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GOOD FAITH BUSINESS JUDGMENT: A THEORY OF RHETORIC IN CORPORATE LAW JURISPRUDENCE

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ABSTRACT

This Article develops a theory of rhetoric in corporate law jurisprudence. It begins by examining a recent innovation in Delaware case law: the emerging principle of "good faith." Good faith is an old notion in law generally, but it offers to bring significant change to corporate law, including realignment of the business judgment rule and a shift in the traditional balance between the authority of boards and the accountability of boards to courts. This Article argues, however, that good faith functions as a rhetorical device rather than a substantive standard. That is, it operates as a speech act, a performance, as opposed to a careful method of analysis.

To explain the sudden appearance of good faith, this Article articulates a model of corporate law rhetoric. Courts invent rhetorical

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devices to loosen corporate law doctrine and increase judicial review of board decisionmaking in response to scandals and other extralegal pressures operating upon the judiciary. These pressures stem largely from the twin threats of corporate migration and federal preemption, both of which imperil the primacy of the Delaware judiciary as a corporate lawmaker. In periods of crisis and scandal, the judiciary employs rhetorical devices to reduce these pressures, typically with the effect of increasing board accountability, only to return, once the pressure recedes, to a position of board deference. After finding several examples of this pattern in corporate law history, this Article argues, ultimately, that regular movement back and forth along the authority/accountability spectrum is an essential feature of corporate law jurisprudence and that understanding the rhetorical devices that permit this movement is necessary to complete any account of what corporate law is and how it works.

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INTRODUCTION

After a period of scandal and crisis in American corporate governance, corporate law has rediscovered good faith.

Good faith is not a new idea. It has long been recognized as a background principle in several areas of law,[1] and no corporate lawyer who was not guilty of malpractice has ever advised a board of directors that its members could safely behave in bad faith.[2] In Delaware, the primary source of American corporate law,[3] both the legislature and the courts have recognized some notion of good faith. Good faith is a prerequisite to a corporation's ability, under § 102(b)(7) of the Delaware General Corporation Law, to absolve its directors for liabilities incurred in shareholder litigation.[4] Moreover, the Delaware Supreme Court has acknowledged good faith in its corporate law opinions, occasionally ranking it alongside the traditional fiduciary duties of care and loyalty and thereby implying that good faith is to be given a role in fiduciary duty analysis equal to the other two.[5]

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1. *See generally* Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U. L. REV. 955 (1995) (describing good faith in various areas of law); Victor P. Goldberg, *Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith*, 35 U.C. DAVIS L. REV. 319 (2002) (tracing judicial development of good faith in commercial contracts).

2. *See, e.g.*, S. Samuel Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 658–59 (1979) ("I don't think it would ever have been possible to persuade Delaware courts that the Business Judgment Rule prevents a transaction from being enjoined or immunizes directors from personal liability if it is established that the directors did not act in good faith . . . ."). In fact, it is a common summation of a director's corporate law obligations to state that she must exercise her fiduciary duties in good faith. *See, e.g.*, Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 983–84 (Del. Ch. 2003) (describing an allegation that "called into question the directors' good faith exercise of their fiduciary duties").

3. The number of major firms incorporating in Delaware and the willingness of other states to be guided by Delaware has established Delaware law as national corporate law. *See* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350 (2001) ("The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law."); *see also* Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 389 (2003) (supplying statistics showing that Delaware is the state of incorporation for half of all public companies and 59 percent of the Fortune 500).

4. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); *see* discussion *infra* Part I.A.

5. These cases refer to a "triad" of fiduciary duties, including care, loyalty, and good faith. *See, e.g.*, Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) ("The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith."); McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000) ("[T]he shareholder plaintiff must effectively provide evidence that the defendant board of directors, in reaching its challenged decision,

The function of good faith in corporate law, however, is not perfectly clear. For all of the judicial and legislative references to it, the principle is defined neither in the Delaware statute nor in judicial precedent.[6] And although everyone understands it, in some general sense, good faith is a difficult concept to operationalize in law.[7] The Delaware Supreme Court has acknowledged that good faith is an amorphous principle, the meaning of which "varies somewhat with the context."[8] In the context of corporate law, it is difficult to give

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breached any *one* of its triad of fiduciary duties, loyalty, good faith or due care." (internal quotation omitted)); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty."); 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.").

6. *See* John L. Reed & Matt Neiderman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 119 (2004) ("Unfortunately . . . 'good faith' is not defined anywhere in the [Delaware General Corporation Law]. Nor does the framing of § 102(b)(7) provide any helpful insight."). The Delaware Supreme Court opinions listing good faith alongside care and loyalty in the "triad" of fiduciary duties neither define good faith nor rely upon it to reach the outcome of the case. *See supra* note 5 and accompanying text. Moreover, the separate status of good faith may be the result of a longstanding confusion between the categories of fiduciary duty and the means by which a plaintiff can rebut the business judgment rule. The string of citations in note 5, *supra*, all trace ultimately to *Aronson v. Lewis*, where a breach of good faith is listed alongside violations of care and loyalty as *situations to which the business judgment rule will not apply*, not as a separate and equal *mode for analyzing fiduciary duty*. 473 A.2d 805, 812 (Del. 1984). It is well understood that there are a handful of situations to which the business judgment rule does not apply, such as waste and illegality. *See, e.g.*, Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355, 1369 (1993) ("[T]he absence of waste, egregious conduct, illegality, fraud, and ultra vires conduct also is necessary for [the business judgment rule's] application."). These, however, are treated as *sui generis* circumstances, not as separate modes of fiduciary duty analysis. Judicial recitations of good faith as a separate fiduciary duty are thus the result of a quotation taken out of context.

7. A general sense of good faith may involve consistency between word and deed. *See, e.g.*, PERMANENT EDITORIAL BOARD COMMENTARY ON THE UNIFORM COMMERCIAL CODE, COMMENTARY NO. 10 (§ 1-203) (final draft Feb. 10, 1994) (defining good faith as "honesty in fact in the conduct or transaction concerned" but ultimately concluding that good faith alone "does not support a cause of action where no other basis for a cause of action exists"); *see also* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 378–85 (1980) (arguing that good faith limits a party's discretion in performance to actions taken for reasons allowed by the original contract); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 512 (2004) (arguing that good faith in corporate law should be interpreted in the same way as it is in the law of contracts).

8. E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 443 (Del. 1996) (quoting RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a. (1979)). The court pursued the

good faith any content that does not merely restate either the duty of care or the duty of loyalty.[9] If one thinks of good faith as doing the job right or adequately fulfilling one's fiduciary obligations, then it drifts towards the sort of prudential issues ordinarily addressed under the duty of care.[10] Likewise, if one thinks of good faith as acting selflessly in the corporation's interest, then it slides towards issues typically analyzed under the duty of loyalty.[11] In his attempt to pin down its meaning, then-Chancellor Allen suggested that good faith

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Restatement quotation, adding "[g]ood faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party." *Id.* Tellingly, the court went on to suggest that good faith has no content of its own, except in relation to an alleged misdeed:

> [Good faith is] a phrase without general meaning (or meanings) of its own and serves to exclude a wide range of heterogeneous forms of bad faith. In a particular context the phrase takes on specific meaning, but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically excluded.

Id. at 443 (quoting Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 201 (1968) (footnotes omitted)).

9. On the traditional division of corporate fiduciary obligations into the duty of care and the duty of loyalty, see *infra* Part I.A.

10. Defining good faith as adequately fulfilling one's obligations, obviously, is question begging. To understand it, one must ask what one's obligations are and then ask whether those obligations have been adequately fulfilled. Each of these inquiries, however, is highly problematic. The first reveals the definition as circular, defining a fiduciary obligation (good faith) in terms of the fulfillment of fiduciary obligations, while the second question is squarely under the duty of care and therefore cannot be asked without disturbing the business judgment rule. On the relationship of good faith to the business judgment rule, see *infra* Part I.A.

11. Several closely reasoned chancery court opinions treat good faith as an aspect of the duty of loyalty. *See, e.g.*, Orman v. Cullman, 794 A.2d 5, 14 n.3 (Del. Ch. 2002) ("[T]he duty to act in 'good faith' is merely a subset of a director's duty of loyalty."); *In re* Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (arguing that good faith, correctly understood, is a component of the duty of loyalty). Moreover, justices of the Delaware Supreme Court have occasionally viewed good faith as a mere aspect of the duty of loyalty. Justice Jacobs, for example, when still a vice chancellor, wrote in his opinion in *Emerald Partners v. Berlin* that "doctrinally [the] obligation [to act in good faith] does not exist separate and apart from the fiduciary duty of loyalty." Civ. Action No. 9700, 2001 Del. Ch. LEXIS 20, at *86 n.63 (Del. Ch. Feb. 7, 2001). A few years later, having been appointed to the Supreme Court, but sitting by designation at the chancery court, Jacobs retreated from these statements, stating that the defendant may have breached his fiduciary duty of loyalty "and/or" good faith and noting "[t]he Court employs the 'and/or' phraseology because the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and of good faith." *In re* Emerging Comm'ns, Inc. S'holders Litig., Consol. Civ. Action No. 16415, 2004 Del. Ch. LEXIS 70, at *142 n.184 (Del. Ch. May 3, 2004). Similarly, it was Chancellor Chandler, who confidently announced in *Orman* that good faith was merely an aspect of the duty of loyalty, *Orman*, 794 A.2d at 14 n.3, who then allowed the plaintiffs in *Disney* to survive dismissal on the basis of good faith when the question of loyalty was not properly before the court, *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 278 (Del. Ch. 2003).

may simply be a shorthand reference to the welfare-maximization goals underlying corporate law.[12]

But the role of good faith in corporate law jurisprudence is changing. An emerging line of cases rejects a vision of good faith as mere shorthand for the duties of care and loyalty and establishes it, instead, as an independent basis for decision. By sustaining causes of action under the principle of good faith when neither traditional mode of fiduciary duty analysis is available, these cases carve a separate doctrinal role for good faith with distinct adjudicative power, opening board governance decisions to a greater degree of judicial scrutiny. This is not a small change. It frees courts from the confines of care and loyalty in reviewing governance decisions and promises to shift the fulcrum on the scale balancing the authority of boards and their accountability to courts.[13] Given the hitherto amorphous character of good faith, this new doctrinal role raises several urgent questions. Most basically, what will good faith come to mean in corporate law? Will it create a new cause of action for shareholder plaintiffs? Will it rewrite the business judgment rule, leading to greater judicial intervention in corporate governance and a lasting shift in the authority/accountability balance?

This Article aims to answer those questions. In it, I argue that the emerging duty of good faith is best understood as a rhetorical device rather than as a substantive standard. Good faith, in other words, is not now and is not likely ever to develop into a distinct doctrine of subrules and multipart tests. Instead, the pattern in the good faith cases is to raise issues under both the duty of care and the duty of loyalty but, rather than following either traditional analysis through to a conclusion, to blend the issues together and, in doing so, identify a basis for liability under the duty of good faith. This mode of analysis, involving the oscillation between two distinct doctrinal categories, I will call "thaumatrope analytics." The term refers to an optical toy involving a disk with a different image on each side—a horse and a man, for example, or a bird and a cage—and a string

12. *See, e.g.*, Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996) ("By 'bad faith' is meant a transaction that is authorized for some purpose other than a genuine attempt to advance corporate welfare . . . .").

13. Throughout this Article, I will use the terms (board) authority and (judicial) accountability to refer to the balance between the authority of boards, on the one hand, and the accountability of boards to courts, on the other. By "judicial accountability," I mean the accountability of boards to the judiciary and not, as the phrase is sometimes used, the accountability of the judiciary to some other authority.

attached at either edge of the disk enabling the device to spin.[14] When the viewer spins the thaumatrope, the images on either side of the disk seem to blend together to produce a third image that is a composite of the other two—the man atop the horse or the bird in the cage. Good faith, I argue, is simply the application of the thaumatrope to the duties of care and loyalty. Spinning the two together, the composite image—of a poor decisionmaking process mixed with hints of conflicting interest—may trigger liability under something the judiciary now calls "good faith."

By distinguishing *rhetoric* from *substance*, I do not mean to denigrate the significance of either good faith or rhetoric, but rather to emphasize good faith as a speech act, a performance, as opposed to a carefully delineated mode of analysis.[15] My account of good faith as a rhetorical device stresses, first and foremost, its contextual contingency. The duty of good faith emerged in an environment of *sturm und drang* in corporate governance, when a series of scandals—including frauds and failures at Enron, WorldCom, Tyco, and Adelphia, celebrity insider trading, and corruption in the IPO market—drew American corporate governance into question and

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14. The thaumatrope was popularized by John Aytron Paris in the 1820s. The name is derived from the Greek "thauma," wondrous or marvelous, and "trope," something that turns or spins. The term was brought into the legal literature by Leon Lipson to criticize Cardozo's analysis in the *Allegheny College* opinion. Leon S. Lipson, *The* Allegheny College *Case*, 23 YALE L. REP. 8, 11 (1977).

15. I take this understanding of rhetoric from the law-and-literature movement. *See* JAMES BOYD WHITE, HERACLES' BOW 28 (1984) (defining rhetoric as "the central art by which culture and community are established, maintained, and transformed"); Sanford Levinson, *The Rhetoric of the Judicial Opinion*, *in* LAW'S STORIES, 187, 187 (Brooks & Gewirtz eds., 1996) ("Judicial opinions are rhetorical performances. The critic who essays an assessment of any performance, whether dramatic or judicial, must be aware, among other things, of the particular role assigned to the actor, the likely audience for the performance, and the effects sought by the performer."). Professor White further describes how to read a work for its rhetorical meaning:

> The basic question we shall ask of the texts we read, and of the particular performances within them, will thus be What kind of action with words is this? This question will be elaborated by being broken down into two others: What kind of relationship does this writer establish with his language? and What kind of relationship does he establish with his audience or reader? To put this in other words: What kind of cultural action is this writing? and What kind of social action is it?

JAMES BOYD WHITE, WHEN WORDS LOSE THEIR MEANING 6 (1984). The rhetorical meaning of a text is not necessarily distinct from its analytical meaning, and I seek to distinguish the two only to emphasize the rhetorical aspect of good faith in arguing, ultimately, that strategic considerations dominate the analytic content of the new doctrine. This distinguishes my account of good faith from those seeking to locate a substantive principle of law in the emerging line of jurisprudence. *See infra* Part I.C. For a similar treatment of "good faith" in contract law, see generally Emily M.S. Houh, *The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?*, 2005 UTAH L. REV. 1.

plunged previously settled questions into heated debate. Post-Enron, the responsiveness (or laxity) of the states, Delaware in particular, in matters of corporate governance was hotly contested. The good faith thaumatrope is a response, in rhetoric, to this environment of crisis and debate.

In probing the nature of this response, this Article argues that the purpose and effect of such rhetoric is to loosen the doctrinal constraints on the Delaware judiciary and to enable its judges to shift the authority/accountability balance in response to a change in the set of pressures and constraints then operating upon them. These pressures stem largely from the twin threats of corporate migration and federal preemption, both of which imperil the primacy of the Delaware judiciary as a corporate lawmaker, but each of which varies in strength depending upon the extralegal environment of scandal or calm. This forms the basis of my theory of rhetoric in corporate law jurisprudence. In periods of crisis and scandal, the judiciary employs rhetorical devices to increase the accountability of boards, making the judiciary appear responsive and thus alleviating the pressures acting on it. Once the pressure recedes, however, the judiciary returns to a position of board deference.[16] An implication of this theory is that in predicting corporate law outcomes, the world outside the courtroom—specifically, the context of crisis or calm and the relative threat of migration or preemption—is at least as important as, and perhaps more important than, the doctrine itself. Another implication, applying this theory of corporate law rhetoric to the emerging jurisprudence of good faith, is that the breadth of judicial scrutiny promised by the new doctrine will eventually narrow as the crisis that spurred its creation recedes.

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16. In this I am neither criticizing nor celebrating the judiciary for invading the domain of board authority, nor am I pressing a normative claim about the optimal balance of board authority and judicial accountability in corporate governance. These issues have been debated by numerous eminent scholars, arguing on the one hand that greater accountability is necessary to reign in board excesses and, on the other, that greater accountability imposes substantial costs on all companies for a highly questionable deterrence effect on a (possibly small) subset of wrongdoers. *Compare* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (advancing a model of corporate governance based on board authority), *with* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance*, 48 VILL. L. REV. 1189, 1189 n.2 (2003) (calling for greater regulation of corporate governance on the basis that "the laxity of Delaware law. . . with [its] shameful and disingenuous opinions . . . can no longer be in dispute"). Because the ultimate resolution of this debate depends on empirical evidence that currently does not exist, rather than offering a normative account of how Delaware law *should* work, I am offering, instead, a descriptive account of how Delaware law *does* work.

This Article's prediction that good faith will not become a fixed doctrine of corporate law should not be taken as an argument that the emerging jurisprudence of good faith is unimportant. Good faith may, after all, return with the next set of corporate governance scandals. But, even if it does not, the jurisprudence of good faith represents a paradigmatic example of corporate law rhetoric, illustrating its ability to shift and, once the undercurrents acting upon the judiciary have changed, to shift back. This pattern recurs so often and is so fundamental to the structure of corporate law jurisprudence that no understanding of corporate law can be complete without it. The central contribution of this Article is its elucidation of the underlying rhetorical structure of corporate law through a close examination of the jurisprudence of good faith.

This Article proceeds as follows: Part I situates good faith in existing corporate law doctrine, describing in particular its relationship with the business judgment rule and statutory law, then tracing the emergence of good faith jurisprudence through a line of Delaware cases and evaluating attempts to import some substantive content into the meaning of good faith. Next, Part II argues that the duty of good faith is best understood as a rhetorical device and shows how the device seems to operate—that is, by oscillating between concerns typically raised under the duties of care and loyalty. Part II also emphasizes the contextual contingency of good faith analyses, situating the emergence of good faith in the recent environment of corporate scandal. Part III then engages the question of the future of good faith in corporate law, describing the system of constraints operating upon the Delaware judiciary, and ultimately arguing that the jurisprudence of good faith is both bounded by the constraints operating upon the judiciary and a means of manipulating those bounds.

I. GOOD FAITH IN CORPORATE LAW

A. The Background of Business Judgment

Fiduciary duty analyses traditionally focus on the duties of loyalty and care.[17] The duty of loyalty, in its simplest formulation, is a

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17. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993) ("Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders. Each of these duties is of equal and independent significance." (citation omitted)); Victor Brudney, *Contract and Fiduciary Duty in Corporate*

proscription against director conflict of interest and self-dealing.[18] Meanwhile, the duty of care, stated on its own terms,[19] requires simply that directors in control of the corporate enterprise exercise the same level of care that would be expected of ordinarily prudent persons in the conduct of their own affairs.[20] In theory, at least, each of these fiduciary duties is an available basis for shareholder causes of action seeking to challenge board decisionmaking. In practice, however, the business judgment rule operates as a significant barrier to claims

Law, 38 B.C. L. REV. 595, 599 n.9 (1997) ("Legal conventions divide fiduciary obligations into obligations of loyalty and obligations of care.").

18. A comprehensive statement of duty-of-loyalty principles appears in *Guth v. Loft, Inc.*:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that *there shall be no conflict between duty and self-interest.*

5 A.2d 503, 510 (Del. 1939) (emphasis added); *cf.* Lyman Johnson, *After Enron: Remembering Loyalty Discourse In Corporate Law*, 28 DEL. J. CORP. L. 27, 29–30 (2003) (developing a broader account of loyalty that distinguishes a "non-betrayal" aspect from a "devotion" aspect).

19. That is, without application of the business judgment rule. *See infra* notes 20–21.

20. Briggs v. Spaulding, 141 U.S. 132, 152 (1891) (requiring that directors act as would "ordinarily prudent and diligent men. . . under similar circumstances"); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) ("[T]he duty of care refers to the responsibility of a corporate fiduciary to exercise . . . the care that a reasonably prudent person in a similar position would use under similar circumstances."); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."). Application of the business judgment rule changes the liability standard under the duty of care from negligence—that is, reasonableness or ordinary prudence—to gross negligence. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence." (footnote omitted)). A shift in the standard of liability does not necessarily imply a shift in the standard of care. *See* William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1311 (2001) (emphasizing that the business judgment rule is a standard of judicial review, distinct from the standards of conduct that directors are expected to uphold); Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 443 (1993) (distinguishing the duty of care, as standards of conduct, from the business judgment rule, as a standard of review). However, a reduction in probable liability for carelessness may have an impact on director incentives to take care, thereby resulting in a de facto shift in the standard of care.

under the duty of care.[21] If the shareholder plaintiff cannot plead facts sufficient to overcome the business judgment rule's substantive standards,[22] the rule will apply, with the typical effect that the board wins, the shareholder loses, and the court stays out of it.[23]

This analytical structure creates a significant obstacle to court intervention in corporate governance decisions which, in the absence of director conflict of interest, raise issues only under the duty of care and are subsequently protected from judicial intervention by the business judgment rule.[24] The business judgment rule, in other words,

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21. *See* ROBERT C. CLARK, CORPORATE LAW 123 (1986):

> The rule is simply that the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment—even for judgments that appear to have been clear mistakes—unless certain exceptions apply.

