

THE DEVELOPING THEORY OF GOOD FAITH IN DIRECTOR
CONDUCT: ARE DELAWARE COURTS READY TO FORCE
CORPORATE DIRECTORS TO GO OUT-OF-POCKET AFTER
DISNEY IV?

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ABSTRACT

In the modern corporate climate, defined by the aftermath of recent corporate scandals, regulatory reforms, high-profile derivative suits and settlements forcing directors to pay claims out-of-pocket, directors face the real possibility of personal liability for their actions. Along with intensified scrutiny of director conduct and calls for stronger corporate governance, some commentators have criticized Delaware for failing to require higher standards for corporate conduct under state law. Contrary to that assertion, the Delaware courts began a cautious exploration of the notion of good faith and the potential expansion of directors' fiduciary obligations well before the collapses of Enron and WorldCom and the subsequent intensified focus on corporate governance.

The doctrine of good faith has been underdeveloped in Delaware, as a result of the established fiduciary duty framework and procedural obstacles. Over ten years ago, the Delaware courts began to provide increasingly specific guidance to plaintiffs to overcome the procedural obstacles that prevented many fiduciary duty claims from surviving the pleadings stage. As more of these claims reached trial on the merits, the Delaware courts began a cautious exploration of the duty of good faith as a theory for increasing standards of director conduct.

*Most recently, the Chancery Court's 2005 decision, *In re The Walt Disney Co. Derivative Litigation*, defined good faith as an amorphous, overarching requirement for director conduct, transcending the established duties of loyalty and care. Although the *Disney IV* plaintiffs could not establish that the directors acted in bad faith, under the Court's formulation of good faith, directors' failure to act in good faith can defeat established procedural and statutory protections for their actions. As a result, the Delaware courts are positioned to continue this development of good faith as a substantive basis for imposing personal liability on directors, thereby elevating standards of directors' fiduciary obligations.*

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INTRODUCTION

2005 is a risky time to be a corporate director. A cultural sea-change in standards for organizational conduct, marked by increased scrutiny of corporate directors' decisions and processes, is well underway. The current climate is defined by developments that force directors to confront heightened scrutiny of their actions, including the very real possibility of personal liability: Sarbanes-Oxley;¹ new self-regulating organization ("SRO") rules;² high-profile corporate cases against directors and officers;³ and increasingly sophisticated institutional investor plaintiffs with their recent efforts to make directors pay settlements out-of-pocket.⁴ Even before the spectacular corporate scandals of recent years, the Delaware courts were setting the stage to develop more refined, higher standards of director conduct through their analysis of "good faith." In the wake of those scandals, directors who fail to pay attention to the developing guidance offered by the Delaware courts in cases like *In re The Walt Disney Co. Derivative Litigation*⁵ ("Disney IV")

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 28, 29, 118 U.S.C.).

2. "Self-regulating organizations" ("SROs") refers to the New York Stock Exchange, The Nasdaq Stock Market, and the American Stock Exchange, which are the largest and most active public stock trading markets subject to regulation under the Securities Exchange Act of 1934. Each of the SROs recently passed stricter listing requirements pertaining to the definition of and role of independent directors. See New York Stock Exchange Listed Company Manual Section 303A Corporate Governance Rules (November 3, 2004), available at http://www.nyse.com/pdfs/section303A_final_rules.pdf; The NASDAQ Stock Market Inc. Corporate Governance, Rules 4200, 4200A, 4350, 4350A, 4351 and 4360 and Associated Interpretive Material (April 15, 2004), available at <http://www.nasdaq.com/about/CorporateGovernance.pdf>; American Stock Exchange Enhanced Corporate Governance Rules Approved by the Securities and Exchange Commission ("SEC") December 1, 2003, available at http://www.amex.com/?href=/atamex/news/am_CorGov.htm (providing link to SEC Release No. 34-48863, approving rule changes to §§ 101, 110, 120, 121, 401, 402, 610, and 1009 and adopting new §§ 801-808 of the Amex Company Guide). The American Stock exchange has changed several other rules, including changes to Director Independent [sic] Standards, Closed-End Audit Committee Meeting Requirements, Disclosure of Independent Director Determinations and Technical Amendments to Corporate Governance Requirements. See http://www.amex.com/?href=/atamex/news/am_CorGov.htm.

3. Joann S. Lublin et al., *Directors are Getting the Jitters: Recent Settlements Tapping Executive' Personal Assets Put Boardrooms on Edge*, WALL ST. J., Jan. 13, 2005, at B1 (recent out-of-pocket settlements by directors); *Executives on Trial: Guilty, Not Guilty, Mistrial*, WALL ST. J. ONLINE, July 13, 2005, at B1 (on file with author) (discussing the status of various suits against executives).

4. Michael Klausner et al., *Outside Directors' Liability: Have WorldCom and Enron Changed the Rules?*, 71 STAN. LAW. 36 (Winter 2005), available at <http://www.law.stanford.edu/publications/lawyer/issues/71/klausner.html> (discussing the recent push by plaintiffs to force directors to pay portions of settlements out-of-pocket even when there is directors and officers insurance available).

5. No. Civ.A. 15452, 2005 WL 1875804 (Del. Ch. Aug. 9, 2005) ("Disney IV"). In accordance with the Delaware Chancery Court's nomenclature of the decisions preceding *Disney IV*, the cases in the Disney litigation are hereinafter referred to as: *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998) ("Disney I"); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ("Brehm"); *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) ("Disney II"); *In re The Walt Disney Co. Derivative Litig.*, No. Civ.A. 15452, 2004 WL 2050138 (Del. Ch. Sept. 10, 2004) ("Disney III"); *In re The Walt Disney Co. Derivative Litig.*, No. Civ.A. 15452, 2005 WL 1875804 (Del. Ch. Aug. 9, 2005) ("Disney IV"). At the time this article went to press, the Delaware

may expect to see more scrutiny, and possibly personal liability, imposed on them and the processes by which they govern corporate activity.

Against this backdrop of corporate scandals, legislative and regulatory reform, and increased scrutiny of corporate behavior, the Delaware courts have been cautiously exploring the concept of good faith and directors' fiduciary obligations under state law in a two-part process.⁶ First, the state's courts have been offering specific directives to plaintiffs, explaining how to overcome procedural obstacles in order to reach trial on the merits.⁷ Second, the courts have engaged in an ongoing discourse regarding the concept of good faith as a potential avenue for finding directors personally liable for certain egregious or outrageous behavior, which might not otherwise be actionable under traditional fiduciary duty doctrines.⁸ This process has developed into guidance, effectively a prescription by the Delaware courts, both for how directors should act in the modern corporate environment and for how stockholders can successfully challenge directors who fail to satisfy the obligation to act in good faith. Most recently, the Chancery Court's description of the obligation of directors to act in good faith in its August 2005 *Disney IV* decision suggests that Delaware's corporate law may ultimately develop to reflect the ongoing sea-change in corporate governance by imposing personal liability on corporate directors.⁹

Interestingly, Delaware judges (both current and former) often suggest that the state's courts occupy a somewhat passive role in bringing these cases before them.¹⁰ The procedural teachings of the Delaware courts and their evolving guidance on the obligation of good faith, however, suggest otherwise.¹¹ Still, some commentators assert that the

Supreme Court was scheduled to hear oral arguments in the appeal of *Disney IV* on January 25, 2006.

6. See discussion *infra* Parts III and IV.

7. See discussion *infra* Part III.

8. See discussion *infra* Part III.

9. *Disney IV*, 2005 WL 1875804, at *36.

10. E. Norman Veasey, *Counseling Directors in the New Corporate Culture*, 59 BUS. LAW. 1447, 1449 (2004) ("Although as judges we appear on panels, give speeches and write articles, we are like clams in the water when it comes to deciding cases. We must wait for a case to come to us . . ."); *id.* at 1451; E. Norman Veasey, Some Current Corporate Governance Issues for Directors of Delaware Corporations, Address at the National Association of Corporate Directors in Washington, DC (Oct. 21, 2003), http://courts.state.de.us/Courts/Supreme%20Court/pdf/?NACD10_03wash.pdf (same proposition); John Gapper, *Capital Punishment*, FIN. TIMES, Jan. 29, 2005, at 16 (interviewing the Hon. Vice Chancellor Leo E. Strine, "He admits that some of Delaware's recent rulings appear tougher on managers than in the past, but says that merely reflects the cases that have come before it"). More recently, however, E. Norman Veasey, retired Chief Justice of the Delaware Supreme Court, has begun to specifically identify the courts' role defining the procedure necessary for plaintiffs to reach trial on the merits. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1405 (2005) [hereinafter Veasey & Di Guglielmo, *Retrospective*] ("The fact that judicial review by Delaware courts of director conduct has resulted in some findings of wrongdoing is primarily a function of intensified judicial focus on process and improved pleading by plaintiffs' lawyers.").

11. See *infra* Part III.

state's courts have failed to act (or act quickly enough) in response to this new era.¹² Contrary to the charge that Delaware has somehow failed to respond to this new environment, Delaware's courts were actually crafting their guidance well *before* the collapses of Enron and WorldCom.¹³ These early efforts evidence the Delaware courts' proactive approach to developing more refined and higher standards for director conduct under state law.¹⁴ This proactive approach notwithstanding, Delaware's most substantial exploration of the concept of good faith as a potential avenue for finding directors personally liable for their actions has unfolded in the modern corporate climate. Understandably, Delaware cannot ignore this backdrop of increased focus on directors' processes and institutional investor plaintiffs' recent efforts to make directors pay settlements out-of-pocket. In fact, Delaware's current and former judiciary freely admits that the stark realities of the current corporate climate must inform and play a part in the courts' exploration of standards for directors' conduct under state law.¹⁵ The mere fact that Delaware's process continues to unfold in and may be informed by the modern corporate climate, however, does not make Delaware's process merely "reactive."¹⁶

While this article argues that the Delaware courts are providing guidance to further develop fiduciary duty jurisprudence to refine stan-

12. Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 457-60 (2004) (noting that Delaware "has been largely absent from the debate" [over how to respond to the post-Enron governance reform movement], but also describing the state's development of good faith, calling it as "the test of the commitment and good faith of Delaware's corporate law and lawmakers"); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L. J. (forthcoming 2005) (manuscript at 3, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=728431) ("Post-Enron, the responsiveness (or laxity) of the states, Delaware in particular, in matters of corporate governance was hotly contested").

13. See discussion *infra* Part III and IV.

14. See discussion *infra* Part III and IV.

15. See Griffith, *supra* note 12, at 48-9 (citing 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, 1001 (2003)) ("State law policymakers – including judges shaping the common law – will undoubtedly be responsive to this expression of concern [the reforms of 2002, Sarbanes-Oxley, in particular] and may use it as an opportunity to reflect more deeply on whether their own policies need adaptation to better protect stockholders"); Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1496 ("[T]he evolution in business and social expectations and norms of directorial conduct may affect outcomes in a common law system like ours by impacting the interpretation and application of such concepts as 'good faith' and 'best interests.'").

16. See Griffith, *supra* note 12, at 8-9 ("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 plunged previously settled questions into heated debate"). While a significant part of Delaware's exploration of good faith has taken place in the modern corporate climate, the author believes that the procedural guidance and exploration of good faith in Delaware courts prior to the collapses of Enron and WorldCom evidence an established interest in developing good faith as a tool to increase standards of corporate conduct.

dards of director conduct,¹⁷ it is important to be mindful of the critical distinction between ideals of corporate governance and the legal requirements for directors to discharge their fiduciary duties under Delaware law.¹⁸ As Chancellor Chandler of the Delaware Chancery Court explained in *Disney IV*,

Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices [T]he 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.¹⁹

Notwithstanding this important distinction, guidance developing in the good faith jurisprudence raises the possibility that Delaware may hold corporate directors personally liable for their perceived failings and demonstrates the nexus between these two notions of director conduct.

This article describes the development of Delaware's two-part prescription to increase standards for director conduct by more fully developing the concept of directors' good faith: through decisions that provide specific instructions to help plaintiffs overcome procedural obstacles and substantive explanations of what a breach of good faith might look like. Part I of this article explores aspects of the current corporate climate and the push for directors' out-of-pocket settlements against which Delaware courts have developed recent portions of their guidance regarding directors' obligations of good faith. Part II begins the exploration of Delaware's corporate law, by describing its traditional formulation of directors' fiduciary duties and the historical challenge of understanding good faith within this framework. Part III considers the procedural obstacles that have historically prevented the duty of good faith from being more fully developed and the process element of the Delaware courts' guidance to plaintiffs on how to overcome these hurdles and

17. Martin Lipton, a partner in the firm of Wachtell, Lipton, Rosen & Katz, who is perhaps one of the best-known counselors to boards of major corporations, has concluded that neither *Disney IV* nor the modern corporate climate "create new criteria for director liability." Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, Key Issues for Directors (Aug. 29, 2005) (on file with author). While it may be as Mr. Lipton suggests, that *Disney IV* represents a withdrawal from the developing notion that good faith may be an independent basis for director liability, the author believes that procedural and substantive guidance coming from the Delaware courts in their exploration of good faith suggest that there is more to come.

18. *Disney IV*, 2005 WL 1875804, at *1.

19. *Id.* The Delaware Supreme Court has also highlighted this distinction. *Brehm v. Eisner*, 746 A.2d 244, 255-56 (Del. 2000).

"This case is not about the failure of the directors to establish and carry out ideal corporate governance practices [T]he law of fiduciary duties and remedies for violations 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."

