THE DUTY OF GOOD FAITH IN CORPORATE LAW

BY MELVIN A. EISENBERG*

ABSTRACT

An important development in corporate law is the recent explicit recognition, in a series of Delaware cases, that corporate managers owe a fiduciary duty of good faith in addition to their traditional duties of care and loyalty. The duty of good faith was not created by those cases. On the contrary, the duty has long been explicit 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 duty not to knowingly cause the corporation to violate the law. 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.

Briefly, the duty of good faith in corporate law is comprised of a general baseline conception and specific obligations that instantiate that conception. The baseline conception consists of four elements: subjective honesty, or sincerity; nonviolation of generally accepted standards of decency applicable to the conduct of business; nonviolation of generally accepted basic corporate norms; and fidelity to office. Among the specific obligations that instantiate the baseline conception are the obligation not to knowingly cause the corporation to disobey the law and the obligation of candor even in non-self-interested contexts.

Turning to the normative issue, there are several basic reasons why the duty of good faith is desirable. To begin with, the duties of care and loyalty do not cover all types of improper conduct by managers, because

---

*Koret Professor of Law, School of Law, University of California, Berkeley (Boalt Hall); Stephen and Barbara Friedman Visiting Professor of Law, Columbia Law School. A.B. 1956, Columbia University; LL.B. 1959, Harvard University. I thank Jesse Fried, Jim Hanks, Jack Jacobs, Amir Licht, Mary Siegel, Marshall Small, and Leo Strine for their very important comments on earlier drafts and Shawn Bayern and Joel Willard for their valuable research assistance. Earlier versions of this article were presented on the occasion of the award of an honorary Doctor of Laws degree by the University of Cologne in 2004, and as the Francis G. Pileggi Distinguished Lecture in Law delivered at the Widener University School of Law on Nov. 19, 2004. A shorter version of this article will appear in the *European Company and Financial Law Review*.

certain kinds of managerial misconduct fall outside the spheres of those duties, and most of these types of misconduct fall within the duty of good faith. Furthermore, various rules limit a manager's accountability under the duties of care and loyalty, and these limiting rules should be and are inapplicable to conduct that violates the duty of good faith. Moreover, the duties of care and loyalty characteristically (although not invariably) function as platforms for liability rules, while the duty of good faith characteristically (although not invariably) functions as a condition to the application of rules that do not in themselves impose liability. This difference in characteristic function makes it desirable to treat good faith separately from care and loyalty. Finally, the duty of good faith provides a principled basis for the courts to articulate new specific fiduciary obligations that come to be seen as appropriate in response to changes in social and business norms, and in the general understanding of efficiency and other policy considerations, but that cannot be easily accommodated within the duties of care or loyalty.

TABLE OF CONTENTS

I. INTRODUCTION

An important development in corporate law is the explicit recognition in recent cases that corporate managers— directors and officers—owe a duty of good faith in addition to their duties of care and loyalty.[1] Because this development has been attended by a certain degree

---

[1]The emerging recognition of the duty of good faith in Delaware case law was first fully developed by Hillary Sale in *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004). Shortly thereafter, a number of other significant articles on that issue appeared. *See, e.g.*, Matthew R. Berry, *Does Delaware's Section 102(b)(7) Protect Reckless Directors From Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L. REV. 1125 (2004); John L. Reed & Matt Neiderman, *Good Faith and the Ability of Directors to Assert § 102(b)(7) of the Delaware Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111 (2004); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004). For an early, more targeted, discussion, see Deborah DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 25 WAKE FOREST L. REV. 15 (1990). All

of controversy, three issues require examination: (1) Does corporate law impose a fiduciary duty of good faith? (2) If so, what should be and what are the contours of that duty? (3) Is an independent duty of good faith justified on normative grounds?

These three issues are tightly connected. For example, the legal status of the duty of good faith depends in part on whether the duty is normally justified, and whether the duty is normatively justified depends in part upon the contours of the duty. Therefore, it is difficult to resolve any one of these three issues in isolation. This article deals with the problem of interconnectedness as follows. Part II consists of an overview of the legal status of the duty of good faith in corporate law, the contours of that duty, and the normative justifications of that duty. Part III develops the legal status of the duty in greater depth. Part IV develops the contours of the duty in greater depth, by setting out the baseline conception of the duty. Part V develops the normative justifications of the duty in greater depth. Finally, Part VI considers some of the specific obligations that instantiate the general baseline conception of the duty of good faith, and some important recent cases concerning that duty.

II. OVERVIEW: THE LEGAL STATUS, CONTOURS, AND NORMATIVE JUSTIFICATIONS OF THE DUTY OF GOOD FAITH

A. *Legal Status*

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

---

of these articles also discuss, to varying extents, the parameters of the duty of good faith. *See, e.g.*, Sale, *supra*, at 482-94. The present article primarily concerns that issue.

B. *Contours*

The duty of good faith in corporate law is comprised of a general baseline conception and specific obligations that instantiate that conception. The baseline conception consists of four elements: subjective honesty, or sincerity; nonviolation of generally accepted standards of decency applicable to the conduct of business; nonviolation of generally accepted basic corporate norms; and fidelity to office. Among the specific obligations that instantiate the baseline conception are the obligation not to knowingly cause the corporation to disobey the law and the obligation of candor even in non-self-interested contexts.

C. *Normative Justifications*

The duty of good faith in corporate law is supported by four normative justifications:

First, the traditional duties of care and loyalty do not cover all types of improper managerial conduct. The standard of conduct under the duty of care essentially requires a manager, when not acting in his own self-interest, to perform his duties in a manner that he reasonably believes to be in the best interests of the corporation, with a view towards maximizing corporate profit and shareholder gain. The standard of conduct under the duty of loyalty essentially requires a manager to act fairly when he acts in his own pecuniary self-interest or in the pecuniary interest of an associate or a family member. Given the ambit of these standards, certain important kinds of managerial misconduct fall outside the spheres of those duties. Most of these types of misconduct, however, fall within the duty of good faith.

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

Third, the duties of care and loyalty characteristically (although not invariably) function as platforms for *liability* rules. In contrast, the duty of good faith characteristically (although again, not invariably) functions as a *condition* to the application of rules that do not in themselves impose liability, such as rules concerning indemnification. This difference in

characteristic function makes it desirable to treat good faith separately from care and loyalty.

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

III. AN INTRODUCTION TO THE LEGAL STATUS OF THE DUTY OF GOOD FAITH UNDER STATUTORY AND CASE LAW

A. *Statutory Law*

There is little doubt that as a matter of positive law, corporate managers owe a duty of good faith. To begin with, that duty is explicitly imposed on directors, officers, or both, under many or most statutes. For example, section 8.30 of the Model Business Corporation Act, which has been adopted in many states, provides that "[e]ach member of the board of directors, when discharging the duties of a director, shall act . . . in good faith."[2] A counterpart provision, section 8.42, provides that "[a]n officer, when performing in such capacity, shall act . . . in good faith."[3] Similarly, the New York statute, and many others, provide that "[a] director shall perform his duties as a director . . . in good faith."[4]

In addition, in all or virtually all states various statutory provisions make the applicability of important rules conditional on managerial good faith. For example, sections 145(a) and (b) of the Delaware General Corporation Law explicitly provide that under designated conditions a corporation has the power to indemnify a manager for the costs and outcomes of litigation and other proceedings, provided the manager acted in good faith.[5] The strength of the good faith requirement in this context is highlighted in cases involving a manager's right to indemnification under private arrangements adopted pursuant to statutory provisions that do not by their terms require good faith as a condition to indemnification. For example, section 145(f) of the Delaware statute provides that "[t]he indemnification . . . provided by, or granted pursuant to . . . this section

---

[2]MODEL BUS. CORP. ACT § 8.30(a) (2005).

[3]*Id.* § 8.42.

[4]N.Y. BUS. CORP. LAW § 717(a) (McKinney 2003).

[5]DEL. CODE ANN. tit. 8, § 145(a)-(b) (2004).

shall not be deemed exclusive of any other rights to which those seeking indemnification . . . may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise."[6]

In *Waltuch v. Conticommodity Services, Inc.*,[7] Article Ninth of the certificate of incorporation of Conticommodity (Conti), a Delaware corporation, gave Conti's managers a right to indemnification under defined circumstances, and did not require a showing of good faith. Waltuch brought suit against Conti under Article Ninth for indemnification of unreimbursed legal expenses that he had incurred in certain proceedings. Conti responded that Waltuch's claim was barred because he did not establish that he had acted in good faith. Waltuch countered that Article Ninth was authorized by section 145(f), and nothing in that section required good faith for indemnification under private arrangements. The Second Circuit held that notwithstanding the absence of an explicit requirement of good faith for indemnification under private arrangements, indemnification in the absence of good faith would exceed the scope of a Delaware corporation's power to indemnify, and a certificate provision, bylaw, or agreement that permitted such indemnification was to that extent invalid. Other cases have taken the same position, typically by subscribing to *Waltuch*.[8]

Another illuminating case concerning the role of good faith in indemnification is *In re Landmark Land Co.*[9] Landmark Land Company (Landmark), a publicly held corporation, sat at the top of a complex corporate structure. Landmark owned all the stock in Oak Tree Savings Bank (the Bank). The Bank, in turn, indirectly owned all the stock of several real estate subsidiaries that used the Bank's funds to finance their operations. Gerald Barton was a 29% shareholder of Landmark; the CEO

---

[6] *Id.* § 145(f).