Id. The business judgment rule operates both as an evidentiary presumption and as a substantive standard. *See* Aronson, 473 A.2d at 812. Although the business judgment rule applies equally to each fiduciary duty as an evidentiary presumption, as a substantive standard the rule applies differently depending upon which of the directors' fiduciary duties is under review. *See* CLARK, *supra*, at 124 n.7 ("The 'gross negligence' formulation is concerned only with adjusting the business judgment rule to the fiduciary duty of care; the duty of loyalty . . . is another matter."). A plaintiff challenging the board's actions under the duty of care must allege facts that show that the board's conduct rises (or falls) to the level of "gross negligence." *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) ("We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."); *Aronson*, 473 A.2d at 812. By contrast, a plaintiff challenging the board's actions under the duty of loyalty does not bear the burden of establishing a *gross* conflict of interest. *Any* material conflict of interest on the part of the board will rebut the business judgment rule and require the board to establish that the challenged decision or transaction was either approved by disinterested directors, ratified by shareholders, or fair to the corporation. *See* DEL. CODE ANN. tit. 8, § 144(a) (2003) (providing that conflict of interests transactions are not void or voidable if they are either approved, ratified, or fair); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (establishing the standard of entire fairness: "[w]hen directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain").

22. These claims are evaluated at the motion to dismiss stage. *See, e.g.*, Orman v. Cullman, 794 A.2d 5, 15 (Del. Ch. 2002) (emphasizing that the plaintiff's claim must be must be supported by facts and not mere conclusory assertions). The principle sources of facts available to plaintiffs at this prediscovery stage in the litigation are media accounts, public filings, and board minutes. *Id.* at 16 n.9.

23. *See* Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001) ("If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule operates to provide substantive protection for the directors and for the decisions that they have made.").

24. Director accountability under state law for corporate governance decisions is a matter of *theory* as opposed to *reality*. See Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051–52 (Del. Ch. 1996), in which Chancellor Allen noted:

> There is a theoretical exception to [the business judgment rule] that holds that some decisions may be so 'egregious' that liability . . . may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has

establishes corporate law's balance between board authority and judicial accountability.[25] It protects the authority of the board to govern the corporation without having to account to courts for their decisions. Delaware's basic policy choice is a robust interpretation of the business judgment rule and respect for the principle of nonintervention in corporate governance.[26] The business judgment rule, however, is a moving frontier. Judges decide themselves when and how it will constrain them,[27] and the Delaware judiciary has recently used the principle of good faith to loosen its constraints.

> resulted in no awards of money judgments against corporate officers or directors in [Delaware] . . . . Thus, to allege that a corporation has suffered a loss . . . does not state a claim for relief against that fiduciary no matter how foolish the investment . . . .

Id. at 1052; *see also* Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 242 (noting that although agency costs may be understood as the sum of managerial selfishness and managerial foolishness, legal liability attaches only to selfishness since "[t]he liability standard that corporate law applies to managerial decisions is, realistically, no liability at all for mistakes, absent fraud or conflict of interest"). Roe further states:

> Conventional corporate law does little, or nothing, to directly reduce shirking, mistakes, and bad business decisions that squander shareholder value. The business judgment rule is, absent fraud or conflict of interest, nearly insurmountable in America, insulating directors and managers from judges and freeing them from legal scrutiny.

Id. at 243.

25. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 103 (2004) (describing the tradeoff between authority and accountability as a central concern of corporate governance and noting that "[t]he difficulty is that authority and accountability are ultimately antithetical: one cannot have more of one without also having less of the other"); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1699 (2001) (describing the business judgment rule as a "jurisdictional boundary" protecting the governance principle of authority within the firm and concluding that "[w]ithout respect for the boundary, centralized management could not operate as it does").

26. The principle of nonintervention is apparent in the care taken by members of the Delaware judiciary to avoid becoming "super-directors." *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) ("To rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation."); *In re* RJR Nabisco, Inc. S'holders Litig., Civ. A. No. 10389, 1989 WL 7036, at *14 n.13 (Del. Ch. Jan. 31, 1989) ("To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors.").

27. The question of how much to intervene in corporate decisionmaking has been described by Chief Justice Veasey as corporate law's "defining tension" and by Chancellor Allen as "the tension that occupies its core." *See* William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 894–95 (1997) (referring to "the tension between the ways in which long-term wealth may be maximized through broad managerial discretion and the ways long-term wealth maximization may be thought to require protections that entail limitation on the power of management"); E. Norman Veasey, *The Defining Tension in Corporate*

Delaware law has at least two doctrinal hooks from which to hang a jurisprudence of good faith. First, good faith appears as a statutory limitation on the ability of a corporation to exculpate its directors for breach of fiduciary duty. Second, good faith is often recited as an aspect of the business judgment rule. In spite of these doctrinal bases, neither the functional meaning of good faith nor its potential relationship to other corporate law doctrines has ever been specified.

The statutory basis of good faith is Section 102(b)(7) of the Delaware General Corporation Law, which permits corporations, through the adoption of a charter term—a so-called "102(b)(7) provision"—to exculpate directors for violations of fiduciary duty provided that the director's liabilities do not arise from a breach of the duty of loyalty or, the statute adds, from conduct "not in good faith."[28] Corporations rushed to adopt 102(b)(7) provisions after the section entered the Delaware code,[29] with the practical effect of creating a dismissal right for shareholder claims under the duty of care.[30] That section 102(b)(7) of the Delaware code is designed to protect directors from liability for violating the duty of care can be gleaned from the statute itself—loyalty, after all, is carved out—but it is most clear when the statutory amendment is considered in light of the circumstances surrounding its adoption.

The Delaware legislature adopted § 102(b)(7) in 1987 after the Delaware Supreme Court's decision in *Smith v. Van Gorkom*[31] raised the risks of serving as a director of a Delaware corporation. In analyzing the conduct of the Trans Union board of directors under the duty of care, the court in *Van Gorkom* did not claim to change the law—the business judgment rule standard of gross negligence was

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Governance in America, 52 BUS. LAW. 393, 403 (1997) (framing corporate law in terms of "the tension between deference to directors' decisions and the scope of judicial review").

28. Under § 102(b)(7), there are four enumerated exclusions to the ability of a corporation to eliminate or limit director liability, including (i) breach of the duty of loyalty; (ii) acts or omissions not in good faith or involving intentional misconduct or knowing violations of law; (iii) unlawful payment of dividends; or (iv) self-interested transactions. DEL. CODE ANN. tit. 8, § 102(b)(7) (1999).

29. *See generally* Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) (studying corporate adoption of § 102(b)(7) provisions after passage of the statute and finding, on the basis of event studies, no significant stock price reaction).

30. *See, e.g.*, Emerald Partners v. Berlin, 726 A.2d 1215, 1223 (Del. 1999) (specifying that the corporation's rights under the § 102(b)(7) provision is "in the nature of an affirmative defense").

31. 488 A.2d 858 (Del. 1985).

held to apply—but it applied the standard of gross negligence aggressively, resulting in an unprecedented finding that the board had breached it.[32] The majority of commentators now agree that on the merits the evidence does not support the conclusion that the Trans Union board had been grossly negligent.[33] Instead, the court's strained interpretation of gross negligence suggested that courts, through similarly loose interpretations, might begin to have a voice in corporate governance notwithstanding the supposed constraint of the business judgment rule.[34]

It is against this background that the legislature passed section 102(b)(7), insulating directors from liability under the duty of care and, perhaps more importantly, cutting off any further growth in the court's corporate governance jurisprudence. Because the dynamics of 102(b)(7) created an immediate dismissal right for duty-of-care claims, there was no room for further innovation in the court's corporate governance jurisprudence through loose interpretations of the gross negligence standard. The passage of 102(b)(7), in other words, was the legislature's affirmation of the principle that the judiciary would stay out of corporate governance, provided that the board did not behave disloyally or, as the statute added, in bad faith.

Unfortunately, the meaning of good faith in 102(b)(7) remains a mystery. The concept is defined neither in the statute nor in the legislative history. And, although canons of statutory construction suggest that the concept, because it appears as a separate numbered item,[35] has some meaning distinct from loyalty and self-interest and that this meaning, judging by nearby words in the series,[36] may have something to do with "intentional misconduct" or "knowing violations," until recently the judiciary has done nothing to fill this statutory lacuna.

The legislature is not alone in creating confusion around the meaning of good faith. Outside of the 102(b)(7) context, Delaware courts occasionally recite good faith as an aspect of the business

32. *Id.* at 864.

33. *See, e.g.*, Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why Van Gorkom Still Rankles, Probably*, 96 NW. U. L. REV. 631, 631 (2002) ("Considered a legal disaster in 1985, it is judged no less disastrous today." (citations, noting criticisms of the decision, omitted)).

34. The strain is evident in the majority opinion itself, which, in the words of the dissent, reads "like an advocate's closing address to a hostile jury." *Van Gorkom*, 488 A.2d at 893.

35. *See, e.g.*, REED DICKERSON, THE INTERPRETATION AND APPLICATION OF STATUTES 233 (1975) (describing *reddendo singular singulis*—"referring each to each").

36. *Id.* (describing *noscitur a sociis*—"known from its associates").

judgment rule. It is here, however, that a distinct principle of good faith begins to clash with more established corporate law doctrines. In the standard formulation of the business judgment rule—that is, "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"[37]—the board's good faith is part of what is presumed.[38] The burden of disproving it, like the burden of challenging the adequacy of the board's information or process, is allocated to the shareholder plaintiff. The standard that the plaintiff must meet to overcome this burden, however, is unclear. Should gross negligence be the standard for establishing lack of good faith, as it is for establishing a lack of information or other failure of the board's duty of care?

The question of what standard to apply to good faith begs the further question of what precisely the plaintiff is seeking to disprove. Is it really distinct from the collection of concerns customarily grouped under the categories of care and loyalty? If good faith is indistinct from concerns underlying traditional fiduciary duty analyses, then it may make sense to collapse the standard for good faith into the standard of care or loyalty. If, on the other hand, good faith is conceptualized as distinct from each of the traditional fiduciary duties, it may demand a new standard for rebutting the presumptions of the business judgment rule—a standard different from a showing of either gross negligence or an uncorrected conflict of interest.[39] The question of good faith in corporate law is thus more than the question of defining terms in vague legislation. It is the question of creating a new standard under the business judgment rule and thereby realigning the balance between authority and accountability in corporate law jurisprudence.

In spite of the importance of these questions and the magnitude of their implications, the Delaware courts seem not to have been interested in pursuing them. The mystery of good faith has been a part of Delaware law for as long as the business judgment rule. It has been an express component of the rule at least since the oft-cited *Aronson* formulation appeared in 1984 and an explicit part of the statute since it was amended in 1987. Yet the concept was unexplored

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37. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

38. *See* Arsht, *supra* note 2, at 662 ("Often the Delaware courts have framed the Business Judgment Rule as a presumption that the directors acted in good faith and in the honest belief that they were acting for the best interests of the corporation." (citations omitted)).

39. *See supra* note 21 and accompanying text.

for almost two decades, until the chancery court's development of good faith jurisprudence in 2003.

B. The Jurisprudence of Good Faith

Many corporate law decisions discuss good faith,[40] but a significant trend has emerged in a handful of recent decisions that not only discuss a fiduciary duty of good faith but also rely upon it as the basis of the decision. These cases suggest that good faith is more than just a new spin on old dicta. It is a *ratio decidendi*. Does this mean that the judiciary, having suddenly awakened to the puzzle of good faith in corporate law, has at last found a way to operationalize the principle in fiduciary duty analysis?

The cases described in this Section develop Delaware's recent jurisprudence of good faith. The leading opinion is the chancery court's 2003 decision in *In re Walt Disney Co. Derivative Litigation*,[41] which established good faith as an independent basis of decision and represented the first effort by a Delaware court to engage in a sustained analysis of good faith as a principle of fiduciary duty.[42] After discussing *Disney* itself, this Section addresses *Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*,[43] the first case to follow and apply the reasoning of *Disney*, and finally, discusses *Levco Alternative Fund v. Reader's Digest Ass'n*,[44] a Delaware Supreme Court decision that preceded the chancery court's decision in *Disney* but which nevertheless suggests additional contexts for good faith analysis.

1. *Disney*. The Disney litigation revolved around the now infamous stint of Michael Ovitz as president of the Disney

40. *See, e.g.*, cases cited at *supra* note 5. *See also* Grogan v. O'Neil, 292 F. Supp. 2d 1282, 1293 (D. Kan. 2003) (treating good faith as the functional equivalent of waste and stating that "to prevail on either [breach of good faith or waste], plaintiff must show that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests"); Scattered Corp. v. Chi. Stock Exch. Inc., 701 A.2d 70, 75 (Del. 1997) ("Failure of an otherwise independent-appearing board or committee to act independently is a failure to carry out its fiduciary duties in good faith . . . .").

41. 825 A.2d 275 (Del. Ch. 2003).

42. The opinion discussed in this Section and referred to throughout this Article as Disney is the chancery court's 2003 decision that established good faith as an independent basis for a fiduciary duty complaint. The chancery court's 2005 decision, after trial, is discussed at *infra* notes 285–306 and accompanying text.

43. C.A. No. 20228-NC, 2004 Del. Ch. LEXIS 122 (Del. Ch. Aug. 24, 2004).

44. 803 A.2d 428 (Del. 2002).

Corporation. Michael Eisner, Disney's CEO and a longtime friend of Ovitz, hand picked him for the job and insisted on his hiring over the objections of several Disney board members.[45] Eisner personally handled many of the details of Ovitz's hiring, including the negotiation of the employment agreement and, not long thereafter, the severance agreement.[46] Ultimately, Ovitz's tenure with Disney was brief and undistinguished. He left the company after fifteen months.[47] His total compensation, however, was inversely proportional to the quality and quantity of his effort. For his pains, Ovitz was paid approximately $140 million in stock, cash, and options.[48]

Not surprisingly, this rather lavish compensation package became the subject of a shareholder derivative suit against the Disney board. The case wended its way through the Delaware courts for years. After an initial dismissal by the court of chancery in 1998,[49] the case reached the Delaware Supreme Court on appeal in 2000 in *Brehm v. Eisner*.[50] The *Brehm* opinion was strongly prodefendant, holding (1) that the board's decisions to hire, fire, and compensate Ovitz, while certainly unfavorable to Disney,[51] did not amount to

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45. *Disney*, 825 A.2d at 287.

46. Arguably, the most glaring error in the negotiation of the contracts was that the employment agreement created incentives for Ovitz to seek a no-fault termination rather than a long term relationship with the company. The chancery court summarized the situation as follows:

> Under a non-fault termination, Ovitz was to receive his salary for the remainder of the contract, discounted at a risk-free rate keyed to Disney's borrowing costs. He was also to receive a $7.5 million bonus for each year remaining on his contract, discounted at the same risk-free rate, even though no set bonus amount was guaranteed in the contract. Additionally, all of his "A" stock options were to vest immediately, instead of waiting for the final three years of his contract for them to vest. The final benefit of the non-fault termination was a lump sum "termination payment" of $10 million. The termination payment was equal to the payment Ovitz would receive should he complete his full five-year term with Disney, but not receive an offer for a new contract. Graef Crystal opined in the January 13, 1997, edition of *California Law Business* that "the contract was most valuable to Ovitz the sooner he left Disney."

Id. at 283.

47. *Id.* at 282–85.

48. The measure is approximate due to the problem of valuing the equity and the options. $140 million is the plaintiff's measurement of the total cost and may be high. *See id.* at 289 n.32 (declining to decide the question of value).

49. *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 380 (Del. Ch. 1998).

50. 746 A.2d 244 (Del. 2000).

51. The opinion noted that "the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious . . . and . . . 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." *Id.* at 249.

waste;[52] (2) that outside of the context of waste, the court would not review the substantive outcome of board decisions;[53] and (3) that the board's decisionmaking process did not amount to gross negligence.[54] Expressing further sympathy for the defendants, Chief Justice Veasey emphasized the difference between ideal corporate governance practices and legally acceptable corporate governance practices:

> [T]he law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability.[55]

There is a difference, in other words, between corporate *law* and corporate *governance*, a difference that is protected by the principle of judicial restraint underlying the business judgment rule.

Nevertheless, the *Brehm* decision granted plaintiffs the opportunity to replead.[56] The plaintiffs did so and found themselves in chancery court in early 2003, once again facing a motion to dismiss. By this point in the litigation, however, the duty-of-loyalty claim had been stripped from the plaintiffs' complaint. It was now clear that

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52. *Id.* at 263–64.

53. There is no such thing, in other words, as substantive due care. In Chief Justice Veasey's words:

> As for the plaintiffs' contention that the directors failed to exercise "substantive due care," we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.

Id. at 264. It is worth noting the appearance of "good faith" at the end of this quotation. Chief Justice Veasey's view, at least in *Brehm*, seems to have been that good faith is whatever is beyond the substantive standard of gross negligence, such as irrationality or waste.

54. *Id.* at 262 (concluding that the "pleading, as drafted, fails to create a reasonable doubt that the Old Board's decision in approving the Ovitz Employment Agreement was protected by the business judgment rule").

55. *Id.* at 256.

56. *See id.* at 248 ("[I]n the interests of justice, we reverse only to the extent of providing that one aspect of the dismissal shall be without prejudice, and we remand to the Court of Chancery to provide plaintiffs a reasonable opportunity to file a further amended complaint consistent with this opinion.").

apart from Eisner everyone on the Compensation Committee and the board as a whole was disinterested in the Ovitz hiring,[57] that Eisner did not participate in the Compensation Committee's review of the Ovitz contracts,[58] and that there was no evidence suggesting Eisner dominated or controlled the board or the Compensation Committee.[59] Without an argument under the duty of loyalty, the plaintiffs were left with only a duty-of-care claim, and Disney had a § 102(b)(7) provision entitling the board to dismissal of claims arising exclusively under the duty of care.[60] Without a loyalty component, the claim seemed to require dismissal.

Instead of dismissing the revised complaint, however, Chancellor Chandler invoked good faith to rescue it, holding that the plaintiffs had pleaded "particularized facts sufficient to raise . . . a reason to doubt that the action was taken honestly and in good faith."[61] Although the chancellor was able to invoke the good faith carve out in 102(b)(7) as the basis for his decision,[62] this application of good faith was unprecedented in Delaware.[63] Good faith had never before been given an independent doctrinal effect, but had typically been mentioned in the context of the other two duties, most often as an

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57. *See Disney*, 825 A.2d at 279–85 (describing the membership of the board and committee and their roles in reviewing the Ovitz hiring and termination decisions).

58. *See id.* at 280 (describing a meeting of Compensation Committee, of which Eisner was not a member).

59. *See id.* at 287 n.30 (noting that the friendship between Eisner and Ovitz is "not mentioned to show self-interest or domination," which the court in fact never analyzed).

60. *See supra* Part I.A.

61. *Disney*, 825 A.2d at 286.

62. *See* DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (1999) (providing that indemnification provisions shall not eliminate or limit director liability for conduct "not in good faith").

63. The Seventh Circuit, however, applying Illinois law, had recently sustained a claim on precisely the same basis. *See In re* Abbott Labs. Derivative S'holders Litig., 325 F.3d 795 (7th Cir. 2001) (invoking good faith as an exception to the corporation's 102(b)(7) provision). The *Abbott* decision involved a board's persistent failure to comply with government regulation and followed Chancellor Allen's often-cited dictum in the *Caremark* opinion that:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability.

In re Caremark Int'l Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996). These statements are technically dicta because the only "holding" of the *Caremark* opinion is the approval of a settlement in a derivative action under the duty of care. In basing its decision on these remarks, the *Abbott* court ultimately concluded that "a sustained and systematic failure of the board to exercise oversight" can raise doubts concerning the board's exercise of its duties in good faith. *Abbott Labs.*, 325 F.3d at 809.

aspect of the duty of loyalty.[64] In *Disney*, however, good faith is separate and distinct from both loyalty and care because the plaintiffs' claim could not have survived dismissal under either traditional fiduciary duty.[65]

Having thus given good faith a new role in fiduciary duty analysis, the *Disney* opinion then had to demonstrate how good faith analyses would work. Although Chancellor Chandler made several references to recklessness and intentional disregard,[66] throughout the opinion he applied an analytic technique that essentially alternated between issues traditionally raised in analyses under the duty of loyalty, on the one hand, and the duty of care, on the other. This alternation between loyalty issues and care issues is the opinion's most distinctive feature.

Loyalty, in the form of the Eisner-Ovitz relationship, is a theme that recurs throughout the chancellor's opinion. Beginning in the recitation of facts and continuing throughout the opinion, the chancellor expressed skepticism at the role that the friendship between the two men might have played in the corporation's decisionmaking.[67] The opinion emphasizes the friendship over and over again, repeating the word "friend" or "friendship" fifteen times, always in reference to the Eisner-Ovitz relationship and usually accompanied by remarks expressing thinly veiled displeasure if not outright criticism. For example, in describing the negotiation of the initial employment agreement, Chancellor Chandler notes that the

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64. *See supra* note 11 and accompanying text.

65. There was no basis under the duty of loyalty because it had not been raised on appeal and no basis under the duty of care because the court was prevented—by the business judgment rule and the 102(b)(7) provision—from reaching it.

66. Near the end of the opinion, Chancellor Chandler stated:

> [T]he facts alleged in the new complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude . . . . Knowing or deliberate indifference . . . to [the director's] duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.

Disney, 825 A.2d at 289. The focus on recklessness and intentional disregard is similar to the Seventh Circuit's analysis in *Abbott*. *See supra* note 63.