Id.

have their fiduciary duty claims heard on the merits. Part IV examines the substantive element of the Delaware courts' guidance on good faith: recent decisions developing good faith as a basis for directors' personal liability, culminating with *Disney IV*'s suggestion that "good faith" is a ubiquitous requirement for director conduct that transcends the specific duties of loyalty and due care. Part V concludes by discussing the potential avenues for finding directors personally liable under Delaware's current formulation of good faith.

I. THE CURRENT CORPORATE CULTURE

Both before and after the spectacular corporate scandals since 2001, the Delaware courts' attempt to increase standards of director conduct face an inherent constraint. Unlike frustrated investors and federal regulators, Delaware courts must work within established precedent and the doctrine of stare decisis.²⁰ The state's judges consider this deference one the most salient features of the state's corporate law, creating its hallmark "stability and predictability."²¹ As a result, although Delaware developed the early aspects of its guidance before the Enron and WorldCom collapses, these factors have forced much of the substantive component of Delaware's prescription to play out against the backdrop of post-scandal public and regulatory pressure to improve corporate governance.²² Two important features of this climate are the increasing presence of institutional investor plaintiffs and their quest to force directors to pay settlements out-of-pocket. Taken together, these forces have greatly shaped the corporate governance climate and increased the likelihood that directors will be held personally liable for their actions. While Delaware's courts must follow legal principles developed through years of jurisprudence to analyze standards of conduct and potential liability for directors, the current climate exerts considerable influence over the substantive formulation of Delaware's prescription.²³

A. The Increased Presence of Institutional Investor Plaintiffs

Since the Private Securities Litigation Reform Act of 1995 ("PSLRA"),²⁴ the typical lead plaintiff in federal securities and state corporate law cases has dramatically changed. Under the PSLRA, a lead

20. Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1409-10. Although disgruntled investors who choose to file suit to address their grievances are also bound by legal precedent and the effects of stare decisis, they have other avenues available to them, including selling their holdings, exercising their voting power at annual meetings and pressuring lawmakers for reforms.

21. *Id.* at 1410.

22. See *infra* Parts III and IV.

23. See *supra* notes 18-19 and accompanying text (discussing the distinction between ideals of corporate governance and fiduciary duties); note 16 and accompanying text (considering commentary by members of Delaware's judiciary on how the current corporate climate impacts the development of state corporate law).

24. Securities Act of 1933 § 27(a)(3), 15 U.S.C. § 77z-1(a)(3)(B)(3)(iii)(I)(bb) (2000); Securities Exchange Act of 1934 § 21D(a)(3), 15 U.S.C. § 78u-4(a)(3)(B)(I)(bb) (2000). [hereinafter, collectively, the "PSLRA"]

plaintiff in federal securities cases must have the “largest financial interest in the relief sought.”²⁵ As a result, institutional investors have replaced the winner of the “race to the courthouse” as the most-likely lead plaintiff in federal securities litigation, and federal courts openly favor institutional investors for this role.²⁶ Because the PSLRA does not apply to cases brought under state corporate law, the phenomenon Vice Chancellor Leo Strine of the Delaware Chancery Court describes as the “medal round of filing speed (also known as the lead counsel selection) Olympics” still exists in Delaware courts.²⁷ Nonetheless, institutional investors have embraced their role in corporate governance reform and have become frequent players in the Delaware courts as well.²⁸

The increased participation of sophisticated institutional investors plaintiffs in these cases appears to have had a significant impact, evidenced by a study of federal securities cases brought since the PLSRA, finding that cases brought by institutional investors result in higher settlements.²⁹ Accordingly, institutional investors have become increasingly attractive to the plaintiffs’ bar.³⁰ Today, both securities and corporate law class-action suits have extraordinarily high economic stakes, in

25. *Id.*

26. See *Malasky v. IAC/INTERACTIVECORP*, No. 04 Civ. 7447 (RJH) (et al.), 2004 WL 2980085, at *3-4, slip op. (S.D.N.Y. Dec. 21, 2004), *reconsidered in part by Malasky v. IAC/INTERACTIVECORP*, No. 04 Civ. 7447 (RJH) (et al.), 2005 WL 549548, slip op. (S.D.N.Y. March 7, 2005) (discussing the interplay between the PSLRA’s requirement that the lead plaintiff have the “largest financial interest” and FED. R. CIV. P. 23’s requirement that the lead plaintiff “adequately protect the interests of the class,” and discussing court opinions interpreting the PSLRA to favor institutional investors for lead-plaintiff status); *Motion for Lead Plaintiff: Only Institutional Investors Need Apply*, CORPORATE GOVERNANCE BULLETIN (Lerach Coughlin Stoia Geller Rudman & Robbins LLP), Second Quarter, 2005 at 4, available at http://www.lerachlaw.com/pdf/newsletters/2005_2nd_Qtr_Corp_Gov.pdf (“The Court did a great service to the class by recognizing the value of having a sophisticated fiduciary such as the Cement Masons appointed to oversee this significant litigation”) (quoting Lerach Coughlin Attorney David Rosenfeld, representing lead-plaintiff in *Malasky* case).

27. *In re Cox Communications, Inc.*, 879 A.2d 604, 608 (Del. Ch. 2005).

28. Institutional investors have embraced their role in shaping corporate practices, as evidenced by the principles or guidelines for corporate governance that many of them publish. See *The California Public Employees’ Retirement System Corporate Governance Core Principles & Guidelines* (updated Apr. 6, 2005), <http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf>; *The Council of Institutional Investors Corporate Governance Policies* (updated Apr. 2005), http://www.cii.org/site_files/pdfs/policies/2005%20april_cii_policies.pdf.

29. Press Release, Cornerstone Research, *Class Action Securities Fraud Settlements are Higher When Institutional Investors are Lead Plaintiffs* (May 10, 2004), http://securities.stanford.edu/settlements/REVIEW_1995-2003/2003_Settlements_Release.pdf.

30. Tamara Loomis, *Milberg Weiss Stronger Than Ever Despite Reform Act*, N.Y. L. J., Apr. 22, 2003, at 1, available at 4/22/03 NYLJ1 (Col. 4)(Westlaw). Firms specializing in class action suits often have institutional investor-specific sections of their websites. See <http://www.milbergweiss.com/practice/practicedetail.aspx?pgid=796> (Milberg Weiss Bershad & Schulman LLP); <http://www.milbergweiss.com/practice/practicedetail.aspx?pgid=796&ControlID=1346> (Milberg Weiss’s “Principles of Corporate Governance for Institutional Investors”); <http://www.lerachlaw.com/lcsr-cgi-bin/mil?templ=inst-invest.html> (Lerach Coughlin Stoia Geller Rudman & Robbins LLP); http://www.blbglaw.com/html/portfolio_monitoring.html (Bernstein Litowitz Berger & Grossmann LLP).

both the relief sought and the legal fees arising from this litigation.³¹ This “big business” aspect of class-action corporate cases, however, has put the plaintiffs’ bar under increased scrutiny about its true motivation.³² In a study published in 2004, Professors Elliott J. Weiss and Lawrence J. White examined merger-related class actions filed in the Delaware Chancery Court between 1999 and 2001, concluding that these cases evidenced “the opportunistic filings, of a lawyer-driven process rather than a true client-driven process.”³³ One commentator has remarked that the class-action model has turned clients into “tokens to be moved around on a game board [by plaintiffs’ counsel].”³⁴ Notwithstanding these critiques of the plaintiffs’ bar, the combination of increased participation by institutional investors and the increasing importance of their role in corporate cases, coupled with the potential economic rewards for the plaintiffs’ bar, has had a substantial impact the current corporate class-action litigation climate.

31. As an example of a recent, high-stakes corporate case, the *Disney IV* plaintiffs claimed \$263 million in damages. *Disney CEO, Directors Dodge Liability Bullet for Paying Ovitz \$140 Million*, ANDREWS DEL. CORP. LIT. REP. Aug. 15, 2005, at 1.

32. Editorial, *The Trial Lawyers Enron*, WALL ST. J., July 7, 2005, at A12 (Discussing the “ever more outrageous” behavior of plaintiffs’ attorneys, “Sham ‘screenings’ to round up asbestos plaintiffs, forum shopping for friendly juries, ‘coupon’ settlements that enrich only lawyers and frivolous lawsuits have all become staples of today’s tort system. Yet they have received almost no media, much less legal, scrutiny”). Recently, some of this criticism of the plaintiffs’ bar has taken on a new, legal shape, in the form of a federal criminal investigation of one of the nation’s largest class-action law firms. Federal investigators are probing the practices of Milberg Weiss Bershad & Schulman for alleged fraud, conspiracy and kickbacks. John R. Wilke & Scot J. Paltrow, *Prosecutors Step Up Probe of Milberg Weiss Law Firm; Ex-Partners Given Immunity in Grand-Jury Investigation of Possible Illegal Payments*, WALL ST. J., Aug. 8, 2005, at A1. The firm considers the allegations “baseless,” and contends that many of the cases in question occurred before the PSLRA, before kickbacks to plaintiffs were illegal. John R. Wilke & Scot J. Paltrow, *Ex-Broker to Aid Milberg Inquiry; Cooperation Underscores Wide Probe of Recruitment of Class-Action Plaintiffs*, WALL ST. J., Jun. 28, 2005, at A2.

33. Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1856 (2004) (finding that in challenged mergers, 77% were filed within one day of the merger announcement and that hourly fees averaged \$492 per hour in settlements without monetary recovery but averaged \$1,800 per attorney hour worked in settlements with a monetary recovery).

34. *In A Class of His Own: How Melvyn Weiss, A Class Action Lawyer, Finds Crimes That Pay*, THE ECONOMIST, Jan. 17, 2002, available at http://www.economist.com/people/PrinterFriendly.cfm?Story_ID=939966 (quoting Walter Olson of the Manhattan Institute). Courts have not turned a blind eye to the aggressive nature of the plaintiffs’ bar, and have increased their scrutiny of class-action firms in evaluating fee requests in settlement agreements in securities and corporate cases. Recent fee requests have been rejected and reduced with increasing judicial criticism, including the suggestion that the plaintiffs can be “mere figureheads” for their attorneys and that to award the full fee in the case at hand would be to grant the plaintiffs’ lawyers a “windfall.” *In re Bristol-Meyers Squibb Securities Litig.*, 361 F. Supp. 2d 229, 236-37 n.8 (S.D.N.Y. 2005). In June 2005, Vice Chancellor Leo E. Strine admonished plaintiffs’ lawyers in a fee award reduction, describing their complaint as a “hastily drafted throw-away,” and explained plaintiffs’ lawyers’ practice of filing a complaint on the public announcement of a merger, rather than based on an actual merger agreement, in order to win the “lead counsel sweepstakes.” *In re Cox Communications*, 849 A.2d at 608, 641.

B. The Push for Out-of-Pocket Settlements

Importantly, institutional investors have wielded their increasing influence by seeking to hold corporate directors personally liable for corporate failings, by forcing them to pay settlements out-of-pocket, despite directors and officers insurance (“D & O insurance”) policies that might be available to cover such settlements.³⁵ Early in 2005, institutional investor lead plaintiffs settled with former Enron and WorldCom directors, forcing them to pay portions of the settlements personally.³⁶ As part of the WorldCom settlement, eleven directors agreed to pay over \$20 million of the \$55.25 million settlement out-of-pocket.³⁷ New York State Comptroller Alan Hevesi, Trustee of the New York State Common Retirement Fund (the WorldCom lead-plaintiff), explained that the out-of-pocket settlement represented over twenty percent of the directors’ cumulative net worth, excluding certain judgment-proof assets.³⁸ “The fact that we have achieved [this] settlement . . . sends a strong message to directors of every publicly traded company We will hold them personally liable if they allow management of the company on whose boards they sit to commit fraud.”³⁹ As further evidence of these funds’ quest to inflict personal liability on directors, some institutional investors are offering higher contingency fees if their attorneys can obtain out-of-pocket payments from corporate officials.⁴⁰

While WorldCom and Enron are extreme examples, they illustrate the current climate in which Delaware courts have pursued their prescription to increase standards of director conduct under the state’s fiduciary duty framework. Prominent Delaware corporate lawyer, A. Gilchrist Sparks III commented on the disturbing trend of clients “wanting a pound of flesh,” and noted that high-profile settlements have “created the perfect storm.”⁴¹

Taken together, the increased litigation activity of institutional investors and their interest in forcing directors to pay out-of-pocket for corporate failures has created a corporate governance climate that increases the likelihood that corporate directors could be personally liable in certain circumstances. Although the Delaware courts embarked on

35. See Lublin, *supra* note 3; Klausner et. al, *supra* note 4, at 36-38.

36. See Lublin, *supra* note 3; Klausner et. al, *supra* note 4, at 36-38.

37. Press Release, Office of the New York State Comptroller, Hevesi Revives Historic Settlement, Former WorldCom Directors to Pay from Own Pockets (Mar. 18, 2005), <http://www.osc.state.ny.us/press/releases/mar05/031805.htm>.

38. Press Release, Office of the New York State Comptroller, Hevesi Announces Historic Settlement, Former WorldCom Directors to Pay from Own Pockets (Jan. 7, 2005), <http://www.osc.state.ny.us/press/releases/jan05/010705.htm>.

39. *Id.* See also Klausner, *supra* note 4 (discussing the increased potential for outside directors’ liability after the Worldcom and Enron cases).

