Rptr. 2d 408 (Cal. Ct. App. 2003).

[158]*Id.* at 419 (quoting Will v. Engebretson, 261 Cal. Rptr. 868, 874 (Cal. Ct. App. 1989)).

> A court's review to uncover bad faith . . . is not a perfunctory one. . . . [W]hether a committee employed proper procedures before rejecting the claim-involves an analysis of the committee's good faith. This means that the court must look into the procedures employed and determine whether they were adequate or whether they were so inadequate as to suggest fraud or bad faith. That is, "[p]roof . . . that the investigation has been so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham, consistent with the principles underlying the application of the business judgment doctrine, would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine." . . . "[I]t [is] necessary for the court to consider whether, on the facts alleged, the refusal of the directors to prosecute the claims was so clearly against the interests of the corporation that it must be concluded that the decision of the directors did not represent their honest and independent judgment."[159]

Similarly, the comment to Model Business Corporation Act § 8.31(a) states:

> If a director's conflicting interest transaction is determined to be manifestly unfavorable to the corporation, giving rise to an interence of bad faith tainting the directors' action approving the transaction under section 8.62, the safe harbor protection afforded by section 8.61 for both the transaction and the conflicted director would be in jeopardy.

In these and like cases, the duty of good faith functions as a condition—specifically, as a condition to the effectiveness of the approving directors' action. Seldom, if ever, would violation of the duty of good faith in this context give rise to liability, because if the approving directors violate the duty of good faith, so that their action is ineffective, the director whose conduct is at issue is left unprotected against suit, and the corporation therefore normally will suffer no damage as a result of the directors' approval.

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[159]*Desaigoudar*, 133 Cal. Rptr. 2d at 419-20 (quoting Auerbach v. Bennett, 47 N.Y. 2d 619, 634-35 (N.Y. 1979) (quoting Findley v. Garrett, 109 Cal. App. 2d 166, 177 (Cal. Ct. App. 1952)).

E. *Substantial Disregard of Responsibilities*

Managers sometimes disregard their responsibilities. Such disregard will almost always constitute a violation of the duty of care (although the manager may be insulted against liability for the violation by the business judgment rule, a gross negligence standard of review, or a shield provision in the corporation's certificate of incorporation). In some cases, however, the magnitude of the disregard rises to so high a level that the manager also violates the duty of good faith, because disregard of responsibilities at that level constitutes a lack of fidelity to one's office, violates generally accepted basic corporate norms, and usually is dishonest in the sense that the manager does not sincerely believe that he is acting properly. A number of important recent cases have so held: in particular, *In re Caremark International Inc. Derivative Litigation* (*Caremark*),[160] *McCall v. Scott* (*McCall*),[161] *In re Abbott Laboratories Derivative Shareholders Litigation* (*Abbott Laboratories*),[162] *In re Emerging Communications, Inc. Shareholders Litigation* (*Emerging Communications*),[163] *Disney III*,[164] and *Disney IV*.[165]

Caremark, decided by Chancellor Allen in 1996, concerned disregard of the board's duty to install monitoring and information systems. Caremark Corporation was a health care provider. A substantial portion of its revenues was derived from payments by Medicare and Medicaid. These payments were subject to the federal Anti-Referral Payments Law, which prohibited health care providers from making payments to third parties—primarily physicians—to induce referrals of Medicare or Medicaid patients.[166]

From its inception, Caremark entered into "consultation agreements" with, and made research grants to, physicians who then prescribed or recommended Caremark to their Medicare patients. Based on these agreements and grants, Caremark was indicted for violating the Anti-Referral Payments Law. Caremark pleaded guilty, agreed to pay civil and criminal fines, and reimbursed various private and public parties. In all,

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[160]698 A.2d 959 (Del. Ch. 1996).

[161]239 F.3d 808 (6th Cir. 2001), *amended by* 250 F.3d 997 (6th Cir. 2001).

[162]325 F.3d 795 (7th Cir. 2003).

[163]No. 16,415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) (revised June 4, 2004).

[164]825 A.2d 275 (Del. Ch. 2003).