67. *See, e.g.*, *id.* at 279 (noting, for the first of many times throughout the opinion, that Ovitz had "been Eisner's close friend for over twenty-five years").

board "passed off the details to Ovitz and his good friend, Eisner."[68] Later, in connection with Ovitz's termination, the chancellor again emphasizes the personal relationship, noting that "[Ovitz's] good friend Eisner came to the rescue, agreeing to Ovitz's request for a non-fault termination"[69] and pointing out that "Eisner [handed] his personal friend, Ovitz, more than $38 million in cash and the three million . . . stock options."[70]

The Eisner-Ovitz relationship, however, falls short of establishing a breach of the duty of loyalty. Even if one accepts that a personal relationship can disqualify a director as disinterested,[71] the only member of the Disney board to flunk the test was Eisner, and none of the usual indicia of "domination or control" were present to suggest that Eisner's conflict had spread to the rest of the board.[72] If anything, the facts recited in the opinion suggest a healthy degree of skepticism on the part of the board, three of whose members raised objections to Ovitz's hiring.[73] But the chancellor never pursued these lines of analysis. The loyalty analysis, in other words, is highly incomplete. Without more, these items would fail to establish liability under the duty of loyalty. No more is given, however, because the chancellor is not raising the Eisner-Ovitz friendship to prove a breach of the duty of loyalty, but rather as a relevant component of the analysis of good faith.[74]

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68. *Id.* at 287. The court repeated its emphasis on this point, noting that "[n]egotiation over the remaining terms took place solely between Eisner, Ovitz, and attorneys representing Disney and Ovitz." *Id.*

69. *Id.* at 288.

70. *Id.* at 289. The court again described the role of the Eisner-Ovitz friendship in the transaction with disapproval when it described Ovitz as having gone "to his close friend, Eisner," with whom he had worked to "develop[] a secret strategy that would enable Ovitz to extract the maximum benefit from his contract, all without board approval." *Id.* at 291.

71. Nonmonetary ties are now increasingly viewed as adequate to disqualify a director as independent and disinterested. See, for example, *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938–39 (Del. Ch. 2002) ("Beholden . . . does not mean just owing in the financial sense, it can also flow out of 'personal or other relationships' to the interested party."), which is discussed at *infra* note 220.

72. *See supra* note 59 and accompanying text.

73. *Disney*, 825 A.2d at 287.

74. See *id.* at 287 n.30:

> The allegation that Eisner and Ovitz had been close friends for over twenty-five years is not mentioned to show self-interest or domination. Instead, the allegation is mentioned because it casts doubt on the good faith and judgment behind the . . . decisions to allow two close personal friends to control the payment of shareholders' money to Ovitz.

Between the recurring references to the Eisner-Ovitz friendship, the *Disney* opinion focuses on the board's process in approving the Ovitz contracts, an issue traditionally considered under the rubric of the duty of care. Criticizing the approval of Ovitz's initial employment contract, the chancellor emphasized that it had been approved without the entire board or any committee having had any role in the negotiations or signing.[75] Reciting a series of facts recalling the criticism of Trans Union's two hour board meeting in *Van Gorkom*,[76] the court stressed that the "[b]oard and the compensation committee . . . each spent *less than an hour* reviewing Ovitz's possible hiring."[77] Twice the court cited with approval the plaintiff's allegation that the board behaved "blindly"[78] and once referred to the board as "ostrich-like."[79] According to the court's reading of the factual allegations, the board "chose to remain invisible in the process. . . . [and] (1) failed to ask why it had not been informed, (2) failed to inquire about the conditions and terms of the agreement; and (3) failed even to attempt to stop or delay the termination until more information could be collected."[80] As in *Van Gorkom*, such allegations would typically form the basis of a complaint under the duty of care, but the court did not pursue the analysis, perhaps because the business judgment rule and the 102(b)(7) provision would

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75. *Id.* at 288 (describing the process and stating that "the board apparently took no action; no questions were asked").

76. *See* Smith v. Van Gorkom, 488 A.2d 858, 868 (Del. 1985) (holding a board liable under the duty of care in connection with the approval of a merger).

77. *Disney*, 825 A.2d at 288 (emphasis added). The court further emphasized that

> neither the Old Board nor the compensation committee reviewed the actual draft employment agreement. Nor did they evaluate the details of Ovitz's salary or his severance provisions. No expert presented the board with details of the agreement, outlined the pros and cons of either the salary or non-fault termination provisions, or analyzed comparable industry standards for such agreements. Notwithstanding this alleged information vacuum, the Old Board and the compensation committee approved Ovitz's hiring, appointed Eisner to negotiate with Ovitz directly in drafting the unresolved terms of his employment, never asked to review the final terms, and were never voluntarily provided those terms.

Id. (footnote omitted). Again, these concerns echo the Delaware Supreme Court's concerns eighteen years earlier in *Van Gorkom*, in which the Trans Union board approved merger without a draft merger agreement or written summary and without an expert fairness opinion. *See Van Gorkom*, 488 A.2d at 877–78.

78. *Disney*, 825 A.2d at 277, 289.

79. *Id.* at 288.

80. *Id.* at 289.

have kept it from getting very far.[81] Instead, the court raised these issues to support the board's lack of good faith.

What, then, does the chancery court's 2003 *Disney* opinion teach about good faith? At the very least, by sustaining the claim on the basis of good faith when neither care nor loyalty was available, *Disney* shows that good faith has a doctrinal effect that is independent of either traditional fiduciary duty. The mode of analysis that *Disney* supplies for good faith claims, however, is closely tied to the traditional fiduciary duties. This mode of analysis can be summarized (somewhat glibly) as follows: First, recite facts drawing both the duty of care and the duty of loyalty into question. Then, rather than pursuing either traditional analysis through to a conclusion, alternate between the two and, in so doing, blend the issues together. Having thus formed a composite picture of the board's conduct, conclude that the analysis raises doubts concerning the good faith of the defendant directors.

2. *Elkins*. A similar mixing of the duties of care and loyalty took place in a still more recent chancery court decision claiming to follow and apply the chancellor's reasoning in *Disney*.

In *Elkins*, the unsecured creditors' committee of bankrupt Integrated Health Services (IHS) pressed fiduciary duty claims against members of the IHS board in connection with the compensation package awarded to Robert Elkins, the company's president and CEO. Although this package was not as lavish as Michael Ovitz's pay day in *Disney*,[82] Elkins benefited from a number of dubious compensation arrangements, including a large bonus, option grants, and various loans, the terms of which were regularly revised to make them more favorable to Elkins.[83] The plaintiff claimed that the IHS board breached the fiduciary duties of care and loyalty in authorizing the Elkins compensation package.[84] The

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81. *See supra* Part I.A. Chancellor Chandler's awareness of this dynamic is evident in his statement in *Disney*: "Where a director consciously ignores his or her duties to the corporation . . . the director's actions are either 'not in good faith' or 'involve intentional misconduct.' Thus, plaintiffs' allegations support claims that fall *outside* the liability waiver provided under Disney's certificate of incorporation." *Disney*, 825 A.2d at 290 (footnote omitted).

82. *See supra* note 48 and accompanying text.

83. Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, C.A. No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *13–*25 (Del. Ch. Aug. 24, 2004).

84. *See id.* at *29 ("One [count] alleges breach of the fiduciary duty of loyalty and the second alleges breach of the fiduciary duty of care.").

defense moved for dismissal of the duty-of-loyalty claim on the ground that each of the compensation arrangements had been approved by a majority of disinterested and independent directors;[85] after analyzing the interest and independence of each board member, the court agreed.[86] This left only the duty-of-care claim, which, given the IHS 102(b)(7) provision, seemed to require dismissal. As in *Disney*, however, the *Elkins* court relied on the bad faith exception to 102(b)(7) in denying the motion to dismiss.[87]

Although it claimed to follow and apply *Disney*, the *Elkins* court expressed some confusion over whether analyses of good faith belong under the duty of care or the duty of loyalty.[88] The court resolved this confusion by pointing out that good faith analyses could be conceptualized as belonging under either traditional duty. Good faith can be viewed as a part of the duty of loyalty, the court pointed out, because "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."[89] Alternately, good faith may be viewed as a component of the duty of care if the defect is a process failure, requiring an inquiry into what the board did or did not do to prevent the loss.[90] That the court paused to describe good faith both ways—and that it located each interpretation in alternative readings of *Disney*—suggests once again that good faith has elements of each traditional fiduciary duty.

Despite its conceptual subtlety in describing good faith, the court's actual analysis of good faith is a fairly plain review of the board processes involved in the approval of each element of the compensation package. Unlike the *Disney* court, the court in *Elkins* did not continually alternate between the two traditional duties, nor

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85. *Id.* at *30; *see also* DEL. CODE ANN. tit. 8, § 144(a) (2001) (allowing a transaction involving a corporation and one of its directors if a majority of disinterested directors with knowledge of material facts regarding the involved director's interests approve of the transaction).

86. *See Elkins*, 2004 Del. Ch. LEXIS 122, at *43 (concluding that "all of these transactions were approved by a board consisting of a majority of independent, disinterested directors").

87. *Id.* at 63; *see also In re* Abbott Labs. Derivative S'holders Litig., 325 F.3d 795, 811 (7th Cir. 2003) (relying on the bad faith exception in 102(b)(7) to deny dismissal).

88. *Elkins*, 2004 Del. Ch. LEXIS 122, at *31–*34.

89. *Id.* at *33 n.36 (quoting Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003)).

90. *See id.* at *34 n.37 ("One may alternatively conceptualize the holding in Disney as a duty of care claim that is so egregious—that essentially alleges the Board abdicated its responsibility to make any business decision—that it falls within the second exception to the general exculpating power of § 102(b)(7).").

did it even describe its review as an analysis of good faith; it referred instead to what it called the "*Disney* Standard"[91] and repeatedly quoted the phrase from *Disney* that a board may not "consciously and intentionally disregard[] [its] responsibilities."[92] In its review of the board's process in approving Elkins' compensation arrangements, the court then dismissed claims wherever it found evidence of deliberation, and sustained them where it found none.[93]

The mode of analysis employed in *Elkins*, where evidence of board processes are reviewed to either dismiss or sustain elements of the complaint, if reduced to the principle that the board spend a *reasonable* amount of time and effort in deliberation, is inconsistent with the business judgment rule, which requires only that the board not behave with *gross negligence*. How much time and effort to spend in deliberation is a board decision that, like the decision to make bottles or bricks, is a matter of business judgment insulated from judicial second guessing.[94] Even without sliding all the way towards the *reductio ad absurdum*—where, for example, a board must meet for more than two hours to approve a merger (a lesson arguably imparted by *Van Gorkom*), one hour for CEO compensation, twenty minutes for plant closure[95]—a court that passes judgment on the reasonableness of board deliberations violates the principle of nonintervention underlying the business judgment rule.[96] Vice Chancellor Noble sought to avoid this inconsistency by emphasizing that his court was looking not for evidence of the reasonableness of deliberations but only for an indication that deliberations had taken

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91. *Id.* at *44.

92. *Id.* at *46; *see id.* at *44 (describing the relevant question as "whether any of the Challenged Transactions was authorized with . . . intentional and conscious disregard to [the] director's duties); *id.* at *46 (stating that to survive dismissal, the pleading must state facts implying that "a Board '*consciously and intentionally disregarded [its] responsibilities*'"); *id.* at *48–*49 (failing to find evidence "that the Defendants intentionally disregarded their responsibilities").

93. *See id.* at *46–*59.

94. *Cf.* CLARK, *supra* note 21, at 641 (discussing the decision to make bottles or bricks in the context of derivative suits).

95. The *Elkins* court noted this possibility, rejecting the plaintiff's argument about the reasonableness of time spent:

> Counsel took the following position: "Now we're not saying if it was 20 minutes, it would have been okay or if it was 5 minutes, it wouldn't have been okay. Perhaps 5 or 10 minutes would have been sufficient if there had been some other involvement or discussion with the expert other than that very brief meeting." The type of inquiry counsel may be suggesting is not particularly helpful in evaluating a fiduciary claim.

Elkins, 2004 Del. Ch. LEXIS 122, at *52 (footnote omitted).

96. *See supra* note 25 and accompanying text.

place at all.[97] One might ask, however, whether the decision not to deliberate at all, like the decision to deliberate for ten minutes or twenty, is not also a business decision, insulated from judicial second guessing by the business judgment rule. But, perhaps, the answer to this question depends on the unique context of executive compensation.

In other contexts, boards may decide not to deliberate—that is, they may defer to management's judgment—but not in questions of executive compensation. *Elkins* states: "While there may be instances in which a board may act with deference to corporate officers' judgments, executive compensation is not one of those instances. The board must exercise its own business judgment in approving an executive compensation transaction."[98] Why is executive compensation different? Why is board deference appropriate in other matters but not here? The answer, obviously, is that management has an overwhelming interest in setting its own compensation as high as it possibly can and cannot be trusted to act in the best interests of the corporation. Because of this conflict of interest, the board cannot simply defer to management's judgment.

Executive compensation, in other words, is a special case in which management's loyalty cannot be assumed.[99] If the board does not exercise its own judgment to constrain management, there is no way to be confident that the resulting decision is not the product of self-interest. Here again, in other words, there is a duty-of-loyalty concern. Executive compensation is a special case for scrutiny of the board's "good faith"—that is, a situation in which the process requirements of the duty of care will be especially scrutinized for what is, at its core, a duty-of-loyalty problem. In *Elkins*, the duties of care and loyalty are interrelated not only as bases from which good faith may be conceptualized; they are also intermixed as the motivating concerns of the analysis. Concerns about loyalty (management's interest in maximizing its own compensation) drive the court's duty-of-care analysis (board processes).

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97. *Elkins*, 2004 Del. Ch. LEXIS 122, at *52 ("The Court does not look at the *reasonableness* of a Board's actions in this context, as long as the Board exercised *some* business judgment.").

98. *Id.* at *45.

99. *See generally* LUCIAN AYRE BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (diagnosing the excesses of executive compensation as a function of the fact that managers, through boards they control, set their own compensation).

3. *Reader's Digest.* Executive compensation issues, however, are not the only ones to trigger good faith analyses, and the chancery court is not the only Delaware court to perform them. At the supreme court level, a very similar analytic technique appears just beneath the surface of *Reader's Digest*, in which the court performed a good faith analysis without naming it as such.[100]

The transaction inciting the litigation was a proposed recapitalization of the Reader's Digest Association (RDA), the effect of which would have been to eliminate RDA's dual capital structure—two classes of shares, one with voting rights and the other without, but otherwise identical—in favor of a single class of common stock with one vote per share.[101] However, the proposed recapitalization created a conflict-of-interest problem because a control group stood to gain $100 million cash in a buyback of shares unavailable to any other RDA shareholders.[102] The control group buyback would thus result in a $100 million decrease in the equity interests of the nonvoting shareholders.[103]

In a somewhat cryptic order enjoining the proposed recapitalization,[104] the supreme court emphasized two elements of the transaction. First, in treating the share buyback as the "key to the

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100. Levco Alternative Fund Ltd. v. Reader's Digest Ass'n, Inc., No. 466, 2002 Del. LEXIS 488, at *6–*8 (Del. Aug. 13, 2002).

101. *Id.* at *2. The recapitalization also would have added antitakeover provisions. *See infra* note 110.

102. The control group consisted of two large funds that together owned fifty percent of RDA's voting shares: the DeWitt Wallace Reader's Digest Fund and the Lila Wallace Reader's Digest Fund. In connection with the recapitalization, RDA would purchase 3,636,363 shares held by the funds. As a result of the repurchase and recapitalization, the funds would go from holding 50 percent of RDA voting rights to holding 14 percent. *Reader's Digest*, 2002 Del. LEXIS 488, at *2.

103. *Id.* at *6. The court explicitly emphasized the already-tenuous financial condition of the corporation in connection with the additional debt burden required to buy shares back from the controlling group. *See id.* (noting the company's "tenuous financial condition, having recently committed to a large acquisition, incurring additional debt in order to pay $100 million to the Class B shareholders").

104. The *Reader's Digest* opinion is unclear regarding, among other things, the standard of review applied by the court. The plaintiffs challenged both the fairness of the transaction and the process of the board committee in agreeing to it. Reversing the chancery court on the question whether the entire fairness standard was appropriate, the supreme court acknowledged that the burden of showing fairness, although initially resting with the defendants, would shift if the committee was genuinely independent. In reviewing the committee's actions, however, the court found them to be "flawed both from the standpoint of process and price." *Id.* at *5. The court then employed an analysis mixing duty-of-loyalty issues with duty-of-care issues to review the conduct of the committee. *Id.* at *6–*8.

recapitalization,"[105] the court focused on the conflict inherent in taking an action to benefit a control group to the exclusion of, and at the expense of, other shareholders.[106] Second, the court criticized the process undertaken by the board and its committees in approving the transaction, admonishing the board for failing to engage a financial advisor to provide a fairness opinion specifically addressing the interests of the nonvoting shareholders.[107]

As in *Disney*, the supreme court's analysis of these issues fluctuated between considerations traditionally raised under duty-of-loyalty (the interest of the controlling shareholders in the buyback) and duty-of-care (the information asked for and obtained by the committee) analyses. Having opened both cans of worms, the court ultimately disposed of neither. The court never fully addressed the influence of the controlling shareholders' interest on the committee, nor did it analyze whether the board's process fell short of the standard of care. Instead, it blended both sets of issues in enjoining the proposed recapitalization.[108] This is similar to the analysis of good faith that later emerged in the chancery court's *Disney* opinion, in which the court oscillated between each traditional analysis without resolving either one. Moreover, when the *Reader's Digest* court addressed the board committee's claim that it acted in the best interests of the corporation,[109] it did so with evident skepticism, noting that the committee's belief was "*perhaps* in good faith."[110]

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105. *Id.* at *2.

106. The crux of the court's reasoning with respect to process was that the committee failed to consider the "specific impact" of the reorganization on *each* of the former classes of shareholders, focusing instead on the effect of the transaction on RDA as a whole. *See id.* at *5 (stating that although the committee "believed it was operating in the interests of the corporation as an entity" and noting that "the committee's functioning, to the extent it was required to balance the conflicting interests of two distinct classes of shareholders, was flawed").

107. *See id.* at *6–*7 ("To the extent that the directors did not secure sufficient information concerning the effect of the recapitalization premium on the Class A shareholders, a serious question is raised concerning the discharge of their duty of care.").

108. *See id.* at *7 (stating that "where, as here, the need for protection outweighs possible detriment to the defendants if the transaction does not proceed immediately the injunction should issue").

109. *Id.* at *6.

110. *Id.* (emphasis added). Is this "perhaps" meant to imply skepticism of the board's good faith? There is, at any rate, ample reason to be skeptical. In addition to the $100 million giveaway to the control group, the recapitalization added antitakeover provisions in a manner reminiscent of what Professor Gordon has referred to as "opportunistic amendment"—by packaging charter terms that harm shareholder welfare along with terms that have positive or ambiguous welfare effects. *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1577–81 (1989) (describing strategic use of "sweeteners," "add-ons,"

C. The Substance of Good Faith

In spite of having been made the *ratio decidendi* in several recent decisions, the precise meaning of good faith remains unclear. None of the cases assigning a distinct doctrinal role to good faith in fiduciary duty analyses has fully specified the steps of that analysis. None has filled in the content of the emerging doctrine. In the words of former Chief Justice Veasey, "the jurisprudence of good faith is unresolved."[111]

Several of the cases recite the language of recklessness and intentional disregard in describing bad-faith conduct. In *Disney*, for example, the court emphasizes that "[k]nowing or deliberate indifference . . . to [the director's] duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company."[112] *Elkins* claims to apply this test, referring to the standard of "intentional and conscious disregard to [the] director's duties"[113] rather than the more general question of good faith. Building upon such language, Professor Hillary Sale has articulated an analysis for good faith that focuses on questions of intent, arguing that directors fail to act in good faith "when they abdicate, subvert, or ignore [their] responsibilities, or act with deliberate indifference toward them."[114] Elaborating this standard, Sale states:

> Good faith based liability . . . 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. . . . Two of the cases . . . that discuss good faith indicate that a breach of the duty requires motive-based allegations of severely

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and "chicken" tactics and noting that "insiders can bundle a wealth-reducing amendment with . . . an unrelated proposal that increases shareholder wealth"). In *Reader's Digest*, the proposed recapitalization packaged a staggered board and the elimination of shareholder ability to act by written consent, well-recognized antitakeover provisions, with increased voting power. *See Reader's Digest*, 2002 Del. LEXIS 488, at *2 (describing the terms of the recapitalization plan). *See generally* Lucian Arye Bebchuk, et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (discussing the antitakeover effect of staggered boards and the inability of shareholders to act by written consent). An awareness of the potential for opportunism beneath the surface of such a charter amendment may have caused the supreme court to doubt the good faith of the RDA board.

111. E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 448 (2003).

112. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003).

113. Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, C.A. No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *44 (Del. Ch. Aug. 24, 2004).

114. Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 486 (2004).

> reckless or seemingly intentional behavior. Situations involving deliberate indifference or abdication would also cross the line.[115]

To define the requisite mental state of recklessness or deliberate indifference, Sale argues that courts hearing corporate law cases ought to follow the lead of the federal securities laws and, in particular, the development of scienter in litigation under rule 10b-5.[116] She then offers several situations that illustrate a state of mind—intentional disregard or extreme recklessness[117]—which would enable a court to find liability under a separate standard of good faith.[118] Professor Sale's analysis of good faith has recently been cited with approval in a chancery court decision.[119]

Nevertheless, there are several reasons to resist an explanation of good faith that would reduce its amorphous character to a standard based on intent or, perhaps, based on anything else. First, the resolute fact specificity of Delaware jurisprudence has continually frustrated attempts to harden fiduciary standards into clear rules.[120] Delaware's

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115. *Id.* at 488–89 (footnotes omitted).

