Delaware’s Good Faith

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DELAWARE’S GOOD FAITH

Hillary A. Sale†

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[T]he state of corporate governance to a very large extent reflects the character of the CEO, and . . . this is a very difficult issue to address. Although we may not be able to change the character of corporate officers, we can change behavior through incentives and penalties. That, in my judgment, could dramatically improve the state of corporate governance.

- Alan Greenspan1

In the post-Enron era, there has been considerable discussion about what went wrong at Enron and elsewhere and how to fix it. Congress passed the Sarbanes-Oxley Act,2 the New York Stock Exchange adopted new corporate governance regulations introducing new checks and balances,3 and other self-regulatory organizations fol-

† F. Arnold Daum Corporate Law Scholar and Professor of Law, University of Iowa College of Law. Special thanks to Bob Thompson for his insights and thanks to Eric Andersen, Steve Bainbridge, Frank Balotti, Claire Moore Dickerson, Jill Fisch, Peter Huang, Herb Hovenkamp, Mark Janis, Lyman Johnson, Don Langevoort, Donna Nagy, Adam Pritchard, Margaret Raymond, Rob Sitkoff, Gordon Smith, Ethan Stone, Albert Yoon. Mistakes, of course, are mine. The author would like to thank Melissa Nguyen, Joseph Raetzer, and Andrew Reardon for their research assistance and the Law Foundation for its financial support.


allowed suit. In addition, the Securities and Exchange Commission, prior to and continuing after the passage of Sarbanes-Oxley, has promulgated many governance- and disclosure-oriented regulations. One voice, however, has been fairly quiet. The State of Delaware, the mother of all corporate law, has been largely absent from the debate. The Delaware judiciary, however, has issued several opinions that indicate movement may be afoot. This Article raises several questions about Delaware's (declining) role in corporate law, and discusses the emerging duty of good faith and its potential for curbing abuses such as those seen in the past few years.

INTRODUCTION

According to Federal Reserve Chair Alan Greenspan, when greed swept through our nation, we were not prepared to address it. Boards of directors, corporate officers, lawyers, accountants, and others failed to detect wrongdoing and blow the whistle. Although the federal government has created new laws and duties for corporate officers, directors, and gatekeepers, the Delaware legislature has, until recently, been silent. Indeed, other than New York Attorney General Elliot Spitzer's actions, most states have been largely absent from the debate.

For many years, people have regarded Delaware as the place from which corporate governance practices emanated. The Delaware statutes provide mechanisms for key corporate governance decisions in default form, leaving corporations to adopt their own practices and procedures. The rationale behind this statutory scheme is that the business of business is better left to those in charge of it rather than to judges and legislators. Of course, the federal securities laws have filled much of the void in state regulations and statutes, at least as to public


6 See infra Part II.D–E.

7 See Monetary Policy, supra note 1, at 5.

8 See supra notes 29–32 and accompanying text.
companies. But gaps remain, and Delaware's legislature is partly to blame. It created several of the existing gaps and has been largely absent from the recent debate about the reform of corporate law and corporate governance. As a result, some think that "Delaware has a bad name, as a haven for incumbent management."

Delaware is not alone in its silence. Although calls for corporate and accounting reform have filled the newspapers, similar pleas for reforming state corporate law have been minimal at best. Commentators have looked to Congress and the SROs, but none have demanded that the states assert themselves, or, more specifically, that Delaware assert itself and begin to take an active role in regulating state corporate governance issues.

Of course, the Delaware legislature has not regulated the recent types of corporate-governance failures in years. In the landmark Delaware case of Smith v. Van Gorkom, the court found directors personally liable for breaches of the duty of care. In response, a healthy debate ensued over the judiciary's ability to measure care properly. At the same time, the insurance rates of directors and officers rose, resulting in concerns about the "continued availability of talented, outside directors." In short, some believed that courts are ill-equipped to measure fiduciary due care, particularly in hindsight. Others retorted that the facts of Van Gorkom were particularly severe and that the judiciary would restrict itself to finding liability only in the worst cases. The legislature responded by abdicating part of its role in regulating corporate governance and adopting the now ubiquitous exculpatory statute that allows companies, at the directors' initiative, to exempt themselves from damages for failing to adhere to their duty of care. As a result, the legislature stifled a potential common law evolution of the duty of care and any accompanying discussion

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11 At the time this Article went to press, only California had adopted a reform to its state laws that was arguably an attempt to respond to the corporate governance crisis. See CAL. CORP. CODE § 1502.5 (West 2002) (new filing requirement for California corporations that includes new compensation disclosures accompanied by fee for Victims of Corporate Fraud Compensation Fund). Pennsylvania was considering an amendment to criminalize knowingly false statements to auditors. See 18 PA. CONS. STAT. § 4107 (2003).

12 488 A.2d 858 (Del. 1985).

13 For an overview of the scholarship on this opinion, see Van Gorkom and the Corporate Board: Problem, Solution, or Placebo?, 96 NW. U. L. REV. 447, 447-48 (2002).

14 Frederick D. Lipman, Directors' Liabilities: Legislature Lends a Helping Hand, FOCUS, May 1987, at 78, 79.

about its norms and components, or even its proper place in the rubric of corporate governance.

Even if plaintiffs could avoid the exculpation barrier, the Delaware legislature had limited personal jurisdiction in Delaware courts to board members. Thus, the courts did not have jurisdiction over most corporate officer fiduciaries. Yet, in today's world, directors play less of a role in establishing corporate norms than their officer counterparts. The result was a strong intimation of permissiveness for the officer fiduciaries who make the day-to-day decisions and set the tone of internal governance.

A similar stumbling block grew out of a series of judicial opinions rendering pre-suit demand on a board determinative of that board's interest and independence. This obstacle, applicable at the motion to dismiss stage, acted as a barrier to litigation over fiduciary duty breaches for some time. The result was a stunting of the growth in the proper corporate governance norms for handling pre-suit demands, and presumably, the substantive law of fiduciary duties blocked by the demand rubric. The Delaware Supreme Court modified the doctrine in 1997— noting that demand does not concede board independence "conclusively"—thus allowing the case law to evolve again.

During the last few years, however, an important common-law change has emerged indicating that at least the Delaware judiciary is at work in this area. Chief Justice Veasey recently made clear that unless Delaware wants to cede corporate law and regulation to the federal government, it must act. And the perception is that the state's judges "have become more sensitive to the wishes of big shareholders, and . . . will be listening attentively." One way in which the courts

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20 Barbarians, supra note 10, at 62.
are acting is through their reference to and expansion of the third element in the fiduciary trilogy of care, loyalty, and good faith. Good faith is increasingly a topic of discussion in cases, in practice, and in academic circles, and the evolution of good faith as a duty may well become the test of the commitment and good faith of Delaware's corporate law and lawmakers.

This Article examines the doctrine of good faith and its more recent evolution. Part I lays the groundwork for that discussion, reviewing basic corporate governance concepts and the ways in which Delaware has chosen to regulate them. Part II provides a discussion and analysis of several key cases that add to our knowledge of the duty and how it might function. Finally, Part III develops the duty further from those cases and through analogies to the case law used to limit the scienter element of federal securities fraud claims, arguing that federal law has much to offer Delaware in the development of a doctrine of good faith. The Article concludes with suggestions for the role of good faith and its application to corporate fiduciaries.

I

GENERAL CORPORATE GOVERNANCE CONCEPTS IN DELAWARE

The term "corporate governance" is widely used to refer to the balance of power between officers, directors, and shareholders. Academics often discuss it in the context of regulating communications and combating agency costs where corporate officers and directors have the power to control the company, but the owners are diverse and largely inactive shareholders. Good corporate governance, then, allows for a balance between what officers and directors do and what shareholders desire. The term implies that managers have the proper incentives to work on behalf of shareholders and that shareholders are properly informed about the activities of managers.

Of course, in today's world of diversified shareholding, most shareholders no longer hold for corporate control and cannot monitor the corporation's daily activities. In the past, legal theory assumed that market monitors, or gatekeepers, partially fulfilled that

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monitoring role. Recent events, however, make clear that they have not been fulfilling their assumed duties for quite some time.

Recent events also reveal that the other monitors, corporate fiduciaries, have been neglecting their duties to the corporation, and through it, to owner shareholders. Under Delaware statutes, directors are the prescribed overseers—the statutes refer to them as the ultimate corporate controllers—and accordingly, the corporate governance provisions are director-focused. The statutes refer to directors as the ultimate corporate controllers. Much of the recent academic corporate governance debate has focused on whether directors, if given the proper incentives and if sufficiently independent, will properly manage officers. Current events indicate that the answer, at least for this era, is no. Directors have not been sufficiently active or independent. Officers have failed to adhere to their duties. Indeed, some of the recent corporate scandals can be tied to governance failures.


27 Apparently, the same was true in 1933. The Senate Report of what was to become the Securities Act of 1933 reveals that the Act did not relieve directors of liability for disclosure violations unless they had fulfilled their duties. For example, in the purpose section of the legislation, the Senate stated:

This phase of the law will have a direct tendency to preclude persons from acting as nominal directors while shirking their duty to know and guide the affairs of the corporation. Upon the discharge of this duty the public and stockholders rely in good faith. We cannot but believe that many recent disastrous events in the investment world would not have taken place if those whose names have appeared as directors had known themselves to be under a legal, as well as a moral, responsibility to the investing public.

and the inability—or unwillingness—of officer and director fiduciaries to manage faithfully.28

Delaware has, for the most part, chosen to let corporations decide what constraints, if any, they should impose on their fiduciaries.29 Although Delaware officers and directors previously had an enforceable duty of care,30 the state legislature eliminated this duty—despite protestations to the contrary by the Delaware judiciary—when it adopted the exculpation statute, section 102(b)(7).31 This provision allows companies to eliminate damages for breaches of the duty of care,32 leaving injunctive relief as the only available remedy.33 It should not be surprising, then, to learn that care-based cases are in the minority of derivative and class action cases filed in Delaware.34

Much ink has been spilled over Van Gorkom, the case that resulted in Delaware’s exculpation legislation. In light of today’s corporate scandals, it is worth reexamining that case along with a few others. This discrete group of cases reveals the underpinnings of the emerging doctrine of a separate duty: the fiduciary duty of good faith. That duty holds considerable promise for creating incentives to instill effective corporate governance and preventing the kind of fiduciary abdication that has occurred.