40. See Lublin, *supra* note 3.

41. Alison Carpenter, *Lawyers Weigh In on Uncertainty About Director Liability*, 20 CORP. COUNS. WKLY. 161, 168 (May 25, 2005).

their prescription before this post-scandal climate ensued, they cannot divorce this process from the new era.⁴² The open question in the wake of *Disney IV* is whether the Delaware courts are backtracking,⁴³ grasping for a temporary solution that will not result in a permanent change to the substantive law,⁴⁴ or providing procedural and substantive guidelines to stockholders interested in promoting heightened standards that reflect the modern climate of pressure to improve corporate governance.

II. DIRECTORS' FIDUCIARY DUTIES UNDER DELAWARE LAW

Although the ideals for corporate governance have undergone a substantial and public transformation since 2001, the Delaware courts' movement to refine its fiduciary duty framework has taken place with considerably less publicity. This is partly caused by the constraints of precedent and stare decisis, which has prevented Delaware from making a quick or unreasoned response.⁴⁵ In addition, the courts are constrained to address the facts of the cases that reach them, which necessarily makes development of jurisprudence an incremental process.⁴⁶ Consequently, the state's courts have methodically worked within these constraints while developing a prescription to hold directors to higher standards of conduct. In order to fully appreciate the nature of these constraints and the development of Delaware's guidance, this Part describes Delaware's traditional fiduciary duties and the difficulty of understanding good faith within this framework.

Under Delaware law, directors manage corporations for the benefit of stockholders.⁴⁷ As a result, directors owe fiduciary duties to both the stockholders and the corporation.⁴⁸ Under Delaware's traditional formu-

42. See Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1412. "The evolution of fiduciary principles occurs not only because courts must decide only the cases before them, but also because business norms and mores change over time. Thus, concepts like "good faith" may acquire more defined content and doctrinal status over time as cases emerge addressing new business dynamics." *Id.* (internal citation omitted).

43. See Lipton, *supra* note 17.

44. See Griffith, *supra* note 12, at 56, 67-69 (arguing that good faith is merely a rhetorical, reactive device employed by the Delaware courts to prevent further federalization of corporate law, and that once pressures for heightened standards for director conduct subside, the Delaware courts will return to a position of greater deference to corporate directors).

45. See *supra* notes 20-21 and accompanying text; *id.* at 1413 (citing *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994)).

46. In re *The Walt Disney Co. Derivative Litigation* ("Disney IV"), No. Civ. A., 15452, 2005 WL 1875804, at *1 (Del. Ch. Aug. 9, 2005) ("It is thus both the province and special duty of this Court to measure, in light of all the facts and circumstances of a particular case, whether an individual who has accepted a position of responsibility over the assets of another has been unremittingly faithful to his or her charge").

47. DEL. CODE ANN. tit. 8, §141(a) (2005). "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." *Id.*

48. *Guth v. Loft*, 5 A.2d 255, 270 (Del. 1939); *Bowen v. Imperial Theatres, Inc.*, 115 A. 918, 922 (Del. Ch. 1922) ("Directors of a corporation are frequently spoken of as its trustees. Their acts are scanned in the light of these principles which define the relationship existing between trustee and cestui que trust.")

lation, these fiduciary duties were the duty of care, which includes a duty to monitor, and the duty of loyalty.⁴⁹ Although the state's courts occasionally mentioned the fiduciary duty of good faith, until recently, this discussion has been relatively superficial.⁵⁰ As such, the duties of care and loyalty have been the almost-exclusive historical standards for measuring directors' conduct under Delaware law.

A. Delaware's Duty of Care

Under Delaware's fiduciary duty of care, directors must act in good faith, with the care of an ordinarily prudent person, and in the best interest of the corporation.⁵¹ In the absence of a conflict of interest, directors' actions fall under the duty of care.⁵² The duty of care measures directors' decision-making processes, requiring that directors be informed in order to discharge this duty.⁵³ Only actions that are grossly negligent, such as allowing a merger agreement to be amended without board authorization and contrary to the directors' intent, will give rise to liability for a breach of the duty of care.⁵⁴ In a duty of care case, directors enjoy the protection of the business judgment rule.⁵⁵ The rule is not substantive, but rather a presumption that directors act "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company."⁵⁶ Plaintiffs can overcome the presumption of the business judgment rule by pleading facts with particularity that suggest the directors were uninformed or their actions were "so far beyond

49. See *Barkan v. Amstead Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (noting that in a sale of control transaction, Delaware law requires that directors discharge their two "fundamental" fiduciary duties, those of care and loyalty); *Emerald Partners v. Berlin*, No. Civ.A 9700, 2001 WL 115340, at *25 n. 63 (Del. Ch., February 7, 2001), *vacated on other grounds*, 787 A.2d 85 (Del. 2001) (discussing the "bedrock" duties of care and loyalty); *In re Caremark Int'l. Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (settlement opinion) (noting that a complaint alleging that directors did not adequately monitor corporate activity, "charges the director defendants with breach of their duty of attention or care").

50. See *Zirn v. VLI Corp.*, 681 A.2d 1050, 1062 (Del. 1996) (discussing good faith within the duty of care); *Emerald Partners*, 2001 WL 115340, at *25 n.63. "Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty." *Id.* See also 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) (explaining Vice Chancellor Strine's suggestion that it is a misunderstanding of *Cede & Co v. Technicolor Inc.*'s mention of a triad to consider good faith as a separate duty) (citing *Cede & Co v. Technicolor Inc.*, 634 A.2d 345 (Del. 1993)).

51. *Disney IV*, 2005 WL 1875804, at *32-33; *Caremark*, 698 A.2d at 967-69; DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS, 117-18 (5th ed. 1998) (citing 2 MODEL BUS. CORP. ACT ANN. §8.30(a) (3d ed. 1996)).

52. See *Brehm v. Eisner*, 746 A.2d 244, 257 (Del. 2000) (considering defendant directors' decisions under the duty of care because an earlier Chancery Court ruling found company directors to be independent).

53. See *id.* at 259.

54. *Smith v. Van Gorkom*, 488 A.2d 858, 882-83 (Del. 1985); *Kahn v. Roberts*, No. C.A. 12324, 1995 WL 745056, at *4 (Del. Ch. Dec. 6, 1995), *aff'd*, 679 A.2d 460 (Del. 1996).

55. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm*, 746 A.2d 744.

56. *Id.*; *Disney IV*, 2005 WL 1875804, at *31.

the bounds of reasonable judgment that it seems inexplicable on any ground other than bad faith.”⁵⁷ Arguably, to overcome this presumption, stockholders might simply allege that directors acted in bad faith. Historically, however, this was an almost impossible undertaking because the Delaware courts’ discussion of good faith was extremely limited, lacking analysis of when it was necessary to meet this “duty” or what its discharge required.⁵⁸ This left stockholders with the burden of challenging the presumption of the business judgment rule without a clear standard for what one of its major components, good faith, required. Given the lack of doctrinal clarity on good faith, application of the business judgment rule became outcome-determinative, preventing most duty of care cases from reaching trial on the merits.⁵⁹

B. Delaware’s Duty of Loyalty

In addition to their obligation to act with care, directors owe a duty of loyalty to the corporation. A question of the duty of loyalty arises when a director has a self-interest in a corporate transaction that is not generally shared by the corporation’s stockholders.⁶⁰ For example, a director who owns stock in both the acquiring corporation and the target in a merger transaction has a financial interest beyond that of the target’s stockholders.⁶¹ To discharge their duty of loyalty, directors must exercise “undivided and unselfish loyalty to the corporation,” and must hold the best interest of the corporation above any self-interest.⁶² The business judgment rule will not apply in a duty of loyalty case unless the directors have expunged the conflict of interest by having a majority of disinterested and independent directors or a majority of the stockholders approve the transaction after full disclosure.⁶³ If the business judgment rule does not apply, directors must prove that the transaction was entirely fair to the corporation.⁶⁴

57. *In re J.P. Stevens & Co., Inc. S’holders Litig.*, 542 A.2d 770, 780-81 (Del. Ch. 1988).

58. See discussion *infra* Part II.D.

59. Griffith, *supra* note 12, at 12 (“[T]he business judgment rule will be held to apply with the typical effect that the board wins, the shareholder loses, and the court stays out of it.”) (internal citation omitted).

60. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citing *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939)).

61. *Nagy v. Bistricher*, 770 A.2d 43, 47, 65 (Del. Ch. 2000).

62. *Cede*, 634 A.2d at 361 (citing *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939)).

63. *Oberly v. Kirby* 592 A.2d 445, 466 (Del. 1991). DEL. CODE ANN. tit. 8, § 144 protects transactions between a corporation and an officer from being “per se voidable” if they are “approved by a majority of the disinterested directors or a good faith vote of the stockholders.” *In re Cox Communications, Inc.*, 879 A.2d 604, 614 (Del. Ch.2005). Once a majority of disinterested directors or a majority of the stockholders approve the transaction, the business judgment rule standard applies to the transaction. *Id.* at 615 (citing *Puma v. Marriott, Inc.*, 283 A.2d 693, 694 (Del. Ch. 1971)). See also J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 342 (2004) (discussing the limited power of the duty of loyalty due to DEL. CODE ANN. tit. 8, § 144).

64. *Kahn*, 1995 WL 745056, at *6.

C. The Practical Realities of the Business Judgment Rule

While both the duty of loyalty and the duty of care are well-developed concepts in Delaware jurisprudence, the duty of care has long been considered to be a “director-friendly” theory, because directors are protected by the business judgment rule in these cases.⁶⁵ A core principle of Delaware corporate law, the business judgment rule exemplifies the judiciary’s extreme deference to directors’ business decisions and Delaware’s value on the social utility of treating directors as experts in evaluating corporate risk.⁶⁶ Chancellor Chandler further described this policy in *Disney IV*, citing *Gagliardi v. Trifoods International, Inc.*:⁶⁷

Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any “upside” gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on “negligence”, “inattention”, “waste”, etc. could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders’ economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimalist proceduralist standards of attention, they can face liability as a result of a business loss.⁶⁸

The rule’s presumption is so strong that when it applies, attacks on directors’ decision-making are rarely successful.⁶⁹ Further, because the rule presumes directors have acted in good faith, the traditionally mechanical application of the rule has precluded meaningful analysis of what good

65. *Caremark*, 698 A.2d at 967 (noting that a claim based on the duty of care is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment”).

66. *See Brehm*, 746 A.2d at 264 n.66 (noting that directors’ decisions will be “respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available”); *In re J.P. Stevens & Co.*, 542 A.2d at 780.

67. 683 A.2d 1049 (Del. Ch. 1996).

68. *Disney IV*, 2005 WL 1875804, at *31 n.408 (citing *Gagliardi*, 683 A.2d at 1053).

69. *Caremark*, 698 A.2d at 967 (noting that a claim based on the duty of care is “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment”); *see Griffith*, *supra* note 12, at 12. “The business judgment rule will be held to apply with the typical effect that the board wins, the shareholder loses, and the court stays out of it.” *Id.* (internal citation omitted).

faith entails.⁷⁰ As a result, only rarely do stockholder challenges to the rule survive the pleadings stage, such as the Chancery Court's landmark 2003 decision, *In re The Walt Disney Company Derivative Litigation* (“*Disney II*”).⁷¹ Under this framework, it is logical that corporate boards will take affirmative steps, such as having disinterested and independent directors approve certain transactions, so their actions will be considered under the duty of care and be protected by the business judgment rule.⁷² Thus, the substantive workings of the business judgment rule within Delaware's fiduciary duty framework has created a judicial environment that until recently has left the duty of good faith a rarely elucidated and amorphous standard.⁷³ This lack of clarity about good faith has been further compounded by the confusion as to how good faith relates to the established fiduciary duties of care and loyalty.

D. Delaware's Traditionally Amorphous Good Faith

Although the Delaware courts frequently mention good faith within discussions of the duties of care and loyalty, traditionally the courts have not substantively defined the “duty” of good faith.⁷⁴ Further clouding the issue, good faith is not defined in the Delaware General Corporation Law (“DGCL”).⁷⁵ Case law demonstrates the courts' historical uncertainty as to whether good faith is an independent duty, a component of the duty of care, or a component of the duty of loyalty. This lack of doctrinal clarity has prevented good faith from commanding a greater role in stockholder suits.

Despite good faith's amorphous status under Delaware law, the Chancery Court's early formulations of good faith suggested that directors' conduct that is “reckless and indifferent as to the rights of the stockholders” may breach the duty of good faith.⁷⁶ The mere description

70. See discussion *supra* Part II.C.

71. 825 A.2d 275 (Del. Ch. 2003), see discussion *infra* Part III.A.2; see also Official Comm. of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290 (Del. Ch., August 24, 2004).

72. DEL. CODE ANN. tit. 8 §144 (2005); see also *supra* note 59.

73. But see *Disney IV*, 2005 WL 1875804, at *1; see *infra* Parts IV, V.

74. See *Zirn v. VLI Corp.*, 681 A.2d 1050, 1062 (Del. 1996) (discussing good faith within the duty of care); *Emerald Partners v. Berlin*, No. Civ.A. 9700, 2001 WL 115340 at *25 n.63 (Del. Ch., Feb. 7, 2001), *vacated on other grounds*, 787 A.2d 85 (Del. 2001) (“Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty.”) Notably, *Disney IV* called into question whether good faith was even a “fiduciary duty” or just a generally applicable standard. “In the end, so long as the role of good faith is understood, it makes no difference whether the words “fiduciary duty of” are placed in front of “good faith,” because acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable because they are disloyal to the corporation.” See *Disney IV*, 2005 WL 1875804, at *36 n.463 (citing DEL. CODE ANN. tit. 8 §102(b)(7) (2005)).