116. *Id.* at 489–94. Elaborating the use of scienter, Professor Sale states:

> 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.

Id. at 490.

117. These include situations in which the directors (1) "benefited in a concrete and personal way from the purported fraud," (2) "engaged in deliberately illegal behavior," (3) "knew facts or had access to information" that indicated the information they relied upon was inaccurate, or (4) failed "to check on information they had a duty to monitor." *Id.* at 491–93 (quoting Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000)).

118. In Professor Sale's words:

> Although a breach of good faith need not be intentional or conscious, it does require some sort of obvious, deliberate, or egregious failure. . . . [M]otive 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 flagrantly reckless actions or inactions are also problematic and, if proved, are breaches of good faith responsibilities.

Id. at 493–94.

119. *See In re* Emerging Commc'ns, Inc. S'holders Litig., Consol. Civ. Action A. No. 16415, 2004 Del. Ch. LEXIS 70, *142–*43 (Del. Ch. May 3, 2004) (citing Professor Sale's article with approval and criticizing directors for "consciously disregarding" shareholder interests when they "knew, or at the very least had strong reasons to believe," that a transaction was unfair).

120. Allen, Jacobs, & Strine, *supra* note 20, at 1294:

> [T]he almost infinite potential variation in the fact patterns calling for director decisions, the disparate time frames within which different boards may be required to act, and the divergent skills and information needed to make particular business decisions, usually make it impossible for courts to articulate ex ante precise guidelines for appropriate fiduciary action in future cases

recent history is no exception. As I discuss in further detail in Part II, at the same time that Delaware courts were rediscovering the concept of good faith, they were destabilizing settled doctrinal paradigms in the areas of change of control[121] and director independence.[122] It would be odd indeed if in the same year that Delaware eschewed doctrinal stability in these other areas, it settled the previously amorphous notion of good faith around a core concept of scienter.

At another level, defining good faith in terms of recklessness or intent does not solve the problem of distinguishing good faith from the duty of care. Because intent and recklessness can be characterized as negligence and negligence similarly can be recast as intent, either analysis will ultimately ask whether the board was careful or prudent according to some standard of conduct. Questions of negligence and intent both focus on how individuals direct their attention. Because attention is a scarce resource—there are too many perceptual influences (whether sensory experiences, intellectual puzzles, memories, or distractions) to focus on all of them at once—individuals must choose how to direct their attention. They must decide, in other words, what they will pay attention to and what they will disregard. This decision can be characterized equally as intentional or negligent. In the context of driving, for example, I might have to decide how to allocate my attention between the road and a conversation on my cell phone. If I choose to talk and drive and subsequently cause an accident, my decision can be described as negligent driving or, just as easily, as intentional disregard of the road in favor of an engrossing conversation. Negligence merely sets the

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After attempting to organize fragmented decisions into a single coherent doctrine, two distinguished commentators accurately predicted what would come of their prediction: "Predicting the course of Delaware law from prior case law is like watching clouds. They seem, at times, to take on recognizable shapes and forms, even to resemble something familiar. But you know that whatever shapes you think you see can vanish in a puff of wind." Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After* QVC *and* Technicolor*: A Unified Standard (and the End of* Revlon *Duties?)*, 49 BUS. LAW. 1593, 1626 (1994).

121. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 933–39 (2003) (applying enhanced scrutiny of deal protection devices and requiring that merger agreements contain a fiduciary out). *Omnicare* is further discussed at *infra* note 220. For a full discussion of the *Omnicare* opinion and its several departures from existing doctrine, see generally Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of* Omnicare v. NCS Healthcare, 29 J. CORP. L. 569 (2004).

122. *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 937–39 (Del. Ch. 2003) (relaxing the traditional tests of director independence in the context of derivative suits). *Oracle* is further discussed at *infra* note 220.

standard of reasonable attention in doing something,[123] but the decision to direct one's attention can still be understood as a question of intent—that is, the choice to allocate attention to one place rather than another.[124]

Tort law distinctions between negligence and intent—in which, for example, someone intends to tap, not to kill, an "egg-shell skull" plaintiff—do not work in the context of board decisionmaking.[125] Whatever the board is deciding, its intent, consistent with fiduciary principles, is always the same—to maximize corporate welfare. To frame the question of whether they are doing it as they ought to as a matter of recklessness or intentional disregard is merely to conduct the negligence inquiry under another label. Moreover, because the business judgment rule eliminates the negligence standard in corporate law,[126] conducting such an inquiry is inconsistent with settled doctrine. Any attempt to distinguish the recklessness inquiry by limiting it to extreme deviations from the norm must encounter the objection that corporate law already has doctrines, such as gross negligence and waste,[127] for dealing with extremes.[128] Chief Justice Veasey's strident rejection of substantive due care in *Brehm* means that a bad outcome, short of waste, cannot be a basis for liability.[129] And the business judgment rule means that misdirected attention, short of gross negligence, cannot give rise to liability.[130] Once intent is

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123. Consider the Hand formula: the burden of care should equal the probability of loss times the magnitude of harm. *See* United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947) (developing the Hand formula: "[i]f the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P").

124. Another way of saying the same thing is to say that negligence is merely misdirected attention. We say that attention is misdirected when it is significantly diverted towards something else, leaving a less-than-reasonable residual allocation of attention on the action that caused the harm.

125. This distinction does not work well in torts either, where defendants are said to take their victims as they find them, whatever they actually intended. *See, e.g.*, Bruneau v. Quick, 447 A.2d 742, 750 (Conn. 1982) (stating that "defendant took the plaintiff as he found her").

126. *See supra* Part I.A.

127. *See, e.g.*, Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (stating that "waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range of what any reasonable person might be willing to trade"); Francis v. United Jersey Bank, 432 A.2d 814, 819–26 (N.J. 1981) (demonstrating that a director's alcoholic stupor can result in gross negligence).

128. Significantly, the Delaware Supreme Court determined that the Disney board's action in the context of the Ovitz compensation dispute was neither gross negligence nor waste. *See supra* notes 51–52 and accompanying text.

129. *See supra* note 53 and accompanying text.

130. *See supra* Part I.A.

collapsed back into negligence, a scienter-based standard of good faith thus merely repeats the analytics of the duty of care. Moreover, if this standard seeks to apply a test other than gross negligence or waste, it is inconsistent with the business judgment rule.

It may be that a rewrite of the business judgment rule is just what advocates of a scienter-based duty of good faith have in mind, perhaps for valid normative reasons.[131] My only point here is a descriptive one—that is, to point out that moving good faith to a substantive standard of intent does not avoid repitition of duty-of-care analytics and, ultimately, confrontation with the business judgment rule. Furthermore, again as a purely descriptive matter, reducing good faith to a substantive standard of intent does not fully capture the more subtle pattern of analysis in the good faith cases. True, several courts have *said* that good faith involves questions of intent and recklessness, but they have not seriously attempted to probe the directors' subjective mental state.[132] Instead, what courts have *done* in analyzing good faith is to raise issues under each of the traditional fiduciary duties, mix them together, then conclude that the board's conduct has thrown good faith into doubt. It is difficult to reduce this pattern of analysis to scienter or perhaps to any substantive standard, and attempts to do so are subject to the criticism that they credit what courts *say* without paying adequate attention to what courts *do*.

In the next Part, I seek to provide a more accurate account of the recent good faith jurisprudence. It attempts to describe good faith in a way that does not reduce it to a substantive doctrine with a rigid core principle. Good faith, it argues, is not a substantive standard. It is a rhetorical device.

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131. Professor Sale, for example, argues that good faith can improve corporate governance by breaking hardened doctrinal paradigms:

> The value of a separate good faith duty . . . 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.

Sale, *supra* note 114, at 494. As mentioned at *supra* note 16, it is debatable whether increasing board accountability to courts—whether through good faith or any other jurisprudential tool—will improve corporate governance by more than it costs.

132. *See, e.g.*, *In re* Emerging Commc'ns, Inc. S'holders Litig., Consul. Civ. Action A. No. 16415, 2004 Del. Ch. LEXIS 70, *145 (Del. Ch. May 3, 2004) (acknowledging that "divining the operations of a person's mind is an inherently elusive endeavor").

II. GOOD FAITH AS A RHETORICAL DEVICE

Good faith, in my view, is not now and is not likely ever to become a doctrine of subrules and multipart tests. It is more subtle and elusive. It has, at its core, the basic concern of all corporate law jurisprudence—the question whether directors are really doing their best in acting for the corporation—but in seeking an answer, it blends questions generally thought to arise under the duty of care with those arising under the duty of loyalty. In seeking to answer the basic corporate law question, courts applying the good faith standard do not confine themselves to the analytics of either traditional fiduciary duty. Instead, good faith is used as a loose rhetorical device that courts can wield to find liability or enjoin actions that do not quite fit within established doctrinal categories. In this Part, I develop my account of good faith as a rhetorical device. Focusing on the pattern of analysis in the recent cases, Section A identifies the interpretive methodology underlying good faith jurisprudence as "thaumatrope analytics." Section B then emphasizes the contextual contingency of the good faith cases, an aspect of the good faith thaumatrope that will serve to connect it, in the next Part, to other evolutionary shifts in corporate law jurisprudence.

A. Thaumatrope Analytics

To understand the jurisprudence of good faith, it is important first to understand the pattern of analysis in the recent good faith cases. Good faith analyses oscillate between elements that traditionally sound under either of the two traditional fiduciary duties, care and loyalty.

In the *Disney* opinion, for example, Chancellor Chandler analyzed the board's good faith by emphasizing elements both of loyalty and care, describing the stages of the board's decisionmaking process, but continually returning to remark on the relationship between "Ovitz and his good friend, Eisner."[133] Process review is, of course, duty-of-care review, whereas conflict issues raise loyalty concerns.[134] In its good faith analysis, the chancery court oscillated between the two modes of analysis, repeatedly raising both care and loyalty concerns without pursuing either to a conclusion, but rather switching between both to raise doubts concerning the good faith of

133. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 287–89 (Del. Ch. 2003).

134. *See supra* Part I.A.

the board.[135] Distinctions between the duties of care and loyalty were similarly blurred in *Elkins*,[136] where the court conceptualized good faith as a component of each of the traditional fiduciary duties and then applied an analysis that resembled the duty of care but that was motivated by concerns arising under the duty of loyalty.[137] Likewise, in *Reader's Digest*, the supreme court oscillated between an emphasis on the conflict of interest inherent in the buyback of the control group's shares and the process failures of the board structures approving the buyback and recapitalization.[138] By the time the court added that the RDA board acted "*perhaps* in good faith,"[139] the court had elicited skepticism on precisely that point.

These analyses of good faith are based on the oscillation between two preexisting doctrinal standards, care and loyalty. Neither traditional standard would have enabled the plaintiffs to prevail, but when spun together, the elements of each analysis make the board appear to have done something sufficiently blameworthy to rule in the plaintiffs' favor. Such tactics have a rich rhetorical history, recalling the optical illusion produced by the thaumatrope.[140] As described by Professor Leon Lipson, "a Thaumatrope is a device in which two objects are painted on opposite sides of a card—for example, a man and a horse or a bird and a cage—and the card is fitted into a frame with a handle. When the handle is rotated rapidly, the onlooker sees the two objects combined into a single picture—the man on the horse's back or the bird in the cage."[141] Following Professor Lipson,[142] the analogy of a thaumatrope is most often used

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135. *Disney*, 825 A.2d at 289–90.

136. Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, C.A. No. 20228-NC, 2004 Del. Ch. LEXIS 122, at *33–*35 (Del. Ch. Aug. 24, 2004).

137. *See supra* Part I.B.2.

138. *See supra* Part I.B.3.

139. Levco Alternative Fund Ltd. v. Reader's Digest Ass'n, Inc., No. 466, 2002 Del. LEXIS 488, at *6 (Del. Aug. 13, 2002).

140. Lipson borrowed the metaphor from the philosophical work of Richard Whately. *See* Lipson, *supra* note 14, at 11 (quoting Whately's description of the thaumatrope).

141. *Id.*

142. Professor Lipson used the thaumatrope to criticize the legal reasoning in the *Allegheny College* opinion, in which Judge Cardozo oscillated between the principles of contract and promissory estoppel to provide relief for the college:

> Now what were the objects painted on the opposite sides of Judge Cardozo's Thaumatrope? His trouble was that on the consideration side he had a solid rule but shaky facts; on the promissory-estoppel side he had a shaky rule but (potentially) solid facts. He twirled the Thaumatrope in order to give the impression that he had solid facts fitting a solid rule. Some lawyers think that what emerges instead is a picture of a bird on the horse's back.

by commentators to describe, and often to critique, the opinions of Judge Cardozo.[143] Here I wish to argue that the emerging jurisprudence of good faith operates as a thaumatrope, but I do not wish to import the implicit critique.

The *Disney* opinion clearly resembles a thaumatrope. On one side of the card, Chancellor Chandler emphasized facts raising issues under the duty of loyalty and, on the other, facts raising issues under the duty of care. When he spun the card, the thaumatrope produced an image of a very bad board of directors, which the chancellor found may well have violated their duty of good faith. *Elkins* and *Reader's Digest* work in the same way. The image of good faith produced by these cases is not a new and distinct doctrinal pillar. It is, instead, the middle space between the twin doctrines of care and loyalty.

The suggestion that good faith operates as a rhetorical device oscillating between two substantive doctrinal principles, neither of which alone would result in liability, opens courts to a charge of unprincipled decisionmaking. Take a losing claim under both loyalty and care, the objection goes, mix the rhetoric of both principles, and suddenly you've got a winning claim? Thaumatrope analytics, however, only appear unprincipled if the two doctrinal categories between which the analysis oscillates are viewed as rigidly formalistic and hermetically sealed. But care and loyalty, in fact, are not mutually exclusive. They can instead be described as what Professor Jack Balkin has referred to as "nested oppositions"—that is, opposed concepts that also have "a relation of dependence, similarity, or containment."[144]

1. *Nested Oppositions, Co-Constitutive Categories, and Two-Fers.* Doctrinal categorizations and other decisionmaking heuristics tend to be built on conceptual oppositions.[145] Conceptual oppositions

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Id.

143. *See, e.g.*, William Powers, Jr., *Thaumatrope*, 77 TEX. L. REV. 1319, 1320–21 (1999) (reviewing ANDREW L. KAUFMAN, CARDOZO (1998)) (quoting Professor Lipson's metaphor of the thaumatrope to describe a common criticism of Judge Cardozo's opinions); Dan Simon, *The Double-Consciousness of Judging: The Problematic Legacy of Cardozo*, 79 OR. L. REV. 1033, 1038 n.44 (2000) (observing that the thaumatrope metaphor is often used to critique Judge Cardozo's opinions); Mike Townsend, *Cardozo's* Allegheny College *Opinion: A Case Study in Law as an Art*, 33 HOUS. L. REV. 1103, 1147 (1996) (asserting that Lipson's use of the thaumatrope metaphor to describe Cardozo's *Allegheny College* opinion is inaccurate).

144. J.M. Balkin, *Nested Oppositions*, 99 YALE L.J. 1669, 1671 (1990) (book review).

145. See, for example, Professor Paul's discussion of the "two-fer," *infra* note 158 and accompanying text.

are established by opposing two terms in a particular context. The context of the opposition is crucial because the concepts are not logically related—and therefore not contradictory—except in a specific context.[146] Balkin illustrates the importance of context with the colors red and green:

> If we say that red and green are opposite colors in a traffic light, we are not saying that they logically contradict each other. Rather, they are opposed with respect to the meanings these colors are given in traffic signals. The context of conventions concerning traffic signals makes them opposites. In another context, they may be seen as similar to each other. For example, red and green are both colors of the natural spectrum, or colors associated with Christmas, while lavender and brown are not. Thus red and green are seen as different in some contexts, and are seen as having similar properties in others.[147]

A nested opposition is a conceptual opposition each of whose terms contains the other, whether through similarity to the opposite, overlap, or a relation of historical dependence or transformation.[148] Recognizing nested oppositions allows ossified categories to be deconstructed and reconstructed in ways that emphasize similarities as well as differences,[149] revealing "similarities where before we saw only differences, or historical or conceptual dependence where before we saw only differentiation."[150]

Nested oppositions appear throughout legal doctrine. Balkin gives the example of negligence and strict liability, which appear as alternate liability rules, growing out of opposed principles—fault and compensation.[151] Balkin, however, shows that many of the subrules and standards of each rule implicate questions ordinarily raised under its opposite.[152] For example, negligence doctrine includes bright-line rules that determine liability without regard to fault, whereas strict

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146. *See* Balkin, *supra* note 144, at 1674–75 (explaining that the distinction between logical contradiction and conceptual opposition, the latter of which depends upon context whereas the former does not, is occasionally overlooked); *see, e.g.*, T.K. SEUNG, STRUCTURALISM AND HERMENEUTICS 12–17 (1982) (providing examples to distinguish logical contradictions and conceptual oppositions).

147. Balkin, *supra* note 144, at 1674.

148. *Id.* at 1676.

149. *See, e.g.*, J.M. Balkin, *Deconstructive Practice and Legal Theory*, 96 YALE L.J. 743, 744 (1987) (describing applications of deconstructive techniques to legal reasoning).

150. Balkin, *supra* note 144, at 1676.

151. *Id.* at 1683.

152. *Id.* at 1683–84.

liability doctrine returns to fault issues in analyzing causation along the lines of foreseeability.[153] Similarly, in constitutional law, Professor Julie Nice has found a "third strand" of equal protection jurisprudence that applies the logic of thaumatrope analytics on the basis of nested oppositions, or what she refers to as "co-constitutive categories."[154] Her survey of recent Supreme Court interpretations of the Fourteenth Amendment provides numerous examples in which the court goes beyond the formalistic doctrinal categories of fundamental rights and suspect classifications by focusing on the relationship between the rights and the class.[155] According to Nice, the co-constitutive relationship between fundamental rights and suspect classes explains the Supreme Court's oscillation between the two traditional categories and the resulting creation of a third analytic category between them:

> The third strand of equal protection analysis recognizes that rights and classes are mutually constitutive in that rights are partially marked, defined, and constructed by the classes who do and do not hold them, just as rights partially mark, define and construct those classes. . . . The third strand recognizes the interdependence, rather than separation and isolation, of rights and the classes of right-holders and non-right-holders.[156]

Nice develops this analysis of equal protection jurisprudence by integrating the two traditional lines of analysis and inquiring into the ways in which each category contains elements that "mark[], define[], and construct[] the meaning" of the other.[157]

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153. *Id.*; *see also* J.M. Balkin, *The Crystalline Structure of Legal Thought*, 39 RUTGERS L. REV. 1, 4–13 (1986) (describing oppositions in legal rule choices).

154. *See* Julie A. Nice, *Equal Protection's Antinomies and the Promise of a Co-Constitutive Approach*, 85 CORNELL L. REV. 1392, 1421 (2000) [hereinafter Nice, *Antinomies*]; Julie A. Nice, *The Emerging Third Strand in Equal Protection Jurisprudence: Recognizing the Co-Constitutive Nature of Rights and Classes*, 1999 U. ILL. L. REV. 1209, 1222 (1999) [hereinafter Nice, *Third Strand*].

155. *See* Nice, *Antinomies*, *supra* note 154, at 1392 (stating that "co-constitutive theory explores both how law shapes society and how society shapes law"); Nice, *Third Strand*, *supra* note 154, at 1215 (defining the co-constitutive thesis with respect to equal protection to mean "both that rights construct the classes of people who hold (and do not hold) them and that the status and conduct of these classes construct the meaning of rights. Because rights and classes are mutually constitutive, the Court can plausibly integrate its consideration of them").

156. Nice, *Third Strand*, *supra* note 154, at 1223–24.

157. *Id.* at 1225. Professor Nice states the analysis more broadly as follows:

> I suggest that co-constitutive theory offers an approach for disrupting and transcending the antinomies. Put simply, co-constitutive theory suggests that the antinomic alternatives are not mutually exclusive, contradictory, or even dichotomous. At a minimum, then, the choices posed are unnecessary ones.

The basic intuition underlying "nested oppositions" and "co-constitutive categories" has been explained with elegant simplicity by my colleague Professor Jeremy Paul. Using the more modest terminology of a "Two-Fer," Paul argues that such analytic techniques are pervasive throughout the law as well as in everyday reasoning.[158] In his words:

> Suppose you were on a diet and had two rules for yourself. One rule was that you would allow yourself a small dessert after dinner if you had skipped lunch on the same day. The other was that you would allow yourself dessert if you had run your typical four miles that day. It is 8 p.m. and that small bowl of frozen yogurt is quite tempting. You reflect back on your day and recall that you had a dry bagel, nothing on it, and black coffee at noontime. You also cut your run short after 3 ½ miles. May you indulge?[159]

Paul's answer, thankfully perhaps, is that you may. His reasoning, similar to Balkin's nested oppositions and Nice's account of co-constitutive categories, is that "the reason behind both the no-lunch rule and the four mile requirement is the same."[160] Where the background rationale for both rules is the same and the dieter has come close, but not quite succeeded, under each rule, the background rationale may have been satisfied without formalistically satisfying either rule. Have the yogurt, Paul says, because you have satisfied the reason behind the rules even if you have not fully satisfied either of the two rules individually.[161]

If a mode of analysis that oscillates between two conceptual categories—what I have called "thaumatrope analytics"—can be defended when the concepts have a relation of similarity, overlap, or historical dependence, the question remains whether there is such a relationship between the duties of care and loyalty. Are there hidden

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> Moreover, the choices posed are harmful because eventually they impair our ability to understand more comprehensively the complex interactions, including the simultaneous, ongoing, and mutual constitution of law and society.