[165]No. 15,452, 2005 Del. Ch. LEXIS 28 (Del. Ch. Feb. 4, 2005), judgment entered 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005), *reprinted in* 31 DEL. J. CORP. L. 349 (2006).

[166]*Caremark*, 698 A.2d at 961-62.

Caremark was required to make payments of approximately $250 million as a result of its illegal conduct.[167]

Derivative actions based on these payments were brought against Caremark's directors, and settled. The issue in *Caremark* itself was whether the settlements should be judicially approved. That issue, in turn, depended in part on the nature of the board's duty, if any, to install information and reporting systems. Chancellor Allen stated that it would

> be a mistake to conclude that . . . corporate boards may satisfy their obligation to be reasonably 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.[168]

Rather, he said, "[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 . . . ."[169]

As to when a failure of directors to assure themselves that appropriate information and reporting systems are in place constitutes a lack of good faith, Chancellor Allen opined that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[170] The *test* laid down by Chancellor Allen—a sustained or systematic failure of the board to exercise oversight—seems appropriate. The *illustration*—an "utter failure"—is certainly an example of a sustained or systematic failure, but it would be inappropriate if it were a test rather than an illustration.

McCall,[171] decided by the Sixth Circuit in 2001 under Delaware law, was a derivative action against former directors of another health care provider, Columbia/HCA Healthcare Corporation. The claims arose out of widespread and systematic fraudulent schemes engaged in by Columbia,

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[167] *Id.* at 960-62.

[168] *Id.* at 970.

[169] *Id.*

[170] *Caremark*, 698 A.2d at 971.

[171] 239 F.3d 808 (6th Cir. 2001), *amended by* 250 F.3d 997 (6th Cir. 2001).

such as systematic overbilling. The complaint alleged that with the board's knowledge, Columbia's senior management devised these fraudulent schemes to improperly increase Columbia's revenue and profits and, to that end, perpetuated a management philosophy that provided strong incentives for employees to engage in such schemes. The directors argued that the complaint should be dismissed because it alleged only a violation of the duty of care, and Columbia's certificate of incorporation included a shield provision, adopted pursuant to Delaware General Corporation Law § 102(b)(7), which insulated the directors from liability for violation of the duty of care.[172] The court rejected this argument because the basis of the complaint was the director's conscious disregard of known risks, and such conduct violates the duty of good faith and is therefore ineligible for protection under the shield. "[D]uty of care claims alleging only grossly negligent conduct are precluded by a § 102(b)(7) . . . provision, [but] it appears that duty of care claims based on reckless or intentional misconduct are not. . . . [A] conscious disregard of known risks, . . . if proven, cannot have been undertaken in good faith."[173]

Abbott Laboratories, decided by the Seventh Circuit in 2002 under Delaware law, was a derivative action against directors of Abbott, a pharmaceutical company. Plaintiffs alleged that the directors had, over a seven-year period, ignored both strong warnings from the Food and Drug Administration (FDA) and reports in the *Wall Street Journal* that two of Abbott's production facilities were seriously and persistently deficient under the FDA's published standards. As a result of the deficiencies and the lack of board action, the plants had to be closed down, and Abbott suffered substantial losses. The court held that the complaint stated a claim that the directors had violated the duty of good faith:

> Delaware law imposes three primary fiduciary duties on the directors of corporations; the duty of care, the duty of loyalty, and the duty of good faith . . . .

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[172] *Id.* at 813-18. More accurately, the precise issue was whether the allegations in the complaint, if true, created a reasonable doubt that a majority of the board was disinterested, so that a derivative action could be brought without first making demand on the board. The governing rule was that "[w]hile the mere threat of personal liability is not sufficient, reasonable doubt as to the disinterestedness of a director is created when the particularized allegations in the complaint present 'a substantial likelihood' of liability on the part of the director." *Id.* at 817 (citations omitted). The directors argued that the allegations in the complaint did not create a substantial likelihood of liability because the complaint essentially alleged that the board had violated the duty of care, and the directors were exculpated from duty-of-care liability under Columbia's shield provision. *Id.*

[173] *McCall*, 250 F.3d at 1000-01.