75. See *Reed & Neiderman*, *supra* note 50, at 119.

76. *Perrine v. Pennroad Corp.*, 47 A.2d 479, 489 (Del. Ch. 1946) (citing *Karasik v. Pacific Eastern Corp.*, 180 A. 604 (Del. Ch. 1935)) (holding, however, that directors' decision was not so grossly inadequate to necessitate a finding of bad faith).

of conduct that may evidence a lack of good faith suggests that it might be a viable doctrine for stockholder claims, but an examination of case law demonstrates the difficulty Delaware courts have had in determining when to analyze good faith.

Although there has been some mention of Delaware's "triad" of fiduciary duties: the duties of care, loyalty and good faith, historically, Delaware cases discussed good faith as part of an analysis of the duty of care or the duty of loyalty.⁷⁷ Beyond this general proposition, however, there is little consistency. Some opinions suggest that good faith is a component of the duty of care. According to the Chancery Court, a director's "good faith effort to be informed and exercise judgment" is a core element of the duty of care.⁷⁸ Similarly, in *Disney II*, the Chancery Court found plaintiffs' well-pleaded claim based on the duty of care to fairly raise the question of whether Disney directors acted in good faith.⁷⁹

In contrast, the Delaware courts have frequently discussed good faith as part of directors' duty of loyalty. The Chancery Court noted that good faith belongs under a duty of loyalty analysis, because "by definition, a director cannot simultaneously act in bad faith and loyally toward the corporation and its stockholders."⁸⁰ Similarly, the Chancery Court explained that the obligation to act in good faith "does not exist separate and apart from the fiduciary duty of loyalty."⁸¹ Irrespective of where the Delaware courts believe good faith belongs, these historical mentions have been just that—judicial notice that some "duty" of good faith exists, without clear guidance as to what it requires or when it applies.⁸²

These contradictions have left the duty of good faith without doctrinal clarity, undermining its potential power in shaping director conduct. Because until recently the state's courts had not yet given guidance as to when an analysis of good faith is proper and what it entails, stockholders historically brought claims under the duty of care or the duty of loyalty, thereby precluding substantive discussions of good faith. More recently, before the decision in *Disney IV*, good faith has been more prominently discussed, but where it fits in the existing descriptions of

77. *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) (citing *Cede*, 634 A.2d at 361); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1164 (Del. 1995) (subsequent history omitted); *Kahn v. Dairy Mart Convenience Stores, G.P. Inc.*, Civ.A. No. 12489, 1994 Del. Ch. LEXIS 22, at *4 (Del. Ch., March 1, 1994) (citing *Cede*, 634 A.2d at 361).

78. *Caremark*, 698 A.2d at 968.

79. *Disney II*, 825 A.2d 275, 278 (Del. Ch. 2003).

80. *Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000) (citing *In re ML/EQ Real Estate P'ship Litig.*, C.A. No. 15741, 1999 WL 1271885 at *4 n.20 (Del. Ch., December 21, 1999)).

81. *Emerald Partners v. Berlin*, No. Civ.A. 9700, 2001 WL 115340, at *25 n.63 (Del. Ch. Feb. 7, 2001), *vacated on other grounds*, 787 A.2d 85 (Del. 2001) (discussing good faith separately only because the defendant directors raised a § 102(b)(7) waiver as an affirmative defense).

82. See David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 496-506 (2004) (discussing the tension between the Delaware Supreme Court and Delaware Chancery Court on how to categorize good faith).

directors' fiduciary duties remained unclear. In a suit alleging that directors breached both the duties of care and loyalty, counsel described their uncertainty as to how to challenge directors' good faith:

What could be confusing in the cases is that there's language—and I don't believe it's subtle—as to whether the bad-faith claim is a subset of the duty of loyalty or not Prior to the [*Disney II*] decision, the cases lined up in saying “Bad faith is a subset of the duty of loyalty, and here's the test.” After the recent [*Disney II*] decision, we have a bad-faith claim under a duty-of-care theory. I'm prepared on this complaint to apply either standard.⁸³

Part of the recent confusion over good faith is the direct result of the Delaware courts' ongoing attempt to refine standards for director conduct through an evolving doctrine of good faith.⁸⁴

E. The Vital Importance of Good Faith

Although there is significant confusion as to what good faith requires of directors or when it applies, it is both a presumption under the business judgment rule⁸⁵ and an ostensible prerequisite to several vitally important statutory protections for directors under the DGCL.⁸⁶

Of primary importance is the widely-used exculpatory charter provision of Section 102(b)(7) of the DGCL.⁸⁷ Under § 102(b)(7), stockholders may adopt an exculpatory charter provision in their certificate of incorporation protecting directors against personal liability for breaches of certain fiduciary duties, but not for breaches of the duty of loyalty or “for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law.”⁸⁸ Claims alleging only a

83. Official Comm. of Unsecured Creditors of Integrated Health Services, Inc., v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290 at *9 n.33 (Del. Ch., Aug. 24, 2004). In the Chancery Court's 2003 *Disney II* decision, the court held that stockholders' claims attacking Disney directors' business judgment created a reasonable doubt that the directors acted in good faith, which was sufficient to survive a motion to dismiss. 825 A.2d 275 (Del. Ch. 2003). See discussion *infra* Part IV.B.

84. See *supra* Parts II.D and Parts IV.A to IV.E.

85. See *supra* Part II.C.

86. DEL. CODE ANN. tit. 8 §§ 102(b)(7), 141, 144, 145 (2005). See also E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 443, 447 (2003) (noting that the duty of good faith arises under case law and under DEL. CODE ANN. tit. 8 § 102(b)(7) and DEL. CODE ANN. tit. 8 § 145).

87. DEL. CODE ANN. tit. 8 § 102(b)(7) (2005).

88. *Id.* § 102(b)(7) provides in pertinent part for:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

Id.

breach of the duty of care are barred by § 102(b)(7).⁸⁹ Delaware courts have been unwilling to infer bad faith into claims premised solely on the duty of care.⁹⁰ According to the Delaware Supreme Court, it is not enough to argue that duty of care claims are “inextricably intertwined with loyalty and bad faith claims” in the face of a § 102(b)(7) charter provision.⁹¹ As a result, to challenge a § 102(b)(7) charter provision in what would otherwise be a duty of care claim, plaintiffs must allege a breach of good faith with well-pled facts.⁹²

Three other sections of the DCGL seemingly require good faith, although there has been little, if any, judicial attention paid to the interplay between these statutory protections and good faith.⁹³ Under DGCL Section 145, corporations may indemnify officers and directors for actions taken in good faith.⁹⁴ In the modern corporate climate, indemnification is a vitally important concept for directors concerned with personal liability. On its face, the statute excludes actions taken in bad faith, so a director’s breach of good faith would prohibit statutory indemnification.⁹⁵

In cases of interested director or officer transactions, under DGCL Section 144(a), a majority of the disinterested directors can approve the transaction and prevent it from being voidable, as long as they are fully informed and they act in good faith.⁹⁶ Importantly, if the requirements of DGCL § 144(a) are met, the business judgment rule applies to the transaction.⁹⁷

Finally, under DGCL Section 141(e), directors are fully protected in relying on the corporation’s officers, committees of the board, or experts, if such reliance is made in good faith.⁹⁸ In order to be protected under this section, reliance on an expert requires that the expert be selected

89. *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) (citing *Emerald Partners v. Berlin*, 726 A.2d 1215, 1224 (Del. 1999); *Arnold v. Society for Savings Bancorp*, 650 A.2d 1270, 1288 (Del. 1994); *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061 (Del. 1996)).

90. *See Malpiede*, 780 A.2d at 1093-94.

91. *Id.* at 1093.

92. Although § 102(b)(7) must be raised as an affirmative defense, there is some question as to what exactly directors must do to effectively raise it. *In re Emerging Communications*, No. Civ.A 16415, 2004 WL 1305745, at *40 (Del. Ch. Jun. 4, 2004) (charging the director with the burden of proving that “[his] failure to withstand an entire fairness analysis is exclusively attributable to a violation of the duty of care”); *Veasey & Di Guglielmo, Retrospective*, *supra* note 10, at 1434 (“In order to achieve exculpation in *Malpiede*, the directors were not required affirmatively to prove the lack of a breach of loyalty.”) *Malpiede*, 780 A.2d at 1094 (holding that defendants only need raise § 102(b)(7) as an affirmative defense).

93. *Disney IV’s* extensive discussion of good faith addressed some of these provisions. *See infra* Part II.F. *But see Veasey & Di Guglielmo, Retrospective*, *supra* note 10, at 1443-44; *Disney IV*, 2005 WL 1875804, at *36.

94. DEL. CODE ANN. tit. 8 §145 (2005).

95. *Id.*

96. DEL. CODE ANN. tit. 8 §144(a)(1) (2005).

97. *In re Cox Comm’n, Inc. S’holder Litig.*, 879 A.2d 604, 615 (Del. Ch. 2005) (citing *Puma v. Marriott, Inc.*, 283 A.2d 693, 694 (Del. Ch. 1971)).

98. DEL. CODE ANN. tit. 8 §141(e) (2005).

with reasonable care and the director must reasonably believe the matter is within the expert's competence.⁹⁹

Given the plain language of these statutory protections, an understanding of good faith is imperative. If stockholders could successfully assert a claim based on good faith, the business judgment rule and these statutory provisions would not apply to protect directors' actions. Until recently, however, the confusion over whether the duty of good faith is a component of the duty of care, the duty of loyalty, or a stand-alone duty has prevented stockholders from making a successful challenge to these statutory protections. In light of the historically amorphous status of good faith, it is logical that stockholders have not been more vigorous in basing their claims on bad faith, leaving cases to be ultimately decided under the duty of care or duty of loyalty.

The limited reach of good faith and the rigidity of the traditional fiduciary duty doctrines have not gone unnoticed by the Delaware judiciary. Perhaps out of frustration with the limited reach of good faith or the outcome-determinative nature of the traditionally mechanical application of the business judgment rule, the Delaware courts have undertaken the exploration of good faith in an attempt to increase standards of director conduct.¹⁰⁰ Refining the substantive doctrine of good faith to ultimately increase standards for directors' actions and processes, however, would be impossible without actionable good faith claims reaching trial on the merits. Accordingly, the first component of Delaware's guidance has been procedural. In order to bring fiduciary duty cases that allow for an exploration of good faith before them, the state's courts have been offering plaintiffs specific instructions on how to overcome procedural obstacles at the pleadings stage and have their claims heard on the merits.

III. PROCEDURAL OBSTACLES TO DEVELOPING GOOD FAITH AND THE DELAWARE COURTS' EFFORTS TO MAKE THEM SURMOUNTABLE

Good faith's traditionally underdeveloped status can be directly traced to two procedural obstacles: (1) the demand requirement, a Chancery Court Rule requiring aggrieved stockholders to first address their complaint to the corporation, and (2) the impact of DGCL § 102(b)(7).¹⁰¹ Together, these obstacles often defeat fiduciary duty cases before they reached trial on the merits.¹⁰² As a result, there has been little opportu-

99. *Id.*

100. *See infra* Part IV.

101. DEL. R. CH. CT. 23.1 ; DEL. CODE ANN. tit. 8 §102(b)(7) (2005).

102. *See Sale, supra* note 12, at 459-60 (discussing the pre-suit demand requirement and Section 102(b)(7) as "barrier[s] to litigation over fiduciary duty breaches"); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 650 (2004) (discussing Delaware's procedural barriers which allow directors to "avoid litigating on the substantive merits of the shareholders' claims") (citing JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS*, 429 (2d ed. 2003)).

nity for the state's courts to conduct a more thorough analysis of the substantive workings of good faith.

The first component of the Delaware courts' guidance to increase standards for director conduct directly addresses these procedural obstacles. Through ongoing and increasingly specific instruction, the courts of Delaware have been detailing how plaintiffs can overcome these procedural obstacles and reach trial on the merits.¹⁰³ In so doing, the courts have brought fiduciary duty suits before them that may allow Delaware to increase standards for director conduct by way of a refined (or defined) conceptualization of the requirement that directors act in good faith.¹⁰⁴

A. Delaware's Procedural Obstacles

1. The Demand Requirement

Under Delaware Chancery Court Rule 23.1 ("Rule 23.1"), stockholders in a derivative action must allege with particularity their efforts to make demand on a corporation's directors seeking resolution of their complaint, or alternately, explain why demand would be futile.¹⁰⁵ Under the standard established by the Delaware Supreme Court in *Aronson v. Lewis*,¹⁰⁶ a plaintiff may establish demand futility by alleging facts which suggest that the directors were not "disinterested and independent" or that the transaction was not "the product of a valid exercise of business judgment."¹⁰⁷

From a policy standpoint, Delaware's demand requirement serves an important gate-keeping function by preventing "costly, baseless suits" while allowing factually-based claims that might benefit the corporation to continue.¹⁰⁸ Establishing demand futility is critical for legitimate claims to move forward, because if a derivative plaintiff instead chooses to make demand on the corporation, the directors have the power to dismiss the suit.¹⁰⁹ Therefore, in order to litigate on the merits, plaintiffs must successfully challenge either the directors' independence (the "first prong of *Aronson*") or the directors' business judgment (the "second prong of *Aronson*").¹¹⁰ In application, the demand requirement imposes

103. See *infra* Part III.B.

104. See *infra* Part IV.

105. DEL. R. CH. CT. 23.1.

106. 473 A.2d 805 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

107. *Aronson*, 473 A.2d at 814-15.