[7] 88 F.3d 87 (2d Cir. 1996).

[8] *See* Kapoor v. Fujisawa Pharm. Co., No. 93C-06-050 SCD, 1997 Del. Super. LEXIS 386,at *11-12 (Del. Super. Ct. Aug. 22, 1997) ("I find persuasive the analysis in *Waltuch v. Conticommodity Services, Inc.*, wherein the court held that subsection (f) 'does not speak in terms of corporate power, and therefore cannot be read to free a corporation from the . . . limitations explicitly imposed in subsections (a) and (b).") (citation omitted); Von Feldt v. Stifel Fin. Corp., No. 15,688, 1999 Del. Ch. LEXIS 131, at *8 (Del. Ch. June 11, 1999) ("It should now be clear that, as far as § 145 is concerned, Delaware corporations lack the power to indemnify a party who did not act in good faith or in the best interests of the corporation."). *See also* Owens Corning v. Nat'l Union Fire Ins. Co., 257 F.3d 484, 494-95 (6th Cir. 2001); Mayer v. Executive Telecard, Ltd., 705 A.2d 220, 225 n.6 (Del. Ch. 1997). *Cf.* Landmark Land Co. v. Cone (*In re* Landmark Land Co.), 76 F.3d 553, 562 (4th Cir. 1996) (discussing the requirement of good faith under the California and other indemnification statutes); Plate v. Sun-Diamond Growers, 225 Cal. App. 3d 1115 (Cal. Ct. App. 1970) (discussing the requirement of good faith under the California statute).

[9] 76 F.3d 553 (4th Cir. 1996).

of Landmark and of the Bank; and a director and chairman of Landmark, the Bank, and the subsidiaries. William Vaughan, Barton's son-in-law, was a director and officer of the Bank and most of the subsidiaries.

In the wake of the savings-and-loan crisis, which had resulted from the use of manipulative accounting that masked the inadequate capitalization of S&Ls, Congress had created the Office of Thrift Supervision (OTS). The OTS was vested with broad regulatory powers to oversee financial institutions to ensure that they were adequately capitalized. An investigation of the Bank by the OTS in June 1990 revealed that the Bank was undercapitalized and had a pattern of consistent losses. The Bank's directors then entered into a Consent Agreement (not, apparently, a consent decree) with the OTS, in which the directors agreed that the Bank's subsidiaries would not engage in any material transaction without the OTS's prior approval. Subsequently, Barton, Vaughan, and other directors of some of the Bank's real estate subsidiaries caused the subsidiaries to file for bankruptcy. The OTS then took control of the Bank and appointed Resolution Trust Corporation as the Bank's receiver. However, the subsidiaries obtained an injunction that prevented the Bank, now controlled by Resolution Trust, from exercising its right, as the subsidiaries' shareholder, to remove and replace the subsidiaries' directors.

In response, the OTS filed administrative charges against Barton, Vaughan, and others, based in part on an allegation that the defendants had violated the Consent Agreement by causing the subsidiaries to engage in material transactions—the bankruptcy filings—without receiving the OTS's prior approval.[10] The boards of the subsidiaries—which were incorporated in various states, all of which required good faith as a condition to indemnification[11]—voted to indemnify Barton, Vaughan, and others for their expenses in connection with these proceedings. The district court, sitting as a bankruptcy court, entered an order to that effect, finding that Barton and Vaughan had acted in good faith. This finding was apparently based on the conclusion that the bankruptcy filings were in the best interests of the real estate subsidiaries, as evidenced by the fact that Resolution Trust kept the subsidiaries in bankruptcy after it eventually took them over. The Fourth Circuit reversed, on the ground that even if Barton and Vaughan had acted in the best interests of the real estate subsidiaries, and even though Burton and Vaughn had not broken any laws, they did not act in good faith, and therefore were not entitled to indemnification,

---

[10]The OTS also alleged that Barton and Vaughan had breached their fiduciary duties by causing the real estate subsidiaries to file for bankruptcy, but this allegation was hard to successfully maintain, because the RTC kept the subsidiaries in bankruptcy.

[11]*See In re Landmark Land Co.*, 76 F.3d at 561-62.

because they had acted to circumvent the Consent Agreement and to undermine the regulatory authority of a governmental agency:

> We cannot conclude that the Directors' action was taken in good faith. If the OTS charges are accurate, the [Directors'] action to place the Debtors in bankruptcy was a deliberate attempt to prevent the OTS from exercising control over the Bank's assets, thus hindering the OTS's ability to deal effectively with a failing savings and loan. Despite the district court's findings that the federal regulators had interfered with the Directors' efforts to keep the Debtors afloat, the fact remains that the Bank could not comply with the minimum capitalization requirement, and the OTS therefore had a statutory duty to force the Bank's management to comply with the capitalization requirement. . . . We cannot condone the Directors' blatant attempt to circumvent the OTS's regulatory authority by holding that they acted in good faith.
>
> Even if the bankruptcy filings benefited the Debtors, we still could not conclude that the Directors acted in good faith. An agent who has intentionally participated in illegal activity or wrongful conduct against third persons cannot be said to have acted in good faith, even if the conduct benefits the corporation. . . . We recognize that the Directors did not break any law by filing the bankruptcy petitions, and that the OTS has not filed criminal charges against the Directors. Nonetheless, we find that a deliberate attempt to undermine the regulatory authority of a government agency cannot constitute good faith conduct, even if such actions benefit the corporation.[12]

Statutory provisions that insulate directors against liability for a self-interested transaction if the transaction is approved by disinterested directors are also normally applicable only if the disinterested directors act in good faith. So too, satisfaction of the duty of good faith is a condition to the applicability of many of the recently adopted exculpation or shield statutes. For example, the Delaware statute permits a certificate of incorporation to include:

---

[12] *Id.* at 564-66 (citation omitted).

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) *for acts of omissions not in good faith* or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.[13]

B. *Case Law*

In addition to the explicit and implicit legislative imposition of the duty of good faith under statutory law, that duty has long been implicit in

---

[13]DEL. GEN. CORP. LAW § 102(b)(7) (2004) (emphasis added). In *Emerald Partners v. Berlin*, No. 9700, 2003 Del. Ch. LEXIS 42, at *139 n.133 (Del. Ch. Apr. 28, 2003), *reprinted in* 28 DEL. J. CORP. L. 1027 (2003), the court took the position that Section 102(b)(7) does not recognize an independent duty of good faith:

> The structure of Section 102(b)(7) [only] balkanizes the fiduciary duty of loyalty into various fragments [including good faith], thereby creating unnecessary conceptual confusion. For example, subsection (i) of Section 102(b)(7) excludes conduct violative of the "duty of loyalty" from exculpatory protection, but then goes on, in other subsections, to carve out conduct that amounts to different examples of quintessentially disloyal conduct. One such example of disloyal conduct is unfair self-dealing, which subsection (iv) describes as a director's receipt of "an improper personal benefit" from a transaction.

Id.

At best this position offers only one possible interpretation of section 102(b)(7)—and why adopt a convoluted and highly speculative interpretation of a statute when a straightforward reading makes complete sense?

Moreover, this position rests on the claim that intentional misconduct and the receipt of an improper personal benefit are simply fragments of the duty of loyalty. In fact, however, intentional misconduct can include malicious conduct that is not self-interested and therefore does not fall within the duty of loyalty. Similarly, not all improper personal benefits are the result of a violation of the duty of loyalty. For example, if a CEO improperly manipulates corporate earnings to increase his bonus, other director-officers who were not involved with the manipulation may receive inflated bonuses in the wake of the CEO's manipulation. The inflated component of those bonuses will constitute improper personal benefits even though these executives did not themselves violate the duty of loyalty. Furthermore, even supposing that the receipt of improper personal benefits was a special case of the duty of loyalty, that would not show that the legislature also regarded good faith as a special case of the duty of loyalty.

Finally, reading good faith out of Section 102(b)(7) would be inconsistent with the provisions of the Delaware statute that require good faith as a condition to indemnification and to the effectiveness of disinterested-director approval of a self-interested transaction, because those statutes clearly treat good faith as an independent requirement, not as a fragment of the duty of loyalty.

case law. For example, it is well established that if a manager is sued for violation of the duty of care, the manager can invoke the protective business judgment rule if, but only if, he acted in good faith. This requirement is reflected in the formulation of the business judgment rule in the American Law Institute's *Principles of Corporate Governance*:

> A director or officer who makes a business judgment *in good faith* fulfills the duty [of care] . . . if the director or officer:
>
> (1) is not interested . . . in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.[14]

Similarly, it is well established that corporate managers have an obligation not to knowingly cause the corporation to violate the law. This obligation has traditionally been conceived as stemming from the duty of good faith, and, as will be shown in Part VI, cannot be rationalized under either the duty of care or the duty of loyalty.[15]

In short, the duty of good faith has long been both explicit and implicit in corporation statutes and implicit in case law. Recently, it has become explicit in case law as well. As early as 1993, the Delaware Supreme Court stated, in *Cede II*, that a "plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* [sic] of their fiduciary duty—good faith, loyalty or due care."[16] This triadic formulation was repeated two years later in *Cede III*,[17] where the court stated that "to rebut the presumption [of the business judgment rule], a shareholder plaintiff assumes the burden of

---

[14]ALI, PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) (1994) (emphasis added).