> . . . . Given the extensive paper trail in *Abbott* concerning the violations and the inferred awareness of the problems, the facts support a reasonable assumption that there was a "sustained and systematic failure of the board to exercise oversight," in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses, establishing a lack of good faith. We find that six years of noncompliance, inspections, . . . Warning Letters, and notice in the press, all of which then resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately $ 250 million in corporate assets, indicate that the directors' decision to not act was not made in good faith and was contrary to the best interests of the company. . . .
>
> The Sixth Circuit followed Delaware law in *McCall* in finding that the directors' fiduciary duties include not only the duty of care, but also the duties of loyalty and good faith, stating that although "duty of care claims alleging only grossly negligent conduct are precluded by § 102(b)(7) waiver provision, it appears that duty of care claims based on reckless or intentional misconduct are not." . . . The *McCall* court . . . further stated, "Under Delaware law, the duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer." . . . Plaintiffs in *Abbott* accused the directors not only of gross negligence, but of intentional conduct in failing to address the federal violation problems, alleging "a conscious disregard of known risks, which conduct, if proven, cannot have been undertaken in good faith."[174]

Emerging Communications[175] was decided in 2004 by Justice Jacobs of the Delaware Supreme Court, sitting by designation as Vice Chancellor. Innovative Communications owned a majority of the stock of Emerging

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[174] *Abbott Labs.*, 325 F.3d at 808-09, 811.

[175] *In re* Emerging Commc'ns S'holders Litig., No. 16,415, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) (revised June 4, 2004).

Communications (Emerging). All of Innovative's stock, in turn, was indirectly owned by Jeffrey Prosser, Emerging's CEO. Innovative and Emerging had engaged in a going-private transaction, which was effectuated through a combined tender offer and cashout merger. The transaction had been recommended by a special committee of Emerging and approved by Emerging's board. Under the transaction, Innovative acquired the minority stock in Emerging at a price of $10.25 per share. There were two issues in the case: whether the transaction was fair to Emerging's minority shareholders and, if it was unfair, whether any Emerging directors were personally liable for breaching their fiduciary duties to those shareholders. The court concluded that the merger price was unfair, and then turned to "the nature of the fiduciary duty violation—whether of care, loyalty, or good faith—that resulted in the unfair transaction."[176]

As to one of the defendant-directors, Raynor, the court concluded that although Raynor did not directly benefit from the transaction, his loyalties ran solely to Prosser because his economic interests were tied solely to Prosser and he acted to further those interests. Accordingly, the court held that Raynor was liable to the minority shareholders for breaching "his fiduciary duty of loyalty and/or good faith."[177] The court explained its use of the "and/or" phraseology as follows:

> The Court employs the "and/or" phraseology because the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and of good faith. If a loyalty breach requires that the fiduciary have a self-dealing conflict of interest in the transaction itself, as at least one commentator has suggested, then only Prosser is liable on that basis. Raynor would be liable for violating his duty of good faith for consciously disregarding his duty to the minority stockholders. On the other hand, if a loyalty breach, does not require a self-dealing conflict of interest or receipt of an improper benefit, then Raynor would be liable for breaching his duties of loyalty *and* good faith. The Court need not decide that definitional issue, because under either definition, Raynor's conduct amounted to a non-exculpated breach of fiduciary duty.[178]

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[176] *Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *137-38.

[177] *Id.* at *142.

[178] *Id.* at *142 n.184 (citations omitted).

The court then turned to another defendant-director, Muoio, and concluded that Muoio was also liable. Even though Muoio's conduct was less egregious than that of Raynor, he was culpable because he voted to approve the transaction although he knew, or at the very least had strong reason to believe, that the merger price was unfair. Muoio was in a special position to know the price was unfair because he "possessed specialized financial expertise and an ability to understand [Emerging's] intrinsic value, that was unique to"[179] the members of Emerging's board, except for perhaps Prosser:

> Informed by his specialized expertise and knowledge, Muoio conceded that the $ 10.25 price was "at the low end of any kind of fair value you would put," and expressed to [another director] his view that the Special Committee might be able to get up to $ 20 per share from Prosser. In these circumstances, it was incumbent upon Muoio, as a fiduciary, to advocate that the board reject the $ 10.25 price that the Special Committee was recommending. As a fiduciary knowledgeable of ECM's intrinsic value, Muoio should also have gone on record as voting against the proposed transaction at the $ 10.25 per share merger price. Muoio did neither. Instead he joined the other directors in voting, without objection, to approve the transaction.[180]