108. *Brehm*, 746 A.2d at 254-55 (citing *Grimes v. Donald*, 673 A.2d 1207, 1216-17 (Del. 1996)).

109. See *Zapata v. Maldonado*, 430 A.2d 779, 784 (Del. 1981) (holding that once a plaintiff makes demand on the corporation, the board has the power to dismiss the suit and such decision by the board is protected by the business judgment rule).

110. *Aronson*, 473 A.2d at 814.

an almost insurmountable procedural hurdle in derivative suits.¹¹¹ In order to survive a motion to dismiss under Rule 23.1, plaintiffs must either establish that the directors were not sufficiently independent (the concept of independence is currently another moving target in Delaware jurisprudence, further adding to this challenge),¹¹² or rebut the presumption of the business judgment rule.¹¹³ Given the relative safety of review under the duty of care because of the application of the business judgment rule,¹¹⁴ boards have an incentive to use the statutory protections of DGCL § 144(a) to avoid a challenge on independence grounds, and instead, have their actions protected under the rule.¹¹⁵ Because of the traditionally hazy notion of good faith is a component of the business judgment rule formula, establishing demand futility under the second prong of *Aronson* has been a significant hurdle.¹¹⁶

2. DGCL Section 102(b)(7)

In addition to the demand requirement, DGCL § 102(b)(7) operates as an affirmative defense against personal financial liability for claims alleging a duty of care violation.¹¹⁷ As previously noted, a § 102(b)(7) exculpatory charter provision bars claims based exclusively on the duty of care, but does not bar director liability for claims based on the breach of the duty of loyalty or actions not in good faith.¹¹⁸ Therefore, to overcome a § 102(b)(7) charter provision by way of challenging a director's good faith, pleadings must allege a loyalty violation or "bad faith, intentional misconduct, [or] knowing violation of the law."¹¹⁹ Unsurprisingly, the traditionally amorphous status of good faith and the business judgment rule's strong presumption gives directors a high likelihood of success under § 102(b)(7).¹²⁰ Recent decisions suggest some confusion as to what the directors' burden is when raising § 102(b)(7) as an affirmative defense. Although the Chancery Court has suggested that directors must prove that their actions fall under the duty of care when raising § 102(b)(7) as an affirmative defense, the Delaware Supreme Court has only required directors to raise the *existence* of the charter provision in

111. See *supra* note 102.

112. See *In re J.P. Morgan Chase & Co. S'holder Litig.*, No. Civ.A 531-N, 2005 WL 1076069, at *10 n. 48 (Del. Ch., Apr. 29, 2005) (discussing the evolving jurisprudence on philanthropic relationships and director independence) (citing *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003); *In re The Limited, Inc. S'holders Litig.*, No. Civ.A. 17148-NC, 2002 WL 537692 (Del. Ch., Mar. 27, 2002); *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985)). The Delaware Supreme Court has not yet settled this issue. See also Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1470-72 (discussing the development of "independence" in the Delaware courts between 1992 and 2004).

113. *Aronson*, 473 A.2d at 815.

114. See *supra* Part II.C.

115. See *supra* Part II.E.

116. See *supra* Part II.C.

117. *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001).

118. DEL. CODE ANN. tit. 8 §102(b)(7) (2005).

119. *In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268, 1270 (Del. Ch. 1995).

120. See *Sale*, *supra* note 12, at 459 (calling § 102(b)(7) a "barrier to litigation").

order to meet this burden.¹²¹ Despite this tension, in practice, § 102(b)(7) has “created an immediate dismissal right for duty of care claims.”¹²²

Both the demand requirement and § 102(b)(7) function as significant procedural barriers to litigation on the merits for fiduciary duty cases.¹²³ In turn, this has prevented meaningful analysis of both the substantive requirement of good faith and how good faith meshes or interacts with other duties and obligations, which has limited the potential for courts and stockholders to hold directors to higher standards of conduct under Delaware law.

B. Part I of Delaware’s Guidance: An Ongoing Tutorial on Procedural Requirements

A review of cases and commentary suggests that the Delaware courts have become increasingly frustrated with the limiting nature of the established duty of care and duty of loyalty tests and the procedural obstacles that defeat many stockholder suits.¹²⁴ In response, the Delaware courts have offered guidance in the form of increasingly specific commentary to help plaintiffs overcome these procedural obstacles. By clarifying procedural standards through commentary in decisions that are decided against plaintiffs or on unrelated grounds, the courts have created the opportunity to hear claims that implicate good faith, ultimately allowing Delaware to increase standards for director conduct through an expanded notion of good faith.¹²⁵ Although Delaware’s judges have downplayed the courts’ role in bringing good faith cases before the courts, their ongoing instructions to plaintiffs appear to be the very impetus behind the factually-specific claims that have provided the courts with the opportunity to continue exploring good faith.¹²⁶

Delaware’s procedural instruction addresses two concepts: the importance of pleading with particularity and the use of Section 220 of the DGCL to gain access to the corporation’s books and records in order to obtain the information necessary to plead with sufficient particularity. Through these cases, the judiciary has provided ongoing guidance, de-

121. See *In re Emerging Communications*, 2004 WL 1305745, at *40 (charging the director with the burden of proving that his “failure to withstand an entire fairness analysis is exclusively attributable to a violation of the duty of care”); *Disney IV*, 2005 WL 1875804, at *35 (citing *In re Emerging Communications* for the proposition that directors asserting a § 102(b)(7) exculpatory charter provision bear the burden of proving they are entitled to its protections); *but cf. Malpiede*, 780 A.2d at 1094 (holding that defendants only need raise § 102(b)(7) as an affirmative defense); *see also Veasey & Di Guglielmo, Retrospective*, *supra* note 10, at 1434 (“In order to achieve exculpation in *Malpiede*, the directors were not required affirmatively to prove the lack of a breach of loyalty.”)

122. See Griffith, *supra* note 12, at 15.

123. See Sale, *supra* note 12, at 459-60.

124. See *supra* Part II; *see infra* Part IV.

125. See *Disney II*, 825 A.2d 275 (Del. Ch. 2003); *Integrated Health Services*, 2004 WL 1949290; *see also infra* Part IV.

126. See *Disney II*, 825 A.2d 275; *Integrated Health Services*, 2004 WL 1949290; *see also supra* note 10.

tailoring the procedural requirements necessary for claims alleging director misconduct to survive the pleadings stage. Ultimately, this process has opened the door for the Delaware to increase standards of director conduct through the courts' cautious exploration of good faith.¹²⁷

1. Delaware is Particular About 'Particularity'

Traditionally, the demand requirement and DGCL § 102(b)(7) have prevented Delaware courts from hearing good faith claims on the merits.¹²⁸ Remarkably, however, cases such as *Disney II*,¹²⁹ and *Official Committee of Unsecured Creditors of Integrated Health Services, Inc., v. Elkins*,¹³⁰ have alleged breaches of good faith with well-pleaded facts and survived motions to dismiss. The success of these complaints appears to be the direct result of the courts' increasingly specific instruction as to the level of particularity required to reach trial on the merits.

To satisfy Rule 23.1 as interpreted by *Aronson*, a complaint must plead facts *with particularity* that if taken as true, raise doubt about the directors' independence or the directors' business judgment.¹³¹ Thus, to survive a motion to dismiss, allegations must be factual, not conclusory, a standard exceeding the "short and plain statement" of notice pleading called for by Chancery Court Rule 8(a).¹³² Derivative plaintiffs frequently fail to meet this standard, due in part to the "race to the courthouse" to win lead-plaintiff status.¹³³ Frustrated by inadequate complaints based on insufficient (or almost non-existent) investigations, Delaware's judges have repeatedly admonished plaintiffs for not pleading with sufficient particularity.¹³⁴ Contrary to the claim that Delaware has somehow failed to respond to the new corporate climate,¹³⁵ much of the courts' ongoing critique of these defective complaints has occurred since 1993, years before the post-Enron and WorldCom environment and

127. See *infra* Part IV.

128. See Sale, *supra* note 12, at 459-61 (discussing the pre-suit demand requirement and Section 102(b)(7) as "barriers to litigation over fiduciary duty breaches"); Jones, *supra* note 102, at 650 (discussing Delaware's procedural barriers which allow directors to "avoid litigating on the substantive merits of the shareholders' claims") (citing JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS, 429 (2d ed. 2003))

129. *Disney II*, 825 A.2d 275.

130. No. Civ.A. 20228-NC, 2004 WL 1949290 (Del. Ch., Aug. 24, 2004).

131. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984), *overruled on other grounds*, *Brehm v. Eisner*, 746 A.2d 744.

132. See *Brehm*, 746 A.2d at 254-55 n.19, 21; *Saito v. McCall*, No. Civ.A. 17132-NC, 2004 WL 3029876, at *7 n.67 (Del. Ch. Dec. 20, 2004); *In re Baxter Int'l. Inc. S'holders Litig.*, 654 A.2d 1268, 1270 (Del. Ch. 1995).

133. *Rales v. Blasband*, 634 A.2d 927, 935 n.10 (Del. 1993) ("Perhaps the problem arises in some cases out of an unseemly race to the court house, chiefly generated by the 'first to file' custom seemingly permitting the winner of the race to be named lead counsel.")

134. *Id.*; see also *infra* note 138 (quoting opinions criticizing incomplete, defective complaints).

135. See INTRODUCTION, *supra*.

the public call for improved corporate governance.¹³⁶ In its 1993 opinion, *Rales v. Blasband*, the Delaware Supreme Court clarified the requirements of Rule 23.1 by rejecting the suggestion that a plaintiff should have to demonstrate a “reasonable probability of success,” explaining that the rule requires only an “allegation of particularized facts.”¹³⁷

Since *Rales*, the Delaware courts have continued to chastise counsel for making “conclusory allegations” in underdeveloped complaints that do not meet the demand requirement or that cannot overcome a § 102(b)(7) charter provision.¹³⁸ In 2003, the Delaware Chancery Court expanded on the problems presented by these defective complaints:

If the facts to support reasonable doubt could have been ascertained through more careful pre-litigation investigation, the failure to discover and plead those facts still results in a waste of resources of the litigants and the Court and, in addition, *ties the hands of this Court to protect the interests of shareholders* where the board is unable or unwilling to do so. This results in the dismissal of what may otherwise may have been meritorious claims, fails to provide relief to the company’s shareholders, and further erodes public confidence in the legal protections afforded to investors.¹³⁹

a. Delaware’s Focus on Particularity: Pre-2001 Cases

Before the today’s post-Enron and WorldCom corporate climate, the Delaware courts issued several opinions explaining the factual particularity necessary to survive the pleadings stage. In 2000, the Chancery Court dismissed a plaintiff’s claims for failure to establish demand futility in *White v. Panic*.¹⁴⁰ In so doing, Vice Chancellor Lamb explained:

136. *Rales*, 634 A.2d at 935 n.10 (describing the “race to the courthouse” and the “plethora of superficial complaints that could not be sustained” that have resulted from this practice).

137. *Id.* at 934.

138. *Brehm*, 746 A.2d at 249 (“The Complaint, consisting of 88 pages and 285 paragraphs, is a pastiche of prolix invective. It is permeated with conclusory allegations of the pleader and quotations from the media, mostly of an editorial nature (even including a cartoon).”); *White v. Panic*, 793 A.2d 356, 367 (Del. Ch. 2000), *aff’d*, 783 A.2d 543 (Del. 2001) (criticizing complaint as “replete with highly moralistic, conclusory charges of misconduct”); *Ash v. McCall*, No. Civ.A. 17132, 2000 WL 1370341, at *1 (Del. Ch. Sept. 15, 2000) (“Although the complaint is generously laden with conclusory allegations that ‘the facts described herein constitute breaches of directors’ duties of good faith, care and loyalty,’ plaintiffs decline to connect the facts of the complaint with specific claims of wrongdoing.”); *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003), *aff’d*, 845 A.2d 1040 (Del. 2004); *Saito v. McCall*, No. Civ.A. 17132-NC, 2004 WL 3029876, at *8 (Del.Ch. Dec. 20, 2004) (describing the pleadings as “conclusory and prolix averments,” and further critiquing the pleadings, “lacking facts to support these legal conclusions, plaintiffs simply insert the names of certain defendants into the relevant legal standard.”).

139. *Beam ex rel. Martha Stewart Living*, 833 A.2d at 982 [hereinafter *Beam I*] (emphasis added).

140. 793 A.2d 356 (Del. Ch. 2000), *aff’d*, 783 A.2d 543 (Del. 2001).

[T]he only reference to [the directors'] independence [the first prong of *Aronson*] in the brief appears *in a footnote* From this, I conclude that plaintiff has chosen not to rely on any allegation of lack of directorial independence in resisting this motion [With respect to the second prong of *Aronson*], the complaint supplies little actual information about either the context underlying the challenged decisions or the process followed by the Director Defendants in reaching them. Instead, the complaint is replete with highly moralistic, conclusory charges of misconduct My review of the totality of the Director Defendants' conduct, as gleaned from the complaint and the magazine article on which it is based, leads to the conclusion that the complaint does not satisfy the second prong of the *Aronson* test and, thus, that demand is not excused.¹⁴¹

Later that same year, the Delaware Supreme Court issued its *Brehm v. Eisner*¹⁴² decision, allowing plaintiffs in the *Disney* litigation to amend their initial complaint.¹⁴³ In describing the factual particularity requirement, the court harshly criticized the *Brehm* complaint for its generality, describing it as “a pastiche of prolix invective,” full of “conclusory allegations,” which were “editorial [in] nature” and served “no purpose other than to complicate the work of [the] reviewing courts.”¹⁴⁴ Rather than merely providing a general critique of the defective nature of the plaintiffs' complaint, the Delaware Supreme Court detailed a laundry list of specific facts the plaintiffs' amended complaint might allege in order to survive a motion to dismiss.¹⁴⁵ For example, the plaintiffs needed to allege “particularized facts (not conclusions)” that directly attacked the directors' business judgment, such as allegations that:

(a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter . . . was material and reasonably available [and] was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the [b]oard was so unconscionable as to constitute waste or fraud.¹⁴⁶

141. *White*, 793 A.2d at 366 n.29, 367-68.