28 Although the statutes refer to directors, the fiduciary duties discussed in this Article apply both to directors and officers. The cases refer largely to directors because of the oddity of the personal jurisdiction statute allowing for suit against directors, but not officers. Because the duties apply to both, for the purposes of this Article, the term fiduciary or fiduciaries refers to both officers and directors.


30 See, e.g., Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (“In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders.”).

31 Section 102(b)(7) creates a place for exculpation provisions in certificates of incorporation by stating that the certifications can contain:

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 or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.


32 See id.

33 See, e.g., Turner v. Bernstein, 776 A.2d 530, 549 (Del. Ch. 2000) (stating that although exculpation provisions bar damages for duty of care breaches, they do not prohibit claims for injunctive relief).

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II

NON-LOYALTY FIDUCIARY DUTIES IN DELAWARE: KEY CASES

The Delaware Supreme Court has referred to the duties of a fiduciary as composed of three elements: care, loyalty, and good faith.35 The good faith element has not been explored in much detail, either by the courts or academics. A series of cases from Delaware, however, reveal an emerging doctrine of good faith.

Presumably, good faith may be applied either as an obligation to the other two key duties, care and loyalty, or as a freestanding duty. The former would make it similar to the good faith obligation that exists in contract law where good faith applies as an obligation to perform contract duties.36 Good faith in this forum would allow one to claim a bad faith breach of care or loyalty.37 Some members of the Delaware Chancery Court have defined good faith as a subset of or an obligation tied to the duty of loyalty, thus limiting it to a role in the context of loyalty. Consider, for example, the words of then-Vice-Chancellor Jacobs:

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

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37 See, e.g., McCall v. Scott, 239 F.3d 808, 818-19 (6th Cir. 2001) (applying Delaware law to hold that some reckless acts may be acts not in good faith and, therefore, not properly exculpated from liability under section 102(b)(7)) (citing BALOTTI & FINKELSTEIN, 1 DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 4.29 at 4-115–4-116.1 (3d ed. Supp. 2000), stating that: Whether the statute would protect a director against reckless acts is not altogether clear. To the extent that recklessness involves a conscious disregard of a known risk, it could be argued that such an approach is not one taken in good faith and thus could not be liability exempted under the new statute. On the other hand, to the extent that the conduct alleged to be reckless is predicated solely on allegations of sustained inattention to the duty it is arguable whether such conduct is “grossly negligent,” but not conduct amounting to bad faith.

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as distinguished from being a compartmentally distinct fiduciary
duty of equal dignity with the two bedrock fiduciary duties of loyalty
Apr. 28, 2003) (citing In re Gaylord Container Corp. S’holders Litig., 753 A.2d 462, 475
n.41 (Del. Ch. 2000) (taking issue with Delaware Supreme Court’s practice of listing good
faith as separate duty)).}

Alternatively, a freestanding duty of good faith is potentially more
expansive, requiring fiduciary compliance in its own right and encour-
aging fiduciary parties to comply with their obligations, thereby avoid-
ing the related shame for noncompliance.\footnote{See, e.g., Emerald Partners, 787 A.2d 85; Cede & Co. v. Technicolor, Inc., 634 A.2d
345, 361 (Del. 1993) ("To rebut the rule, a shareholder plaintiff assumes the burden of
providing evidence that directors, in reaching their challenged decision, breached any one of
the triads of their fiduciary duty—good faith, loyalty or due care.").} In contrast to the
approach described above, the Delaware Supreme Court now lists the
duty as separate and on par with the other two.\footnote{See, e.g., Citron v. Fairchild Camera and Instrument Corp., 569 A.2d 53, 64 (Del.
1989) (noting that to rebut business judgment rule, plaintiff must introduce evidence of
self-dealing or self-interest, such as loyalty concerns, good faith, or failure to exercise due
care).} Older cases arguably
did the same.\footnote{Id. at 881.} This distinction is important. As a separate duty,
good faith can attach to situations beyond those invoking loyalty con-
cerns and can grow to address its own category of governance issues.

In my examination of the cases in this section, I argue that the
courts have laid the groundwork for such a freestanding duty. Of
course, like all common law, the precise contours of the duty will be
clarified as courts apply the concept to difficult factual patterns.
Nonetheless, existing cases do shed light on the potential limits of
good faith. Moreover, reexamining the duty of good faith in the fac-
tual context of these cases indicates that as an independent duty, good
faith offers powerful incentives for making better corporate govern-
ance decisions.

A. \textit{Smith v. Van Gorkom}\footnote{488 A.2d 858 (Del. 1985), superseded by statute as stated in Emerald Partners, 787 A.2d
85.}

The first key governance case, \textit{Van Gorkom} was a shareholder class
action suit decided mostly in the disclosure context, but also held that
the company’s directors had neglected their duty of care when they
failed to explore fully a strategic combination presented by the
CEO.\footnote{464 [Vol. 89:456}
ity. Directors and officers who comply with the duty of due care are less likely to violate other duties. They are more likely to weigh decisions, consult with appropriate advisers, and disclose conflicts of interest. Thus, they are more likely to act both loyally and in good faith and run their companies in an ethical manner. Essentially, the premise is that good procedure leads to good substance.

The Delaware Supreme Court held the duty of due care to require that fiduciaries make informed decisions with the requisite amount of attention to detail and process. In so holding, the court made clear that the duty is procedural, not substantive. Courts monitor the duty through the business judgment rule, which delegates the business and affairs of Delaware corporations to the board of directors. The business judgment rule presumes that in making decisions and managing the corporation, fiduciaries have “acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Plaintiffs can rebut the business judgment rule by showing that the board’s decision was uninformed.

To fulfill their duty prior to making a business decision, fiduciaries must inform themselves of all material information reasonably available; uninformed and unadvised judgments are not protected. Instead, as a fiduciary, an officer or a director acts on behalf of the shareholders, and in that capacity must fully assess information before making decisions. A grossly negligent failure to do so, even absent bad faith or fraud, violates the duty of due care.

In Van Gorkom, the Delaware court applied this “informed-and-deliberate” standard to a merger transaction, holding, in part, that directors cannot create a safe harbor for their decisions simply by securing shareholder approval. Rendering a decision without the im-

45 See Van Gorkom, 488 A.2d at 872-73.
46 See Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) [hereinafter Brehm I] (noting that "substantive" due care violations are misplaced in corporate decisionmaking context).
47 See Van Gorkom, 488 A.2d at 872.
48 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Stephen M. Bainbridge, Corporation Law and Economics, § 6.4, at 269 (2002) (noting that “assumption” is better term than “presumption,” which is used in evidence contexts and differently).
49 See Van Gorkom, 488 A.2d at 872.
50 Id.
51 Id.
52 See id.
53 Id. at 872–73.
54 Id. at 889–93.
plementation of a thorough process for examining the decision with the requisite care is a violation of the duty of care.\textsuperscript{55} Translated into practical terms, the duty of due care requires directors and officers to slow their decisionmaking process by weighing appropriate alternatives, seeking appropriate advice from lawyers, accountants, or bankers, and considering the long-term implications of their decisions.\textsuperscript{56} According to the Delaware Supreme Court, such deliberate behavior is, and should be, the norm. In \textit{Van Gorkom}, the court explained how the norm should be enforced: through the imposition of substantial personal liability on the fiduciaries involved in the challenged decision.\textsuperscript{57} This liability created an incentive for other fiduciaries to avoid such penalties and to adhere to the norms of good corporate governance.

In a swift response to \textit{Van Gorkom}, the Delaware legislature amended the Delaware General Corporation Law to allow for an optional charter provision to exculpate directors for violations of the duty of due care.\textsuperscript{58} Only the board of directors can propose the addition or removal of such a change to a corporation’s charter.\textsuperscript{59} Shareholders vote on the directors’ recommendation, but once the provision is adopted, shareholders cannot put it back on the ballot, to, for example, remove it; only the directors can do so.\textsuperscript{60} The exculpatory provision eliminates liability for due care violations and operates
like an affirmative defense, applicable at the motion to dismiss stage. As a result, it has tremendous potential power.

In a separate line of cases, however, the Delaware Supreme Court carefully indicated that due care is unique in the world of exculpation and has cabined the reach of such clauses in litigation over motions to dismiss. Now, exculpation applies as an affirmative defense only as to due care allegations that are not intertwined with other fiduciary allegations, such as those involving loyalty or good faith. If a complaint alleges breaches of care intertwined, for example, with loyalty, and rebuts the business judgment rule, the entire complaint will survive the motion to dismiss. As a result of the exculpation clause, damages are no longer available against directors for breaches of their duty of due care.

B. In re Caremark International Inc. Derivative Litigation

The Caremark case is a settlement opinion from the Court of Chancery. Although it lacks the controlling power of an opinion of the Supreme Court, Caremark generated considerable discussion as a duty of due care case when issued. It remains an important contribution to the perceived standards of care, but arguably is also one of the cases discussing good faith explicitly in the context of corporate decisionmaking.

The issue in Caremark was whether the board had failed to monitor sufficiently the company’s compliance with the law. Chancellor Allen reviewed the adequacy of the settlement proposal, and noted that to succeed with their case, the plaintiffs had to show that the directors knew or should have known that violations of the law were occurring, yet “took no steps in a good faith effort to prevent or remedy that situation,” thereby resulting in a loss to the company.