On this basis, the court continued:

> The credible evidence persuades the Court that Muoio's conduct is explainable in terms of only one of two possible mindsets. The first is that Muoio made a deliberate judgment that to further his personal business interests, it was of paramount importance for him to exhibit his primary loyalty to Prosser. The second was that Muoio, for whatever reason, "consciously and intentionally disregarded" his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair. If motivated by either of those mindsets, Muoio's conduct would have amounted to a violation of his duty of loyalty and/or good faith. . . . Muoio has not established to the satisfaction

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[179] *Id.* at *144.

[180] *Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *144 (footnotes omitted).

> of the Court, after careful scrutiny of the record, that his motivation was of a benign character . . . .[181]

The court amplified its reasoning on Muoio's violation of the standard of good faith as follows:

> Although the Supreme Court has yet to define the precise conduct that would actionably violate that duty, this Court has recently held that directors can be found to have violated their duty of good faith if they *"consciously and intentionally disregard . . . their responsibilities,* adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[182]

Disney III[183] involved a motion to dismiss on the pleadings. Accordingly, the court assumed that the facts alleged in the complaint were true. These facts were essentially as follows: Michael Eisner was Disney's chief executive officer. Disney needed a president to be Eisner's second-in-command. Eisner chose Michael Ovitz, who had been Eisner's close friend for over twenty-five years. In September 1995, Disney prepared a draft five-year employment agreement for Ovitz. At a meeting of the board's compensation committee on September 26, the committee members were provided with a rough summary of the agreement, but not the draft agreement itself, and even the summary was incomplete. The summary stated that Ovitz was to receive options to purchase five million shares of stock, but did not state the exercise price. Furthermore, no analytical document that showed the potential payout to Ovitz, or the possible cost of his severance package, was either created or presented to the committee. The committee neither requested nor received any information concerning how the agreement compared with agreements in the entertainment industry involving similarly situated executives. The committee nevertheless approved the general terms and conditions of the agreement. Disney's board met immediately after the compensation committee meeting. Again, no documents were produced for the board to review before the meeting, and the board did not consider the various payout scenarios if a termination should occur.[184]

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[181] *Id.* at *146-47 (footnotes omitted).

[182] *Id.* at *153 (quoting *Disney III*, 825 A.2d at 289).

[183] 825 A.2d 275 (Del. Ch. 2003).

[184] *Id.*

Final negotiation of the employment agreement was left to Eisner, Ovitz's close friend. Neither the board nor the compensation committee reviewed or approved the final agreement. The final agreement differed significantly from the summary presented to the compensation committee. One major difference concerned the circumstances surrounding Ovitz's severance benefits. The draft provided that in the case of a "non-fault" termination, Ovitz would receive very substantial benefits, but that a non-fault termination would occur only if Disney wrongfully terminated Ovitz or Ovitz died or became disabled. In contrast, the final agreement stated that Ovitz would receive non-fault termination benefits if he was terminated by Disney and had not acted with gross negligence or malfeasance. Therefore, under the final agreement, Ovitz would receive "non-fault" termination benefits even if he was terminated by Disney because he acted negligently, as long as his behavior did not reach the level of gross negligence or malfeasance.[185]

Ovitz's tenure as Disney's president was extremely unsuccessful. Although Ovitz admittedly did not know his job, he studiously avoided attempts to be educated.[186] Instead of working to learn his duties as Disney's president, Ovitz began seeking alternative employment. Under his contract, Ovitz could properly terminate his employment only if one of four designated events occurred. None of these events ever occurred. However, Eisner rewrote Ovitz's contract so that in the event of Ovitz's voluntary departure for *any* reason, Disney would pay him the benefits provided for in the event of a non-fault termination. As a result, Ovitz received termination benefits of $140 million for doing a terrible job for one year.[187]

If the alleged facts were true, Disney's directors would have violated their duty of care, but the directors would have been insulated from liability for violation of that duty by Disney's shield provision. However, violations of the duty of good faith are not protected under the Delaware shield provision and on the basis of "the foundational directoral obligation to act honestly and in good faith to advance corporate interests,"[188] the court held that if the alleged facts were true, the directors' conduct also violated the duty of good faith:

> These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of

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[185] *Id.*

[186] *Id.* at 283.