Nice, *Antinomies*, *supra* note 154, at 1415–16.

158. Jeremy Paul, *Changing the Subject: Cognitive Theory and the Teaching of Law*, 67 BROOK. L. REV. 987, 1011 (2002).

159. *Id.* at 1013–14.

160. *Id.* at 1014.

161. In Professor Paul's words, "the combination of a light lunch and an almost full workout is quite likely to be a greater net contribution to weight loss than either one alone. Even though the rules crafted for the diet are separate, it would be rather stubborn to insist on keeping them that way." *Id.*

similarities between the two traditional fiduciary duties? Do they overlap? Are thaumatrope analytics appropriately applied to them?

2. *Care as Loyalty and Loyalty as Care.* At first glance, the duties of care and loyalty appear quite distinctive. The basic concern under the duty of care is prudence, whereas under the duty of loyalty it is fidelity.[162] The question of prudence depends upon whether the directors have conducted themselves in the management of the corporation as ordinary persons would in the management of their own affairs.[163] The issue of fidelity, by contrast, involves whether the directors have put their own interests ahead of corporate interests and is generally answered by pointing to an unmitigated conflict of interest.[164] These appear as different questions with distinctive lines of inquiry.

A bit of digging beneath these surface differences, however, reveals the richly interconnected roots of the two doctrinal paradigms.[165] Start with the duty of care: directors must conduct themselves as ordinarily prudent persons managing their own affairs. So far so good, but a moment's reflection reveals that an ordinarily prudent *person* becomes an ordinarily prudent *director* only once an element of loyalty is assumed. How do ordinarily prudent directors conduct their affairs? A decision is taken with due care when, from an array of alternatives,[166] the directors employ a procedure to pick the one that best advances *the interests of the corporation*.[167] Now pause for a moment to consider what a funny way this is of conceiving what an ordinarily prudent persons would do *in the conduct of their own affairs*. One might typically assume that an ordinarily prudent person, in evaluating a set of alternatives, picks the one that provides the most personal benefit and the least personal cost. A director's decisionmaking process, however, can be evaluated only by changing the referent from the individual director to the corporation. The question of prudence, in other words, is framed with a tacit element

162. *See supra* Part I.A.

163. *See supra* notes 19–23 and accompanying text.

164. *See supra* note 21 and accompanying text.

165. *See* Johnson, *supra* note 18, at 45–47 (linking care and loyalty on a philosophical basis that is different from, but consistent with, the account in this Part).

166. Delaware law assumes, first and foremost, that directors investigate the terms of a potential transaction and that they act "in a deliberate and knowledgeable way in identifying and exploring alternatives." Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989).

167. MODEL BUS. CORP. ACT, § 8.30(a) (2004).

of loyalty. The question is not, even when one looks only to the decisionmaking process, whether it was designed to maximize the benefit to the individual director (or to the director's family or alma mater or some other noncorporate constituency), but rather whether it was designed to maximize the benefit to the corporation. Until the corporation is substituted for the individual, it is not possible even to ask whether the director has followed a reasonable process in making the decision.[168] The process can only be evaluated once its purpose is understood. The directors must design their decisionmaking process to benefit the corporation, not themselves, but taking this as the goal of the process founds the duty-of-care analysis on an element of the duty of loyalty.

The proximity of the duty of care to the duty of loyalty has prompted several observers to note that in those rare situations in which courts have imposed liability under the duty of care, there is often a *sub rosa* element of loyalty at stake in the transaction.[169] Recognizing this overlap between care and loyalty, an eminent commentator argues:

> Not infrequently, the facts [in a duty-of-care case] suggest that the directors were actually being sued and held liable because of wrongful self-interested conduct—for a violation of the fiduciary duty of loyalty—and the courts' talk about duty of care is simply a way of letting the plaintiffs win without having to prove all the elements of a wrongful conflict of interest transaction.[170]

The duty of care, in other words, contains within itself an assumption that the decisionmaker is motivated by the corporation's business

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168. The information gathered to make a decision to benefit oneself is different from the information gathered for a decision to benefit someone or something else. With different objectives, one asks different sorts of questions. For example, a person designing a transaction to maximize benefits to herself might care about individual income tax consequences, while someone designing a transaction to maximize benefits to the corporation will care only about the corporate level consequences.

169. *See, e.g.*, Allen, Jacobs & Strine, *supra* note 20, at 1290 ("Where courts encountered troubling instances of director action in cases where the directors had no apparent conflict of interest, the courts were inclined to ask loyalty-based questions, such as whether the action constituted a fraud or a 'constructive fraud' against the corporation or its minority shareholders." (citation omitted)); Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1100 (1968) (discussing a case that is apparently a duty-of-care case but noting that "the facts are heavy with the odor of self-dealing").

170. CLARK, *supra* note 21, at 126.

purpose.[171] This tacit subordination of self-interest to corporate interest is generally discussed under the duty of loyalty but without it analyses under the duty of care do not make sense.

Now come to the duty of loyalty. The duty of loyalty turns on the problem of conflict between directors' personal and fiduciary interests. This includes situations in which the directors, rather than maximizing corporate wealth, divert corporate cash flows or investment opportunities to themselves, lavish corporate assets and perquisites on themselves, and cause the corporation to take action to protect their positions or reputations.[172] None of these transactions would raise an eyebrow if they were entered into at arm's length with a third party. The basic problem is that the transaction is not at arm's length and involves, in some way, directors self-dealing through the corporations they control. The intuition that identifies this as an obvious problem is that the corporation, that collection of wealth belonging to people *other than* the director, is likely to get a raw deal in this kind of bargain. To protect these *other* people from getting a bad deal, the law proscribes transactions of this type or, at the very least, permits directors to enter into them only after satisfying procedural safeguards.[173]

Step back for a moment. Worry about the directors' loyalty arises from concern that their disloyalty will result in a poor bargain for the corporation. The concern, in other words, is that conflicted directors will strike bargains for the corporation that ordinarily prudent persons would not strike for themselves. This can be seen most clearly if the non-arm's-length transactions that raise duty-of-loyalty concerns are imagined as arm's-length transactions with third parties. Would an ordinarily prudent person lease a corporate asset to a third party on exceedingly generous terms?[174] Would an ordinarily prudent person lavish compensation on a third party and permit the third

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171. *See generally* E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 BUS. LAW. 2065, 2071–72 (1990) (stating that "even if the business judgment rule is applicable . . . a directorial decision cannot be allowed to stand if it . . . 'cannot be attributed to any rational business purpose'" (quoting *In re* J. P. Stevens & Co. S'holders Litig., 542 A.2d 770, 780–81 n.5 (Del. Ch. 1988)).

172. *See* CLARK, *supra* note 21, at 14 (describing four paradigmatic conflict-of-interest patterns, including basic self-dealing, executive compensation, the taking of corporate or shareholder property, and corporate action with mixed motives).

173. *See supra* note 21 and accompanying text.

174. *See, e.g.*, Lewis v. S. L. & E., Inc., 629 F.2d 764, 768–69 (2d Cir. 1980) (self-dealing in leasing of property).

party to usurp investment opportunities?[175] These are duty-of-loyalty concerns framed as duty-of-care questions. The phrasing is natural because, at its core, the duty of loyalty is just a bet that some situations are likely to lead to careless or imprudent transactions for the corporation, which is to say that the duty of care is a motivating concern for the duty of loyalty. Here again the duties overlap.

Taking this view of the fundamental question of corporate law shows that the duty of care and the duty of loyalty are indeed nested oppositions. They are co-constitutive. Their meanings overlap as both seek to answer the fundamental question of whether a particular decision or a particular transaction is likely to be beneficial to the corporation. Whether the question is confronted from the perspective of the duty of care or of the duty of loyalty is just a difference in approach. To put it another way, the fundamental question underlying both duties really is good faith. Are the directors doing their best in acting for someone else? Arguably, that is the only question in all of corporate law.[176] It is simply asked in different ways in different contexts.[177]

Because both the duty of care and the duty of loyalty get at the same fundamental question, it is possible that there will be situations in which one can answer the fundamental question without checking all of the boxes for liability under either analytic standard. This is the key to the thaumatrope. The sides of the disk might be different, but spinning it reveals a relationship between the two sides. So the picture becomes a man atop a horse or a bird in a cage.

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175. *See, e.g.*, Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 154–55 (Del. 1996) (corporate opportunities).

176. This view has been attributed to Samuel Arsht, a leader in the Delaware bar, who is said to have proposed that the Delaware law be simplified to the following principle: "Directors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith." *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997) (characterizing the statement as "a completely accurate description of Delaware fiduciary duty law").

177. One might argue that the traditional rubrics of care and loyalty had become exceedingly rule-like and rigid and that the good faith thaumatrope merely restores the law to a flexible fiduciary standard that asks the essential question: Are the directors acting to advance corporate welfare? It is, after all, a fair assumption that Chancellor Chandler would not have resorted to good faith if the interplay of the business judgment rule and Disney's 102(b)(7) provision had left room for liability under the duty of care or if the formal independence of the board and Eisner's lack of formal control or domination had left room for liability under the duty of loyalty. Consider, on this point, Professor Roe's observation that "[h]ad *Van Gorkom* survived, one wonders whether boards like Enron's and WorldCom's would have been more alert." Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 633 n.183 (2003).

B. Crisis as Context

Although the good faith thaumatrope may be viewed as a coherent approach to problems at the intersection of conceptually overlapping doctrinal categories, it is an analytic technique that changes the law of fiduciary duty. The duties of care and loyalty have traditionally been viewed as distinct, with separate doctrinal requirements. Now, however, the good faith thaumatrope suggests that there are situations in which the categories may be blended, allowing claims to survive when some but not all of the traditional doctrinal requirements have been met. This blending of substantive issues fundamentally loosens the doctrinal constraints on the judiciary. Looser doctrinal requirements enable judges to intervene more easily in corporate decisionmaking. In other words, by blending the duties of care and loyalty and removing the need to completely satisfy either traditional standard, the good faith thaumatrope moves the frontier on the spectrum of authority and accountability away from board authority and toward judicial accountability.

Seeing the change in this way, one can ask why and, more specifically, why now? The duties of care and loyalty, after all, have long been a part of corporate law. Why then are courts only now recognizing their interrelationship and bringing good faith forward to fill the gap? And, now that they have done so, is there not a risk that the mixing of the traditional standards will overwhelm the distinctions between them and that the longstanding requirements of each will be abandoned in favor of more flexible thaumatrope analytics? More simply, what caused good faith, as I have described it, to appear only now? And what will prevent good faith from overwhelming the traditional doctrines of care and loyalty? The answer to all of these questions lies, I believe, in the interpretive context of the good faith cases.

The context of the good faith cases was corporate scandal and economic downturn.[178] In the wake of the accounting debacles at

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178. *See* Ronald Alsop, *Reputations of Big Companies Tumble in Consumer Survey*, WALL ST. J., Feb. 19, 2004, at B1 (reporting on results of a Harris Interactive/ Reputation Institute poll finding that 75 percent of respondents felt that the image of large corporations was either "not good" or "terrible"); Julie Rawe, *Heroes to Heels*, TIME, June 17, 2002, at 48 (outlining improprieties at Tyco, Enron, Global Crossing, and Adelphia and describing the contribution of these activities to an environment of scandal and distrust). On the coincidence of scandal with economic downturns in provoking reform, see Gregory Mark, *The Legal History of Corporate Scandal: Some Observations on the Ancestry and Significance of the Enron Era*, 35 CONN. L. REV. 1073, 1083 (2003) ("As long as corporate managers make us money we not only overlook

Enron and WorldCom,[179] the looting of Tyco and Adelphia,[180] the allegations of celebrity insider trading,[181] and revelations of conflict of interest in analyst recommendations,[182] the American corporate governance system was thrown into stark relief.[183] Law reviews hosted symposia on reforming American corporate governance[184] and published an unprecedented number of articles on corporate law.[185]

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practices that are a bit edgy, but we also make excuses for them and in many cases celebrate the genius that gave rise to the practices. But when the market goes down, the dark side emerges and so does public outrage—it is the loss of money that triggers the outrage, not the practices themselves.").

179. *See generally* William W. Bratton, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) (analyzing both the immediate and root causes of the accounting fraud and resulting collapse at Enron); Simon Romero & Riva D. Atlas, *Worldcom's Collapse: The Overview*, N.Y. TIMES, July 23, 2002, at C1 (describing the fraud and collapse at Worldcom).

180. *See generally* Peter Grant & Christine Nuzum, *Adelphia Founder and One Son Are Found Guilty*, WALL ST. J., July 9, 2004, at A1 (reporting developments in the criminal trials of Adelphia executives accused of corporate looting); Mark Maremont & Jerry Markon, *Former Tyco Executives Are Charged: New York Prosecutors Say Ex-CEO, Finance Officer Ran "Criminal Enterprise,"* WALL ST. J., Sept. 13, 2002, at A3 (describing allegations that the former CEO and CFO stole more than $170 million from the company, engaged in illegal stock sales and committed accounting fraud to cover up their activities).

181. *See generally* Sean J. Griffith, *Being Martha Stewart—Will Her Celebrity Status End Up Doing Her In?*, CHI. TRIB., Nov. 19, 2002, at A25 (arguing that publicly disclosed facts did not support a charge of insider trading); Matthew Rose & Kara Scannell, *Executives on Trial: Lawyers for Stewart, Bacanovic Vow to Appeal*, WALL ST. J., Mar. 8, 2004, at A1 (describing the conviction of Martha Stewart on obstruction of justice charged in connection with the government's investigation of her insider trading).

182. *See generally* Ann Davis & Susanne Craig, *Analyze This: Research Is Fuzzier Than Ever*, WALL ST. J., Apr. 26, 2004, at C1 (describing and critiquing the outcome of investigations into investment analyst conflicts of interest).

183. In a speech before the National Press Club, Henry Paulson, Chairman and CEO of Goldman Sachs, stated:

> In my lifetime, American business has never been under such scrutiny. To be blunt, much of it is deserved . . . . [T]he Enron debacle and subsequent revelations have revealed major shortcomings in the way some U.S. companies and those charged with their oversight have gone about their business. And it has, without doubt, eroded public trust.

Henry M. Paulson, Jr., Chairman & CEO, Goldman Sachs, Address at the National Press Club, Restoring Investor Confidence: An Agenda for Change (June 5, 2002) *available at* http://www.gs.com/our_firm/media_center/docs/restoring-investor-confidence.pdf.

184. See, for example, Symposium: Enron and its Aftermath, 76 ST. JOHN'S L. REV. 671 (2002); Symposium: Enron: Lessons and Implications, 8 STAN. J.L. BUS. & FIN. 1 (2002); Symposium: Lessons From Enron, How Did Corporate and Securities Law Fail?, 48 VILL. L. REV. 989 (2003); Symposium: On Enron, Worldcom, and Their Aftermath, 27 VT. L. REV. 817 (2003); Symposium: Securities Regulation and Corporate Responsibility, 55 ADMIN. L. REV. 211 (2003); Symposium: Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron, 35 CONN. L. REV. 915 (2003).

185. According to statistics kept by the Corporate Practice Commentator, in 1999 there were 235 articles published on corporate law (The Top 10 Corporate and Securities Articles

Legal academics testified in Washington.[186] Editorials and features on corporate reforms began to appear regularly in the *Wall Street Journal*.[187] As a result, principles that had long formed the background context of corporate governance and corporate law adjudication were suddenly pushed into the foreground and sharply contested, ultimately leading to a presidential promise,[188] federal legislation,[189] and a host of administrative and other rulemaking proposals.[190]

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of 1999 (2003), http://law.vanderbilt.edu/faculty/thompson/1999best.htm (last updated May 23, 2003)), 250 in 2000, (The Top 10 Corporate and Securities Articles of 2000 (2003), http://law.vanderbilt.edu/faculty/thompson/2000best.htm (last updated May 25, 2003)), then 300 in 2001, (The Top 10 Corporate and Securities Articles of 2001 (2003), http://law.vanderbilt.edu/faculty/thompson/2001best.htm (last updated May 25, 2003)), 350 in 2002, (The Top 10 Corporate and Securities Articles of 2002 (2003), http://law.vanderbilt.edu/faculty/thompson/2002best.htm (last updated May 25, 2003)), and more than 425 articles in 2003 and 2004, (E-mail from Robert Thompson, Editor, Corporate Practice Commentator, to author (May 21, 2005) (on file with the *Duke Law Journal*)).

186. *See, e.g.*, Testimony of John C. Coffee, Jr., *Auditors and Analysts: An Analysis of the Evidence and Reform Proposals in Light of the Enron Experience* (U.S. Senate Committee on Banking, Housing and Urban Affairs, March 5, 2002); Testimony of Frank Partnoy, *Enron and the Derivatives World* (U.S. Senate Committee on Governmental Affairs, Jan. 24, 2002); Testimony of John H. Langbein, *What's Wrong With Employer Stock Pension Plans* (U.S. Senate Committee on Governmental Affairs, Jan. 24, 2002). This testimony is collected in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 145, 169, 487 (Nancy B. Rapaport and Bala G. Dharan, eds., 2004).

187. *See, e.g.*, Paul Volcker & Arthur Levitt, Jr., Editorial, *In Defense of Sarbanes-Oxley*, WALL ST. J., June 14, 2004, at A16; John Thain, Editorial, *Sarbanes-Oxley: Is the Price Too High*, WALL ST. J., May 27, 2004, at A20; G. Bennett Stewart III, Editorial, *Debating Sarbanes-Oxley: Why Smart Managers Do Dumb Things*, WALL ST. J., June 2, 2003, at A16; Stan O'Neal, Editorial, *Risky Business*, WALL ST. J., Apr. 24, 2003, at A16; Max Baucus, et al., *A Second Betrayal*, Editorial, WALL ST. J., Mar. 13, 2003, at A12; Arthur Levitt, Jr., Editorial, *The SEC's Repair Job*, WALL ST. J., Feb. 10, 2003, at A14.

188. *See* George W. Bush, President of the U.S., Remarks by the President on Corporate Responsibility (July 9, 2002), at 4, *available at* 2002 WL 1461845 (detailing the president's ten-point Accountability Plan for American Business).

189. *See, e.g.*, Sarbanes-Oxley Act, Pub. Law No. 107-204, 116 Stat. 745 (codified as amended at §§ 7201–02, 7211–19, 7231–34, 7241–46, 7261–66, 78o-6, 78d-3, 1519–20, 1514A, 1348–1350 (2003)).

190. The flurry of SEC rulemaking in the wake of the corporate scandals can be seen in the Commission's online archives of proposed rules and comments. U.S. SEC. & EXCH. COMM'N, PROPOSED RULES AND COMMENTS, *available at* http://www.sec.gov/rules/proposed.shtml (last visited May 19, 2005). Other standards-setting and self-regulatory bodies have also been making rule changes, often at the urging of the SEC. *See, e.g.*, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (2004), *available at* http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_2.pdf; Self-Regulatory Organizations, Order Approving Proposed Rule Changes by the NASD and NYSE, 67 Fed. Reg. 34,968-01 (May 15, 2002) (approving new NASD and NYSE regulations).

I cite this chapter in our recent history not to argue that these reforms were right or wrong, good or bad, but to illustrate the emergence of a national debate about corporate governance issues. As a result of the debate that started in late 2001, Delaware's basic policy choice—a robust vision of the business judgment rule and maximum respect for the principle of board authority—was suddenly less tenable. As the question of board deference versus judicial (or administrative) accountability moved from the background to the foreground of the public agenda, decisionmakers who hewed to older, now openly contested discourses were threatened with serious rhetorical consequences. The rote application of the business judgment rule could make a judicial body appear lax and unresponsive to the national debate or, worse, beholden to managerial interests.

As evidence that this turmoil was felt by the Delaware judiciary, consider two addresses, later published as law review articles, by Chief Justice Veasey. In an address given at the University of Pennsylvania Law School on December 8, 2000 and published in the school's law review in June 2001, Veasey emphasized the principle of judicial nonintervention in board decisionmaking.[191] He drew upon his court's opinion in *Brehm* to illustrate a situation in which the court would not find liability despite its disapproval of the firm's corporate governance practices.[192] Veasey further described how the Council of Institutional Investors lobbied the court to define and adopt a standard of director independence.[193] In spite of finding aspects of the proposal "interesting," Veasey argued that the court had to refuse the Council's request because "it is not the province of the courts to 'legislate' or otherwise impose such rules."[194] Corporate governance standards would not be incorporated into the law of fiduciary duty on the view that "[c]odes of best practices or corporate bylaws . . . not judicial fiat . . . are the appropriate intracorporate vehicle to establish

191. E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—Or Vice Versa?*, 149 U. PA. L. REV. 2179 (2001). Chief Justice Veasey repeated the principle of judicial nonintervention several times. *See, e.g.*, *id.* at 2179–80 ("The private ordering aspect of [judge-made law] must provide ex ante the contractual stockholder protections deemed important, as distinct from ex post judicial rewriting of the contractual framework."); *id.* at 2180 ("[C]ourts should be reluctant to interfere with business decisions and should not create surprises or wild doctrinal swings in their expectations of directorial behavior."); *id.* at 2181 ("Courts do not reach out to monitor boards or to resolve disputes.").