On the basis of the record before it, the court first addressed whether Caremark’s directors had knowledge of violations of the law—involving payments to physicians who had prescribed treatments that Caremark had participated in providing—and found that the evidence did not reveal that any of the directors knew of such viola-

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62 See id. at 92; see also Malpiede v. Townsend, 780 A.2d 1075, 1093 (Del. 2001) (affirming plaintiffs’ concession that dismissal is appropriate where complaint “unambiguously and solely” alleges due care claim); McMullin v. Beran, 765 A.2d 910, 926 (Del. 2000) (noting that exculpation provision is not appropriately invoked for dismissal of claims of due care intertwined with those of loyalty); Emerald Partners v. Berlin, 726 A.2d 1215, 1224 (Del. 1999) (holding that exculpation clause is properly invoked for dismissal where “factual basis for a claim solely implicates” due care violation).
63 698 A.2d 959 (Del. Ch. 1996).
64 Id. at 959.
65 Id. at 960.
66 Id. at 971.
Instead, according to the court, the board appeared to have relied on expert opinions stating that the company's practices, although contestable, were lawful. Absent evidence that the board's reliance on those opinions was unreasonable, the court found that the record did not support an argument that the directors had breached their fiduciary duties by "knowingly causing the corporation to violate a criminal statute." Further, the court noted that a standard requiring directors "to possess detailed information about all aspects of the operation of the enterprise . . . would simply be inconsistent with the scale and scope of efficient organizational size in this technological age."

Next, the court examined whether the directors, though unaware of the criminal violations, had failed to exercise sufficient oversight to alert them to the likelihood of such violations. Here, Chancellor Allen explored the fiduciaries' duty of good faith, finding that "only a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability." The test, he noted, is "quite high," consistent with the general balance that Delaware courts have struck between encouraging peer and company monitoring, and not discouraging qualified individuals from serving as board members.

Chancellor Allen did not find any evidence in the record of a "sustained failure [by Caremark's directors] to exercise their oversight function[,]" noting that the company's monitoring program appeared to represent "a good faith attempt to be informed of relevant facts." As a result, he concluded that the claims against the company were "extremely weak." This conclusion allowed Chancellor Allen to accept the settlement's proposed changes in corporate practice, even though he stated that they did "not impress [him] as very significant."

The Delaware Supreme Court has never examined this opinion. The explication of the good faith obligations—indeed, even the use of that term—is dicta. Nevertheless, many commentators credit

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67 Id. The federal sentencing guidelines, or federal pressure on Delaware law, played a role in this decision.
68 Id.
69 Id.
70 Id.
71 Id.
72 Id.
73 Id.
74 Id.
75 Id. at 972.
76 Id. at 970.
77 The court has, however, cited the opinion with approval. See White v. Panic, 783 A.2d 543, 551–2 (Del. 2001).
Caremark with updating the duties of directors from the 1963 Graham v. Allis-Chalmers Manufacturing case, which held that absent red flags, directors need not “ferret out wrongdoing.” In fact, one Delaware Supreme Court Justice has indicated that Caremark better represents today’s standards of directorial conduct.

Caremark instructs fiduciaries to prevent and address problems through compliance and monitoring programs. A sustained and utter failure to ensure the existence of a functioning program may well be grounds for a good-faith cause of action. Indeed, a failure to attempt to comply with one’s fiduciary duties is likely to result in a breach of good faith. Thus, Caremark supports the position that good faith is not simply another version of care, but rather is an emerging and independent doctrine. Viewed in that context, Caremark lays the groundwork for the argument that good faith is best understood as a freestanding duty—one that creates its own incentives for fiduciaries to make thoughtful decisions *ex ante* and that regulates, in part, abdication of the fiduciary’s role.

C. Scattered Corp. v. Chicago Stock Exchange, Inc.

In this case, the Delaware Supreme Court focused on the way in which courts should review the refusal by officers and directors of a corporation of a demand to investigate and remedy alleged corruption, addressing the existing standard of review that insulated directors from further litigation when plaintiffs chose to make a demand before suing. In Scattered, the plaintiffs, members of the Chicago Stock Exchange, alleged that the defendants, officers and board members of the Exchange, were involved in “systemic corruption of the Exchange and its subsidiaries.” According to the court, the alleged corruption included “bribery, refusal to enforce violations of rules of the Exchange by favored members, the hiring of ‘ghost employees,’ and inappropriate discipline of nonfavored employees.” The plaintiffs submitted a draft complaint to the board along with a demand that the board investigate the allegations and remedy all abuses.

In response, the chair of the board told the plaintiffs that the Executive Committee had the “full authority to act for the Board between meetings,” and that the Executive Committee had appointed

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78 188 A.2d 125, 130 (Del. 1963).
79 See Veasey, supra note 19.
80 701 A.2d 70 (Del. 1997), overruled by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
81 See supra notes 17–20 and accompanying text.
82 701 A.2d at 71.
83 Id.
84 Id.
85 Id.
a Special Committee to investigate the complaint. The chair then informed the plaintiffs that the Special Committee had reviewed the allegations, retained independent counsel, interviewed more than twenty-five individuals, and was unable to substantiate the demand. The chair also informed the plaintiffs that, "after careful consideration, the Executive Committee had determined that there was no basis upon which to take further action with respect to [their] demand."

The plaintiffs then filed a derivative suit in the Court of Chancery, repeating the allegations contained in their demand. Having made a demand before filing suit, the plaintiffs faced judicial review in the demand-refusal context. In its review, the Delaware Supreme Court made two surprising moves. First, it reframed the standard applicable to demand-refusal cases, making clear that although prior cases had indicated that the act of making demand conceded the disinterestedness and independence of the board, it did so only ex ante, not ex post. The court thus ruled that a board that fails to act in a disinterested or independent fashion while investigating a demand fails to carry out its fiduciary duties. As a result, the court opened for further litigation a door many had presumed closed by demand, eliminating a key common law insulator for fiduciaries.

Second, the supreme court framed the test for review in terms of good faith, not simply care. The court stated that when "an otherwise independent appearing board or committee [fails] to act independently [it fails] to carry out its fiduciary duties in good faith or to conduct a reasonable investigation. Such failure could constitute wrongful refusal." In the end, the supreme court affirmed the Court of Chancery's dismissal, finding that the plaintiffs had failed to plead facts showing that either the Special Committee, as the investigator, or the Executive Committee, as the decisionmaker, had failed to adhere to its duties.

One of the most interesting aspects of the opinion for the purposes of examining what good faith might involve is the list of items that the supreme court considered when it reviewed the findings of

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86 Id. In fact, it later surfaced that the board, not the Executive Committee, appointed the Special Committee, but the Court of Chancery deemed this fact to be irrelevant. See id. at 72 & n.1.
87 Id. at 71.
88 Id. at 71–72.
89 Id. at 72.
90 Id. at 71–74.
91 Id. at 74.
92 Id. at 75.
93 See id.
94 Id.
95 Id. at 76–77.
the Court of Chancery. The court examined the following: the board had created a Special Committee; the committee had inter-
viewed twenty-five people and others that the plaintiffs had indicated could substantiate their claims of wrongful conduct; the committee
found that the allegations contained in the complaint were unsubstan-
tiated; and, finally, the Executive Committee, after carefully consider-
ing the committee's report, found no basis on which to take action. According to the supreme court, the Court of Chancery correctly con-
cluded on these facts that the Executive Committee's decision was “the product of a valid exercise of business judgment.” In the ab-
sence of any pleadings to show that these findings were not accurate, the supreme court upheld the lower court's decision.

Notably, although the Court of Chancery listed the factors in the context of a duty of care, the supreme court listed them in the context of the duty of good faith. Here again, the supreme court deployed the term “good faith” as its term of choice for referring to the duty at issue, making clear that something more than excusable due care was involved, furthering the growth of good faith and fiduciary res-
ponsibilities and even the emergence of good faith as a separate duty. Scattered thus indicates that good faith applies to decisionmaking processes, not just loyalty issues.

D. Brehm v. Eisner

In two recent opinions, the Delaware courts further explicated good faith, demonstrating that fiduciaries cannot avoid this duty. Both opinions involved a lawsuit against fiduciaries at the Walt Disney Company. In Brehm I, the Delaware Supreme Court explored and ex-
panded its good faith jurisprudence. In Brehm II, the Court of Chancery applied that jurisprudence to a complaint pleaded with in-
formation obtained pursuant to a demand for books and records and found that the plaintiffs had pleaded sufficient allegations of a fiduci-
ary breach to survive a motion to dismiss. These opinions build on the earlier foundation of cases discussing good faith, provide further elaboration on the nature of good faith, and move it toward a separate duty. Of course, none of the cases develop bright-line rules for this—
or any other—fiduciary duty. In part, that is because each situation carries with it different facts, making a bright-line approach to the three key elements of a fiduciary’s duties impossible. The Disney cases do, however, illustrate that allegations of abdications of governance responsibilities will lead to further expansion and regulation of the duty of good faith.

_Brehm I_ addressed a complaint (the “First Complaint”), in which the shareholders sued derivatively, arguing that the directors had breached their fiduciary duties in approving two contracts for Michael Ovitz. According to _Brehm I_, the First Complaint included three main arguments. First, the plaintiffs alleged that the board violated its duties in its initial approval of Ovitz’s extravagant and wasteful employment contract (the “Employment Agreement”). Second, they argued that a year later, when the board approved the contract regulating Ovitz’s termination (the “Termination Agreement”), it breached its duties by approving a non-fault agreement that was extravagant and wasteful. And, third, the plaintiffs alleged that the directors were not disinterested and independent.