[187] *Disney III*, 825 A.2d 275 (Del. Ch. 2003).

[188] *Id.* at 291.

> material importance to their corporation. Instead, the facts alleged in the . . . complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company. 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. Viewed in this light, plaintiffs' . . . complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests . . . .[189]

After the denial of the motion to dismiss on the pleadings, the case went to trial. The evidence at trial diverged from the allegations in the complaint, and on the basis of that evidence, in *Disney IV* Chancellor Chandler held for the defendants. In the course of his opinion, the Chancellor elaborated on the duty of good faith as follows:

> Bad faith has been defined as authorizing a transaction "for some purpose *other than* a genuine attempt to advance corporate welfare or [when the transaction] is *known to constitute* a violation of applicable positive law." In other words, an action taken with the intent to harm the corporation is a disloyal act in bad faith. A similar definition was used seven years earlier, when Chancellor Allen wrote that bad faith (or lack of good faith) is when a director acts in a manner "unrelated to a pursuit of the corporation's best interests." It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation.
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[189] *Id.* at 289.

> Bad faith can be the result of "any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation," including greed, "hatred, lust, envy, revenge,... shame or pride." Sloth could certainly be an appropriate addition to that incomplete list if it constitutes a systematic or sustained shirking of duty....
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> .... [T]he defendants' motion to dismiss this action was denied because I concluded that the complaint... alleged that Disney's directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."
>
> Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty*, a *conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith....
>
> .... The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but 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. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.[190]

The cases use various formulations as tests for determining when the magnitude of disregard of responsibilities rises to so high a level that a manager has violated not only the duty of care, but also the duty of good faith. These tests include "a sustained or systematic failure of the board to

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[190]*Disney IV*, 2005 Del. Ch. LEXIS 113, at *169-70, 173-77 (footnotes omitted), *reprinted in* 31 DEL. J. CORP. L. at 422-25.

exercise oversight,"[191] "reckless or intentional misconduct,"[192] "a conscious disregard of known risks,"[193] "consciously and intentionally disregard[ing] their responsibilities,"[194] "adopting a 'we don't care about the risks' attitude concerning a material corporate decision,"[195] "intentional dereliction of duty,"[196] "conscious disregard for one's responsibilities,"[197] "[s]loth . . . if it constitutes a systematic or sustained shirking of duty,"[198] and "[k]nowing or deliberate indifference . . . [to one's] duty to act faithfully and with appropriate care."[199]

These tests are not conflicting. Rather, they are various ways to indicate the magnitude and type of disregard required to establish a breach of the duty of good faith on the basis of disregard of one's responsibilities. Chancellor Chandler said as much in *Disney IV*: "[T]he concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (*although not the only*) standard for determining when fiduciaries have acted in good faith."[200]

The terms "intentional" and "conscious," as used in that and some other tests, need interpretation. The formulations that employ these terms would make little or no sense unless they mean either that the manager was conscious that he was disregarding his duties or that a reasonable person in the manager's position would have known that he was disregarding his duties—not that the actual manager was subjectively conscious that he was disregarding his duties. Surely it would be no defense in such a case that the manager on being asked, "Were you consciously disregarding your duties?" truthfully replied, "No," or, "I didn't think about it one way or the other."

Once that is understood, it is not necessary to choose a single formulation of when disregard of responsibilities rises to a magnitude that constitutes a violation of the duty of good faith, because there is more than one way for disregard to rise to that level. For simplicity, I will use the

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[191] *Caremark*, 698 A.2d at 971.

[192] *Abbott Labs.*, 325 F.3d at 811; *McCall*, 250 F.3d at 1000-01.

[193] *Abbott Labs.*, 325 F.3d at 811; *McCall*, 250 F.3d at 1000-01.

[194] *Disney II*, 825 A.2d at 289; *Disney IV*, 2005 Del. Ch. LEXIS 113, at *174, *reprinted in* 31 DEL. J. CORP. L. at 424; *Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *153 (emphasis omitted).