142. *Brehm*, 746 A.2d at 244.

143. *Id.* at 267. In the first chapter of the *Disney* litigation, plaintiffs brought claims alleging that the directors breached their duties of loyalty, care and good faith. *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 351 (Del. Ch. 1998) [hereinafter “*Disney I*”]. The plaintiffs failed to establish demand futility under either prong of *Aronson* and their claims were dismissed. *Id.* at 379-80. Their appeal to the Delaware Supreme Court was heard as *Brehm*, 746 A.2d 244.

144. *Brehm*, 746 A.2d at 249.

145. *Id.* at 262.

146. *Id.*

Despite the fact that the *Brehm* complaint did not meet the stringent particularity requirement to establish demand futility under *Aronson*, the Delaware Supreme Court expressed concern that the case was potentially “very troubling . . . on the merits.”¹⁴⁷ Citing the “unusual nature” of the case and “the interests of justice,” the court allowed the plaintiffs to amend their complaint.¹⁴⁸ Armed with the Supreme Court’s specific instruction for meeting the particularity requirement, the plaintiffs amended the complaint and in 2003 returned to the Chancery Court in *Disney II*, where they established demand futility under the second prong of *Aronson*.¹⁴⁹

Later in 2000, the Delaware Chancery Court dismissed plaintiffs’ claims in *Ash v. McCall*,¹⁵⁰ for failure to meet the particularity requirement necessary to establish demand futility.¹⁵¹ Chancellor Chandler explained, “The shorthand shibboleth of ‘dominated and controlled directors’ is insufficient [P]laintiffs have not alleged a single fact in support of their domination theory and, as Delaware courts have repeatedly observed, such assumptions will not be made in the context of pre-suit demand.”¹⁵²

b. Delaware’s Focus on Particularity: Post-2001 Cases

Against the current backdrop of the post-Enron and WorldCom climate and calls for increased scrutiny of directors’ actions, the Delaware courts have continued to instruct plaintiffs on how to avoid pre-trial dismissal so legitimate suits can reach trial on the merits. Several recent cases highlight the courts’ attempt to illustrate the types of factual allegations that will satisfy the particularity requirement. In 2001, in *Telxon Corporation v. Bogomolny*,¹⁵³ the plaintiffs alleged that the board’s committees did not keep minutes of their meetings, including a meeting of the compensation committee where directors agreed to let the chairman acquire ten percent of a corporate subsidiary.¹⁵⁴ The Chancery Court denied defendants’ Rule 12(b)(6) motion to dismiss based on the

147. *Id.* at 249.

148. *Id.* at 267.

149. *Disney II*, 825 A.2d at 289-90.

150. No. Civ.A. 17132, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000).

151. *Ash*, 2000 WL 1370341, at *1.

152. *Id.* at *7 (internal citation omitted). The plaintiff’s oversight claims were dismissed without prejudice and plaintiffs were permitted to replead their claims. *Id.* at *16. Based on the factually particular repleaded complaint, plaintiffs established demand futility and survived a motion to dismiss. *Saito v. McCall*, No. Civ.A. 17132-NC, 2004 WL 3029876, at *6-7 (Del. Ch. Dec. 20, 2004). See also *infra* Part III.B.1.b.

153. 792 A.2d 964 (Del. Ch. 2001 Ch. 2001), *reargument denied*, *Telxon v. Cribb*, No. CIV.A. 17706, 2001 WL 1641236 (Del. Ch. Oct. 29, 2001). The Chancery Court’s *Telxon* decision was issued on Oct. 29 and revised on Nov. 1. *Telxon*, 792 A.2d at 964. Enron’s public decline began in part with its Oct. 16 announcement of a quarterly loss and its Oct. 17 announcement that it would decrease its stated assets by over \$1 billion. See C. William Thomas, *The Rise and Fall of Enron*, J. ACCT., April 15, 2002, at 41.

154. *Telxon*, 792 A.2d at 975.

plaintiffs' "well-pleaded allegations" that overcame the "usual presumption" of the business judgment rule, creating a reasonable doubt that the directors acted in good faith.¹⁵⁵ Similarly, in 2002, in *California Public Employees' Retirement System v. Coulter*¹⁵⁶ ("CalPERS"), the Chancery Court held that a factually specific claim alleging that directors acted in bad faith by blindly relying on an expert's overvaluation of an acquisition target owned by the CEO was sufficiently particular to establish demand futility and survive a motion to dismiss.¹⁵⁷ Likewise, the Chancery Court's 2004 *Integrated Health Services* decision held that some of the plaintiffs' factually-particular claims that company directors approved certain executive compensation transactions without any information or deliberation met Delaware's particularity requirement, by pleading facts alleging that directors "consciously and intentionally disregarded their responsibilities."¹⁵⁸ More recently, the Chancery Court denied a motion to dismiss in the 2004 case of *Saito v. McCall*.¹⁵⁹ Alleging a failure of oversight (a subset of the duty of care), plaintiffs met the particularity requirement of Rule 23.1 under the second prong of *Aronson*, by pleading factually particular allegations that defendant directors knew or should have known about accounting irregularities at a merger target yet failed to take action or disclose the problems.¹⁶⁰

The Delaware courts have also used decisions dismissing claims as part of their tutorial about factual particularity. In 2004, the Delaware Supreme Court affirmed the dismissal of a stockholder suit in *Beam v. Stewart*¹⁶¹ ("*Beam II*") for failure to establish demand futility.¹⁶² While the complaint alleged that company directors were interested and not independent, it did not provide the factual particularity required.¹⁶³ The Delaware Supreme Court criticized the complaint for failing to give *any* examples of directors' actions or their relationships with company CEO, Stewart, that would meet the particularity requirements of Rule 23.1 and satisfy the first prong of *Aronson*.¹⁶⁴ In its earlier disposition of the case, the Chancery Court explicitly described specific facts that could have met the particularity requirement.¹⁶⁵ Chancellor Chandler counseled:

I would be remiss, though, if I failed to point out that with a bit more detail about the 'relationships,' 'friendships,' and 'inter-connections' among Stewart and the other defendants or with some additional arguments as to why there may be a reasonable doubt of the directors'

155. *Id.* at 973-75.

156. No. Civ.A. 19191, 2002 WL 31888343 (Del. Ch., Dec. 18, 2002).

157. *CalPERS*, 2002 WL 31888343, at *12-14.

158. *Integrated Health Services*, 2004 WL 1949290, at *10, 12.

159. No. Civ.A. 17132-NC, 2004 WL 3029876, at *6-7 (Del. Ch. Dec. 20, 2004).

160. *Saito*, 2004 WL 3029876, at *7.

161. 845 A.2d 1040 (Del. 2004) [hereinafter *Beam III*].

162. *Beam II*, 845 A.2d at 1044.

163. *Id.*

164. *Id.* at 1047.

165. *Beam I*, 833 A.2d at 984.

incentives when evaluating demand with respect to Count I, there may have been a reasonable doubt as to one or all of the outside directors' disinterest, independence, or ability to consider and respond to demand free from improper extraneous influences. Nevertheless, on this pleading, no such doubt is raised.¹⁶⁶

Not surprisingly, when the Delaware Supreme Court affirmed, it too explained that the plaintiff's claim failed to make allegations about the "closeness or nature of the friendship" in question, or specific factual allegations as to why the defendant directors could not objectively consider pre-suit demand.¹⁶⁷

Most recently, in 2005, the Chancery Court again reiterated the critical requirement of factually particularized pleading and dismissed plaintiffs' complaint in *In re J.P. Morgan Chase Co., Shareholders Litigation*.¹⁶⁸ The complaint alleged that directors breached their fiduciary duties in a merger transaction and that demand was futile under both prongs of *Aronson*.¹⁶⁹ Despite the plethora of recent cases describing the factual particularity required, the pleadings failed to provide details alleging that the directors were not disinterested and independent and merely asserted that the directors could not act independently, without any detail as to how the directors specifically might have been influenced.¹⁷⁰ Further, the complaint failed to include particularized allegations challenging the directors' honesty, good faith, or to assert that the directors were not informed.¹⁷¹

These cases illustrate the Delaware courts' attempt to help stockholders survive the pleadings stage, by explaining the factual particularity necessary to overcome a motion to dismiss based on Rule 23.1 or DGCL § 102(b)(7). While the Delaware courts have been painfully direct about the particularity required for stockholder claims to reach trial on the merits, plaintiffs' sole opportunity to meet this burden is at the pleadings stage.¹⁷² Notwithstanding that *Brehm* and *Ash* allowed plaintiffs to amend their complaints, these are the exception rather than the rule.¹⁷³ After *Brehm*, then-Vice Chancellor Steele denied a plaintiff's request to replead explaining, "I do not share plaintiff's counsel's belief that [*Brehm*] suggests that trial judges should treat every complaint like a

166. *Id.* at 984.

167. *Beam II*, 845 A.2d at 1047.

168. No. Civ.A. 531-N, 2005 WL 1076069, at *12 (Del. Ch., Apr. 29, 2005).

169. *J.P. Morgan Chase*, 2005 WL 1076069, at *4-5.

170. *Id.* at *10-11.

171. *Id.* at *12.

172. See generally *Criden v. Steinberg*, No. 17082, 2000 WL 354390, at *2 (Del. Ch., Mar. 23, 2000) (then-Vice Chancellor Steele (now Chief Justice of the Delaware Supreme Court) erased any doubt on this point, "I have neither the authority nor the predilection to entertain a practice where I, as a trial judge, develop my own theories of possible recovery for plaintiffs or hear them for the first time from plaintiffs at oral argument, and then allow them to replead until some viable claim hits the wall and sticks.")

173. *Brehm*, 746 A.2d at 248; *Ash*, 2000 WL 1370341, at *1.

Phoenix ever ready to spring to life from its ashes upon learning of its imminent demise.”¹⁷⁴

2. Utilizing DGCL Section 220’s “Tools at Hand”

On its face, the requirement that plaintiffs plead with factual particularity before they can engage in discovery may seem inequitable.¹⁷⁵ Arguably, without access to information, stockholders cannot plead with the requisite particularity necessary to reach trial on the merits. The DGCL, however, provides a statutory method for obtaining this information. Under Section 220 (hereinafter “DGCL § 220” or “§ 220”), a stockholder asserting proper purpose and making a “specific and discrete identification” of the particular records sought may inspect the corporation’s books and records.¹⁷⁶ As part of the procedural element of Delaware’s prescription, the state’s courts have made a concerted push over the past decade to encourage stockholder plaintiffs to utilize this tool.¹⁷⁷

In 2003, the Delaware General Assembly broadened the reach of § 220 by extending inspection rights to beneficial owners and allowing inspection of a corporation’s subsidiaries’ records in certain cases.¹⁷⁸ This amendment evidences the legislature’s shared interest in helping stockholders obtain the necessary information to draft complete complaints and have their legitimate claims heard on the merits.

According to the Delaware Supreme Court, § 220 generally has not enjoyed widespread use and “[t]he result has been a plethora of superficial complaints that could not be sustained.”¹⁷⁹ Contemporaneously with the courts’ clarification of the particularity required at the pleadings stage, the Delaware courts have been increasingly blunt in their recommendation that stockholders utilize this tool.

a. Delaware’s Push for Plaintiffs to Utilize §220: Pre-2001 Cases

Even before the corporate scandals that so dramatically impacted the corporate climate, the Delaware courts were issuing guidance to stockholders on how to meet the particularity requirement and have their legitimate claims heard on the merits. In 1993, in *Rales*, the Delaware

174. *Criden*, 2000 WL 354390, at *4. Vice Chancellor Steele became Chief Justice of the Delaware Supreme Court on May 26, 2004.

175. *See Rales v. Blasband*, 634 A.2d 927, 935 n.10 (Del. 1993).

176. DEL. CODE ANN. tit. 8, § 220 (2005).

177. *See Beam II*, 833 A.2d at 981-82 n.66 and accompanying text. *See also* Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands*, 26 CARDOZO L. REV. 1595 (2005), J. Travis Laster & K. Tyler O’Connell, *Improving the “Tools at Hand”: Recent Delaware Books and Records Decisions*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Jan. 2005, at 9. William M. Lafferty & Alan J. Stone, *Recent Developments in Shareholder/Director Inspection Cases: A Resurgence in the Use of Section 220 of the Delaware Corporation Law*, CORPORATION, June 2, 1997, § 2, at 1.

178. DEL. CODE ANN. tit. 8, § 220.

179. *Rales*, 634 A.2d at 935 n.10.