[15]*See infra* Part VI.A.

[16]Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993) (*Cede II*).

[17]Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995) (*Cede III*) (emphasis omitted).

providing evidence that the board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties: good faith, loyalty, or due care."[18] In 1998, the court stated, in *Malone v. Brincat*, that "[t]his Court has endeavored to provide the directors with clear signal beacons and brightly lined-channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders."[19] In 2001, the Court stated, in *Emerald Partners v. Berlin*,[20] that "[t]he directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith. . . . [T]he shareholders of a Delaware corporation are entitled to rely upon their board of directors to discharge each of their three primary fiduciary duties at all times."[21] The court continued:

> [U]nless there is a violation of the duty of loyalty *or* the duty of good faith, a trial on the issue of entire fairness is unnecessary because a Section 102(b)(7) provision will exculpate director defendants from paying monetary damages that are exclusively attributable to a violation of the duty of care.[22]

One commentator counted more than a dozen Delaware cases decided by mid-2002 that adopted the triadic formulation of the duties of corporate managers,[23] and this duty has been recognized by other Delaware and non-Delaware cases decided since that time, some of which will be considered in Part VI.[24]

C. *Vice Chancellor Strine's Opposing View*

Against the view that there is a duty of good faith in corporate law, Vice Chancellor Leo Strine of the Delaware Court of Chancery has come down, in footnotes appearing in four opinions, in favor of a *dyadic* view,

---

[18] *Id.* at 1164.

[19] 722 A.2d 5, 10 (Del. 1998).

[20] 787 A.2d 85 (Del. 2001).

[21] *Id.* at 90.

[22] *Id.* at 92 (emphasis added). *See also* McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000) ("The Chemical Board owe[s] fiduciary duties of care, loyalty and good faith to all Chemical shareholders in recommending a sale of the entire corporation.").

[23] Charles Hansen, *Sowing the Seeds of Confusion: The Ephemeral Triad*, 73 ASPEN L. & BUS. CORP. 1, 2 (June 3, 2002) [No. 11].

[24] *See infra* Part VI. For a comprehensive history of the development of the doctrine of good faith in explicit terms under Delaware law, see Sale, *supra* note 1.

in which the only fiduciary duties are care and loyalty, and good faith is simply a component of the duty of loyalty or a different way of describing that duty.

In 1999, in a footnote to *In re ML/EQ Real Estate Partnership Litigation*,[25] Vice Chancellor Strine opined that

> [w]ithin [the duty of loyalty] would seem to be logically subsumed a duty to act with good rather than bad faith . . . . Bad faith conduct . . . would seem to be other than loyal conduct. *See Webster's Ninth New Collegiate Dictionary* 446 (1987) (indicating that: the primary definition of "faith" is "allegiance to duty or a person: LOYALTY"; the primary definition of "faithless" is "not true to allegiance or duty: TREACHEROUS, DISLOYAL"; "loyal" is a synonym for "faithful"; and "disloyal" is a synonym for "faithless").[26]

The next year, in *In re Gaylord Container Corp. Shareholders Litigation*,[27] Vice Chancellor Strine maintained that the dyadic view was supported by two brief passages in Delaware Supreme Court cases involving the business judgment rule. The first passage is from *Barkan v. Amsted Industries, Inc.*,[28] where the court said, in connection with that rule, that "a board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence and in good faith. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule."[29] The second passage is in footnote 36 to *Cede II*. In the text of its opinion in *Cede II*, the court paraphrased *Barkan* by saying, "[W]e have also stated [in *Barkan*] that the [business judgment] rule is premised on a presumption that the directors have severally met their duties of loyalty . . . and that the directors have collectively, as a board, met their duty of care."[30] Following this paraphrase, the court inserted footnote 36, which quoted from *Barkan*, but added the words "care" and "loyalty" in brackets: "[A] board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence [care] and good faith [loyalty]. If no breach of duty is found, the board's actions are entitled to the protections of the

---

[25]No. 15,741, 1999 Del. Ch. LEXIS 238 (Del. Ch. Dec. 20, 1999).

[26]*Id.* at *16 n.20.

[27]753 A.2d 462 (Del. Ch. 2000).

[28]567 A.2d 1279 (Del. 1989).

[29]*Id.* at 1286.

[30]*Cede II*, 634 A.2d at 368 (citing *Barkan*, 567 A.2d at 1286).

business judgment rule."[31] In *Gaylord*, Vice Chancellor Strine stated that "[i]t is clear [that in *Barkan*] the [Delaware] Supreme Court used the terms 'due diligence' and 'good faith' as a fresh way of referring to the 'fundamental duties of care and loyalty'"[32] and that footnote 36 in *Cede* endorses that view by quoting from *Barkan* and adding the word "care" in brackets after the words "due diligence" and the word "loyalty" in brackets after the words "good faith."[33]

Next, in *Nagy v. Bistricer*,[34] the Vice Chancellor repeated the claim he made in *ML/EQ*, but added in a footnote:

> If it is useful at all as an independent concept, the good faith iteration's utility may rest in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.[35]

Finally, in *Guttman v. Huang*,[36] Vice Chancellor Strine maintained, in still another footnote:

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

---

[31] *Id.* at 368 n.36 (quoting *Barkan*, 567 A.2d at 1286).

[32] *Gaylord Container*, 753 A.2d at 476 n.41 (citing *Cede II*, 634 A.2d at 368 n.36).

[33] *Id.* (citing *Barkan*, 567 A.2d at 1286).

[34] 770 A.2d 43 (Del. Ch. 2000).

[35] *Id.* at 48-49 n.2.

[36] 823 A.2d 492 (Del. Ch. 2003).

> corporation's best interest does not make it faithful, as opposed to faithless.[37]

If we put to one side the somewhat platonic claims that the duty of good faith is "logically subsumed" within the duty of loyalty, or that the triadic view separates the duty of loyalty "from its own essence," there are two basic arguments in Vice Chancellor Strine's footnotes. One argument is semantic, based on the definition of "faith" in *Webster's Ninth New Collegiate Dictionary*. The second argument is precedential, based on the Vice Chancellor's interpretation of passages in *Barkan* and *Cede II*. Neither argument is persuasive.

1. The Semantic Argument Based on the Definition of "Faith" in *Webster's Ninth New Collegiate Dictionary*

Consider first the argument based on the definition of "faith" in *Webster's Ninth New Collegiate Dictionary*. There are two basic flaws in this argument.

First, a determination of whether there is an independent duty of good faith in corporate law is a substantive issue. Common usage, as captured in dictionaries, may certainly be helpful in resolving this issue, but dictionaries are only one source to be used for this purpose. Also important, perhaps more important, are statutes and cases in both Delaware and other jurisdictions, and normative considerations, including the reasonable expectations of shareholders and the society at large.

Second, although dictionary definitions are relevant to the meaning of good faith, Vice Chancellor Strine checked only one dictionary and then *looked up the wrong word*. There is a crucial difference between *faith*, upon whose definition the Vice Chancellor's argument rests, and *good faith*. Faith, as Vice Chancellor Strine accurately reports, means *allegiance*. Good faith does not. The difference is severe. A person can have allegiance to a bad government, a bad organization, a bad person, or a bad cause. A person who acts on the basis of such an allegiance does not act in good faith. Furthermore, good faith involves several elements, not just one. Had Vice Chancellor Strine canvassed various leading unabridged dictionaries, rather than only one abridged dictionary, and had he looked up the meaning of *good faith* rather than the meaning of *faith*, he would have found that the definition of good faith includes multiple elements, and that neither allegiance nor loyalty is one of those elements.

---

[37] *Id.* at 506 n.34.

Consider the definition of good faith in four leading unabridged dictionaries. *Webster's Third New International Dictionary* defines good faith as "[a] state of mind indicating honesty and lawfulness of purpose: belief in one's legal title or right: belief that one's conduct is not unconscionable or that known circumstances do not require further investigation: absence of fraud, deceit, collusion, or gross negligence."[38] The *American Heritage Dictionary* defines good faith as "[c]ompliance with standards of decency and honesty."[39] The *Random House Dictionary* defines good faith as "accordance with standards of honesty, trust, sincerity, etc."[40] *Black's Law Dictionary* defines good faith as "[a] state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one's duty or obligation, (3) observance of reasonable commercial standards of fair dealing in a given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage."[41]

Furthermore, good faith is defined not only in dictionaries, but also in various bodies of law. As in the case of dictionaries, these bodies of law almost always define good faith in terms of multiple elements, none of which is either allegiance or loyalty. Both the dictionary and legal definitions of good faith will be discussed further in developing the baseline conception of the duty of good faith in corporate law.