192. *Id.* at 2182.

193. *Id.* at 2182–83.

194. *Id.* at 2183.

this type of protocol."[195] Veasey went on to describe what he saw as good corporate governance practices, but emphasized repeatedly that these were aspirational ideals to be decided upon by individual boards, not legal mandates of the court.[196]

Now fast forward two years to an address given by the same justice at the University of Iowa Law School on March 6, 2003 and printed in the *Journal of Corporation Law* that spring.[197] In this postscandal address, Chief Justice Veasey's tone was considerably more cautionary, emphasizing the responsibilities of directors rather than the restraints on the judiciary, pointing out that "directors must be careful and work hard to understand the facts behind that which they are deciding,"[198] and underscoring that the lack of a bright-line rule about excessive compensation "does not mean there are no limits."[199] The Disney litigation was again mentioned as an example, but this time it was the 2003 chancery court decision, cited with approval and used to illustrate how directors may sometimes go too far.[200] Good faith, Veasey then suggested, might be usefully employed as a doctrinal hook to incorporate the emerging consensus on best corporate governance practices.[201] Stating first that "the utter failure to follow the minimum expectations of the evolving standards of director conduct, the minimum expectations of Sarbanes-Oxley, or the NYSE or NASDAQ Rules . . . might . . . raise a good faith issue,"[202] Veasey later repeated that "it is arguable—but not settled—that the issue of good faith may be measured . . . against the backdrop of Sarbanes-Oxley and the SRO requirements."[203] The differences between the two addresses could hardly be more pronounced. In the winter of 2000–2001, the chief justice lectured on judicial restraint,

195. *Id.*

196. *Id.* at 2188–91. Veasey emphasized: "These are recommended protocols offered as an aspirational matter only. They do not necessarily drive liability considerations, and they do not portend how a case will be decided." *Id.* at 2190. After his list of corporate governance suggestions, he emphasized again: "these suggestions are purely aspirational and not necessarily liability-related." *Id.* at 2191.

197. Veasey, *supra* note 111.

198. *Id.* at 445.

199. *Id.* at 447. In the next breath, he suggested that there may be greater space to review compensation matters: "Judicial review of these kinds of director decisions is not about dollar amounts in isolation." *Id.*

200. *Id.* at 447.

201. *Id.* at 446–48.

202. *Id.* at 446.

203. *Id.* at 448. SROs or "self-regulatory organizations" refer to the stock exchanges, including the NYSE, and national securities associations, such as the NASD.

nonintervention in corporate affairs, and the difference between corporate governance aspirations and corporate law standards. In the spring of 2003, however, he lectured on director responsibilities, available avenues of judicial review of certain board decisions, and the incorporation of corporate governance standards into corporate law fiduciary duties. On the last point, the two lectures could not be more different. Prior to the scandals, Chief Justice Veasey sought to delineate a hard boundary between corporate *governance* and corporate *law*. After the scandals, the chief justice offered a conception of good faith that could import "best practices" in corporate governance into the substantive standards of fiduciary duty. The very issues advocated by the Council of Institutional Investors and other would-be "change entrepreneurs" without much success prior to the corporate crises of late 2001 and 2002 were suddenly taken much more seriously after events pushed them into the foreground and made them the subject of public debate.[204] Veasey's two lectures straddle this shift in the interpretive context of corporate law. The difference in tone and content between them illustrates judicial responsiveness to changes in the interpretive context and Delaware's sensitivity to federal preemption, a concern Veasey candidly admitted after leaving the bench.[205]

As further evidence of the responsiveness of the judiciary to shifts in the corporate law discourse, consider another postscandal article by two sitting members of the chancery court, Chancellor Chandler and Vice Chancellor Strine, that addressed the shift in

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204. *See generally* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (describing the passage of the Sarbanes-Oxley Act as the result of political tumult when "policy entrepreneurs" were suddenly influential). For a discussion of "change entrepreneurs" and their role in changing the law, see Lawrence Lessig, *Erie-Effects of Volume 110: An Essay on Context in Interpretive Theory*, 110 HARV. L. REV. 1785, 1805, 1807 (1997) (describing both Catherine MacKinnon and Oliver Wendell Holmes as "change entrepreneurs"). In the corporate law context, academic commentators have occasionally served as would-be change entrepreneurs in disparaging the role of Delaware and arguing for federalization of corporate law. Most famously, Professor Cary characterized Delaware as a destructive "pygmy" in calling for federal incorporation. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 701 (1974) (arguing for an "escape from the present predicament in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy").

205. E. Norman Veasey, *Musings from the Center of the Corporate Universe*, 7 DEL. L. REV. 163, 163 (2004) ("[V]igilance is needed because Delaware's corporate preeminence is more vulnerable to a pervasive federal encroachment now than it was before [the scandals].").

interpretive context.[206] Expressly recognizing the "tumult" in American corporate governance,[207] Chandler and Strine described the post-Enron reforms undertaken by the federal government as "a relatively aggressive move by the federal government and the Exchanges into the realm of board decision making and composition, an area where, traditionally, the states have been predominant."[208] The encroachment of highly specific federal rules on what had been more flexible, "principles-based" state law,[209] Strine and Chandler argue, may be due in part to the failure of Delaware law to respond with sufficient speed to changes in business practices, specifically questions of executive compensation:

> [I]t can be argued fairly that Delaware's common law did not react quickly or aggressively enough to changes in compensation practices during the last two decades, changes that were so substantial quantitatively that they required a qualitatively more intense form of judicial review, through, for example, a reinvigorated application of the concept of waste. In the past, the Delaware courts had generally taken a hands-off approach to executive compensation based on the assumption that this was a matter of business judgment, which could also be factored into the electorate's voting decisions.[210]

The authors then suggested that states' inattentiveness to corporate governance problems could be corrected through greater sensitivity going forward:

> The 2002 Reforms contain measures reflecting a policy judgment that the constraints of state law on executive compensation are, in

206. William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003).

207. This description appears in the first sentence of the article. *Id.* at 953.

208. *Id.* at 959. Later the authors repeat the charge, arguing that:

> The most striking feature of the 2002 Reforms is a pervasive and general one: the extent to which they can be seen as a shadow corporation law that requires public company boards to comply with a very specific set of procedural prescriptions. This aspect of the Reforms represents a departure from the general spheres in which the three principle sources of corporate governance in the American system have operated.

Id. at 973 (footnotes omitted).

209. *Id.* at 979 ("From the perspective of Delaware . . . the 2002 Reforms are somewhat problematic because they supplement our principles-based, substantive corporation laws with a variety of specific requirements that are not part of any overall system of corporate governance." (footnote omitted)).

210. *Id.* at 1001.

> themselves, inadequate to protect investors against abusive compensation practices. State law policymakers—including judges shaping the common law—will undoubtedly be responsive to this expression of concern and may use it as an opportunity to reflect more deeply on whether their own policies need adaptation to better protect stockholders.[211]

Strine and Chandler are thus offering a prescription on how states can avoid further federal encroachment: state corporate law courts should interpret legal standards in ways that permit them to respond flexibly to shifts in the interpretive context of corporate law.

The chancery court's 2003 opinion in *Disney* can be read as an example of this prescription in action. The Disney litigation, like Chief Justice Veasey's two speeches, spans the shift in corporate law discourse resulting from the arrival of the corporate governance crisis in 2001 and 2002. The deferential tone of the supreme court's opinion in 2000 reflects the last days of the bull market of the late 1990s, when a promarket, antiregulatory approach ruled the day. With the decline of the market and the arrival of several highly public scandals the following year, the world (or at least as much of it as matters to corporate law policymakers) began to change. Public outrage emerged as a real constraint,[212] and the threat of federal intervention in corporate governance reappeared.[213] Policy mavens actively debated what ought to be done "to prevent future Enrons,"[214] and people again began to discuss whether control of the nation's corporate governance system ought to be wrested away from the tiny state of Delaware.[215] The hitherto backgrounded discourse of

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211. *Id.*

212. *See* Lucien Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 786–88 (2002) (describing "outrage" as a cost of and constraint on high executive compensation). Professor Roe has demonstrated that the force of "outrage" varies across cultures and therefore exerts a different quality of constraint in, for example, the United States and France. Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law*, 69 U. CHI. L. REV. 1251, 1256–62 (2002). I would add only that the force of outrage can vary within a single country at different cultural moments—for example, in times of calm and times of crisis.

213. Professor Roe explains the tendency of the federal government to regulate corporate governance in response to scandal by analogy to a paradigm from the political science literature. Congress regulates corporate governance with a fire alarm approach, rather than a policy patrol approach: "[T]he fire alarm is the scandal or bad economic performance." Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2530 (2005).

214. Harvey L. Pitt, *How to Prevent Future Enrons*, WALL ST. J., Dec. 11, 2001, at A18.

215. George Mellon, Editorial, *Can Outside Directors Ride Herd on CEOs?*, WALL ST. J., July 16, 2002, at A17 (describing "yet another effort building to federalize corporate law").

authority versus accountability was brought into the foreground, and the rhetorical stakes of appearing lax or unresponsive were raised.[216] By the time it heard *Disney* again in 2003, the Delaware judiciary had internalized this shift in the corporate law discourse.[217] More directly, *Disney* was a case about compensation, the area in which Chancellor Chandler and Vice Chancellor Strine argued that Delaware had been least responsive,[218] and an area that has recently generated significant attention and proposals for reform in the legal and financial literature.[219] In this environment, the judiciary decided that it could no longer remain passive, and the good faith thaumatrope was born.

The jurisprudence of good faith is not the only line of recent Delaware case law to interpret existing corporate law doctrine in a way that increases judicial flexibility and, therefore, board accountability to courts.[220] Of all the postscandal decisions empowering the judiciary vis-à-vis boards, however, the emergence of good faith in *Disney* has the most far-reaching potential. By loosening the doctrinal standards of both care and loyalty to create a new avenue of judicial intervention in corporate governance, the good faith thaumatrope promises to increase the judicial scrutiny of board conduct. This raises the question, discussed in the next Part, of whether good faith will shift the business judgment rule and realign the balance of authority and accountability.

216. It is worth noting that 2001–2002 is not the first time this has happened. Professor Roe has documented several instances, notably including the passage of the Federal Securities Laws in the 1930s, when the "populist and progressive goal of superseding lax state corporation laws with more stringent federal standards" was nearly realized. *See* Roe, *supra* note 177, at 602–04 (describing various efforts to end Delaware's primacy in corporate law).

217. *See* Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1202 (2004) (arguing that extrajudicial pronouncements by Chief Justice Veasey and Vice Chancellor Strine signal that "Delaware judges are fully aware of corporate misconduct and its pernicious effects on our corporate law system, and that Delaware judges intend to creatively deploy their arsenal of doctrinal concepts to reinvigorate their assessment of corporate decision-makers").

218. *See supra* note 210 and accompanying text.

219. *See generally* BEBCHUK & FRIED, *supra* note 99; Bebchuk et al., *supra* note 212.

220. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 930 (Del. 2003) (rejecting the established change-of-control paradigm as applied to deal protection provisions); *In re* eBay, Inc. S'holders Litig., No. C.A. 19988-NC, 2004 WL 253521, at *4 (Del. Ch. Feb. 11, 2004) (applying the corporate opportunities doctrine to the practice of "spinning"—that is, the preferential allocation of hot IPO shares); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 937–38 (Del. Ch. 2003) (loosening the traditional tests of director independence in the derivative suit context by accepting that noneconomic ties without any of the traditional indicia of "domination and control" may draw a director's independence into doubt).

III. FLEXIBILITY AND CONSTRAINT: A THEORY OF CORPORATE LAW RHETORIC

Whether doctrinal flexibility is good or bad for corporate law generally—a point on which there is ample debate[221]—it certainly empowers courts vis-à-vis boards. The real question for an analysis of

221. Flexible law is indeterminate, which commentators argue imposes costs on the corporation while conferring benefits on corporate lawyers and the state of incorporation. *See, e.g.*, Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 601–02 (2002) (summarizing the costs of indeterminacy arguments); Lucian Arye Bebchuk & Louis Kaplow, *Optimal Sanctions When Individuals Are Imperfectly Informed About the Probability of Apprehension*, 21 J. LEGAL STUD. 365, 367 (1992) (arguing that indeterminate sanctions overdeter); Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 108 (1990) (linking indeterminacy to the public choice account of corporate law); Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1208 (2001) (arguing that indeterminacy enables Delaware to engage in price discrimination); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1946 (1998) (arguing that indeterminacy makes it difficult for other states to copy the Delaware package); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 515 (1987) (arguing that indeterminate corporate law favors the corporate bar); A. Mitchell Polinsky & Steven Shavell, *On the Disutility and Discounting of Imprisonment and the Theory of Deterrence*, 28 J. LEGAL STUD. 1, 4–7 (1999) (discussing the problem of overdeterrence in the context of uncertainty). On the other hand, flexible law may encourage innovative transactions and prevent well-counseled clients from evading the rationale behind the rule. *See, e.g.*, Allen, *supra* note 27, at 898 ("[C]ertainty . . . creates the risk that . . . corporate management . . . might deploy such well-defined rules cleverly (and technically correctly), but with the purpose in mind not to advance long-term interests of investors, but to pursue some different purpose."); Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1403–08 (1992) (book review) (analyzing the role of "muddy defaults" in triggering optimal bargains); Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1095 (1995) (arguing that where each party has a probable claim in the entitlement, muddy defaults facilitate bargaining when parties cannot predict ex ante which of them will win in litigation); Tom Baker et al., *The Virtues of Uncertainty in Law: An Experimental Approach*, 89 IOWA L. REV. 443, 446 (2004) (showing, through behavioral experimentation, that deterrence goals can be achieved by increasing uncertainty—i.e., volatility—without increasing expected sanctions); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1081 (2000) ("Delaware's indeterminate corporate law . . . induces negotiation and removes some incentives for strategic behavior. . . . Delaware's lawmaking is uniquely structured to maximize responsiveness to changing business developments. Delaware reduces the potential for rent seeking in connection with the lawmaking process."); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 604 (1988) (describing the importance of oscillation between muddy and crystalline rules); Leo E. Strine, *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahn & Kamar's Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1257, 1259 (2001) (stating that "much of Delaware corporate law's indeterminacy and litigation intensiveness is an unavoidable consequence of the flexibility of the Delaware Model, which leaves room for economically useful innovation and creativity"). It is tempting to conclude that this debate about flexibility and indeterminacy is itself indeterminate.

corporate law jurisprudence, however, is the relative freedom or constraint of the judiciary in *using* that flexibility. If the judiciary is largely unconstrained by doctrine, is it also unconstrained in injecting itself into board decisionmaking? Or are there other sources of constraint, apart from corporate law doctrine, that limit the ability of the courts to realign the authority/accountability balance? If the flexibility of corporate law doctrine empowers judges, what weakens or threatens them?

A. *Judicial Power and Judicial Constraint*

The authority of corporate law judges in Delaware is contingent upon having jurisdiction—in the literal sense of *speaking law*—over the nation's most important corporations. This jurisdiction is subject to two pervasive threats: corporate migration and federal preemption. If enough corporations leave Delaware, the law that Delaware judges speak will have fewer listeners, thus reducing the judiciary's ability to make national corporate law. And if the federal government passes legislation or regulations moving corporate law, in whole or in part, into the federal sphere, the authority of the Delaware judiciary over those matters is effectively preempted.[222] Building upon a classic political science model of judicial behavior, in which judges act to protect their authority,[223] one might expect judges to respond to these pressures in the only way they know how—through the rhetoric of the judicial opinion. This forms the basis of a model of corporate law rhetoric. Rhetorical devices such as the good faith thaumatrope are designed to manage threats to judicial authority. This Section elaborates on these fundamental undercurrents of Delaware law,

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222. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478–79 (1977) (respecting the internal affairs doctrine by denying the federal judiciary the authority to create and impose fiduciary duties inconsistent with state law, but noting that authority to override state corporate law rests with Congress).

223. *See, e.g.*, WALTER F. MURPHY, ELEMENTS OF JUDICIAL STRATEGY 2 (1964) (seminal study of judicial power "to shape, through the peculiar kinds of authority and discretion inherent in [the] office, the development of a particular public policy or set of public policies"). This is not to accuse judges of base motivations. Many judges may in fact believe that their rulings are on the whole beneficial to society. In protecting this benefit to society, then, the judge will also be motivated to maximize the scope of her rulings and protect them from reversal—that is, to protect her own authority. Of course, judges may derive other benefits from their authority, including reputational rewards and, for Delaware corporate law judges, public regard as leading economic policymakers. But these motivations need not dominate the desire to do good, which the judiciary advances, at least in part, by protecting its own authority. *See, e.g.*, Veasey, *supra* note 205, at 163 (arguing that preserving the Delaware franchise is in the best interest of the general public).

focusing on the ways in which they shape (and are shaped by) corporate law rhetoric.

Corporate migration—the possibility that corporations will leave Delaware for another state of incorporation—poses a direct threat to the state fisc. Incorporations and related taxes and fees are a significant source of revenue for the state of Delaware,[224] the loss of which would have serious budgetary consequences for the state and equally serious political repercussions for its elected officials. Most obviously, Delaware legislators would be forced either to reduce spending or to increase taxation to make up for any shortfall from corporate migration, neither of which would be particularly popular with the electorate. It is therefore sensible to expect legislators, because they suffer the direct effects of corporate migration, to remain highly sensitive to corporate suggestions (and threats) that they may leave the state as a result of inhospitable law.[225] However, because Delaware judges are appointed, not elected,[226] and therefore not directly answerable to those whose taxes are increased or whose services are reduced, they may have less at stake. That the impact of corporate migration on the judiciary is indirect, however, does not mean that there is no impact. Judges are, after all, appointed by elected officials, who can be expected to screen candidates for their sensitivity to these issues at appointment and to retaliate at reappointment should a judge show himself or herself to be insensitive.[227] More directly, the legislature has shown itself willing to

224. *See, e.g.*, Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 690–92, 724–25 (2002) (detailing revenues that incorporations and related taxes and fees bring Delaware and arguing that Delaware exerts monopoly power in this market).

225. These threats may be made by corporate lobbies, such as the business roundtable or corporate advisors, often packaged as law firm memoranda to clients. For example, the preeminent law firm of Wachtell, Lipton, Rosen & Katz circulated several such memoranda at the height of the takeover controversy, threatening to "leav[e] Delaware for a more hospitable state of incorporation" and suggesting that "[p]erhaps it is time to migrate out of Delaware." *See* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1959 & n.95 (1991) (quoting these memoranda).

226. *See* Randy J. Holland & David A. Skeel, Jr., *Deciding Cases Without Controversy*, 5 DEL. L. REV. 115, 121–23 (2002) (describing the appointment process).

227. Delaware is lauded for its largely apolitical system of appointments. *See id.* (noting, in particular, that political party affiliations must be equally represented on the courts and that members of the bar, legislative committee members, and the governor all play a significant role in the selection process). However, the process is apolitical only in the sense of ensuring equal representation of Democrats and Republicans. A candidate whose political views favored abolition of the business judgment rule would probably not fare well in the appointments process.

reverse the substance of judicial decisions in response to the threat of corporate migration—*Van Gorkom* is the starkest example.[228] To avoid reversal—a legislative incursion into judicial authority—judges may craft opinions to limit the risk of corporate migration, thus internalizing, albeit for indirect reasons, the constraining effect of this threat. Finally, although a few reincorporations out of state do not represent a serious threat to the authority of the Delaware judiciary, large scale corporate migration poses a direct threat to Delaware courts as national corporate lawmakers. The judiciary therefore has a direct incentive to avoid opinions that would unleash a flood of corporate migration.[229]

By contrast, whether it is comprehensive[230] or piecemeal,[231] federal preemption reduces the number of issues over which Delaware judges effectively speak law and thus poses a direct threat to judicial authority.[232] The legislature, in a reversal of institutional incentives, may be less sensitive to the threat of federal preemption

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228. *See supra* Part I.A. (discussing the legislative reversal of *Van Gorkom*).

229. This feature may explain the tendency of Delaware courts to announce narrow fact-specific rulings rather than broadly applicable rules that may prompt many similarly situated firms to leave the state.

230. Federal preemption would be comprehensive only with a system of federal incorporation with jurisdiction in federal courts. *See, e.g.*, RALPH NADER ET AL., CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976); William L. Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974); Cary, *supra* note 204; Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976). Full-scale federal incorporation has not been seriously advocated since the late 1970s, although piecemeal preemption has been a nearly constant threat. *See infra* note 231 and accompanying text.

231. Piecemeal preemption has taken place through the enactment of federal statutes, such as the Sarbanes-Oxley Act, touching on matters of corporate governance. *See* Pub. Law No. 107-204, 116 Stat. 745 (codified as amended 15 U.S.C. §§ 7201–7266 (2003) (federalizing several substantive aspects of corporate governance regulation that had previously been left to state law, including rules requiring independent audit committees, barring accounting firms from providing both audit and nonaudit services, barring corporate loans to executive officers, requiring executive certification of financial statements, and mandating forfeiture of CEO and CFO incentive compensation in the event of an earnings restatement). Piecemeal preemption also takes place through SEC rulemaking that supplants state law, such as the "all-holders" rule after *Unocal*, which Professor Roe describes as a "Sharp Federal Incursion" on state corporate law. *See* SEC Rule 13e-4, 17 C.F.R. § 240.13e-4 (2003); SEC Rule 14d-10, 17 C.F.R. § 240.14d-10 (2003) (reversing the narrow holding of *Unocal*, which allowed selective self-tenders, with a rule requiring tender offers to be made to all holders); Roe, *supra* note 177, at 616, 619.