Supreme Court pointed to § 220 as a means for gaining the information necessary to plead with sufficient factual particularity.¹⁸⁰ The Delaware courts have repeatedly encouraged stockholder plaintiffs to utilize this tool through “suggestions, encouragement and downright admonitions.”¹⁸¹ For example, in 2000, in *White*, the Chancery Court dismissed plaintiffs’ claims for failure to establish demand futility.¹⁸² In a section of that opinion focusing on § 220, Vice Chancellor Lamb explained that what was missing from the complaint, details of the directors’ actions, could have been uncovered using § 220.¹⁸³

Later in 2000, the Delaware Supreme Court admonished the (*Disney*) plaintiffs in *Brehm* for failing to use § 220 as one of the “tools at hand” to uncover the detailed facts necessary to develop an actionable claim.¹⁸⁴ After the court’s reprimand, the plaintiffs made a § 220 books and records request, amended their complaint and ultimately established demand futility.¹⁸⁵ In considering the plaintiff’s amended and factually-specific complaint in *Disney II*, the Chancery Court noted it was a “perfect illustration of the benefit [of using § 220].”¹⁸⁶ Chancellor Chandler tempered his praise, however, describing the wasted time and expense because the plaintiffs failed to make a § 220 request at the outset and instead filed suit based on an incomplete complaint.¹⁸⁷ In another opinion addressing § 220 in 2000, *Ash*, Chancellor Chandler dismissed an oversight claim without prejudice, for failure to establish demand futility.¹⁸⁸ In so doing, he specifically referenced the Delaware Supreme Court’s repeated instruction that plaintiffs utilize § 220 as one of their “tools at hand” to develop factually particular complaints and suggested that the plaintiffs take advantage of § 220 in developing their amended complaint.¹⁸⁹

180. *Id.*; see also *id.* at 931 n.4.

181. See *Beam I*, 833 A.2d at 981, 982 n.65-67 and accompanying text (discussing plaintiff’s failure to make a books and records request under § 220 and citing to numerous Delaware Supreme Court and Chancery Court opinions criticizing stockholders for lackluster investigations which prevented the development of viable complaints, noting “[i]t is troubling to this Court that, notwithstanding repeated suggestions, encouragement, and downright admonitions over the years both by this Court and the Delaware Supreme Court, litigants continue to bring derivative complaints pleading demand futility on the basis of precious little investigation beyond perusal of the morning newspapers.”) (internal citations omitted).

182. *White v. Panic*, 793 A.2d 356, 371 (Del. Ch. 2000), *aff’d*, 783 A.2d 543 (Del. 2001).

183. *White*, 793 A.2d at 364-65.

184. *Brehm*, 746 A.2d at 266-67.

185. *Disney II*, 825 A.2d at 279, 289-90.

186. *Id.* at 279 n.5.

187. *Id.*

188. *Ash*, 2000 WL 1370341, at *16.

189. *Id.* at *15 n.56; see *id.* at *16 (explaining, “Using the tools at hand, plaintiffs may seek to develop additional particularized facts in order to allege properly an oversight claim that will meet the demand futility standard”).

b. Delaware's Push for Plaintiffs to Utilize § 220: Post-2001 Cases

In the current corporate climate, the Delaware courts continue to discuss the importance of § 220. In *CalPERS*,¹⁹⁰ while denying the defendant's motion to dismiss, the court explained that the plaintiffs utilized § 220, providing them with detailed facts necessary to meet the particularity requirement to establish demand futility.¹⁹¹

In light of this ongoing discourse on the importance of § 220, the Delaware courts seem increasingly exasperated with plaintiffs who rush to file suit, failing to take advantage of this tool. In its 2003 decision, *Guttman v. Huang*,¹⁹² the Chancery Court expressed frustration with plaintiffs' conclusory claim made without the benefit of facts that could have been uncovered with a § 220 books and records request.¹⁹³ In granting the defendants' motion to dismiss for failure to establish demand futility, Vice Chancellor Strine expressed disbelief that the plaintiffs did not avail themselves of § 220, noting, "the plaintiffs have unsurprisingly submitted . . . [a] complaint that lacks particularized facts . . . [w]hen the case most cries out for the pleading of real facts . . . the complaint is at its most cursory."¹⁹⁴ Similarly, in dismissing claims for failure to establish demand futility in *Beam II* the Delaware Supreme Court criticized the plaintiff for electing not to make a books and records request noting, "had Beam first brought a *Section 220* action . . . she might have uncovered facts that would have created a reasonable doubt."¹⁹⁵ Specifically, the court explained, a § 220 request might have uncovered "cronyism" in the nominating process, facts suggesting that Stewart "unduly controlled the nominating process," or other specific facts supporting the allegation that Stewart dominated the board.¹⁹⁶ While he declined to speculate as to whether a claim based on such investigation would have been successful, then-Chief Justice Veasey remarked, "the point is that it was within the plaintiff's power to explore these matters and she elected not to make the effort."¹⁹⁷ More recently, in its 2005 decision, *In re J.P. Morgan Chase Co. Shareholder Litigation*, the Chancery Court dismissed a claim for failure to establish demand futility. "In this case, the court is once again confronted with a situation in which the plaintiffs attempt to plead demand futility, but have not sought access to the books and records of the corporation under § 220 Despite the frequent admonitions of the Delaware Supreme

190. No.Civ.A. 19191, 2002 WL 31888343 (Del. Ch., Dec. 18, 2002).

191. *CalPERS*, 2002 WL 31888343, at *4, 12-14.

192. 823 A.2d 492 (Del. Ch. 2003).

193. *Guttman*, 823 A.2d at 492.

194. *Id.* at 493-94.

195. *Beam II*, 845 A.2d at 1056.

196. *Id.*

197. *Id.*

Court and the Court of Chancery, the plaintiffs did not pursue this remedy,” Vice Chancellor Lamb explained.¹⁹⁸

Although stockholders challenging directors’ discharge of their fiduciary duties face the inherent procedural obstacles of the demand requirement and § 102(b)(7), the Delaware courts have provided substantial instruction to help plaintiffs overcome these obstacles. By detailing how stockholders can reach trial on the merits for fiduciary duty claims including those alleging breaches of good faith, the courts have positioned themselves to hear cases that will allow them to explore the concept of good faith and thus increase standards of director conduct through this good faith jurisprudence.

IV. PART II: DELAWARE’S DEVELOPMENT OF GOOD FAITH: FROM AMORPHOUS TO UBIQUITOUS

Like the guidance on the procedural requirements offered by the Delaware courts, the courts’ cautious exploration of good faith also began before the collapses of Enron and WorldCom and the modern corporate climate that followed. Nevertheless, a considerable amount of the substantive exploration of good faith has played out against the backdrop of the current corporate climate and the increased focus on director conduct. This new era, particularly the increased pressures exerted by institutional investors seeking to hold directors personally liable, cannot be ignored by Delaware courts as they decide cases that will ultimately define what directors’ good faith requires.¹⁹⁹

This doctrinal development of good faith has been shaped by the Delaware courts’ deep respect for precedent, *stare decisis* and the stability and predictability that strict adherence to these principles creates.²⁰⁰ Under these constraints, the state’s courts have approached the second part of Delaware’s prescription and the refinement of good faith with caution. Downplaying assertions that Delaware law has undergone a substantial shift by its increased focus on good faith, E. Norman Veasey, former Chief Justice of the Delaware Supreme Court, describes changes to standards of director conduct under state law as “evolving expectations.”²⁰¹ Importantly, he also has identified what he considers “an important genre of Delaware decision making . . . an opinion that raises questions or teaches without imposing liability [that] may provide guidance to the corporate world to conform to best practices without the downside of actually imposing personal liability.”²⁰² This description

198. *J.P. Morgan*, 2005 WL 1076069, at *7-8.

199. See *supra* notes 15, 42, and accompanying text.

200. See *supra* note 20 and accompanying text.

201. Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1436; Veasey, *Counseling Directors in the New Corporate Culture*, *supra* note 10, at 1451; Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibility of Advisors*, *supra* note 86, at 444.

202. Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1406.

describes an important aspect of Delaware's exploration of good faith: the judiciary's value on "encourag[ing] the quest for best practices of due care, loyalty, good faith, and independence, mixed with a good dose of constructive skepticism and a demand for total understanding before taking action."²⁰³

This Part traces the exploration of good faith in the Delaware courts, beginning in 1996 with the Chancery Court opinion, *In re Caremark International Inc. Derivative Litigation*.²⁰⁴ Over the past nine years, the Delaware courts have continued to cautiously explore the concept of good faith as a potential standard for director liability. The most recent chapter of this process, *Disney IV*, announced good faith as a ubiquitous requirement for director conduct that transcends the specific duties of loyalty and due care.

*A. Directors' Good Faith Duty to Establish Monitoring Systems: In Re Caremark International Inc. Derivative Litigation*²⁰⁵

In the context of a traditional duty of care analysis, directors must make a good faith attempt to monitor corporate activity. Until recently, the level of monitoring necessary to establish good faith and satisfy the fiduciary duty of care was quite low. For over thirty years, under *Graham v. Allis-Chalmers Manufacturing Company*,²⁰⁶ directors were not required to establish or maintain systems to "ferret out wrongdoing" absent cause for suspicion.²⁰⁷ Under *Allis-Chalmers*, unless directors had knowledge of a problem, there was no need to have investigatory systems in place.²⁰⁸ *Allis-Chalmers* ostensibly provided directors with an incentive to take an ostrich-like approach to corporate operations, because action was required only if directors had knowledge of suspicious circumstances.²⁰⁹

In 1996, however, the Delaware Chancery Court announced a new, heightened monitoring requirement in *In re Caremark International Inc. Derivative Litigation*.²¹⁰ In so doing, the court expressly acknowledged the requirement that directors must act in good faith in order to discharge their duty of care.²¹¹ Under *Caremark*, directors have an affirmative obligation to assure that adequate internal systems exist such that the board will receive appropriate information in a timely manner.²¹² Failure to do so, evidenced by a "sustained or systematic failure of the board to

203. Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1506.

204. 698 A.2d 959 (Del. Ch. 1996) (settlement opinion).

205. *Id.*

206. 188 A.2d 125, 130 (Del. 1963).

207. *Allis-Chalmers*, 188 A.2d at 130.

208. *Id.*

209. *Id.*

210. 698 A.2d 959.

211. *Caremark*, 698 A.2d at 968.

212. *Id.* at 969-70.

exercise oversight” will establish a lack of good faith sufficient to find directors liable for a breach of the duty of care.²¹³ The court justified this heightened monitoring standard as beneficial both to stockholders and to directors, because it “makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.”²¹⁴

While *Caremark* places a greater burden on directors by requiring them to act in good faith to evaluate corporate monitoring systems in order to satisfy their duty of care, it does not destroy the general protections of the business judgment rule.²¹⁵ The Chancery Court specifically noted that even if the fact finder “believes a decision substantively wrong, or degrees of wrong extending through ‘stupid’ to ‘egregious’ or ‘irrational,’ [such belief] provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests.”²¹⁶ Despite allegations that *Caremark* directors failed to adequately monitor company employees and failed to prevent ongoing violations of federal regulations, the court found that the directors demonstrated the good faith necessary to discharge their duty of care by relying on experts who opined that the company’s practices “while contestable, were lawful.”²¹⁷

The Delaware Supreme Court has not yet had the opportunity to accept or reject the Chancery Court’s *Caremark* reasoning. Nonetheless, in 2003 then-Chief Justice Veasey remarked, “my personal view is that the expectations of directors . . . progressed in the thirty-plus years from *Allis-Chalmers* to *Caremark*.”²¹⁸ Both *Caremark* and former Chief Justice Veasey’s comments suggest that Delaware courts consider acting in good faith a necessary component to directors’ discharge of their duty of care. Ultimately, requiring directors to act in good faith in the corporate monitoring context imposes significant affirmative obligations on corporate boards, thus elevating the fiduciary standard directors must meet. Although *Caremark* considered good faith as a component of directors’ duty of care, its announcement of this elevated process standard serves as the Chancery Court’s first step defining the concept of good faith.

213. *Id.* at 971 (holding that directors discharged their duty of care because the corporation’s information systems “represented a good faith attempt to be informed of relevant facts”).

214. *Id.* at 971.

215. *See id.* at 967.

216. *Id.* at 967.

217. *Id.* at 971-72.