The Court of Chancery dismissed the case with prejudice. On appeal, the supreme court reversed part of the “with prejudice” aspect of the Court of Chancery opinion, allowing the plaintiffs to replead some of their allegations. In reaching that outcome, the supreme court made some strong statements about fiduciary duties and the contract at issue. The court began by stating that “[t]his is potentially a very troubling case on the merits.” According to the supreme court, Ovitz’s compensation and the Termination Agreement appeared to be “exceedingly lucrative, if not luxurious, compared to [his] value to the Company. . . .” The supreme court also noted that, as alleged, the “processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory.”

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105 _Brehm I_, 746 A.2d at 248.
106 _Id._ at 248–49.
107 _Id._ at 248.
108 _Id._ at 248–49.
109 _Id._ at 249. The Court of Chancery had found that the plaintiffs failed to plead that the directors were not disinterested and independent. The Delaware Supreme Court agreed. _Id._ at 248 n.3.
110 _Id._ at 267.
111 _Id._
112 _Id._ at 249.
113 _Id._
114 _Id._
The plaintiffs caught the supreme court's attention with their allegation that the termination provisions of the Employment Agreement and, ultimately, the Termination Agreement itself, were so much more generous than his five-year contract that Ovitz had an incentive to orchestrate a non-fault termination as soon as possible after the execution of the Employment Agreement. Moreover, the plaintiffs argued that the board, although advised by a compensation expert, failed to consider the incentives that the Termination Agreement created.

The lower court had found that although the plaintiffs had pleaded that the compensation expert who advised the board had admitted that "[n]obody quantified [the total cost of the severance package]," that fact did "not create a reasonable inference that the Board failed to consider the potential cost to Disney in the event that they decided to terminate Ovitz without cause." Then, the lower court went one step further, finding that even if the plaintiffs claimed that the board had failed to calculate the cost to Disney, that allegation was insufficient to withstand a motion to dismiss. Instead, according to the lower court, regardless of what the board's expert said in hindsight, the board presumably had not considered the cost of the package to be material at the time the agreement was entered into.

The Court of Chancery stressed the specific protection of the business judgment rule from hindsight evaluations of plaintiffs' claims. Instead, it found that even if the board failed to consider the "exact amount of a severance payout but nonetheless [was] fully informed about the manner in which such a payout would be calculated," it had met its duty of care. Thus, concluding that the plaintiffs had failed to plead sufficient facts to support a reasonable doubt that the board was not reasonably informed on the issue, the court dismissed the First Complaint.

On appeal, the supreme court reviewed the First Complaint in the context of the plaintiffs' failure to make demand on the Disney board before filing suit. The relevant test in such situations is the

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115 Id. at 251. The Economist referred to the Termination Agreement as "an obscene pay-off to ... a failed former company president." Barbarians, supra note 10, at 62.
116 746 A.2d at 251.
118 Id. at 361–62.
119 Id. at 362.
120 See id.
121 See id.
122 Id.
123 Id.
124 Brehm I, 746 F.2d 244, 254 & n.19 (Del. 2000).
“demand futility” standard.\textsuperscript{125} This test has two alternative prongs: whether the plaintiffs have created a reasonable doubt that the directors are disinterested and independent, or “whether the [complaint] creates a reasonable doubt that the challenged transaction was otherwise the product of a valid exercise of business judgment.”\textsuperscript{126}

Applying the \textit{de novo} standard in the demand-futility context, the supreme court first considered whether a majority of the board members in office at the time the plaintiffs filed the First Complaint were disinterested and independent.\textsuperscript{127} Holding that the plaintiffs failed to plead sufficient facts to support their allegations of interest and lack of independence, the supreme court rejected the plaintiffs’ contentions and upheld the lower court’s findings on this issue.\textsuperscript{128} As a result, the court precluded the plaintiffs from repleading their allegations on this point.\textsuperscript{129}

The supreme court next turned to what it termed the “Analytical Framework for the Informational Component of Directorial Decision-making.”\textsuperscript{130} Here, the court responded to the plaintiffs’ contention that the lower court had applied an incorrect standard.\textsuperscript{131} The plaintiffs argued that the lower court had erred in requiring only that the board be “reasonably informed” when it makes decisions, but not “informed of every fact.”\textsuperscript{132} According to the plaintiffs, this standard was “too lax.”\textsuperscript{133} Instead, they proposed that the standard should be whether the board members availed themselves of “all material information reasonably available. . . .”\textsuperscript{134} In response, the supreme court agreed with the lower court’s finding that directors need not be informed of “\textit{every} fact[.]”\textsuperscript{135} but explained that the board “is responsible for considering only material facts that are reasonably available. . . .”\textsuperscript{136}

Next, the court turned to the actual pleadings to determine whether they met the Rule 23.1 standard.\textsuperscript{137} Here, the courts dif-

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{125} \textit{Id.} at 256.
\item \textsuperscript{126} \textit{Id.} at 256–57 (citing Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).
\item \textsuperscript{127} \textit{Id.}
\item \textsuperscript{128} \textit{Id.} at 257–58.
\item \textsuperscript{129} \textit{See id.} at 258.
\item \textsuperscript{130} \textit{Id.}
\item \textsuperscript{131} \textit{See id.}
\item \textsuperscript{132} \textit{Id.} (footnote and internal quotation marks omitted).
\item \textsuperscript{133} \textit{Id.}
\item \textsuperscript{134} \textit{Id.}
\item \textsuperscript{135} \textit{Id.} at 259.
\item \textsuperscript{136} \textit{Id.} In fleshing out this test, the Delaware Supreme Court noted that although the Court of Chancery’s description of the standard was arguably consistent with prior Delaware Supreme Court formulations, the lower court did not state the test in a helpful manner. \textit{Id.}
\item \textsuperscript{137} \textit{Id.} at 259–62.
\end{enumerate}
\end{footnotesize}
fered. After finding that the potential payouts under the Employment Agreement were material in light of their size, the supreme court concluded that the plaintiffs' pleadings indicated that the numbers were reasonably available, thus satisfying the tests of materiality and reasonable availability.

In examining whether the plaintiffs had met their burden, however, the supreme court held that one further step was necessary—determining whether the lower court's interpretation of the First Complaint's allegations was accurate. On this issue, the supreme court found that the lower court had erred. According to the court, the Court of Chancery had made two findings regarding the First Complaint. First, it found that the plaintiffs had alleged that only the expert, and not the board, had failed to calculate the payout. Second, it found that even if the board failed to do so, the expert's belief that the calculation was not critical indicated that any failure by the board to make the calculation did not raise a reasonable doubt as to its due care.

The supreme court read the First Complaint differently. It held that a fair reading of the complaint indicated that the plaintiffs alleged the expert had "admitted that 'nobody'—not [it] and not the directors—made [the] calculation." As a result, the supreme court concluded that the lower court's reading of the First Complaint was "too restrictive." Further, the supreme court criticized this reading as too simplistic at the pleading stage to constitute a "comprehensive analysis of the issue."

The supreme court held, however, that the Court of Chancery's error was harmless, because the pleadings indicated that the board had been advised by a compensation expert and thus, the board was entitled to a presumption of reliance on that expert. Here, the supreme court applied the expert provision of Delaware General Corporation Law, even though the lower court had not done so explicitly. Under section 141(e) of this statute, a board is entitled to rely on an expert and, if sued, is entitled to the business judgment rule standard

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138 Id. at 260–62.
139 Id. at 259–60.
140 Id. at 260–61.
141 Id.
142 Id. at 260.
143 Id.
144 Id.
145 Id.
146 Id. at 261.
147 Id.
148 Id.
149 Id.
of review on the question of whether that reliance was proper and in good faith.150

The supreme court then held that the First Complaint was subject to dismissal because the plaintiffs had failed to plead sufficient particularized facts to support this claim.151 The court then provided a list of the types of facts that, if proved, could provide evidence of a fiduciary breach and, therefore, enable a complaint to withstand dismissal.152 To meet that burden, the court held that the plaintiffs needed to provide evidence of one of the following types of allegations.158 First, the directors did not actually rely on the expert.154 Second, their “reliance was not in good faith.”155 Third, the board did not reasonably believe that the advice was within the expert’s area of competence.156 Fourth, the expert was not selected with reasonable care and the directors were responsible for such failure.157 Fifth, the contested subject matter was “so obvious” that failing to consider it amounted to gross negligence by the board, regardless of the expert’s advice or lack thereof.158 Or, sixth, the board’s decision was so “unconscionable as to constitute waste or fraud.”159 According to the supreme court, the First Complaint failed to include particularized allegations of any of these six categories.160 As a result, it affirmed dismissal of the First Complaint, but gave the plaintiffs leave to replead.161

The supreme court also addressed the plaintiffs’ argument that the board violated the substantive due care standard by committing waste in approving Ovitz’s Employment Agreement.162 Here, the court inquired into whether the lower court erred when it rejected the contention that the Employment Agreement was waste ab initio because it allegedly created an incentive for Ovitz to seek non-fault termination as early as possible.163 The lower court had dismissed the waste allegation, finding that it did not meet the test for waste, which requires a transaction to be “so one sided that no business person of ordinary, sound judgment could conclude that the corporation ha[...]

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151 Id. at 262.
152 See id.
153 Id.
154 Id.
155 Id.
156 Id.
157 Id.
158 Id.
159 Id.
160 Id.
161 Id.
162 Id.
163 Id. at 262-63.
received adequate consideration" for it.\textsuperscript{164} According to the Court of Chancery, the Disney board had determined that it needed to offer a significant package to Ovitz in order to hire him, and the First Complaint could be fairly read to support the conclusion that the option vesting schedule created a disincentive for Ovitz to leave Disney early.\textsuperscript{165}

The supreme court agreed with the lower court's findings that the First Complaint was "deficient," but again left open the possibility of a successful amended complaint.\textsuperscript{166} Moreover, the court asserted that the due care matter was only procedural.\textsuperscript{167} In so doing, it rejected the plaintiffs' argument that the board's decision was faulty in and of itself.\textsuperscript{168} Rather, the court held that an irrational decision, like waste, would be one that was at the "outer limit of the business judgment rule," and that if the board lacked good faith in making such a decision, it might lose the favorable presumption of that rule.\textsuperscript{169} Here, again, the court referred to good faith rather than due care, further carving out space for good faith as a separate duty.