232. *See generally* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005) (describing the longstanding ambition of the SEC to regulate corporate governance).

given that, short of a comprehensive regime of federal incorporation—not presently a serious prospect—federal law does not offer corporations an alternative to organizing in states or to paying state franchise fees,[233] and as long as Delaware's franchise fees are safe, state legislators are less likely to be concerned. But, because the state courts lose some measure of their authority with every federal incursion into what would otherwise be the domain of state law, an authority-maximizing judiciary will remain highly sensitive to the threat of federal preemption. Indeed, these concerns predominate in Chancellor Chandler and Vice Chancellor Strine's recent call for greater judicial responsiveness to precisely those issues that are most likely to pique federal interest.[234]

In order to preserve its place in corporate lawmaking amid these threats to its authority, the judiciary must respond, and the only way that it can respond is through the rhetoric of the judicial opinion. As a speech act designed to accomplish some end,[235] the essential function of rhetoric in corporate law jurisprudence is thus revealed as the protection of judicial authority from the twin threats of corporate migration and federal preemption. Rhetorical devices, such as the good faith thaumatrope, force open rigid doctrines to permit the judiciary greater flexibility in responding to these threats, or alternately, countervailing devices, such as the business judgment rule, allow courts to promise less intervention. The dynamic interplay of these rhetorical devices in different interpretive climates is what gives corporate law jurisprudence its basic shape: When federal preemption looms large, as in periods of scandal and crisis,[236] corporate law judges manipulate doctrine to increase management accountability in hopes of quieting calls for federal intervention. When the risk of federal intervention recedes, however, the corporate lobby may reassert itself, pressing the legislature and, indirectly, the judiciary to return to a position of board deference. This motion, forward and back, along the authority/accountability spectrum as a function, not of law, but of the extralegal pressures exerted upon the

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233. Short of a comprehensive regime of federal incorporation, federal corporate law could threaten Delaware revenues if it preempted so much of the scope of corporate law that it made the state of incorporation essentially irrelevant. The incremental steps toward federalization of corporate law, however, seem well short of this point.

234. *See supra* notes 206–11 and accompanying text.

235. *See supra* note 15 and accompanying text.

236. *See* Karmel, *supra* note 232, at 80 (noting that the SEC "from time to time, has exploited scandals in the public securities markets" to achieve the goal of regulating corporate governance).

judiciary, is the essence of corporate law jurisprudence. The rhetorical devices, whether "good faith" or "intermediate scrutiny" or "business judgment," are the tools that the judiciary employs to accomplish this motion.

The remainder of this Part applies this theoretical model to corporate law jurisprudence, first illustrating the pattern of regulation and retreat in a brief review of corporate law history, then arguing that the same forces of doctrinal expansion and contraction are likely to play a central role in the evolution of the jurisprudence of good faith.

B. Expansion and Contraction

Corporate law doctrines expand and contract as a result of pressures on the judiciary. Board accountability increases in periods of scandal and crisis, only to decrease again as the crisis recedes. This is a recurring pattern in corporate law, documented recently by Professor Roe.[237] Of the various episodes of expansion and contraction,[238] the one that may be most illustrative of the likely evolution of good faith is the one that began with the "watershed" year of 1985.[239]

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237. *See* Roe, *supra* note 177, at 641–43 (illustrating this pattern over a forty-year survey of Delaware corporate law and finding that "[s]tate competition's effect on Delaware seem[ed] comparatively subdued in the 1970s and early 1980s" when "the federal threat seem[ed] to influence Delaware more," but then "in the late 1980s, [when] the federal players [left] the scene [,]" promanagement decisionmaking reemerged and continued throughout the 1990s, until the reemergence of federal pressure in "with the Enron-era scandals").

238. A story similar to the account of takeover jurisprudence argued in this Section can be told, for example, about the 1977 Delaware Supreme Court decision in *Singer v. Magnavox Co.*, 380 A.2d 969, 979 (Del. 1977), in which the court essentially held that a board must have a business purpose for a cash-out merger, only to be reversed, in 1983, by *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983), which held that boards were under no such requirement and merely had to meet loose procedural standards in such transactions. The *Singer* decision arose at a time when the federalization of corporate law was actively debated, and the decision arguably caused the SEC to curb the more restrictive aspects of its rulemaking on cash-out mergers. *Compare* Securities Exchange Act Release No. 14185 (Nov. 17, 1977) (proposing a rule that included a fairness test as well as disclosure requirements in such transactions) *with* Securities Exchange Act Release Nos. 6100, 6109 (adopting a final rule without a fairness test). Professor Roe documents a number of such incidents at "recurring breakdowns" in American corporate governance. Mark J. Roe, *The Inevitable Instability of American Corporate Governance*, *in* RESTORING TRUST IN AMERICAN BUSINESS 9, 13 (Jay W. Lorsch et al. eds., 2005) (describing recurring breakdowns and various legal and institutional responses).

239. *See* E. Norman Veasey, *The Roles of the Delaware Courts in Merger and Acquisition Litigation*, 26 DEL. J. CORP. L. 849, 849 (2001) ("The year 1985 was a watershed in Delaware corporate jurisprudence.") Chief Justice Veasey continued, in unusually florid prose, to emphasize the tensions confronting the Delaware judiciary as they decided these cases:

1. *The Watershed Year.* The corporate law jurisprudence that emerged in Delaware in 1985 was, like the recent post-Enron decisions, a product of crisis and controversy. The late 1970s and early 1980s were a time of general economic malaise, with high inflation, high interest rates, and ultimately, recession and unemployment.[240] American companies seemed to be losing ground to Japanese rivals, with observers predicting dire consequences for the national economy. At the same time, hostile takeover activity exploded.[241]

Takeover battles became public events, spilling over from boardrooms to the mainstream media, legislatures, and courtrooms.[242] The financiers who engineered these acquisitions were vilified for fiddling while Rome fell—getting rich while the deals they made resulted in plant closures and layoffs, endangering the national economy and leaving ordinary workers without jobs.[243] If the public was largely opposed to takeovers, corporate managers were even more so,[244] thus presenting state politicians with a unique opportunity to unite the interests of wealthy campaign-contributing corporate

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> At the height of the takeover era the Delaware Court of Chancery and the Supreme Court found themselves trying to navigate through a ferocious tempest of mergers and acquisitions. The high velocity winds of the economics of these transactions were swirling around time-honored jurisprudential concepts of fiduciary duty of directors. Change was in the air! The stability of the anchor chain of the business judgment rule was severely strained.

Id.

240. JERRY W. MARKHAM, 3 A FINANCIAL HISTORY OF THE UNITED STATES 70–73 (2002) (describing the economic environment of the late 1970s and early 1980s as a time of rapidly increasing inflation and shocks in the world oil market resulting in action by the Federal Reserve Board to constrain inflation by increasing interest rates, leading to a recession, with unemployment reaching 10.7 percent in 1982).

241. *See* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 873–74 (2002) (providing statistics on the takeover wave of the early- and mid-1980s and noting that "[a] substantial portion of the deals during this period were hostile takeovers or defensive transactions undertaken in response to hostile takeovers").

242. Takeover battles generated a new vocabulary, involving "junk bonds," "raiders," "white knights," "crown jewels," "shark repellants," "poison pills," and "scorched earth defenses." *See, e.g.*, KNIGHTS, RAIDERS, AND TARGETS 3 n.1 (John C. Coffee, Jr. et al. eds., 1988) (translating the new lexicon). The obvious connotative value of these labels provides fairly clear guidance on the identity, in popular opinion, of the good guys and the bad guys.

243. *See, e.g.*, WALL STREET (Twentieth Century Fox 1987) (film personifying this Manichean view of takeovers in the seductively evil character of Gordon Gekko).

244. *See, e.g.*, *Who Likes Takeovers?*, FORBES, May 18, 1987, at 12–16 (describing a 1987 Harris public opinion poll showing that 58 percent of respondents viewed takeovers as harmful, whereas only 8 percent thought them beneficial).

managers with rank-and-file voters.[245] On the other side, however, were the academics and shareholder-rights advocates whose arguments resonated not in the mainstream media,[246] but in Washington where, through the early 1980s, the federal government adopted a protakeover attitude.[247]

In the thick of this controversy, the Delaware courts handed down a monumental set of fiduciary duty decisions. In a single year, the Delaware Supreme Court (1) reset the standard of gross negligence in *Smith v. Van Gorkom*,[248] (2) restricted the ability of an incumbent board of directors to resist an unwanted takeover offer in *Unocal Corp. v. Mesa Petroleum Co.*,[249] and (3) set limits on when a target board could favor one buyer over another in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[250] All three of these decisions changed the law of fiduciary duty by modifying or inventing doctrines that empowered the judiciary, shifting the authority/accountability balance in favor of greater board accountability to courts.

This Article has already discussed the shock of the *Van Gorkom* decision.[251] In the first of its watershed decisions, the Delaware

245. The outcome of these unified interests was antitakeover legislation. *See* Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE, 321, 331 (Margaret M. Blair ed., 1993) ("[L]egislators who do managers' bidding do not have to fear reprisal from voters. It is the opposite. Politicians who bash Wall Street and thwart takeovers are rewarded by the average voter."); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 (1988) (describing the adoption of antitakeover statutes by state legislatures and explaining that "[t]he statutes are typically enacted rapidly, with virtually unanimous support and little public notice, let alone discussion. They are frequently pushed through the legislature at the behest of a major local corporation that is the target of a hostile bid or apprehensive that it will become a target" (footnotes omitted)).

246. Academics have argued, then and now, that takeover defenses obstruct the efficient transfer of resources, impede the capital market discipline of managers, and hinder the ability of shareholders to sell their interest at a premium. *See, e.g.*, Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 975, 983–84 (2002) (arguing that boards should not be able to block noncoercive bids); Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1194–97 (1981) (arguing for board passivity in the face of takeovers); Bengt Holstrom & Steven Kaplan, *Corporate Governance, and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121 (2001) (describing the arguments of takeover proponents); Michael Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS, AND TARGETS, *supra* note 242, at 314, 329–37 (describing positive economic effects of bust-up takeovers).

247. *See* Roe, *supra* note 177, at 16 ("At the time, powerful policymakers in Washington favored takeovers.").

248. 488 A.2d 858, 873 (Del. 1985).

249. 493 A.2d 946, 955 (Del. 1985).

250. 506 A.2d 173, 184–85 (Del. 1985).

251. *See supra* Part I.A.

Supreme Court changed the law not by creating a new standard, but by applying an old one, gross negligence, in an unprecedented manner. Because a looser interpretation of gross negligence means more opportunities to hold directors accountable for their actions, the majority's interpretation of gross negligence moved the barrier between board authority and judicial accountability—in this case, the business judgment rule itself—to permit greater judicial intervention in corporate governance.

Similarly, *Unocal* promised to increase the scope of judicial intervention in takeovers by giving courts a say in which takeover defenses were appropriate and which were not.[252] Prior to *Unocal*, courts had treated board actions in the takeover context with roughly the same deference as board decisionmaking in any other context. As long as the target board could claim some benefit to the corporation from resistance, takeover defenses were permitted under the "business purpose" standard,[253] which essentially applied the business judgment rule to takeover defense.[254] In *Unocal*, however, the court expressly recognized the possibility of an entrenchment motivation underlying a takeover defense and therefore refused to grant simple deference to the board.[255] Instead, the court created a new "intermediate standard" between the deferential business judgment

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252. *Unocal*, 493 A.2d at 955.

253. *See* Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964) ("[I]f the [board's takeover defense was] motivated by a sincere belief that the [takeover defense] was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course."). Although aware of the potential entrenchment motivation for takeover resistance, courts did not allow this theoretical possibility to overcome the principle of board authority. *See, e.g.*, Bennet v. Propp, 187 A.2d 405, 409 (Del. 1962) (finding a conflict of interest on the part of a board that used corporate funds to repurchase in order to protect its own control). The apparent willingness of the *Bennett* court to acknowledge a target board's conflict of interest in the takeover context was qualified in later opinions. *See e.g.*, Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980) (upholding the trial court's jury instruction that the business judgment rule "is rebutted only where a director's sole or primary purpose for adopting a course of action or refusing to adopt another is to retain control").

254. *See* Pogostin v. Rice, 480 A.2d 619, 624, 627 (Del. 1984) (holding that the "bedrock" principle of the business judgment rule was "equally applicable here in the context of a takeover").

255. The court stated:

> Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.

Unocal, 493 A.2d at 954.

rule and strict "entire fairness" review,[256] thus increasing the accountability of boards to courts in the takeover context.[257]

Like *Unocal*, the *Revlon* decision emerged from a takeover battle.[258] After a series of maneuvers designed to frustrate Ron Perelman's hostile bid, the Revlon board ultimately negotiated a sale of the company to a preferred buyer at a price lower than Perelman's bid.[259] This, the Delaware Supreme Court held, went too far.[260] In so holding, the court created so-called "*Revlon* duties,"[261] a special case

256. *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review*, 44 BUS. LAW. 247, 252–60 (1989) (reviewing the operation and effect of *Unocal* scrutiny). Like the recent jurisprudence of good faith, intermediate scrutiny is constructed on a rhetoric that mixes categories in developing a new basis for judicial intervention in board decisionmaking. Intermediate scrutiny occupies the middle space between the entire fairness standard and the business judgment rule.

257. The new standard ultimately tested the proportionality between the threat to target shareholders and the target board's response, requiring that the response have an "element of balance" and be "reasonable in relation to the threat posed." *Unocal*, 493 A.2d at 955. The threat in *Unocal* itself was Mesa's two tier-tender offer, which promised shareholders who tendered a better mix of consideration (primarily cash) than shareholders who chose not to tender (junk bonds), thus pressuring shareholders who wished to avoid the back-end consideration to tender regardless of whether they considered the transaction optimal. Unocal's response was a tender for its own shares. In evaluating proportionality, however, the court failed to analyze the coerciveness of Unocal's tender offer, which replicated the essential structure of the Mesa offer. Those who did not or could not tender their shares in the offer would continue to be shareholders of Unocal, but after the massive front-end payout, their shares would be worth far less than the front-end offer of seventy-two dollars. *See* Michael C. Jensen, *When Unocal Won over Pickens, Shareholders and Society Lost*, FINANCIER, Nov. 1985, at 50, 51 (finding that the market value of remaining Unocal shares was thirty-five dollars). Worse still, the effective back end of the Unocal offer, unlike the Mesa offer, created no appraisal rights for recipients because they simply *remained* Unocal shareholders. *See* DEL. CODE ANN. tit. 8, § 262 (2001) (establishing appraisal rights for shareholders who exchange their shares for consideration, not for those who remain holders). In this way, the Unocal offer had exactly the same structure as the Mesa offer and was, if anything, more coercive, yet the court deemed it to be a proportional response to the Mesa threat. This hidden deference, under the surface of *Unocal* itself, did not become clear until later. *See infra* notes 263–72 and accompanying text.

258. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 173 (Del. 1985).

259. As a "white knight," Forstmann agreed to buy Revlon and let incumbent management run it, provided that management sold off some of the company's business divisions and remained capable of servicing its debt obligations. *Id.* at 178–79.

260. Because either transaction would result in the breakup of the corporation, the board was required to get the most it could for its shareholders. The court stated:

> [I]t became apparent to all that the break-up of the company was inevitable. . . . The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. . . . The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

Id. at 182.

261. Ivanhoe Partners v. Newmont Mining Corp., 533 A.2d 585, 603 (Del. Ch. 1987).

in which the deference of the business judgment rule would not apply. Like the invention of intermediate scrutiny, the creation of *Revlon* duties shifted the frontier of the authority/accountability spectrum in favor of greater board accountability to courts.

In each of these cases, Delaware courts responded to crisis by creating a means for greater judicial intervention. *Van Gorkom*'s revision of gross negligence, *Unocal*'s invention of intermediate scrutiny, and the creation of *Revlon* duties each increased the ability of the judiciary to intervene in board decisionmaking. All three of the decisions, in other words, reacted to the climate of controversy by shifting the balance of power from board authority in the direction of greater judicial accountability.

2. *The Waters Recede*. This shift in the authority/accountability balance, however, did not last. The ultimate impact of each of the watershed decisions has been either eliminated or substantially reduced. *Van Gorkom* has been reversed by the legislature, *Unocal* slowly eroded through lax application, *Revlon* expressly narrowed. This retreat from doctrinal innovation is as much a part of corporate law as the innovations themselves, with important implications for the development of the jurisprudence of good faith.

As described above, the supreme court's attempted rewrite of the business judgment rule in *Van Gorkom* did not survive the legislature.[262] With the adoption of § 102(b)(7) of the Delaware General Corporation Law, the management lobby won an amendment effectively overturning the decision.[263] This episode fits nicely with the standard political economy account of Delaware corporate law: legislators are sensitive to changes in the law that might cause corporations to leave and, when they can be persuaded that the courts have made such changes, are apt to undo them.[264]

Although the retreat from intermediate scrutiny was more gradual, there is a sense in which *Unocal* did not last much longer

262. *See supra* Part I.A.

263. The threat to leave Delaware may have been especially credible after *Van Gorkom* because another state, Indiana, had acted first in passing a statute to shield its directors from liability under the duty of care. *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, *in* TORT LAW AND THE PUBLIC INTEREST: COMPETITION, INNOVATION, AND CONSUMER WELFARE 151, 157 (Peter H. Schuck ed., 1991) (pointing out that Indiana's statute was enacted prior to Delaware's and noting its difference in approach).

264. *See supra* Part III.A; *see also* Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120–22 (1987) (describing the coalition explanation of takeover legislation).

than *Van Gorkom*. Within a few months of *Unocal* itself, the supreme court, in *Moran v. Household International*, applied intermediate scrutiny to *uphold* the adoption of a poison pill, arguably the most significant structural defense in a takeover target's arsenal,[265] thus signaling a retreat from strong readings of *Unocal*.[266] An even clearer sign of *Unocal*'s surrender, however, came five years later in *Paramount Communications, Inc. v. Time, Inc.*, in which the Delaware Supreme Court validated the "just say no" defense, holding that a target board does not have to remove defensive devices when confronted by a plainly superior offer.[267] If *Unocal* scrutiny permitted the "just say no" defense, it was difficult to argue that the standard provided a serious check on target board conduct in takeover battles.[268] Later decisions have further solidified the ability of boards to refuse offers that are not coercive but merely "inadequate,"[269] allowing practitioners to conclude that "'just say no' is alive and well."[270]

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265. Poison pills work by making hostile tender offers prohibitively expensive. However, a company with a poison pill alone is not takeover proof. *See generally* Bebchuk et al., *supra* note 110 (describing the combined effects of takeover defenses).

266. Moran v. Household Int'l, 500 A.2d 1346, 1350 (Del. 1985).

267. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990). In *Time*, the court stated:

> Plaintiffs' position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment of what is a 'better' deal for that of a corporation's board as to directors. To the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis.

Id. at 1153.

268. *See* Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 551 (1997) (arguing that ability of boards to resist takeovers *ad infinitum* "would . . . have a devastating impact on the control market and, ultimately, would have large scale economic effects").

269. Moore Corp. v. Wallace Computer Servs., 907 F. Supp. 1545, 1557 (D. Del. 1995) (recognizing as a threat the possibility that shareholders, "tempted by the suitor's premium, might tender their shares in ignorance or mistaken belief as to management's representations of intrinsic value and future expectations"); *see also* Unitrin, Inc. v. Am. Gen. Corp. (*In re* Unitrin, Inc.), 651 A.2d 1361, 1384 (Del. 1995) (endorsing the concept of "substantive coercion" and recognizing the threat that shareholders would mistakenly sell for an apparent premium when "the board considered Unitrin's stock to be a good long-term investment"); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search For Hidden Value*, 96 NW. U. L. REV. 521, 523 (2002) (stating that "'substantive coercion,' [is] a term which one of us now regrets having introduced . . . to describe how a court might (by squinting) conclude that shareholders who wished to accept a tender offer were coerced into doing so, merely because the target's board considered the offer price to be too low").

270. *See* Adam O. Emmerich et al., "Just Say No" is Alive and Well, Wachtell Lipton Rosen & Katz client memorandum, Dec. 4, 2003 (describing ArvinMentor's attempted takeover of the

Unocal, by contrast, is not doing so well. The doctrinal evolution since 1985 clearly shows a steady decline in the stringency of intermediate scrutiny. No case has yet overruled *Unocal*, but given the fact-specific nature of Delaware law, none has had to.[271] Instead, courts have steadily eroded the application and force of intermediate scrutiny.[272] Professors Thompson and Smith empirically confirmed the steady erosion of the *Unocal* standard in a study that gathered all Delaware decisions citing *Unocal* between 1985 and the end of 2000.[273] The study found that the vast majority of chancery court decisions and all supreme court decisions outside of the change-of-control context approved boards' defensive devices in spite of claiming to apply intermediate scrutiny.[274] In sum, little of substance

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Dana Corporation and Dana's use of the just say no defense to remain independent) (on file with the *Duke Law Journal*).

271. *See* Fisch, *supra* note 221:

> [T]he [Delaware] supreme court . . . appears ready to distinguish or overrule a precedent without regard to considerations of stare decisis. The absence of attention to stare decisis is partially a consequence of the fact-intensive nature of the court's decisions; the court can easily deny that it is overruling a precedent by using case specific facts to distinguish its prior holding. Similarly the court can narrow the precedential effect of its decisions by framing its holdings narrowly and tying those holdings to specific facts.