The omission of both *allegiance* and *loyalty* from both the dictionary and the legal definitions of good faith is not surprising. Good faith is always desirable; allegiance and loyalty are not always desirable, because one can have allegiance, and be loyal, in bad faith. An actor who satisfies all the elements of good faith cannot be acting badly. An actor who satisfies all the elements of allegiance or loyalty may be acting either well or badly. A mafioso who has murdered an informer has displayed allegiance and loyalty to the mafia. An Enron mid-level executive who participated in Enron's duplicitous and rapacious culture displayed allegiance and loyalty to that culture and to his superiors. Neither has acted in good faith.

2. The Argument from Precedent Based on *Barkan* and *Cede II*

Turn now to the argument based on precedent, which turns on a passage in *Barkan* and footnote 36 in *Cede II*. "It is clear," Vice

---

[38]WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH UNABRIDGED 978 (3d ed. 1993).

[39]AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 757 (4th ed. 2000).

[40]RANDOM HOUSE UNABRIDGED DICTIONARY 822 (2d ed. 1993).

[41]BLACK'S LAW DICTIONARY 713 (8th ed. 2004).

Chancellor Strine claims, that in *Barkan* the Delaware Supreme Court used the terms "due diligence" and "good faith" as a fresh way to refer to the duties of care and loyalty, and that footnote 36 in *Cede II* endorses that view by quoting from *Barkan* and adding the word "care" in brackets after the words "due diligence," and the word "loyalty" in brackets after the words "good faith." In fact, however, just the opposite is clear.

First, *Barkan* was not using the terms "due diligence" and "good faith" as a fresh way to refer to the duties of care and loyalty. Rather, *Barkan* was stating the business judgment rule. The business judgment rule consists of four conditions, and a special standard of review for managerial decisions—the standard of rationality—that is applicable if the four conditions are satisfied. The four conditions are: a judgment must have been made; the manager must have informed himself with respect to that judgment to the extent he reasonably believed appropriate under the circumstances; the decision must have been made in good faith; and the manager may not have a financial interest in the subject matter of the decision.[42] All that the court did in *Barkan* was to reiterate that diligence (reasonably informing oneself) and good faith are conditions to the application of the business judgment rule. Far from equating good faith with loyalty, *Barkan* recognized that there is an independent duty of good faith, which must be satisfied as a condition to the application of the business judgment rule.

Just as *Barkan* does not stand for the proposition that good faith is a part of the duty of loyalty, neither does *Cede II*. Footnote 36 in *Cede II* is not about the duty of good faith—not even remotely. Recall that the text of *Cede II*, at the point where footnote 36 is inserted, concerns, like *Barkan*, not the duty of good faith as such, but the elements of the business judgment rule. The text says, "[W]e have . . . stated that the business judgment rule is premised on a presumption that the directors have severally met their duties of loyalty . . . and that the directors have collectively, as a board, met their duty of care." The court in *Cede II* cited *Barkan* for this proposition. Then in footnote 36, the court quoted from *Barkan*, and added bracketed words, as follows: "A board's action must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence [care] and good faith [loyalty]. If no breach of duty is found, the board's actions are entitled to the protections of the business judgment rule." Here, as in *Barkan*, the court was simply attempting to state the elements of the business judgment rule—not attempting to determine whether there is a duty of good faith. Contrary to

---

[42] *See* ALI, PRINCIPLES OF CORPORATE GOVERNANCE, supra note 14, § 4.01(c).

Vice Chancellor Strine's position, we can be sure that in footnote 36 the Delaware Supreme Court was not asserting that "due diligence" was a fresh way to refer to the duty of care. How could it? Due care is much more complex than due diligence. And we can be equally sure that in the next, parallel, clause, the court did not think that "good faith" was a fresh way to refer to the duty of loyalty.

How can we be so sure of this? Partly because if the court did not mean—since it could not have meant—that due diligence was the same as the duty of care, there is no reason to believe that in the next, parallel, clause, the court meant that good faith was the same as the duty of loyalty. More important, when the court got down to business in *Cede II*—that is, when the court directly considered whether there was an independent duty of good faith in the *text* of its opinion—it made its position clear. In the text of *Cede II*, the court stated, in the most explicit way, that there is such a duty. "A shareholder," the court said, "assumes the burden of providing evidence that the board of directors, in reaching their challenged decision, breached *any one of the triads* [sic] of their fiduciary duty—good faith, loyalty or due care."[43]

A triad is a group of three things. A triad cannot consist of two things. There cannot be a triad of the law of tort, the law of contract, and the law of offer and acceptance. There cannot be a triad of the duty of care, the duty of loyalty, and the corporate-opportunity doctrine. Correspondingly, if the court in *Cede II* had treated good faith as part of loyalty, it could not possibly have said that there was a *triad* of the duties of good faith, loyalty, and care. But, of course, that is just what the court did say.

Moreover, even if, counterfactually, *Cede II* meant what Vice Chancellor Strine interprets it to mean on the basis of footnote 36, in disregard of the text of the opinion, that would be irrelevant to the Vice Chancellor's argument based on precedent, because in cases decided *after Cede II*, the Delaware Supreme Court stated unequivocally and unambiguously that good faith and loyalty were separate duties. In *Cede III*, the Delaware Supreme Court stated unequivocally and unambiguously that there is a "triad of fiduciary duties: good faith, loyalty, [and] due care."[44] In *Malone v. Brincat*, decided after Vice Chancellor Strine had staked out his position, the Delaware Supreme Court stated unequivocally and unambiguously that directors must navigate "with due care, good faith, and loyalty."[45] In a Delaware Court of Chancery decision in *Emerald*

---

[43]*Cede II*, 634 A.2d at 361.

[44]663 A.2d at 1164.

[45]*Malone*, 722 A.2d at 10.

Partners v. Berlin, the court repeated Vice Chancellor Strine's view that good faith is only "a subset or 'subsidiary requirement' that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care."[46] On appeal, the Delaware Supreme Court brought the chancery court up short: "The directors of Delaware corporations," the supreme court reminded the chancery court, "*have a triad of primary fiduciary duties: due care, loyalty, and good faith*. . . . [T]he shareholders of a Delaware corporation are entitled to rely upon their board of directors to discharge *each* of their *three* primary fiduciary duties at all times."[47]

How much clearer could the court get?

Furthermore, although at one time it appeared that there might be a Delaware Court of Chancery position (rather than simply a position of Vice Chancellor Strine) in favor of the dyadic view,[48] that appearance—which, of course, would in any event be trumped by the Delaware Supreme Court's view—has eroded away over time. In *In re Emerging Communications, Inc. Shareholders Litigation*,[49] former Vice Chancellor Jacobs, now a Justice of the Delaware Supreme Court but sitting by designation in *Emerging* as a Vice Chancellor, stated that

> if a loyalty breach requires that the fiduciary have a self-dealing conflict of interest in the transaction itself . . . then only [the defendant] Prosser is liable on that basis. . . . On the other hand, if a loyalty breach . . . does not require a self-dealing conflict of interest or receipt of an improper benefit, then [the defendant] Raynor would be liable for breaching his duties of loyalty *and* good faith.[50]

Further, in *Disney IV*,[51] Chancellor Chandler stated:

---

[46]2001 Del. Ch. LEXIS 20, at 86 n.63.

[47]Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (emphasis added).

[48]*Cf.* Jackson Nat'l Life Ins. Co. v. Kennedy, 741 A.2d 377, 388 n.18 (Del. Ch. 1999), where Vice Chancellor Steele said, with an extra-heavy dose of skepticism, "I leave it to the [Delaware] Supreme Court and to the academic community to distinguish the fiduciary duties of loyalty and 'good faith.'"

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

[50]*Id.* at 142 n.184 (emphasis added).

[51]The recent *Disney* derivative litigation involved four principal opinions, which will be referred to in this article as *Disney I, II, III*, and *IV*. In *In re Walt Disney Co. Derivative Litig.* (*Disney I*), 731 A.2d 342 (Del. Ch. 1998), the chancery court dismissed the plaintiff's complaint against Disney's directors and Michael Ovitz. In *Brehm v. Eisner* (*Disney II*), 746 A.2d 244 (Del. 2000), the Delaware Supreme Court held that the plaintiffs should be allowed to replead their

> 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.[52]

Vice Chancellor Strine's dyadic view is also inconsistent with American statutory law generally, and with Delaware statutory law in particular. As discussed above, many or most American corporate law statutes explicitly impose a duty of good faith on directors, officers, or both; and all, or virtually all, statutes implicitly impose that duty by making good faith a condition to the applicability of one or more important statutory provisions, such as indemnification provisions, provisions concerning approval of a self-interested transaction by disinterested directors, and exculpatory or shield provisions. For example, in *Disney IV*, Chancellor Chandler pointed out that treating good faith as part of the duty of loyalty (or for that matter, the duty of care) would be inconsistent with Section 144 of the Delaware General Corporation Law: That section provides that 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.[53] As Chancellor Chandler tellingly observed:

---

complaint. In *In re the Walt Disney Co. Derivative Action* (*Disney III*), 825 A.2d 275 (Del. Ch. 2003), the chancery court denied a motion to dismiss the revised complaint on the pleadings. In *In re the Walt Disney Co. Derivative Action* (*Disney IV*), 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) [*Disney IV*], *reprinted in* 31 DEL. J. CORP. L. 349 (2006), the chancery court held for the defendants after a trial.