The plaintiffs further argued that the later board decision for the payout in the Termination Agreement also amounted to waste.\textsuperscript{170} In support of this claim, the plaintiffs argued that when Ovitz left Disney, he did so in a manner not provided for in the non-fault termination provisions of the Employment Agreement—either by resigning or by committing acts sufficient for the board to terminate him for cause.\textsuperscript{171} Thus, they argued that by paying him, the directors wasted Disney assets.\textsuperscript{172} Here, the supreme court noted that the First Complaint did not set forth sufficient particularized facts to show that Ovitz either resigned or unarguably breached the Employment Agreement.\textsuperscript{173} Moreover, the court reasoned that the plaintiffs' argument was, in part, premised on the assumption that Ovitz would not resign until he could collect the payout, and thus the argument that he had resigned was contradictory.\textsuperscript{174} The court also found that the for-cause argument lacked sufficiently pleaded facts to meet the applicable stan-

\begin{footnotesize}
\textsuperscript{165} Id. at 362-63.
\textsuperscript{166} Brehm I, 746 A.2d at 263.
\textsuperscript{167} Id. at 264 (stating that "[d]ue care in the decisionmaking context is process due care only.").
\textsuperscript{168} See id.
\textsuperscript{169} Id.
\textsuperscript{170} Id.
\textsuperscript{171} Id.
\textsuperscript{172} Id.
\textsuperscript{173} Id.
\textsuperscript{174} Id.
\end{footnotesize}
Nevertheless, the court held that the plaintiffs could replead this issue as well.176

Finally, although discovery is not allowed at the motion to dismiss stage in such cases in Delaware, the supreme court made clear that the plaintiffs were entitled to seek relevant Disney books and records pursuant to section 220 of the Delaware General Corporation Law.177 That provision allows shareholders access to corporate books and records when they are able to show a proper purpose for their request.178 The supreme court did not analyze whether the plaintiffs could meet the standard of showing a proper purpose, but it did indicate that the lower court should treat the matter expeditiously179 and in so doing, indicated that the plaintiffs should be allowed access to books and records, though not without limits.

E. In re The Walt Disney Derivative Litigation180

The plaintiffs obtained information pursuant to section 220 and filed a repleaded complaint (the “Second Complaint”). Chancellor Chandler's opinion analyzing the Second Complaint reveals that the plaintiffs had obtained information that, at least at the motion to dismiss stage, raised some very troubling facts. Indeed, the Chancellor found that the plaintiffs had pleaded allegations which, if true, indicated a breach of good faith, allowing the action to survive the motion to dismiss.181 As the following discussion reveals, the Chancery Court's examination of the facts of the Second Complaint reveals substantial differences from those initially pleaded.182

To begin with, Chancellor Chandler's opinion indicates that the plaintiffs pleaded that the value of the Termination Agreement to Ovitz exceeded $140,000,000 for what amounted to one year of employment.183 Further, the plaintiffs alleged that the board had not reviewed either the Employment Agreement or the Termination Agreement.184 Thus, according to Brehm II, the Second Complaint alleged that board minutes revealed that the board in office at the time of the Employment Agreement (the “Old Board”) failed to “ask any questions about the details of Ovitz’s salary, stock options, or possible

175 Id. at 265–66.
176 Id. at 266.
177 Id.
179 Brehm I, 746 A.2d at 267.
181 Id. at 278.
182 Id. at 279.
183 Id. at 278–79.
184 See id. at 281.
termination."\textsuperscript{185} Moreover, the allegations stated that the Old Board did not consider the "consequences of a termination, or the various payout scenarios that existed."\textsuperscript{186} Instead, according to Chancellor Chandler, the plaintiffs alleged that all of the negotiations were left to Eisner, Ovitz’s long-time friend.\textsuperscript{187} Neither Eisner nor Ovitz signed the Employment Agreement until after Ovitz began working for Disney.\textsuperscript{188} Further, although the Old Board’s compensation committee had been informed about the nature of an early draft, the plaintiffs alleged that it did not see either this version or the final Employment Agreement.\textsuperscript{189} Apparently, the committee also did not request to see any version of the Employment Agreement.\textsuperscript{190}

Yet, according to \textit{Brehm II}, the Second Complaint alleged that, as signed, the Employment Agreement provided Ovitz with more generous terms than the early draft.\textsuperscript{191} For example, the final agreement included a provision allowing Ovitz access to the termination benefits with a non-fault provision rather than the initial wrongful termination provisions.\textsuperscript{192} Additionally, the non-fault termination provisions were more generous than the wrongful termination provisions and were, according to Chancellor Chandler’s opinion, so potentially lucrative that they created an incentive for Ovitz to leave the company as soon as possible after signing the Employment Agreement.\textsuperscript{193}

According to the plaintiffs, that is indeed what Ovitz did. As relayed by the Court of Chancery, the Second Complaint alleged that Ovitz was not well-suited to the position. Rather than taking the time to learn the job, he cancelled meetings with the company’s chief financial officer, Stephen Bollenbach, who said that Ovitz “didn’t understand the duties of an executive at a public company[,] and he didn’t want to learn.”\textsuperscript{194} Instead, according to the court, Ovitz simply began to look for other work, with Eisner’s permission.\textsuperscript{195} Unfortunately, Ovitz did not obtain the job he sought, and as a result, the termination provisions of the Employment Agreement became relevant.\textsuperscript{196}

\begin{itemize}
\item \textsuperscript{185} Id.
\item \textsuperscript{186} Id.
\item \textsuperscript{187} Id.
\item \textsuperscript{188} See id.
\item \textsuperscript{189} Id. at 281–82.
\item \textsuperscript{190} Id.
\item \textsuperscript{191} Id. at 282–83.
\item \textsuperscript{192} Id.
\item \textsuperscript{193} Id. at 283.
\item \textsuperscript{194} Id. (alteration in original) (internal quotation marks omitted) (quoting PIs.’ Second Am. Compl. ¶ 73).
\item \textsuperscript{195} Id.
\item \textsuperscript{196} Id.
\end{itemize}
Under those provisions, Ovitz could not leave Disney and garner the termination benefits unless: “(1) he was not elected or retained as president and a director of Disney; (2) he was assigned duties materially inconsistent with his role as president;” or (3) he was not paid his salary or options. 197 Absent the occurrence of one of these events, he could not resign without potential liability to Disney for damages, and he could not access the benefits of a non-fault termination under the Employment Agreement. 198 The plaintiffs alleged, however, that Eisner labored with Ovitz to achieve a severance that would allow access to those benefits. 199

Further, according to the Second Complaint, although the board knew that Eisner was working to complete a non-fault termination, it was never told the terms and did not inquire. 200 Instead, according to the Court of Chancery’s recitation of the allegations, when Ovitz’s departure became public, neither the board then in office (the “New Board”) nor the compensation committee had been consulted about or had given their approval of the Termination Agreement. 201 Further, the allegations stated that there was no record of the New Board taking any action to approve the Termination Agreement after it became public. 202 Later, according to the Second Complaint, the Termination Agreement was further revised with terms arguably more favorable to Ovitz, and the New Board still did not review or approve it. 203 Yet according to Chancellor Chandler’s review of the allegations, Disney’s bylaws required board approval for the non-fault termination. 204 Despite that requirement, and the New Board’s knowledge of ongoing negotiations, the New Board took no action to question, affirm, or rescind the Termination Agreement. 205 Moreover, Chancellor Chandler found that based on the Second Complaint’s allegations, no record of any discussion of alternatives or options existed. 206

In response, the defendants argued that the breach of fiduciary duty, if any, at issue in this case amounted only to a breach of the duty of due care, excusable under Disney’s charter. 207 The Court of Chancery, however, rejected the due care argument, finding that a fair reading of the Second Complaint created doubt as to whether the

197 Id. at 283–84.
198 Id. at 284.
199 Id.
200 Id.
201 Id.
202 Id.
203 Id.
204 Id. at 285.
205 Id.
206 Id.
207 Id. at 286.
Board had acted “honestly and in good faith.” Unlike their due care counterparts, dishonest and bad faith actions are not excusable.

The defendants further argued that Ovitz’s prior position at the Creative Artists Agency warranted a large compensation package at Disney, thus justifying the Employment Agreement. Moreover, they argued that the Termination Agreement was appropriate because the board wanted to avoid protracted litigation with him. In essence, they argued that the two agreements represented reasonable exercises of business judgment. Chancellor Chandler rejected those arguments, finding that the facts as pleaded in the Second Complaint indicated that neither the Old nor the New Board (the “Boards”) had exercised any business judgment or made any good faith attempts to fulfill their fiduciary duties to the shareholders with respect to either agreement.

Instead, the Chancellor found that the Second Complaint alleged that the Boards allowed Eisner to make a unilateral decision to hire Ovitz, design the terms of the Employment Agreement, and negotiate the Termination Agreement. Although the compensation committee and the Old Board did review the hiring decision, no minutes of any board meeting reflected any questions about or evidence of further review or approval of the Employment Agreement. The same was true of the non-fault termination and the Termination Agreement. According to the Court of Chancery, the Second Complaint alleged that neither the compensation committee nor the Boards evaluated the details of the salary, the Employment Agreement, or the Termination Agreement. Further, no evidence existed to show that the Boards consulted experts at either the commencement or completion of Ovitz’s employ with Disney.