[195] *Disney III*, 825 A.2d at 289; *Emerging Commc'ns*, 2004 Del. Ch. LEXIS 70, at *153.

[196] *Disney IV*, 2005 Del. Ch. LEXIS 113, at *175, *reprinted in* 31 DEL. J. CORP. L. at 424.

[197] *Id.*

[198] *Id.* at *173, *reprinted in* 31 DEL. J. CORP. L. at 423.

[199] *Disney III*, 825 A.2d at 289.

[200] *Disney IV*, 2005 Del. Ch. LEXIS 113, at *175, *reprinted in* 31 DEL. J. CORP. L. at 424 (emphasis added; emphasis by the court omitted).

term *substantial disregard of responsibilities* to embody that level, on the understanding that (1) this term is intended to capture any unjustifiable or inexplicable disregard of responsibilities that is either persistent or concerns a very important event, and (2) this term is intended to embrace, rather than supplant, the various formulations that have been used in the cases.

Two important observations need to be made about *Disney III* and *IV* in particular, and a substantial disregard of responsibilities (however formulated) in general.

The first observation is that a substantial disregard of responsibilities effectively operates only as a condition, not as a basis of liability. The reason is that a manager who substantially disregards his responsibilities violates the duty of care, and that violation is a sufficient basis for liability in all cases. Since the manager is liable for breach of the duty of care, his breach of the duty of good faith does not add a new liability. The only operational effect of the fact that the disregard is substantial, and therefore a violation of the duty of good faith, is that the manager cannot avail himself of a shield provision that does not exculpate violations of the duty of good faith.

The second observation is that although at the beginning of his discussion of good faith in *Disney IV* Chancellor Chandler states that "[d]ecisions from the Delaware Supreme Court and the Court of Chancery are far from clear with respect to whether there is a separate fiduciary duty of good faith," the entire balance of the Chancellor's discussion endorses that duty:

> To create a definitive and categorical definition of the universe of acts that would constitute bad faith would be difficult, if not impossible. And it would misconceive how, in my judgment, the concept of good faith operates in our common law of corporations. Fundamentally, the duties traditionally analyzed as belonging to corporate fiduciaries, loyalty and care, are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary. The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but 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. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient. As evidenced by previous rulings in this case both from this Court and the Delaware Supreme Court, issues of the Disney directors' good faith (or lack thereof) are central to the outcome of this action.[201]

Although the Chancellor took the view that the duty of good faith embraces the duties of care and loyalty, rather than the view that good faith stands alongside care and loyalty, there is little or no functional difference between those two views. Under either view, good faith is an independent duty that gives rise to specific obligations not comprehended within the duties of care and loyalty.

VII. CONCLUSION

An important development in corporate law is the recent explicit recognition, in a series of Delaware cases, that managers have a fiduciary duty of good faith. That duty was not created by those cases. On the contrary, the duty has long been explicit or implicit under the statutes—for example, in statutory provisions that require directors to act in good faith and in provisions concerning indemnification. The duty of good faith has also long existed implicitly in the 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 rule that a manager acts improperly if he knowingly causes the corporation to take an illegal action. Nevertheless, the explicit recognition of the duty of good faith in recent Delaware cases shines a spotlight on that duty and therefore makes it especially important to develop the contours of the duty and to examine the duty from a normative perspective. It is these two issues with which this article has been primarily concerned.

The duty of good faith has a Janus-like quality, looking both backward and forward. Looking backward, the duty of good faith rationalizes and explains a variety of specific obligations that are already established, although they do not fit comfortably or at all within the duties

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[201] *Id.* at *176-77, *reprinted in* 31 DEL. J. CORP. L. at 424-25 (footnote omitted).

of care and loyalty, such as the obligation not to knowingly cause the corporation to disobey the law and the obligation of candor, even when law violation and lack of candor are not self-interested and are reasonably designed to maximize corporate profits and shareholder gain. Looking forward, the general duty of good faith may give rise to the articulation of new specific fiduciary obligations that come to be seen as appropriate in response to social changes, but cannot be accommodated within the duties of care or loyalty.