[52]*Disney IV*, 2005 Del. Ch. LEXIS 113, at *176-77 (footnotes omitted), *reprinted in* 31 DEL. J. CORP. L. at 425 (emphasis added).

[53]DEL. CODE ANN. tit. 8, § 144(a)(1) (2004).

> 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).[54]

IV. THE BASELINE CONCEPTION OF THE DUTY OF GOOD FAITH

In 1968, Robert Summers published an influential article arguing that in contract law, good faith was best understood as an excluder—that is, "a phrase which has no general meaning . . . of its own, but which serves to exclude many heterogeneous forms of bad faith."[55] "[I]n cases of doubt," Summers suggested, "a lawyer will determine more accurately what the judge means by . . . 'good faith' if [the lawyer] does not ask what good faith itself means, but rather asks: What . . . does the judge intend to rule out by his use of this phrase?"[56]

Certainly, Summers made an important point.[57] It is easier to characterize a given action as lacking good faith than to provide a general definition of good faith.[58] Nevertheless, as Deborah DeMott has observed, "[In a] contractual context, good faith has suppletory and protective functions whose scope is defined by the express terms of the parties' contract. In contrast, as applied to the decisions of corporate directors, good faith focuses on directors' position as fiduciaries obliged to serve the interests of others."[59] Accordingly, in corporate law the duty of good faith must be given a positive meaning.

It is neither necessary nor appropriate, however, to delineate that meaning by a single phrase. The duty of good faith is a general principle,

---

[54]*Disney IV*, 2005 Del. Ch. LEXIS 113, at *178 n.464, *reprinted in* 31 DEL. J. CORP. L. at 425 n.464.

[55]Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968).

[56]*Id.* at 200 (footnote omitted).

[57]In fact, Summers's analysis made its way into the commentary to the good faith provision in the *Restatement (Second) of Contracts*. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981).

[58]For ease of exposition, unless the context indicates otherwise, in the balance of this article the terms *action* and *conduct* will be used interchangeably, and the term *lacks good faith* will be used synonymously with the term *in bad faith*.

[59]DeMott, *supra* note 1, at 24.

and general principles often are delineated by baseline conceptions consisting of a cluster of elements. For example, the general principle of care is delineated by a baseline conception consisting of elements such as diligence and rationality. The general principle of loyalty is also delineated by a baseline conception consisting of elements such as fairness and disclosure. The general principle of good faith is also delineated by a baseline conception consisting of a cluster of elements.

To begin with, good faith requires subjective honesty. Subjective honesty, in turn, requires several types of sincerity. A corporate manager must sincerely believe that his conduct is in the best interests of the corporation, that any statements he makes in his managerial capacity are truthful, and that his conduct is within the realm of decent behavior.

It is not enough, however, that a manager acts honestly in the sense that he acts sincerely. Many persons adopt belief systems that allow them to sincerely conclude that their morally outrageous conduct is proper. This point is well made in a review by Mick LaSalle of the film *Downfall*, which concerns Adolph Hitler's final days.[60] As LaSalle noted, the fact that "Hitler is portrayed as human made the film mildly controversial in America, as though that were the same as making him likeable." This, LaSalle pointed out, missed the value of the film, which is to "remind us of a lesson that simply can't be repeated enough—that absolute faith in one's own virtue is not a commitment to virtuous behavior but a commitment to one's own will."[61] Or, as Deborah De Mott puts it:

> Wholly apart from these practical issues of proof, a standard for good faith that looks solely to directors' motives ignores the function to be served by the standard. As applied to directors' decisions, a standard of good faith tests directors' fidelity to the interests they may appropriately consider or serve. Subjective motivation and sincere belief are, at best, imprecise surrogates to measure fidelity. Directors, like other people, are capable of deceiving themselves about the point and effect of their actions. Sincere self-deception is not responsive to the obligation to which directors, as fiduciaries, are subject. Fiduciary norms are stringent: they prohibit the fiduciary from creating interests in conflict with interests of the beneficiary protected by the relationship, and they deny a fiduciary the profit derived from a breach of duty even when

---

[60]Mick LaSalle, *Downfall*, SAN FRANCISCO CHRONICLE DATEBOOK, Aug. 7, 2005, at 28, *available at* http://sfgate.com/cgi-bin/article.cgi?file=c/a/2005/08/07 (last visited Oct. 7, 2005).

[61]*Id.*

> the breach caused no demonstrable injury to the beneficiary. One explanation for this stringency is the persistent capacity of decisionmakers for sincere self-deception when self-interest is at stake.[62]

Accordingly, good faith in law includes objective as well as subjective elements. So, for example, in *First National Bank v. F.C. Trebein Co.*,[63] the court said, "[G]ood faith in law . . . is not to be measured always by a man's own standard of right, but by that which [the law] has adopted and prescribed as a standard for the observance of all men in their dealings with each other." Indeed, in law generally, the objective elements of good faith dominate the subjective element. For example, in *Landmark Land* the court held that the defendants' deliberate action to circumvent the authority of a governmental agency constituted bad faith even if the defendants intended to and did act in the best interests of the corporation.[64] In *T.S. Kaung v. Cole National Corp.*,[65] a Delaware decision, Kaung had been an employee of Cole National. Based on his conduct in that capacity, Kaung had been made a party to a class action and was also a target of an SEC investigation. Kaung hired Kelso as a consultant in connection with these proceedings, and retained the law firm of O'Rourke & Cundra to represent him in the proceedings. Cole at first advanced Kaung's expenses, but later began to question Kelso's qualifications (Kelso was not a lawyer), his role, and the reasonableness of his fees, and pending an investigation into these issues, suspended its advances. Kaung then brought suit against Cole for continued advancement of his expenses.

The Delaware Court of Chancery not only ruled against Kaung on the merits (on the ground that the time billed by Kelso was not reasonable), but also ordered Kaung to pay the attorneys' fees that Cole had incurred in connection with defending against the suit. Although the winning party in litigation is usually not entitled to recover its fees from the losing party, there is an exception where the losing party has acted in bad faith. The chancery court held that Kaung's actions in the course of the litigation fell within the bad faith exception. The Delaware Supreme Court affirmed, in large part on the basis of the objective actions of Kaung's representatives, and without an inquiry into whether Kaung or his representatives subjectively believed those actions were morally defensible:

---

[62]DeMott, *supra* note 1, at 22-23.

[63]52 N.E. 834, 837 (Ohio 1898).

[64]*See supra* text accompanying note 9.

[65]No. 163-N, 2004 Del. Ch. LEXIS 126 (Del. Ch. Aug. 27, 2004), *aff'd in part and rev'd in part*, 884 A.2d 500 (Del. 2005).

> [T]he record shows that throughout the litigation Kaung's representatives made excessive and duplicative deposition requests while ignoring their own discovery obligations. They refused to facilitate the schedule of Kelso's deposition, and when he finally appeared for deposition, he refused to answer questions and instead peppered Cole's attorneys with questions and accusations. [Kaung's lawyer,] Cundra, who accompanied Kelso to the deposition, aggravated the situation by supporting Kelso's behavior and failing to provide any substantive answers to Cole's discovery requests regarding Kelso.[66]

In corporate law, as in law generally, the objective elements of good faith are far more important in practice than the subjective elements. There are three objective baseline elements of good faith in corporate law, which are founded on the meaning of good faith in common usage, as reflected in dictionaries; on the meaning of good faith developed in various bodies of law, including corporate law; and on the basis of the reasonable expectations of shareholders and of the society at large.

First, the duty of good faith in corporate law requires a manager not to violate generally accepted standards of decency applicable to the conduct of business.[67] This element reflects the reasonable expectations of society and conforms to a standard meaning of good faith in common usage: "[c]ompliance with standards of decency."[68]

Second, the duty of good faith in corporate law requires a manager not to violate generally accepted basic corporate norms.[69] This element reflects the constitution of the corporation, which includes such norms, and is analogous to the meaning of good faith in Article 2 of the Uniform Commercial Code, which provides that in the case of a merchant, good faith means honesty in fact and the observance of reasonable commercial standards of fair dealing.[70]

Third, the duty of good faith in corporate law requires a manager to have fidelity to his office. This element reflects the reasonable expectations of shareholders and conforms to standard usage, which

---

[66] *Kaung*, 884 A.2d at 507.

[67] *See* DeMott, *supra* note 1.