The result, according to the Chancellor, was allegations directors who had “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.” In Chancellor Chandler’s opinion, allegations of such knowing or deliberate indifference amounted to conduct that “may not have been taken honestly and in good faith to

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\begin{align*}
\text{208 Id.} \\
\text{209 Id.} \\
\text{210 Id.} \\
\text{211 Id.} \\
\text{212 Id. at 287.} \\
\text{213 Id.} \\
\text{214 Id.} \\
\text{215 Id. at 288.} \\
\text{216 Id. at 288–89.} \\
\text{217 Id.} \\
\text{218 Id. at 289.}
\end{align*}
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advance the best interests of the company.” In sum, the Court of Chancery concluded, when viewed in the light most favorable to the plaintiffs, if the Second Complaint’s alleged facts were true, they implied that the director-defendants knew they were making material decisions without adequate information or deliberation, and appeared not to care if the decisions caused injury or loss to the corporation or the shareholders. Thus, the court concluded, such allegations were sufficient to withstand dismissal and to be subjected to full discovery.

_Brehm II_ thus built on the Delaware Supreme Court’s opinion in _Brehm I_. The ultimate outcome of this litigation is unknown, but it is unlikely that the supreme court could have reached a different conclusion on the facts as relayed by Chancellor Chandler.

Importantly, the opinions reveal a clearly emerging third, and separate, duty: that of good faith. Loyalty was not at issue. In _Brehm I_, the Supreme Court held that the plaintiffs had failed to plead any facts on interest and lack of independence sufficient to allow repleading on that point. Their failure to do so means that they failed to meet the prongs of the business judgment rule traditionally used to screen for loyalty concerns. Moreover, as recited in _Brehm II_, at least with respect to the board allegations, the facts do not relate to the types of conflict of interest or traditional loyalty issues into which some have tried to cabin good faith. Further, in _Brehm II_, Chancellor Chandler rejected the defendants’ attempt to locate the facts in the due care category. Instead, the facts that Chancellor Chandler relays in _Brehm II_ describe a board dominated by one officer and reflect the egregious type of behavior—abdication of duties—that either defines bad faith or calls into play the duty of good faith. As revealed by former Chancellor Allen’s opinion in _Caremark_, conscious disregard of one’s duties to the company presents a good faith issue, not simply a procedural lapse of due care.

**III**

**Defining Good Faith**

As Part II illustrates, recent cases discussing and expanding the duty of good faith separate it from the duties of care and loyalty. These cases lay a foundation for further explication of the duty. _Brehm II_, for example, adds considerable detail to the structure of good

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219 Id.
220 Id.
221 Id. at 289–90.
222 _Brehm I_, 746 A.2d 244, 258 (Del. 2000).
223 _Brehm II_, 825 A.2d 275, 286 (Del. Ch. 2003).
224 See supra notes 63–79 and accompanying text.
DELAWARE'S GOOD FAITH

This section explores that structure further, provides a set of definitions for the duty of good faith under Delaware law, and draws some conclusions about how it might apply in future cases.

Delaware courts traditionally refer to three aspects of fiduciary duties: loyalty, care, and good faith.\textsuperscript{225} The discussion of Smith v. Van Gorkom above covers the duty of care in some detail.\textsuperscript{226} The duty of loyalty requires that officers and directors act in the best interests of the corporation and prioritize its interests over their own.\textsuperscript{227} Thus, when fiduciaries have a conflict of interest in a transaction, they must act in the corporation's interest and refrain from self-dealing, from taking a benefit not generally available to other shareholders, and from personally usurping opportunities that would benefit the corporation.\textsuperscript{228} In sum, fiduciaries should not obtain improper personal advantages from their association with the corporation. Instead, they should be disinterested in their decisions. Conflicts should be disclosed, and, if properly cleansed, such disclosure can remove any taint from an otherwise interested decision. To screen claims at the motion to dismiss stage, courts look for allegations of either interest or lack of independence. This procedural test for loyalty usually measures a fiduciary’s status of independence or disinterest before the substance of the transaction is measured for either actual loyalty or an outcome that is connected to a conflict and is sufficiently egregious. Sufficient allegations of interest or lack of independence can result in a lack of protection for fiduciaries through the business judgment rule.

These duties can overlap with each other. For example, good faith can overlap with the duty of loyalty when a fiduciary’s lack of independence and interest come into play. A traditional formulation of the duty of loyalty states that if directors and officers are independent of and disinterested in the complained of transaction, the court will not find them liable for a breach of that duty, unless the facts of the transaction are “such that no person could possibly authorize [it]
if he or she were attempting in good faith to meet their duty.\textsuperscript{230} Thus, one can simultaneously be disloyal and act in bad faith.

Importantly, one can also act in bad faith without being disloyal, at least as traditionally viewed.\textsuperscript{231} That is, rather than relying on allegations of the fiduciaries' status or conflict, bad faith focuses on the indifference or egregiousness with which fiduciaries approached the substance of the transaction. As a result, mere mismanagement is insufficient to establish a breach of good faith. Erroneous or simply bad decisions are also inadequate. If a corporate officer makes an expenditure for a corporate purpose, whether it "was wise or foolish, low risk or high risk," it is outside the bounds of the court's review.\textsuperscript{232} However, if the fiduciaries are independent and disinterested in an expenditure that a person in good faith could not possibly have approved, they will violate the duty of good faith, without necessarily violating their duty of loyalty.\textsuperscript{233}

Neither loyalty nor care was at issue in the Disney and Scattered cases. Loyalty issues need not overlap with good faith. Instead, as it emerged from those cases, good faith was not simply an overlay on, or obligation related to the performance of, the other two duties, but its own freestanding duty. The separate nature of good faith was apparent in how the Disney and Scattered courts focused on the questioned transactions and allegations of egregious decisions, rather than traditional loyalty or care breaches. These cases, then, demonstrate that fiduciaries can act in bad faith for reasons other than "personal pecuniary interest." They also make clear that regardless of their motives, fiduciaries "who consciously disregard[ ] [their] duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm" caused.\textsuperscript{234} Accordingly, deliberate indifference to their tasks or intentional subversion of their duties will relegated fiduciaries to the realm of bad faith.

Recall that in Scattered the Supreme Court held that an ostensibly independent board that failed to act independently or carry out a reasonable investigation would fail to perform its duties in good faith.\textsuperscript{235} This formulation of good faith makes clear that independent status alone is insufficient to withstand a breach-of-good-faith allegation. The circumstances of the transaction or outcome must reflect good

\textsuperscript{230} Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1053 (Del. Ch. 1996).
\textsuperscript{231} But see Nagy v. Bistricer, 770 A.2d 43, 48 n.2 (Del. Ch. 2000) ("By definition, a director cannot simultaneously act in bad faith and loyally towards the corporation and its stockholders.").
\textsuperscript{232} Gagliardi, 683 A.2d at 1053.
\textsuperscript{233} See Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985) (disclosure and approval from appropriate group can cleanse otherwise tainted transaction).
\textsuperscript{234} Nagy, 770 A.2d at 48 n.2.
\textsuperscript{235} For a detailed discussion of the Scattered case, see supra Part II.C.
faith as well. Thus, the *Scattered* court rejected a breach-of-good-faith theory, noting that the plaintiffs had failed to plead that the board's approach to, and process for, an investigation, as well its findings, were sufficiently unreasonable. Instead, the court upheld a process requiring that the Executive Committee appoint an untainted Special Committee to complete an investigation into the allegations.

The court also noted that the undisputed facts revealed that the Special Committee interviewed all of the people that the plaintiffs alleged had knowledge about the company problems. Based on its investigation, the Special Committee found that the allegations were unsubstantiated. Further, the Executive Committee separately reviewed those findings, determining them to lack merit. As a result, the supreme court held that absent other pleadings from the plaintiffs indicating a failure by the Special Committee to look into an allegation or the neglect of the Executive Committee to consider those findings fully, the plaintiffs did not meet the standard of pleading a good-faith issue. The opinion thus reveals that based on the facts before it, the supreme court could not hold that the defendants had acted with deliberate indifference to their role, or intentionally subverted or avoided an assigned or otherwise materially important task. Instead, based on the facts before it, the supreme court could conclude only that the defendants had carried out their jobs, and although one might disagree with the ultimate decision, their good faith in completing their task prevented further review.

From these facts, then, we can glean a further understanding of how the duty of good faith differs from the duties of care and loyalty. Fiduciaries acting in good faith abide by the norms of corporate governance and comply with legal standards while performing their jobs. Egregious or conspicuous failures to do so are subject to liability under the duty of good faith.\(^2\) For example, directors must ensure that complaints about the company or its officers are honestly and thoroughly investigated with sufficient care and attention to detail. They must listen to information reported to them and question it not just for its accuracy, but also for the good faith of those reporting it. Officers, of course, must set up appropriate systems within the company to ensure its proper governance and share what they find with the directors. Fiduciaries who fail to act in such a manner violate their duty of good faith. When fiduciaries make material decisions, they need to assure themselves that they know all of the material and reasonably available facts and options before embarking on a major program, granting their approval, or discontinuing an investigation.

\(^{236}\) *See Brehm I*, 746 A.2d 244, 256 (Del. 2000) (noting that violations of aspirational or idealistic norms are not necessarily actionable).
They cross the line when they abdicate, subvert, or ignore these responsibilities, or act with deliberate indifference toward them.