Id. at 1078 (footnote omitted).

272. Delaware Supreme Court decisions have narrowed *Unocal* to situations in which a board acts unilaterally and adopts a defense that is outside of a "range of reasonable responses." *See Unitrin*, 651 A.2d at 1367, 1388 (stating that the "*ratio decidendi* for the 'range of reasonableness' standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint" (citation omitted)); Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996) (applying the business judgment rule to a shareholder-approved charter amendment and stating that "*Unocal* analysis should be used only when a board unilaterally (i.e., without stockholder approval) adopts defensive measures in reaction to a perceived threat").

273. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2002).

274. *Id.* at 284–86. Throwing out incidental citations, the authors found thirty-four chancery court decisions and eight supreme court decisions applying intermediate scrutiny. They found nine chancery court decisions that concluded that the target's defenses were disproportionate. *Id.* Among these were *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112 (Del. Ch. 1986) (finding a two-tier self-tender to be a disproportionate response to a "concededly fair" and "non-coercive" takeover bid), *City Capital Assocs. Ltd. P'Ship v. Interco, Inc.*, 551 A.2d 787, 799 (Del. Ch. 1988) ("[T]he . . . $74 cash offer did not represent a threat to shareholder interests sufficient in the circumstances to justify, in effect, foreclosing shareholders from electing to accept that offer."), *Grand Metro. Pub. Ltd. Co. v. Pillsbury Co.*, 558 A.2d 1049, 1057 (Del. Ch. 1988) (stating that "a Pillsbury shareholder [might prefer the takeover offer, but] a stockholder in Pillsbury cannot make that choice unless the Rights are redeemed"), *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1238–39 (Del. Ch. 1988) ("[R]estructuring represents an unreasonable and disproportionate antitakeover response to the Bass Group proposals, and

remains of *Unocal*, and judicial scrutiny of takeover defenses has slid most of the way back to the business judgment rule.[275]

Subsequent decisions also weakened *Revlon* duties. Soon after it was decided, *Revlon* could be read to require an auction any time a target company was acquired, whether for stock or cash, whether as part of a long-standing business strategy or a sudden tender offer. This broad reading was later rejected by cases holding that any process, not necessarily an auction, could satisfactorily maximize shareholder consideration.[276] This reading was also rejected by the Delaware Supreme Court in *Time*, which narrowed *Revlon* duties to non-"strategic" (primarily cash) deals.[277] *Time* later became the

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thus constitutes a violation of the defendants' fiduciary duties under *Unocal* entitling plaintiffs to an injunction."), *Tate & Lyle Pub. Ltd. Corp. v. Staley Cont'l, Inc.*, Civ. A. No. 9813, 1988 WL 46064, at *10 (Del. Ch. May 9, 1988) ("[P]laintiffs have shown a reasonable probability that the Funding Trust, as presently enacted, is invalid and that they will suffer irreparable harm if the Funding Trust becomes immediately funded upon any change in control of Staley."), and *Phillips v. Insituform of N. Am., Inc.*, Civ. A. No. 9173, 1987 WL 16285, at *11 (Del. Ch. Aug. 27, 1987) ("If, as currently appears, it is determined that the board engaged in conduct wrongful to plaintiffs in order to get [the merger] proposal to a shareholder vote, any approval thus obtained will necessarily be invalidated."). It is worth noting, however, that several of these decisions were later criticized by the supreme court in *Time*. *See supra* note 267.

275. *See generally* Eric A. Chiappinelli, *The Life And Adventures Of* Unocal—*Part I: Moore The Marrier*, 23 DEL. J. CORP. L. 85, 143 (1998) (stating that "*Unocal* was created, debated, and turned into the equivalent of the business judgment rule"); Ronald J. Gilson, Unocal *Fifteen Years Later (and What We Can Do about It)*, 26 DEL. J. CORP. L. 492, 512 (2001) ("*Unocal* was to provide the theory that *Household International* lacked, but the lesson of *Unocal's* first fifteen years is that the Delaware Supreme Court's march toward an unarticulated and unjustified preference for elections over markets, however understandable in its original motivation, has proven to be a failure."); Paul L. Regan, *What's Left of* Unocal?, 26 DEL. J. CORP. L. 947, 969 ("*Moran*'s *Unocal* promise—of fiduciary accountability for the board's use of a pill in the face of an actual offer—has vanished."); Roe, *supra* note 177, at 625 (noting that Delaware "consciously sought to be 'proportional' for most of the 1980s" but that "at the end of the decade, with the 1989 *Time-Warner* decision, . . . Delaware turn[ed] anti-takeover").

276. *See* Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989) ("*Revlon* does not demand that every change in the control of a Delaware corporation be preceded by a heated bidding contest."). *See generally* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53 (Del. Ch. 1989) (holding that *Revlon* duties do not require the best price but rather the best transaction).

277. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1150–51 (Del. 1989). Because Time had not "abandon[ed] its long-term strategy [to] seek[] an alternative transaction [also] involving the breakup of the company," the supreme court held that the Time board was not required to maximize short term consideration and pursue a transaction with Paramount rather than Warner, its preferred merger partner. *Id.* at 1150. The court specified two circumstances in which *Revlon* duties were implicated:

> The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction [also] involving the breakup of the company.

exception that swallowed the rule because the vast majority of acquisition transactions in the 1990s were structured as the kind of "strategic" transactions that did not implicate *Revlon* duties.[278]

So what happened? What explains the judiciary's retreat from its own doctrinal innovations? Federal preemption was a significant threat to the Delaware judiciary in the early- and mid-1980s, when protakeover forces were strongest in Washington. These decisions can be read in part as a prospective response to this threat. The watershed decisions responded to the pressures on the judiciary by shifting the authority/accountability balance, empowering judges at the expense of directors and promising some limitation on the ability of target boards to resist takeover.[279] At the same time, however, there was also a significant promanagement lobby. Hence, *intermediate* scrutiny.[280] Later, because the preemption threat did not last,[281] but rather faded as the takeover discourse settled to the background of *academic* (as opposed to public) debate,[282] corporate and business lobbies were able to increase the pressure on Delaware to moderate its takeover jurisprudence. The legislature passed antitakeover legislation and reversed *Van Gorkom*. The courts began to understand that the real threat to their authority was now from the promanagement interests represented in the legislature, which

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Id. (citation omitted). *Paramount Communications, Inc. v. QVC Network, Inc.* qualified this rule slightly by holding that *Revlon* duties could be triggered by a stock-for-stock deal that caused a target corporation to go from being diffusely held to having a controlling shareholder who would dominate the corporation going forward. 637 A.2d 34, 43 (Del. 1993).

278. *See* Joseph H. Flom, *Mergers & Acquisitions: The Decade in Review*, 54 U. MIAMI L. REV. 753, 761–62 (2000) (stating that friendly transactions far outnumbered hostile ones in the 1990s).

279. It is worth noting that the promise of greater judicial scrutiny of takeover defenses did not successfully avert all federal incursions into the state-law territory. Consider, on this point, the SEC's all-holders rule adopted soon after *Unocal*, which effectively banned the exclusionary self-tender used by Unocal and blessed by the Delaware Supreme Court. *See supra* note 257.

280. *Unocal* scrutiny was thus intermediate not only in splitting the difference between the business judgment rule and entire fairness and in combining aspects of loyalty and care, but also in mediating the influence of public outcry (that the law do *something* about takeover and takeover defense) and the political concerns of Delaware and its interest groups (that Delaware not do *too much* to restrain management).

281. *See* Andrew G.T. Moore III & Bayless Manning, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 782 (1987) (noting that federal interest in takeovers had waned).

282. At the same time, new "adaptive responses" were invented to alleviate some of the strain on the market for corporate control caused by antitakeover provisions, including increasing reliance on outside directors and compensation arrangements structured to encourage insiders to look more favorably upon takeover proposals. Adaptive responses arguably reduce the harm of judicial deference to takeover defenses. *See* Kahan & Rock, *supra* note 241, at 873, 890–93.

threatened to wrest control of corporate law.[283] As a result, courts began to apply *Unocal* less aggressively and to narrow *Revlon*.

This, then, is the rhetorical structure of corporate law. Loose doctrinal constraints permit constant jurisprudential motion, forward and back on the authority/accountability spectrum, in response to pressures on the judiciary. Doctrinal flexibility permits judges to respond to shifts in interpretive context by increasing or decreasing their scrutiny of board conduct. This responsiveness is facilitated by the use of rhetorical devices, such as intermediate scrutiny, that can support scrutiny in one case and deference in the next.[284]

C. *Uncharted Waters:* Disney *and Beyond*

The good faith thaumatrope is a rhetorical device that can support scrutiny in one situation, deference in the next. Having emerged in an environment of scandal and crisis, it retains a loose doctrinal structure—*some* elements of care along with *some* elements of loyalty—to provide the judiciary with maximum flexibility in its corporate law jurisprudence. Delaware's history of expansion and contraction in corporate law, however, teaches that the flexibility of good faith at the level of doctrine should not be taken to imply that judges will have great flexibility, given the constraints of migration and preemption, in applying it. The Delaware judiciary has never been free to write corporate law according to its whims. If it shifts the balance too far in favor of board accountability, it will stir the threat of corporate migration. If it shifts the balance too far in favor of board deference, it risks increased federalization of corporate law. The flexibility of rhetorical devices, including the good faith thaumatrope, is thus constrained to a range dictated by the prevailing

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283. *See* Lucian Ayre Bebchuk & Allen Ferrell, *The Race to Protect Managers From Takeovers*, 99 COLUM. L. REV. 1168, 1169 (1999) (describing states' incentives to produce takeover law favoring management).

284. *Unocal* is more flexible than *Revlon*. Although there is some interpretive flexibility in deciding whether the board's processes in fact comply with its *Revlon* duties, the crucial question is whether *Revlon* applies. The rest is an if-then statement: if *Revlon* applies, then the board must maximize consideration at sale. *Unocal*, by contrast, is a flexible, standards-based adjudication, from the initial determination of reasonable threat assessment to the second step of evaluating the proportionality of the board's response to the threat. The greater flexibility of *Unocal* may explain why it has survived and remains broadly applicable to any arguably "defensive" action, whereas the *Revlon* rule has been limited to a unique transaction form. That *Unocal* has, at least until recently, been frequently recited, occasionally applied, but rarely violated is an indication of the rhetorical climate in which it evolved. In another climate, in which federal intervention in takeover law remained a real threat, it might have been used more aggressively.

interpretive context and the strength and source of the threat to the court's jurisdiction.

What does this mean for the likely evolution of the jurisprudence of good faith? My theory of corporate law rhetoric can now support a prediction. Because it is rhetorically useful, good faith is likely to retain the loose character of a thaumatrope, empowering the judiciary to apply it (or not) depending upon the interpretive context. More specifically, the good faith thaumatrope is most likely to be used when public outcry and the possibility of federal intervention put pressure on the authority/accountability discourse. When, by contrast, the scandal calms and the economy recovers—a process that, by some indications at least, began in 2003—there is likely to be less threat of federal intervention and, therefore, less need for aggressive judicial oversight of boards of directors.[285] Under such circumstances, corporate law jurisprudence is likely to return to a more deferential position. Indeed, the retrenchment of deference began as early as 2004, when several of the post-scandal decisions that had increased the accountability of boards to courts were qualified or narrowed in subsequent opinions.[286] The jurisprudence of good faith seems likely to follow the same path, perhaps coming to resemble intermediate scrutiny under *Unocal*: often recited, occasionally applied, and rarely violated.

This evolutionary trajectory of good faith is confirmed in the chancery court's subsequent decision in the Disney litigation. Having sustained the plaintiffs' claim in his 2003 opinion,[287] Chancellor Chandler presided over the Disney trial in the fall and winter of 2004,

285. On the heels of positive stock market returns in 2003 and 2004, a backlash against aggressive SEC rulemaking and enforcement seems to have caused the agency to signal a partial retreat. *See, e.g.*, Stephen Labaton, *SEC's Chairman Is Stepping Down From Split Panel*, N.Y. TIMES, June 2, 2005, at A1 (noting that "some business groups and administration officials . . . contended that [outgoing SEC Chairman William Donaldson's] enforcement and policy decisions had been too heavy-handed"); Deborah Solomon, *SEC to Host Talks on Contentious Rule*, WALL ST. J., Feb. 8, 2005, at A3 (citing recent examples to suggest that "the SEC is adopting a more moderate tone as it tries to balance corporate concerns with its mission to protect investors").

286. The postscandal decisions are discussed at *supra* note 220. For cases narrowing or qualifying them, *see, e.g.*, Beam v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) (narrowing *Oracle* and suggesting, more broadly, that social ties are not enough to establish a conflict sufficient to draw independence into doubt); Orman v. Cullman, No. 18039, 2004 Del. Ch. LEXIS 150, at *21 (Del. Ch. Oct. 20, 2004) (distinguishing *Omnicare* to uphold deal protections in an acquisition, like the NCS-Genesis transaction, involving a controlling-shareholder voting agreement).

287. *See supra* Part I.B.1.

ultimately issuing yet another opinion on August 9, 2005.[288] This latter opinion give the chancellor a second opportunity to define and analyze a fiduciary duty claim under the rubric of good faith.

Directors act in bad faith, Chancellor Chandler wrote in the 2005 opinion, when they act "for some purpose *other than* a genuine attempt to advance corporate welfare."[289] After suggesting several examples in which directors may place their own "interests, preferences or appetites before the welfare of the corporation,"[290] the chancellor fell back on the intentional-disregard language he had used in the 2003 decision, stating that "the concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith."[291] Again, however, the court's analysis of intent ultimately focused on process, including, as in *Van Gorkom*, the length of the board's meetings,[292] inquiries typically conducted under analyses of the duty of care.[293] To these discussions of process, the chancellor merely appended a conclusory assertion that the director in question had acted in pursuit of the best interests of the company.[294]

The motivation of this analysis of process, however, was the court's suspicion of disloyalty. As Chancellor Chandler emphasized in

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288. *In re* The Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005).

289. *Id.* at *170 (quoting Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1051, n.2 (Del. Ch. 1996)).

290. *Id.* (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)). The examples range from the ordinary (greed and envy) to the fanciful (lust and revenge).

291. *Id.* at *175 (emphasis omitted).

292. *Id.* at *208–20 (evaluating the conduct of directors Sidney Poitier and Ignacio Lozano). The court is aware of the parallel, noting that the "arguments understandably hearken back to *Van Gorkom*, where the Supreme Court condemned the Trans Union board for agreeing to a material transaction after a board meeting of about two hours . . . ." *Id.* at *210–11. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), and the discussion at *supra* note 76 and accompanying text. In order to avoid parsing the minutes spent on various types of decisions, the chancellor ultimately concluded that because the discussion of the Ovitz matter went on for a "not insignificant length of time," the board had not acted with deliberate indifference. *Disney*, 2005 Del. Ch. LEXIS 113, at *216.

293. *See supra* notes 93–97 and accompanying text (discussing this suggestion with *Elkins*).

294. *See id.* at *199 (analyzing Eisner's conduct and concluding that no evidence showed Eisner had been motivated by anything other than "the best interests of the Company"); *id.* at *205 (analyzing Russell's conduct and concluding that Russell "was doing the best he thought he could to advance the interests of the Company"); *id.* at *207 (analyzing Watson's conduct and concluding that "[n]othing in his conduct leads me to believe that Watson had anything in mind other than the best interests of the Company . . . .").

the 2005 opinion, judges will be especially skeptical of "an imperial CEO or controlling shareholder with a supine or passive board" who seeks to commandeer the board to satisfy a personal rather than a corporate interest.[295] The ultimate question in *Disney*, most simply, was whether Ovitz's hiring and severance arrangement resulted from the board kowtowing to a desire on the part of Eisner to spread the company's wealth among his personal network of friends. Although willing to characterize Eisner as an imperial CEO and criticize the board as not truly independent,[296] by 2005 the chancellor no longer seemed to believe that the Eisner-Ovitz friendship explained Ovitz's hiring and firing.[297] Such considerations, of course, illustrate the loyalty side of the thaumatrope. Taken together with the process analysis, the 2005 *Disney* decision provides another example of thaumatrope analytics.

In granting judgment for the defendants on all claims,[298] the 2005 *Disney* decision also illustrates that the balance between board authority and judicial accountability has has returned to a highly deferential position. No longer seeking to forge new ground in corporate law jurisprudence, the 2005 opinion refers to the shareholders' complaint as "a non-exculpated breach of fiduciary duty claim" rather than a claim of bad faith.[299] Moreover, Chancellor Chandler emphasized the distinction between the aspirations of corporate governance and the requirements of corporate law from the very outset of the opinion,[300] recalling the themes that former Chief Justice Veasey had sounded in *Brehm* and his pre-scandal speeches.[301]

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295. *See id.* at *192, n.487.

296. *Id.* at *192–93.

297. Derivations of the word "friend" appear half as often in the 2005 opinion as in the 2003 opinion, and as the trial revealed, the word did not seem to mean as much as one might have supposed. In his testimony, Eisner emphasized that his relationship with Ovitz was more accurately characterized as a business relationship. "Michael Ovitz," Eisner testified, "had a lot of best friends." *See* Laura M. Holson, *Eisner, on the Stand, Describes Courting of Ovitz*, N.Y. TIMES, Nov. 15, 2004, at C1.

298. *Disney*, 2005 Del. Ch. LEXIS 113, at *3.

299. *Id.* at *174.

300. *Id.* at *4 ("Delaware law does not . . . hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices . . . .").

301. *See* Brehm v. Eisner, 746 A.2d 244, 256–57 (Del. 2000) ("Aspirational ideals of good corporate governance practices . . . are highly desirable . . . . But they are not required by the corporation law."); Veasey, *supra* note 191 (discussing the interplay between corporate law and aspirational ideals).

Compare Veasey's 2001 speech at Penn, previously discussed,[302] with Chandler's insistence, in the 2005 opinion, that:

> other institutions may develop, pronounce and urge adherence to ideals of corporate best practices. But the development of aspirational ideals, however worthy as goals for human behavior, should not work to distort the legal requirements by which human behavior is actually measured. Nor should the common law of fiduciary duties become a prisoner of narrow definitions or formulaic expressions.[303]

The pendulum, it seems, has swung back in favor of board authority and away from judicial intervention.

It is the Delaware Supreme Court that will ultimately decide the doctrinal status of good faith, possibly in its consideration of the plaintiffs' appeal.[304] As this Article has argued, the outcome will depend largely on pressures within the corporate law discourse. If economic recovery continues, however, and further scandals do not suddenly arise, the supreme court seems likely to affirm the 2005 decision and to explain the chancery court's good faith jurisprudence as a welcome rehabilitation of the duty of loyalty. The chancery court's basic emphasis—that directors can be disloyal for a variety of reasons other than simple financial self-interest—essentially extends the meaning and reach of the duty of loyalty beyond the narrow categories into which it had previously been confined.[305] This interpretation would simultaneously retain good faith as an open-textured rhetorical device while also creating a means by which boards could respond—through, for example, disclosure and approval or ratification[306]—to avoid its application.

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302. *See supra* notes 191–96 and accompanying text.

303. *Disney*, 2005 Del. Ch. LEXIS 113, at *5.

304. The chancellor's decision was immediately appealed. *See* Bruce Orwall & Merissa Marr, *Judge Backs Disney Directors In Suit on Ovitz's Hiring, Firing*, WALL ST. J., Aug. 10, 2005, at A1 ("Attorneys for shareholders who sued the board said they would appeal the ruling.").

305. Chancellor Chandler suggested this himself, quoting an earlier version of this Article to argue that the real problem is the excessive rigidity of existing doctrinal classifications. *See Disney*, 2005 Del. Ch. LEXIS 113, at *149 n.402.

306. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a) (2003) (providing that conflict-of-interest transactions are not voidable if they are approved, ratified, or fair).

CONCLUSION

This Article has drawn upon corporate law theory and corporate law history to analyze the Delaware judiciary's rediscovery of the principle of good faith. Tracing the principle through a line of cases, this Article has described good faith as a thaumatrope. In their discussions of good faith, courts oscillate between loyalty issues and care issues, finding good faith to be in doubt if issues are raised under each traditional fiduciary duty, regardless of whether all of the doctrinal requirements of either standard have been fulfilled.

It is no accident that good faith reemerged during a period of scandal and crisis in American corporate governance. After Enron, WorldCom, and the like, the Delaware judiciary faced a heightened threat of federal preemption, and it responded by loosening its doctrinal constraints to intervene more actively in corporate governance. Corporate law history provides several examples of such shifts toward greater judicial accountability in periods of scandal and as many examples of shifts back once the scandal recedes and the threat of corporate migration reappears. Each of these shifts is accomplished through the invention and deployment of rhetorical devices. The good faith thaumatrope is one such device, not unlike intermediate scrutiny or a host of other devices in this repeated pattern of regulation and retreat. As such, it is likely to follow the same evolutionary path, being applied less aggressively as the calamity calms.

This Article's prediction that the shift in the authority/accountability balance brought by good faith will not be permanent should not be construed as a suggestion that good faith is unimportant. Good faith is a paradigmatic illustration of the workings of corporate law jurisprudence, demonstrating both the basic flexibility of corporate law doctrine and the vital importance of the political undercurrents both motivating and constraining the judiciary in its application of doctrine. No understanding of corporate law is complete without an account of these forces, which is what this Article, at its core, has sought to provide, elaborating the rhetorical structure of corporate law through a close analysis of the emerging jurisprudence of good faith.