[68] *See* AMERICAN HERITAGE DICTIONARY, *supra* note 39, at 757.

[69] *Cf.* E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, 38 WAKE FOREST L. REV. 839, 850 (2003) ("Today, the 'utter failure' to follow the minimum expectations of the evolving standards of director conduct . . . might . . . raise a good-faith issue.").

[70] *See, e.g.*, CAL. COM. CODE § 2103(b) (West/Deering 2002).

includes faithfulness to one's duty or obligation.[71] *Office* in this context means a position of duty, trust, or authority in an organization. *Fidelity* to one's office means an attempt to execute an office, and the role that the office implicates, in the manner in which execution of the office is reasonably to be expected, given the constitution of the office and of the organization in which the office is embedded.

The role of the baseline conception of the duty of good faith must be understood against a distinction between standards of conduct and standards of liability.[72] A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test that a court should apply when it reviews an actor's conduct to determine whether to impose liability on the actor. In many or most areas of law, these two kinds of standards tend to be conflated. For example, the standard of conduct that governs automobile drivers is that they should drive carefully, and the standard of review in a liability claim against a driver is whether he drove carefully. The conflation of standards of conduct and standards of review is so common that it is easy to overlook the fact that whether the two kinds of standards are or should be identical in any given area is a matter of prudential judgment.

For a variety of reasons, in corporate law the standards of review and the standards of conduct pervasively diverge.[73] For example, in the area of loyalty the general standard of conduct is that a manager who acts in his own financial self-interest, or the financial interest of an associate or a family member, should act fairly. However, if a self-interested transaction has been approved by disinterested directors, a standard of review that is much easier for the manager to satisfy may be applied. Similarly, in the area of care the general standard of conduct is that a manager should act reasonably. If the manager's conduct satisfies the conditions of the business judgment rule, however, the standard of review is whether the manager's judgment was rational, which is also a much easier standard for the managers to satisfy.

---

[71] *See* BLACK'S LAW DICTIONARY, *supra* note 41, at 713. *See also, e.g.*, *In re* Hicks, 79 B.R. 45, 47 n.5 (Bankr. N.D. Ala. 1987).

[72] *See* Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 52 FORDHAM L. REV. 437 (1993). That article touched on the duty of good faith, but did so only briefly.

[73] This divergence between standards of conduct and standards of review in corporate law was long implicit. The Model Business Corporation Act has now made this divergence explicit. Section 8.30 of the Model Act sets forth "Standards of *Conduct*" for directors, while section 8.31 sets forth "Standards of *Liability*" for directors. MODEL BUS. CORP. ACT §§ 8.30, 8.31 (2005) (emphasis added).

Similarly, while the baseline conception of the duty of good faith is a standard of conduct, noncompliance with that conception does not in and of itself give rise to liability. Liability will arise only under specific obligations that instantiate the duty of good faith. In this respect, the duty of good faith operates like the duties of care and loyalty. Courts normally do not impose liability on a corporate manager simply on the ground that the manager acted without due care. Instead, they impose liability only on the ground that the manager violated a specific obligation that is based on the duty of care, such as the obligation to become properly informed before making a decision. Correspondingly, courts normally do not impose liability on a manager simply on the ground that the manager acted disloyally. Instead, they impose liability only on the ground that the manager violated a specific obligation that is based on the duty of loyalty, such as the obligation not to engage in a self-interested transaction at an unfair price.

The fact that the baseline conception of the duty of good faith is not itself a liability rule does not mean that the conception lacks legal significance. On the contrary, the baseline conception has three important roles in corporate law.

First, the baseline conception is a legal standard of conduct.

Second, where good faith is a condition to the application of a legal rule that would benefit a manager, such as the business judgment rule or a statutory provision concerning indemnification or exculpation, the condition will not be satisfied if there has been a failure to comply with one or more of the elements of the baseline conception.

Third, the general baseline conception serves as a platform for more specific obligations that instantiate that conception, whose violation may give rise to liability.

To summarize, the elements of the baseline conception of the duty of good faith in corporate law are subjective honesty or sincerity, nonviolation of generally accepted standards of decency applicable to the conduct of business, nonviolation of generally accepted basic corporate norms, and fidelity to office. This baseline conception serves three functions. (1) The baseline conception is a standard of conduct. (2) The elements of the baseline conception figure in determining whether a manager has satisfied a condition of good faith. (3) The general baseline conception provides a platform for more-specific obligations. These more specific obligations, some of which will be discussed in Part VI, serve to give further texture to the duty of good faith in cases where good faith operates as a condition and may also serve as liability rules.

To put this differently, when good faith operates as a *condition*, the courts should ask whether the manager has violated either an element of the

baseline conception of the duty of good faith or a specific obligation that is based on that conception. When *liability* is at issue, however, the court should ask the narrower question, whether the manager has violated a specific obligation that instantiates the baseline conception.

V. NORMATIVE CONSIDERATIONS

Part II of this article briefly described four reasons why the duty of good faith not only is but should be part of American corporate law. In this Part, those reasons will be developed in greater depth.

A. *The Duty of Good Faith Covers Managerial Conduct That Is Improper but Falls Outside the Spheres of the Duties of Care and Loyalty*

The duties of care and loyalty, as traditionally understood, have well-defined ambits. The duty of care (although not the standard of review for liability under that duty) requires a manager who is not self-interested to perform his duties in a manner that he reasonably believes to be in the best interests of the corporation, with a view to enhancing corporate profit and shareholder gain. In that connection, the standard of *conduct* under the duty of care (although not the standard of review) requires a manager to act reasonably—with due care—in informing himself concerning a proposed decision, and in making the decision itself. The duty of loyalty requires a manager to act fairly when he is interested in a transaction or a course of conduct. A manager is interested, for purposes of the duty of loyalty, when he, an associate, or a family member has a financial interest in the transaction or the conduct. For example, section 1.23(a) of the ALI's *Principles of Corporate Governance* defines "interested," for purposes of the duty of loyalty, as follows:

> A director . . . or officer . . . is "interested" in a transaction or conduct if either:
>
> (1) The director or officer . . . is a party to the transaction or conduct;
>
> (2) The director or officer has a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director's or officer's judgment with respect to the transaction or conduct in a manner adverse to the corporation;

> (3) The director or officer has a material pecuniary interest in the transaction or conduct . . . and that interest . . . would reasonably be expected to affect the director's or officer's judgment in a manner adverse to the corporation . . . .[74]

Similarly, section 8.60 of the Model Business Corporation Act defines a "director's conflicting interest transaction" as follows:

> [A] transaction effected or proposed to be effected by the corporation . . . .
>
> (i) to which . . . the director is a party; or
>
> (ii) respecting which . . . the director had knowledge and a material financial interest known to the director; or
>
> (iii) respecting which . . . the director knew that a related person was a party or had a material financial interest.[75]

In various important kinds of cases, however, a manager's conduct is improper, but falls outside the spheres of the duties of care and loyalty. An example is provided by Chancellor Chandler in *Disney IV*:

> [In the context of] an imperial CEO or controlling shareholder with a supine or passive board . . . the concept of good faith may prove highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of

---

[74] ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 1.23.

[75] MODEL BUS. CORP. ACT § 8.60 (2005).

> purpose and with an understanding of whose interests they are there to protect.[76]

Other examples, which will be discussed in Part VI, include cases in which a manager knowingly causes the corporation to violate the law, lacks candor in a non-self-interested context, or acts out of improper nonfinancial motives. An important reason for the duty of good faith, therefore, is that this duty covers most of the important types of cases in which a manager's action, although improper, does not violate the duties of care or loyalty.

B. *Certain Rules That Limit the Duties of Care and Loyalty Should Not and Do Not Apply to Conduct That Lacks Good Faith*

Various rules limit a manager's accountability under the duties of care and loyalty. For example, a manager will not be liable for breach of the duty of care, even if he is negligent, if his conduct is protected by the business judgment rule or a gross negligence standard. In the case of the duty of loyalty, self-interested transactions may be insulated from effective judicial review if they are approved by a director's friends and colleagues on the board. Furthermore, injury to the corporation, or gain to the manager, are normally elements of a breach of those duties. So, for example, even if a manager employs a grossly negligent decision making process, he will not have violated the duty of care if the outcome is no worse than it would have been if he had been careful. Similarly, a director who sells a building that he owns to the corporation at a price that is at the very high end of the range of market prices will not be liable for violating the duty of loyalty.

These limiting rules should be and are inapplicable to conduct that violates the duty of good faith, because of the high degree of wrongfulness that such conduct involves. Conduct that lacks good faith, such as knowingly causing the corporation to violate the law, should not be protected by the business judgment rule or a gross negligence standard, and should not be insulated from effective judicial review by the approval of a director's friends and colleagues. Furthermore, injury to the corporation or gain to the manager should not be an element of a breach of the duty of good faith. For example, a manager who knowingly causes the corporation to break the law violates the duty of good faith even if breaking the law maximizes profits, and a manager who acts on the basis of an improper

---

[76] *Disney IV*, 2005 Del. Ch. LEXIS 113, at *191 n.487, *reprinted in* 31 DEL. J. CORP. L. at 431 n.487.

nonpecuniary motive violates the duty of good faith even if his action fortuitously does not injure the corporation.