The supreme court's opinion allowing repleading in *Disney* further fleshes out the good faith structure, illustrating that a failure to be reasonably informed of a material fact—the payout scenarios for the Ovitz Employment Agreement—might result in liability. Such a failure, if it occurred, was not one of loyalty, because loyalty was not at issue. In *Brehm I*, the court upheld the lower court's finding that the plaintiffs had failed to plead sufficient allegations of either interest or lack of independence, and no allegation of conflicts is discussed. Instead, in the First Complaint, the plaintiffs argued that the board had not considered the payout scenarios, and absent some form of dependence or interest, that claim was not loyalty-based. Nor, as the court found in *Brehm II*, was it one of due care.

The situation as pleaded in *Brehm II* suggests an egregious failure to perform. It is a good-faith based claim, akin to an utter failure to monitor the material payout scenarios, abdication. As pleaded, it is not a situation in which the board, in good faith, took negligent, or even grossly negligent, action. Instead, in *Brehm II*, the Court of Chancery addressed allegations from the Second Complaint arguing that the New Board abdicated a responsibility that the by-laws required it to shoulder with regard to the Termination Agreement. Put another way, the court read the Second Complaint to allege that the New Board acted with deliberate indifference to its assigned task. The court's view of those allegations, in conjunction with the facts of *Brehm I*, reveals that even where interest and independence or traditional conflicts of interest are not at issue, and no allegations of due care violations exist, sufficiently faulty actions that no well-intentioned, properly governing fiduciaries could take, are actionable as good faith violations.

The *Brehm* opinions also demonstrate that good faith can be at issue in executive compensation and other settings. In *Brehm*, the fiduciaries allegedly allowed the completion of a Termination Agreement valued at $140 million, thereby specifically raising a compensation issue. But the language of the opinions extends beyond compensation and waste, making clear, as did the *Scattered* court, that

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237 If it is a loyalty claim at all, it is so only in the sense that one who fails to do his duty or reasonably attempt to fulfill it is acting disloyally, even if not, for example, in the conflicted manner on which Delaware case law has generally focused. This type of loyalty claim is rarely explored in Delaware, perhaps because of the conflict oriented business judgment rule approach. For a discussion of Delaware's approach to loyalty issues that considers those cases in two lights, betrayal and devotion, see Johnson, *supra* note 228.

238 See also Aronoff v. Albanese, 446 N.Y.S.2d 368, 371 (N.Y. App. Div. 1982) (finding that excessive difference between value of assets expended and benefits received is evidence of bad faith in waste setting).
good faith applies in other contexts as well. If the conduct at issue is sufficiently irresponsible, even if about neither compensation nor self-dealing, good faith is implicated. As a result, for example, fiduciaries who fail to attend or attend to board meetings, or who do not ensure consideration of the requisite amount of information for decisions on material questions in those meetings, act irresponsibly. Such behavior, if sufficiently egregious, is now appropriately branded a breach of good faith.

The duty of good faith presumably also applies where candor and disclosure are implicated. Disclosure is sometimes referred to as a separate duty, though it is not listed as part of the Delaware triad of care, loyalty, and good faith. The so-called duty of candor arises out of agency law, and its boundaries remain undefined when applied to corporate fiduciaries. In the post-Enron era, however, this duty and the apparent failure of officer fiduciaries to provide information to board fiduciaries, and of board fiduciaries to question or tell shareholders about the actions of their officers and others, has drawn attention. Although the obligations to disclose and be candid are undisputed, the duty is properly located as a subset of the duties of care, loyalty, and good faith.

Consider the issues surrounding candor and disclosure. The debate about when and where disclosure obligations are implicated focuses mostly on its boundaries. The Court of Chancery, for example, has noted that directors who knowingly or deliberately withhold information from shareholders material to a decision are exhibiting bad faith. Arguably, the same standard should apply to directors who withhold material information from one another and to

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239 See supra note 35 (citing cases referring to triad of duties).
officers who withhold information from boards. Disclosure allegations related to conflicts of interest or a fiduciary's personal interests implicate loyalty. The duty of care issue arises when a director's omission or misstatement occurs in good faith, but results from the director's "erroneous judgment." In such a situation, the duty of loyalty is not implicated, but an obvious or egregious violation, resulting from abdication, subversion, or deliberate indifference, however, calls good faith into play.

To further define the boundary of good faith, we must separate it from what a defendant might prefer to characterize as a care-based situation. The distinction is key to the corporate governance regulation that can occur through a separate duty. If only the duty of care applies, the directors are exculpated and thereby effectively insulated from personal liability. The Disney fiduciaries, for example, attempted to persuade Chancellor Chandler that the plaintiffs pleaded only a due care allegation. The Chancellor rejected that argument, and the effect of his decision was powerful. If the duty of good faith applies to acts or omissions even where the duty of loyalty is not otherwise implicated, the claims are not excusable, and the potential for monetary liability expands. Brehm II and Scattered both lay the groundwork for such liability. More importantly, when good faith emerges as a separate duty, it can apply to situations where fiduciaries failed to adhere to basic practices or forms. It can, therefore, regulate non-conflicted but deliberately indifferent behavior and transactions, creating incentives for action rather than passivity.

Good faith based liability, then, moves the bar from negligent behavior to deliberately indifferent, egregious, subversive, or knowing behavior, and thereby raises issues related to the motives of the actors. Of course, the key question is how to define "egregious." Without an appropriate line between the grossly negligent duty of care violations and those that are more deliberate and egregious, good faith will not serve as a meaningful separate duty, and it will raise

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244 See Potter v. Pohlad, 560 N.W.2d 389, 395 (Minn. Ct. App. 1997). Such an allegation would involve a breach of the duty of candor, which is a hybrid duty involving an underlying fiduciary duty breached in the context of a disclosure. See, e.g., McMullin v. Beran, 765 A.2d 910, 925 (Del. 2000) (noting that fiduciaries "must exercise due care, good faith, and loyalty whenever they communicate with shareholders").


246 Id.

247 See Brehm II, 825 A.2d 275, 278 (Del. Ch. 2003).

248 See id.

249 See Malpiede v. Townson, 780 A.2d 1075, 1094 (Del. 2001).

the same concerns as those that followed *Smith v. Van Gorkom.*

Some types of gross negligence, for example, that amount to a failure to adhere to a process before making a decision fall into the due care category. Presumably, then, good faith claims must be different from negligence and gross negligence.

Two of the cases in this Article that discuss good faith indicate that a breach of the duty requires motive-based allegations of severely reckless or seemingly intentional behavior. Situations involving deliberate indifference or abdication would also cross the line. Recall that in *Caremark,* Chancellor Allen drew such a line, explaining that sustained failures to monitor for compliance with criminal laws were unacceptable. The court invoked this standard in the context of the sentencing guidelines, which provide lenience for compliance and monitoring programs. If the fiduciaries had failed to provide mechanisms that connected noncompliance with significant and real consequences, their failure would have been inexcusable. Thus, as Chancellor Allen suggested in *Caremark,* facts of that sort, even if they do not involve loyalty issues, should raise the courts' ire. But, the standard applies equally well to other situations in which the board or officers fail to set up any systems by which they can measure the company's performance, review material matters, or address concerns about company compliance with the law or corporate governance norms. Complete abdication, whether intentional or deliberately indifferent, should result in good faith liability.

Interestingly, situations involving deliberate indifference are of the type evaluated regularly under the scienter standard in federal securities law. Scienter is a key element of claims pursuant to section 10(b) of the 1934 Securities Exchange Act and the accompanying Rule 10b-5 ("10b-5 claims"). In reviewing this element, courts focus on the defendants' state of mind in relation to the misstatement or omission. Plaintiffs who wish to succeed with their 10b-5 claims must plead scienter, or facts supporting their claim that the defendant made a misstatement or omission with sufficient recklessness.

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251 See supra note 58.
253 See *Caremark,* 695 A.2d at 969.
254 See id.
255 See id. at 969–70.
258 See *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 707 (3d Cir. 1996).
259 See id.
10b-5 claims are subject to heightened pleading standards, like claims subject to Federal Rule of Civil Procedure 23.1, and there is a significant amount of case law analyzing different factual scenarios and explicating the law as applied to those situations. The scienter standard has its early roots in *Ernst & Ernst v. Hochfelder*, a United States Supreme Court case which addressed whether proof of a violation of a 10b-5 claim should require scienter or something less. The Court held that the language and history of the statute required something more than negligent nonfeasance and, in fact, allowed liability only for people who did not act in good faith. Thus, the Court drew the line between good faith and bad faith as one of the ways in which it delimited recklessness.

*Ernst & Ernst*'s progeny provide guidance on what is simply gross negligence and what amounts to severely reckless or egregious behavior in the context of scienter. The cases draw a line based on a connection between the defendants’ knowledge and their misstatements or omissions. Scienter need not necessarily be pleaded with facts suggesting actual knowledge. For particularly egregious behavior, it is presumed that knowledge of an omission or misstatement existed, or should have existed.

The standard defeats complaints that fail to allege either intentional misconduct or conduct that is sufficiently willful that bad faith is at issue. The cases provide examples of measures for the type of egregious, subversive, or deliberately indifferent conduct this Article proposes as the standard for good faith. Under such a standard, known or obvious infractions of corporate rules or governance standards, or failures to create such standards, would be actionable. Fiduciaries who fail to perform assigned tasks and to set up mechanisms to ensure that they are aware of such tasks would also be actionable. And, of course, good faith reliance on the reports or information of others would still defeat such claims.

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261 See, e.g., id.
263 Id. at 206.
264 Id. at 205-06.

[...]

Id. at 725.
Of course, like their Delaware counterparts, these federal securities cases do not provide a single bright line rule that distinguishes scienter from other states of mind. They cannot. Each corporate situation and fiduciary is different. As a result, the Delaware courts deploy standards, not rules. The result is fact-based determinations of law that evolve over time with each fact pattern and provide definitions of excessive recklessness that are applicable in the fiduciary context.

Consider, for example, the Second Circuit's opinion in *Novak v. Kasaks*. In *Novak*, the court refused to adopt bright line rules delimiting sufficient and insufficient pleadings of scienter, indicating that a synthesis of its case law revealed four scenarios in which the court had found that a complaint contained an appropriate inference of scienter. Under the court's first scenario, the requisite inference of scienter exists where plaintiffs plead with particularity that the defendants "benefited in a concrete and personal way from the purported fraud." These situations are most likely to fall into the loyalty-based category of good faith claims, like breaches of the corporate opportunity doctrine, and are probably the easiest to diagnose. Fiduciaries who approve outright abuses may well have breached both good faith and loyalty duties.

The *Novak* court next addressed pleadings alleging that the defendants "engaged in deliberately illegal behavior." Pleadings with this type of factual scenario are not unfamiliar to the Delaware courts. The plaintiffs in both *Scattered* and *Caremark* alleged illegal behavior or deliberate ignorance of such behavior by the defendants. And, in both cases, the courts made clear the plaintiffs needed to flesh out those scenarios to survive dismissal. Sufficient pleadings would include fact-based allegations that the defendants engaged in such behavior, did not set up systems for compliance, or ignored deficiencies

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267 The Delaware courts have utilized standards from federal securities law in other contexts, for example, in the definition of the term "material." See, e.g., Rosenblatt v. Getty Oil, 493 A.2d 929, 944 (Del. 1985) (citing TSC Indus. v. Northway, 426 U.S. 438, 449 (1976) (adopting definition of materiality for federal securities purposes)).


270 216 F.3d 300, 311 (2d Cir. 2000).

271 *Id.*

272 *Id.*

273 *Id.*


275 See *Scattered*, 701 A.2d at 73; *Caremark*, 698 A.2d at 971–72.
in the corporate system or other fiduciaries. Given such facts, the Delaware courts would be hard-pressed to dismiss a case.

The Second Circuit also held that a third type of scenario, complaints sufficiently alleging that the defendants either "knew facts or had access to information suggesting that their public statements were not accurate," can meet the pleading standard. Of course, 10b-5 claims are premised on a misstatement or omission, and good faith claims need not be, but this test is quite useful for thinking about good faith violations. Officers who give only part of the necessary information to their boards violate their fiduciary duty of candor in the context of their duty of good faith. Directors who provide shareholders with partial or incorrect information, knowing it to be erroneous or having the ability to ascertain the accuracy of the statement, would also be in violation. As discussed above, candor or disclosure violations occur through breaches of loyalty, care, or good faith. Where the candor violation is willful or deliberately reckless, although not disloyal, it falls in the good faith realm.

*Brehm II* also contained allegations that might fit into this category. Indeed, the *Novak* standard is similar to the one applied in *Brehm I*. There, the Delaware Supreme Court held that the payout amounts at issue were sufficiently material so that if the plaintiffs could plead that the defendants had failed to consider those scenarios before agreeing to the Employment and Termination Agreements, they would fail to meet their duty of good faith. This standard is not one of simply neglecting to meet one's duties of disclosure and candor, but of failing in an obvious, egregious, or even willful way to act as a responsible member of the board or management team.

Moreover, the concern extends beyond good or bad process. The focus in this third scenario is on the circumstances surrounding the act or omission in question. Under this standard, board members are at risk when they fail to ask questions and monitor officers and material corporate decisions. They would also be at risk when they fail to investigate the circumstances surrounding decisions by officers who make "obviously evasive and suspicious statements," or when they make decisions without assuring themselves that they are deciding based on sufficient information.

Again, the facts pleaded in *Brehm II* presented such a scenario. According to Chancellor Chandler's opinion, the plaintiffs alleged

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276 See Caremark, 698 A.2d at 971–72.
277 See Novak, 216 F.3d at 311.
278 See supra notes 256–64 and accompanying text.
279 See supra notes 239–46 and accompanying text.
280 See Brehm II, 825 A.2d 275, 278 (Del. Ch. 2003).
281 See Brehm I, 746 A.2d 244, 259–60 (Del. 2000).
282 Novak, 216 F.3d at 309 (quoting SEC v. McNulty, 137 F.3d 792, 741 (2d Cir. 1998)).
that Eisner failed to keep the board informed about the status of the negotiations on the Employment Agreement, or even its final terms.\textsuperscript{283} The same was true of the Termination Agreement. The allegations that he failed to do so were sufficient to plead a breach of the duty of good faith.\textsuperscript{284}

In \textit{Brehm II}, the plaintiffs also alleged that the board failed to ask Eisner about the negotiations and Agreements.\textsuperscript{285} The allegations that it failed to do so were sufficient to plead a breach of its duty of good faith.\textsuperscript{286} By not inquiring, the board arguably breached its duty of good faith to execute its obligations responsibly. Had it asked and been lied to, the board might have met its duty of care. Compliance with its good faith duty might require the board to react further if the proposed agreements were so far out of the bounds of business judgment as to be egregious and warrant further investigation. A lying officer, of course, would have acted in bad faith.

Finally, the Novak court described a fourth category of pleadings that might reach the high threshold for scienter allegations. It held that plaintiffs can succeed in pleading scienter by alleging defendants’ failure “to check on information they had a duty to monitor.”\textsuperscript{287} This standard is very similar to the Caremark standard, which requires the board and officers to have compliance programs in place.\textsuperscript{288} A fiduciary’s failure to implement the programs and to ensure regular and accurate reporting under such programs might, in egregious cases, amount to a good faith violation. But, the standard could also apply in a situation like that pleaded in \textit{Brehm II}, where the board is charged with approving a Termination Agreement. The failure to do so is presumably a good faith violation by itself. But the failure to monitor shifts in the negotiations of something as material as this Termination Agreement\textsuperscript{289} could amount to a breach beyond the bounds of ordinary care and judgment: a breach of good faith.

The four Novak categories thus provide useful ways to consider good faith. Although a breach of good faith need not be intentional or conscious, it does require some sort of obvious, deliberate, or egregious failure. That standard is like the standard of review applied to pleadings of scienter in securities fraud claims: motive is relevant, but not required. Intentional misstatements or omissions are actionable and intentional breaches of fiduciary duties should be as well. But, as the Disney cases make clear, allegations of unintentional but fla-

\begin{thebibliography}{9}
\bibitem{283} See \textit{Brehm II}, 825 A.2d at 278.
\bibitem{284} See id.
\bibitem{285} Id. at 289.
\bibitem{286} See id.
\bibitem{287} Novak, 216 F.3d at 311.
\bibitem{288} See \textit{In re Caremark Int’l Inc. Derivative Litig.}, 698 A.2d 959, 971 (Del. Ch. 1996).
\bibitem{289} See \textit{Brehm II}, 825 A.2d at 289.
\end{thebibliography}
grantly reckless actions or inactions are also problematic and, if proved, are breaches of good faith responsibilities.

The above discussion also illustrates that cases implicating good faith can, but need not, implicate loyalty or care. Although good faith may exist as a component of care and loyalty, confining it to those situations would diminish its power as a prophylactic tool or incentive for good fiduciary conduct. Care is a matter of process, not substance. Grafting good faith onto breaches of care would limit it to the procedural context. Similarly, loyalty is limited to situations involving conflicts of interest and generally viewed through the procedural telescope of interest and lack of independence. The status-based case law that has evolved in the loyalty context would further limit possible applications of good faith, potentially rendering it useless in other contexts. Further, the role of good faith as a separate duty proved important in Brehm I and II, where loyalty and care were not at issue.

The value of a separate good faith duty, then, is in its potential for addressing those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts. And, of course, its real value is not simply in the compensation it can provide to, for example, Disney shareholders, but in the ex ante role it can play in changing the behavior and incentives of corporate fiduciaries and, thereby changing corporate governance. As the role of officer fiduciaries has expanded, so must the duties of both officers and those charged with monitoring them: directors.

**CONCLUSION**

In today's corporate structure, directors are less involved in management and the role of officers has grown, making the good faith duty an increasingly important tool for controlling egregious fiduciary behavior. When, as allegedly occurred at Disney, an officer provides some, but not all, of the available material information to the board for its consideration, and the board fails to question the officer or the information before either making decisions based upon it or failing to do so, a good faith issue is presented.\(^290\) The duty involves not only process or conflicts of loyalty, but also the circumstances, or lack thereof, surrounding the substantive outcome. Thus, good faith is a separate duty from those of care and loyalty. Fiduciaries who ignore deficiencies in the information they receive or the reporting system on which they rely violate their duty of good faith to the shareholders.\(^291\) By ignoring those deficiencies, fiduciaries contribute to an at-

\(^{290}\) See id. at 287.

mosphere of permissiveness, recklessness, or deliberate indifference that can result in bad governance and business decisions, or worse, illegal activity.

Strong enforcement of the duty of good faith creates an incentive to prompt fiduciaries to better behavior, even if we cannot change their character. That enforcement by the Delaware courts will, in turn, protect the shareholders, whom Delaware law prohibits from assuming a managerial role. Shareholders, of course, are harmed by all kinds of fiduciary failures, but those arising from failures to comply with the common law, the Sarbanes-Oxley Act, the other federal securities laws, and the requirements of the New York Stock Exchange and other self-regulatory organizations—regardless of whether the failure to comply carries with it a private right of action—may fall into the category of good faith.

Facts like those pleaded in Brehm I and II test Delaware’s good faith. In those cases, the Delaware courts met the test. They accepted, at least pending full discovery, allegations that fiduciaries completely abdicated their responsibility to the shareholders. Such strong enforcement of good faith standards by the stewards of state corporate law contributes to good corporate governance norms. It also increases the good faith of shareholders in Delaware as the appropriate home for business and as the place for creating and enforcing those norms.

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292 Brehm II, 825 A.2d at 278; Brehm I, 746 A.2d 244, 268 (Del. 2000).