C. *The Duty of Good Faith Characteristically Functions Differently From the Duties of Care and Loyalty*

The duty of good faith characteristically functions differently from the duties of care and loyalty. To understand this difference, it is useful to analogize to contracts. Contracts are constructed on the basis of two very different types of provisions—promises and express conditions. A promise is a commitment to perform in a designated manner. An express condition provides that a contracting party does not come under a duty to perform a promise unless and until some designated state of events occurs or fails to occur. Breach of a promise gives rise to liability. Nonfulfillment of a condition does not. Instead, nonfulfillment of a condition by one party relieves the other party of his duty to perform.

The duties of care and loyalty for the most part function as promises do; that is, they characteristically serve as bases of liability. In contrast, although the duty of good faith serves as a platform for certain liability rules, good faith much more commonly serves as a condition to the application of a rule that does not in itself impose liability, such as an indemnification provision or the business judgment rule. Where the duty of good faith serves as a condition, failure to fulfill that duty does not in and of itself lead to liability. For example, a manager who is deprived of the benefit of a shield provision is not liable simply for that reason: he is only liable if he would be liable but for the shield. Just as conditions and promises are treated differently in contract law because they serve different functions, so the duty of good faith should be treated differently from the duties of care and loyalty because for the most part it serves a different function than the latter duties do.

D. *The Duty of Good Faith Provides the Courts with a Principled Basis for Articulating New Specific Fiduciary Obligations in Response to Social Changes*

The life of the law, including the life of corporate law, is in a constant state of change in response to social changes. Circumstances change, the social norms applicable to the conduct of business change, business practices change, concepts of efficiency and other issues of policy applicable to corporate law change. Sometimes, social changes indicate that an existing fiduciary obligation should be modified or cut back. An example is the widespread legislative adoption of exculpatory or shield

provisions. Other times, social changes indicate that a new specific fiduciary obligation should be articulated because a type of conduct that was once regarded as proper is no longer so regarded. In some cases, the articulation of such an obligation can be justified by the duties of care or loyalty. In other cases, it cannot. In those cases, the duty of good faith often provides a principle that supports the articulation of the new obligation.[77] An example is the emerging obligation of candor in non-self-interested contexts, which will be discussed in Part VI.

VI. SOME SPECIFIC OBLIGATIONS UNDER THE DUTY OF GOOD FAITH

A. *The Obligation Not to Knowingly Cause the Corporation to Violate the Law*

A well established principle under the duty of good faith is that a manager may not knowingly cause the corporation to violate the law, even when it is rational to believe that the violation would maximize corporate profits and shareholder gain because the cost of the violation, consisting of the legal penalty and damage to reputation discounted by the likelihood of detection and enforcement, is less than the expected profit from the violation. Like other obligations that fall under the duty of good faith, fulfillment of this obligation will often operate as a condition, as illustrated by *Landmark Land*, which held that a deliberate attempt to undermine the regulatory authority of a government agency, although short of an actual violation of law, constituted a lack of good faith that precluded indemnification. However, violation of this obligation also gives rise to liability.

The reason for the obligation not to knowingly cause the corporation to violate the law is as follows: A complex society in which individuals obeyed the law only because they feared prosecution could not thrive. For a complex society to thrive, the bulk of its members must internalize the moral obligation to obey the law. Similarly, given the dominance of

---

[77]As Summers points out in connection with the duty of good faith in contract law:

> [The function that good faith doctrines] perform further[s] the most fundamental policy objectives of any legal system—justice, and justice according to law. By invoking good faith, . . . it may be possible for a judge to do justice *and* do it according to law. Without legal resources of this general nature he might, in a particular case, be unable to do justice at all, or he might be able to do it only at the cost of fictionalizing existing legal concepts and rules, thereby snarling up the law for future cases. In begetting snarl, fiction may introduce inequity, unclarity or unpredictability. In addition, fiction can divert analytical focus . . . .

Summers, *supra* note 55, at 198-99.

organizations in complex societies, such a society could not thrive if individuals believed themselves free of a moral obligation to obey the law when they acted in an organizational rather than personal capacity.

Therefore, there is a strong social interest in prohibiting managers from knowingly causing the corporation to disobey the law in search of profits. This objective cannot be achieved solely by criminal and regulatory actions against the corporation. Corporate violations of law will often go undetected or unprosecuted simply because government resources are very limited. Furthermore, the principle that corporations must obey the law is most likely to be internalized by the corporation and its managers if the principle is part of corporation law itself. Moreover, because the corporation is the primary wrongdoer, the probability that a manager who knowingly causes the corporation to violate the law will be made subject to criminal or regulatory sanctions for the corporation's act is very low. Thus, an additional sanction is required as a disincentive to managers to engage in such conduct.

Accordingly, a corporation is obliged to obey the law, not only as a matter of criminal and regulatory law, but as a matter of corporate law. This obligation is reflected in section 2.01 of the ALI's *Principles of Corporate Governance*. Section 2.01(a) of the *Principles* provides that, with certain exceptions, "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."[78] Under section 2.01(b)(1), however, "[e]ven if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . [is] obliged, to the same extent as a natural person, to act within the boundaries set by law."[79]

I will call the principle embodied in section 2.01(a) the *profit-maximization principle* and the principle embodied in section 2.01(b)(1) the *legal-conduct principle*. The legal-conduct principle is exemplified in Illustration 7 to section 2.01(b)(1):

> F Corporation is a publicly held corporation with annual earnings in the range of $3-5 million. F hopes to be awarded a supply contract by P, a large publicly held corporation. The anticipated profits on the contract are $5 million over a two-year period. A vice-president of P has approached Brown, the relevant corporate decisionmaker of F, with the suggestion that if F pays the vice-president $20,000, F will be awarded the contract. Brown knows such

---

[78] ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 2.01(a).

[79] *Id.* § 2.01(b)(1).

> a payment would be illegal, but correctly regards the risk of detection as extremely small. After carefully weighing that risk and the consequences of detection, Brown causes F to pay the $20,000. F's action involves a departure from the principle stated in § 2.01(b)(1).[80]

Assume that the payment demanded by the vice-president of P, plus the present value of a fine and all other financial and reputational costs that might flow from the illegal payment, discounted by the likelihood of detection and enforcement, is less than the present value of the supply contract. On a profit-maximization analysis, A should pay the bribe. Under the legal-conduct principle, however, the bribe should not be paid. Instead, A should cause F to obey the legal rule that prohibits bribery. Cost-benefit analysis may very well factor into an authoritative determination whether a given type of conduct should be deemed legally wrongful. Once that determination has been made, however, the resulting legal rule normally represents a community decision that such conduct is wrongful. Violations of the rule cannot then be morally or socially justified on the ground that in a particular case the violator's financial gains would outweigh its financial losses or even social financial losses (except in those relatively rare cases where either the sanction under the relevant legal rule is properly regarded as a price, such as the fine for parking overtime at a meter, or where the norm of obedience to law is conventionally deemed inapplicable or counterbalanced by another norm, such as necessity). So, for example, Milton Friedman, in a well-known essay, denied that corporations have any social responsibility other than to increase profits, but also made clear that the pursuit of profits had to be conducted while conforming to the basic rules of society, including legal rules.[81]

Indeed, the legal-conduct principle is consistent with the profit-maximization principle. The profit-maximization principle states what the

---

[80] *Id.* § 2.01(b)(1), illus. 7. Here is another illustration:

> 8. G Corporation owns and operates 15 plants that were traditionally non-union. For the last several years, Union U has been attempting to organize G's workers, and has won elections at three of G's plants. Although G does not have a good faith belief that the elections were invalid, it adopts a strategy of refusing to bargain at these three plants and harassing members, adherents, and supporters of U at G's other 12 plants. The relevant corporate decisionmaker knows that the conduct violates the National Labor Relations Act, but believes that a long time will elapse before sanctions are imposed, and that the profit from this conduct will far exceed the cost of possible sanctions. G's action involves a departure from the principle stated in § 2.01(b)(1).

[81] Milton Friedman, *The Social Responsibility of Business Is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine), at 33.

objective of the corporation should be. The legal-conduct principle does not modify that objective, but rather lays down the channels within which that objective may properly be realized. An analogy may be drawn to the rules of a game. An objective of playing a game is to win. Obeying the rules of a game is consistent with that objective, even when breaking the rules would make winning more likely. If a player asserted that she was justified in breaking the rules of a game because doing so maximized her chances of winning, we would say that she does not understand what it means to play a game. As with the rules of a game, so with the rules of law. A corporate actor who said that profit-maximization justifies causing the corporation to break the law would not understand what law means and would not understand what profit-maximization means.

Section 2.01 of the *Principles of Corporate Governance* concerns the objectives of the corporation rather than the duties and liabilities of corporate managers. However, the principle reflected in that section also applies to corporate managers, for the same reasons. Accordingly, section 4.01(a) of the *Principles* states that "[a] director or officer has a duty to the corporation to perform the director's or officer's functions in good faith," and the comment to this section makes clear that a manager who knowingly causes the corporation to violate the law is in breach of the duty of good faith: "The duty of a director or officer to 'perform the director's or officer's functions in good faith' includes the obligation to act consistently with § 2.01."[82] The comment continues: "[A] director or officer violates the duty to perform his or her functions in good faith if he or she knowingly causes the corporation to disobey the law."[83] Similarly, the comment to Model Business Corporation Act § 8.31 states: "Conduct involving knowingly illegal conduct that exposes the corporation to harm will constitute action not in good faith, and belief that decisions made (in connection with such conduct) were in the best interests of the corporation will be subject to challenge as well."[84]

The rule embodied in the comments to the *Principles of Corporate Governance* and the Model Business Corporation Act is well supported by case law. For example, in *Roth v. Robertson*,[85] the managing director of a corporation that owned an amusement park caused the corporation to pay off persons who had threatened to complain to authorities that the park was unlawfully operating on Sundays. Undoubtedly, the director made these payments to maximize corporate profits. Moreover, the director could have

---

[82]ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 4.01(a).

[83]*Id.* § 4.01(a) cmt.

[84]MODEL BUS. CORP. ACT § 8.31(a) cmt. a (2005).

[85]118 N.Y.S. 351 (N.Y. Sup. Ct. 1909).

rationally believed that the expected corporate profits from operating the amusement park on Sundays would exceed the possible cost of punishment to the corporation, discounted by the likelihood of detection and enforcement. Nevertheless, the court held that the director was liable to the corporation for the amount of the payoffs:

> For reasons of public policy, we are clearly of the opinion that payments of corporate funds for such purposes as those disclosed in this case must be condemned, and officers of a corporation making them held to a strict accountability, and be compelled to refund the amounts so wasted for the benefit of stockholders .... To hold any other rule would be establishing a dangerous precedent, tacitly countenancing the wasting of corporate funds for purposes of corrupting public morals.[86]

In *Abrams v. Allen*,[87] plaintiffs brought a derivative action against the directors of Remington Rand, alleging that the directors had illegally closed and relocated corporate plants and curtailed production in order to intimidate and punish employees for their involvement in a labor dispute, in violation of the New York Labor Law and the National Labor Relations Act.[88] Undoubtedly, the directors engaged in this conduct to maximize corporate profits. Moreover, the directors could have rationally believed that the expected corporate profits from fighting unionization would exceed the possible cost of punishment to the corporation, discounted by the likelihood of detection and enforcement. Nevertheless, the court held that proof of the plaintiff's allegation could sustain recovery against the directors.[89]

In *Miller v. American Telegraph & Telephone Co.*,[90] AT&T had failed to collect an outstanding debt of $1.5 million owed by the Democratic National Committee for communications services that AT&T had provided during the 1968 Democratic National Convention. Plaintiffs brought a derivative action against AT&T's directors, on the ground that the failure to collect the debt was a corporate contribution to the Democratic Party, in violation of the Federal Election Campaign Act of 1971.[91]

---

[86] *Id.* at 353.
[87] 74 N.E.2d 305 (N.Y. 1947).
[88] *Id.* at 306-07.
[89] *Id.* at 306.
[90] 507 F.2d 759 (3d Cir. 1974).
[91] *Id.* at 761.

Undoubtedly, the board took this action to maximize corporate profits. Moreover, the board could have rationally believed that the expected corporate profits from making a contribution to the Democratic Party would exceed the possible cost of punishment, discounted by the likelihood of detection and enforcement. Nevertheless, the court held that on the facts stated in the complaint the directors would be liable:

> Had plaintiffs' complaint alleged only failure to pursue a corporate claim, application of the sound business judgment rule would support the district court's ruling that a shareholder could not attack the directors' decision. . . . Where, however, the decision not to collect a debt owed the corporation is itself alleged to have been an illegal act, different rules apply. When New York law regarding such acts by directors is considered in conjunction with the underlying purposes of the particular statute involved here, we are convinced that the business judgment rule cannot insulate the defendant directors from liability if they did in fact breach [the Federal Election Campaign Act], as plaintiffs have charged.[92]

Similarly, in *Metro Communications Corp. BVI v. Advanced Mobilecomm Technologies Inc.*,[93] the Delaware Court of Chancery held that "[u]nder Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity."[94] In *Guttman v. Jen-Hsuan Huang*,[95] another Delaware Court of Chancery case, the court also held that causing the corporation to violate the law violates a manager's fiduciary duty.[96]

---

[92]*Id.* at 762.

[93]854 A.2d 121 (Del. Ch. 2004).

[94]*Id.* at 131.

[95]823 A.2d 492 (Del. Ch. 2003).

[96]*See also, e.g.*, Wilshire Oil Co. v. Riffe, 409 F.2d 1277, 1283-86 (10th Cir. 1969) (holding that suit could be brought by corporation against employees whose antitrust violations subjected the corporation to civil and criminal liability); H.R. Plate v. Sun-Diamond Growers, 275 Cal. Rptr. 667, 672 (Cal. Ct. App. 1990) ("'For example, corporate executives who participate in a deliberate price-fixing conspiracy with competing firms could not be found to have acted in good faith, even though they may have reasonably believed that a deliberate flouting of the antitrust laws would increase the profits of the corporation.'") (quoting HAROLD MARSH, JR. ET AL., CALIFORNIA CORPORATION LAW § 9.42 (2d ed. 1981)); Di Tomasso v. Loverro, 293 N.Y.S. 912, 916-17 (N.Y. App. Div. 1937), *aff'd mem.*, 276 N.Y. 551 (N.Y. 1937) (holding that it was proper to grant injunction and impose liability on directors for damages, in derivative action, where they knew, or should have known, the contract was in restraint of trade); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 129-30 (1979) ("Bad faith may preclude the application of the business judgment defense where directors knowingly violate a

A manager who knowingly causes the corporation to violate the law is liable to the corporation for any losses, such as fines, that the corporation incurs as a result of the legal violation. Furthermore, the amount of the manager's liability should not be offset by profits that the corporation made as a result of the violation, because such an offset would be contrary to the purpose of imposing liability. This position is embodied in section 7.18(c) of the *Principles of Corporate Governance*, which provides that a manager's liability arising out of a wrongful transaction may not be offset by gains to the corporation that arose out of the same transaction if the offset would be contrary to public policy. This rule is exemplified as follows:

> A derivative action is brought to require a corporate official of XYZ Corporation to account to the corporation for $200,000 in legally questionable overseas political contributions. The defendant admits the payments, but seeks to defend on the basis that in prior years other such payments had produced profitable contracts.... Even if the offsets arise out of the same transaction, the court should decline to permit offsets that it determines are contrary to an established public policy.[97]

---

statute or comparable expression of public policy, even if such a violation is undertaken in the corporation's best interests.").

[97]ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 7.18 illus. 4. Several New York cases decided between 1941 and 1963 held that a derivative action based on directors' illegal conduct would be dismissed even if the plaintiff alleged that the corporation had to pay criminal fines, unless the plaintiff also alleged that the corporation suffered a net loss. *See* Smiles v. Elfred, N.Y.L.J., Feb. 20, 1963, at 14, col. 6 (Sup. Ct.); Borden v. Cohen, 231 N.Y.S.2d 902 (N.Y. 1962); Spinella v. Heights Ice Corp., 62 N.Y.S.2d 263 (N.Y. 1946); *cf.* Diamond v. Davis, 31 N.Y.S.2d 582 (N.Y. App. Div 1941). These cases were incorrectly decided, for the reasons given in the text. In any event, New York law is not completely clear on this issue. In *Premselaar v. Chenery*, No. 6151, N.Y. Sup. Ct., N.Y. County, Feb. 13, 1963, the court held a complaint sufficient despite the absence of allegations that the corporation had suffered a net loss. Plaintiff alleged that the defendant had caused Airco to engage in conduct that violated an antitrust decree, and that as a result Airco suffered damages consisting of a $60,000 fine, expenses of litigation, potential triple-damage liability, loss of goodwill, and loss of time of corporate executives. The court said that "[t]he contention that the complaint fails to allege damages sufficient to sustain the causes of action is without merit." (The opinion in *Premselaar* was apparently unpublished, and seems to be no longer available. I take the facts from descriptions of the case in several contemporaneous law review articles and notes. *See* Wesley E. Forte, *Liabilities of Corporate Officers for Violations of Fiduciary Duties Concerning the Antitrust Laws*, 40 IND. L.J. 313, 334-35, 338-39 (1965); Joel B. Harris, *Derivative Actions Based upon Alleged Antitrust Violations: Trap for the Unwary*, 37 BROOK. L. REV. 337, 350 (1971); *Recent Developments—Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions*, 64 COLUM. L. REV. 174, 177 (1964).) *Knopfler v. Bohen*, 225 N.Y.S.2d 609 (App. Div. 1962), seems to take the same position as *Premselaar*.