218. Veasey, *supra* note 86, at 446.

*B. Allegations of Directors' Lack of Good Faith Sufficient to Establish Demand Futility and Overcome a Section 102(b)(7) Charter Provision: In re The Walt Disney Company Derivative Litigation*²¹⁹

In 2000, the Delaware Supreme Court rescued the Disney plaintiffs' case in *Brehm*, by allowing them to replead in the Chancery Court.²²⁰ Although the original complaint was not factually-specific enough to establish demand futility, the allegations, as understood by the court, alleged waste, which could evidence that the board's decision was not made in good faith.²²¹ After making a books and records request, the plaintiffs amended their complaint and returned to court.²²² In 2003 the Chancery Court issued its *In re The Walt Disney Company Derivative Litigation* ("*Disney II*") opinion, holding that the amended complaint's well-pled allegations attacking directors' business judgment created a reasonable doubt that the directors acted in good faith and established demand futility under the second prong of *Aronson*.²²³ Furthermore, the plaintiff's factually particular complaint also survived a motion to dismiss based on Disney's § 102(b)(7) charter provision.²²⁴

Disney II arose out of the allegedly unilateral decision by Disney's CEO, Michael Eisner, to hire his long time friend, Michael Ovitz, as Disney's president.²²⁵ Company stockholders challenged the Disney board's process, whereby company directors allegedly approved Ovitz's employment contract without knowing its material terms or consulting an expert.²²⁶ In all, they claimed, Disney paid Ovitz in excess of \$140 million dollars for just over one year of work.²²⁷

According to the complaint, rather than reviewing a draft of Ovitz's employment agreement, the board's compensation committee relied on a summary and left the final negotiations up to Eisner, Ovitz's close friend of twenty-five years.²²⁸ After the compensation committee approved Ovitz's hiring, the full board met.²²⁹ According to the complaint, Disney directors authorized hiring Ovitz without receiving a summary of his salary or severance terms, without the advice of an expert and without asking questions.²³⁰ Allegedly, the board left Eisner to set the final terms of the contract, which they claimed ultimately varied substantially from

219. 825 A.2d 275 (Del. Ch. 2003).
220. *Brehm v. Eisner*, 746 A.2d 244, 248 (Del. 2000).
221. *See id.* at 263.
222. *Disney II*, 825 A.2d at 289-90.
223. *Id.* at 289-90.
224. *Id.* at 290.
225. *Id.* at 279.
226. *Id.*
227. *Id.* at 278-79.
228. *Id.* at 287.
229. *Id.*
230. *Id.*

the summary provided to compensation committee.²³¹ Ultimately Ovitz left Disney under the contract's non-fault termination clause ("NFT"), a departure allegedly brokered by Eisner without input from the board.²³² As to Ovitz's \$38 million NFT payment, a compensation expert commented, "the contract was most valuable to Ovitz the sooner he left Disney."²³³

Although the Chancery Court acknowledged extreme hesitation to "second-guess the business judgment" of directors under the duty of care,²³⁴ the court held that the facts alleged in the complaint suggested not just gross negligence, but that directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision," which would fall outside the protections of the business judgment rule.²³⁵ By alleging that company directors engaged in decision-making without material facts, without the use of an expert and left the determination of material terms up to Eisner, the plaintiffs created a reasonable doubt as to the directors' good faith.²³⁶ As a result, the directors could not assert Disney's § 102(b)(7) exculpatory charter provision as an affirmative defense and the case proceeded to discovery.²³⁷

While *Disney II* garnered significant attention, former Chief Justice Veasey insists that the business judgment rule is alive and well, implying that absent well-pled allegations that raise a reasonable doubt as to directors' good faith or other breach of duty such as those alleged in *Disney II*, the state's courts will continue to defer to the decision-making of directors.²³⁸ These remarks foreshadowed the Chancery Court's opinion distinguishing between director conduct that is protected by the business judgment rule and that which may evidence a "conscious and intentional disregard" sufficient to establish director liability in *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*.²³⁹

C. *The Crucial Distinction Between Nondeliberation and Not Enough Deliberation: Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*²⁴⁰

Just fifteen months after *Disney II*, the Chancery Court again addressed good faith in *Official Committee of Unsecured Creditors of Inte-*

231. *Id.*

232. *Id.* at 288.

233. *Id.* at 283.

234. *Id.* at 278.

235. *Id.* at 289.

236. *Id.* at 290.

237. *Id.*

238. Veasey, *Counseling Directors in the New Corporate Culture*, *supra* note 10, at 1454.

239. See No. Civ.A. 20228-NC, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004).

240. *Id.*

grated Health Services, Inc. v. Elkins.²⁴¹ *Integrated Health Services* held that while directors' complete lack of deliberation may support a charge of bad faith, as long as directors engage in some form of deliberation, the court will not review directors' processes.²⁴² The *Integrated Health Services* complaint claimed that the company's CEO, Elkins, and company directors breached their fiduciary duties by approving certain executive compensation transactions without the use of an expert, without information, with little deliberation, and in some instances, only deliberating after a decision had been made.²⁴³ In considering the defendant directors' motions to dismiss based on IHS's § 102(b)(7) exculpatory charter provision, the court acknowledged the parties' confusion as to whether claims alleging that directors acted in bad faith implicated the duty of care or the duty of loyalty.²⁴⁴ While the court did not resolve this question, it quoted *Disney II*'s "conscious and intentional disregard" language on bad faith, explaining that *Disney II* could be construed to implicate both the duty of loyalty and the duty of care.²⁴⁵

While all of the *Integrated Health Services* claims were extremely factually specific, only those alleging that directors acted without *any* information or deliberation survived the defendants' motion to dismiss.²⁴⁶ Specifically, the court denied motions to dismiss on claims that the members of the compensation committee approved certain transactions without deliberation, investigation, or consultation with an expert; that they acted without knowledge of the compensation committee's decision-making process; and that they added a forgiveness term to a loan to IHS's CEO without considering of reasons the committee had denied to do so just five months earlier.²⁴⁷ These claims alleged directors' "knowing and deliberate indifference to [their] duties to act 'faithfully and with appropriate care,'" and if true, would not satisfy the directors' duty of good faith.²⁴⁸

The Chancery Court distinguished these claims from other transactions whereby compensation committee retained a compensation expert, had *brief* discussions, or granted stock options leaving the number of options and price to be determined "at a later date."²⁴⁹ In refusing to evaluate the reasonableness of the length of time the directors discussed

241. *Id.*

242. *Integrated Health Services*, 2004 WL 1949290, at *14.

243. *Id.* at *1.

244. *Id.* at *4-9.

245. *Id.* at *9 n.36 (noting that the *Disney II* claim that Eisner breached his duty of good faith negotiations with Disney after he became its fiduciary falls under the duty of loyalty). "One may alternatively conceptualize the holding in [*Disney II*] as a duty of care claim that is so egregious—that it 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)." *Id.* at n.37.

246. *Id.* at *12, 14-15.

247. *Id.*

248. *Id.* at *15.

249. *Id.* at *13-14.

certain transactions or the reasonableness of directors' use of a compensation expert suggested by Elkins, the court held that, "as long as the Board engaged in action that can lead the Court to conclude it did not act in knowing and deliberate indifference to its fiduciary duties, the inquiry of this nature ends."²⁵⁰ These claims, suggesting that IHS directors engaged in some form of deliberative yet abbreviated process, were insufficient to challenge directors' good faith.²⁵¹ In transactions where directors appeared to exercise "some business judgment," the court refused to evaluate directors' processes.²⁵² Vice Chancellor Noble explained, "allegations of nondeliberation are different from allegations of not enough deliberation."²⁵³ The Chancery Court's willingness to apply the business judgment rule to transactions whereby directors engaged *some* deliberation suggests that Delaware's evolving concept of good faith will not result in liability for directors who engage in some deliberative process evidencing that they engaged in some business judgment.²⁵⁴

*D. Directors' Expertise and Acting in Good Faith: In re Emerging Communications, Inc. Shareholders Litigation*²⁵⁵

In 2004, the Chancery Court evidenced good faith's continued amorphous status by holding two directors liable for a breach of the duty of loyalty "and/or" the duty of good faith *on the merits* in *In re Emerging Communications, Inc. Shareholders Litigation*.²⁵⁶ In finding directors liable for breach of their fiduciary duties in a going-private transaction, the Chancery Court acknowledged that the Delaware Supreme Court has not yet clarified the relationship between the fiduciary duties of loyalty and good faith.²⁵⁷ According to Justice Jacobs,²⁵⁸ even if the only directors subject to review under the duty of loyalty were those directors with a personal interest in the transaction, the non-interested directors would still be liable for a breach of the duty of good faith for "consciously disregarding his duty to the minority stockholders."²⁵⁹ In either case, Emerging Communications' § 102(b)(7) charter provision would not protect the directors from personal liability.²⁶⁰

One director's liability arose from the court's finding that he acted solely to further the interests of the company's CEO.²⁶¹ Importantly, the

250. *Id.* at *14.

251. *See id.* at *13-14.

252. *Id.* at *14.

253. *Id.* at *12 n.58 (noting that the *Disney II*'s analysis turned on "total lack of deliberation," and that "even a short conversation may change the outcome") (emphasis added).

254. *See id.*

255. No. Civ.A 16415, 2004 WL 1305745 (Del. Ch., June 4, 2004).

256. *Emerging Communications*, 2004 WL 1505745, at *39.

257. *Id.* at *39 n.184.

258. Justice Jacobs of the Delaware Supreme Court authored the *In re Emerging Communications* opinion while sitting by designation as Vice Chancellor as per Delaware statute. *See id.*

259. *Id.* at *39 n.184.

260. *Id.*

261. *Id.* at *39.

Chancery Court held the second director, Salvatore Muoio, liable in part because he possessed specialized expertise from his position as principal and general partner in an investment advising firm.²⁶² Specifically, the court found that Muoio's unique and "specialized financial expertise," meant that he knew or should have suspected that the proposed merger price was unfair, yet he failed to call this to the attention of the other directors and voted to approve the transaction.²⁶³ Although the Delaware Supreme Court has not had the opportunity to determine whether expertise subjects directors to higher standards of conduct to discharge their fiduciary duties, this aspect of the decision has generated concern that directors possessing specific expertise will be held to higher standards under Delaware law.²⁶⁴ Notably, former Chief Justice Veasey asserts that Muoio's particular expertise was not dispositive on the question of whether he breached his duty of loyalty or good faith to the corporation.²⁶⁵ Rather, because Muoio possessed special expertise, this raised a question of his good faith *reliance* on the CEO hired-expert's opinion on the fairness of the merger price.²⁶⁶ This distinction, however subtle, suggests that the fiduciary *standards* applied to directors with particular expertise will not differ from those applied to non-expert directors. Veasey explained:

It would be a perversity of corporate governance goals, in my view, for the Delaware courts to announce a general rule that a director with special expertise is more exposed to liability than other directors solely because of her status as an expert. Rather, the facts and procedural posture should be key. When purporting to rely on another expert in a transaction where a director knows that the expert's opinion is questionable, the director could be at greater risk of liability than other directors. This is not because of the director's status as an expert. It is simply that a director with such expertise cannot rely in good faith on another expert's particular opinions under section 141(e).²⁶⁷

This interpretation of *Emerging Communications* is consistent with the notion that Delaware courts prefer to teach by announcing concepts that generally (although not in this case) allow directors to alter their conduct without increasing the risk of increased liability.

262. *Id.*

263. *Id.* at *39-40.

264. See David H. Cook, *The Emergence of Delaware's Good Faith Fiduciary Duty: In re Emerging Communications, Inc. Shareholders Litigation*, 43 DUQ. L. REV. 91, 110 (2004); Kenneth Heineman et al., *Recent Developments in Corporate Counsel Law*, 40 TORT TRIAL & INS. PRAC. L.J. 311, 327 (2005); Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1445.

265. Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1445-47.

266. *Id.*

267. *Id.* at 1446.

E. *Emerald Partners v. Berlin*²⁶⁸: *The Delaware Supreme Court Acknowledges Disney II's Formulation of Good Faith*

Until *Disney IV*, the Chancery Court's *Disney II* opinion provided the best developed exploration of good faith in the Delaware courts. Nonetheless, *Disney II* was a Chancery Court opinion, and the Delaware Supreme Court has not yet weighed in on the evolving concept of good faith.²⁶⁹ In *Emerald Partners v. Berlin*,²⁷⁰ however, while upholding a merger transaction as entirely fair (a duty of loyalty issue), the Delaware Supreme Court noted concern over the directors' good faith.²⁷¹ The fact that directors did not exclude an interested director from their decision-making process and allowed him unfettered access to their valuation expert evidenced "process flaws" that raised "serious questions" of the directors' good faith and a "we don't care about the risks' attitude."²⁷²

Ultimately *Emerald Partners* affirmed for the defendant directors based on an expert financial advisor's determination that the merger price was fair, suggesting (somewhat surprisingly) that a successful showing of entire fairness overcomes a potential breach of good faith. The Delaware Supreme Court's mention of good faith in *Emerald Partners* suggests that given the right case, the court is poised to conduct a more thorough analysis of the meaning of good faith.

F. *Good Faith as a Ubiquitous Requirement: Disney IV*²⁷³

In 2005, Chancellor Chandler issued the much-anticipated Chancery Court opinion in *In re The Walt Disney Co. Derivative Litigation* ("*Disney IV*").²⁷⁴ In determining that defendant directors were not liable for a breach of the duty of care or for acting in bad faith, *Disney IV* offers important insights about the Chancery Court's view of the position of good faith under Delaware law. Importantly, Chancellor Chandler temporarily settled the debate about whether good faith is a subset of either due care or loyalty, or a freestanding obligation, by announcing good faith as a ubiquitous requirement for director conduct:

Fundamentally, the duties traditionally analyzed as belonging to corporate fiduciaries, loyalty and care, are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary. The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all

268. *Emerald Partners v. Berlin*, No. 295, 2003 WL 23019210 (Del. Dec. 23, 2003).

269. *Disney II*, 825 A.2d 275.

270. *Emerald Partners*, 2003 WL 23019210.

271. *Id.* at *1.

272. *Id.*

273. No. Civ.A. 15452, 2005 WL 1875804 (Del. Ch. Aug. 9, 2005).

274. *Id.*

actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders.²⁷⁵

In an opinion vacillating between reasoned discussion of how directors discharged their fiduciary duties and scathing commentary as to how their processes fell far short of aspirational ideals, *Disney IV* provides an important tutorial on the interplay between the modern corporate climate and legal standards for director conduct under Delaware law. “Times may change, but fiduciary duties do not,” Chancellor Chandler opined, reasoning, “[t]he 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.”²⁷⁶

Noting the inherent difficulty in defining good faith, Chancellor Chandler described good faith as acting “at all times with an honesty of purpose and in the best interest[.]” of the corporation.²⁷⁷ Under this formulation, failures to act in good faith include affirmative acts, such as “intentionally act[ing for] a purpose other than that of advancing the best interests of the corporation,” acting with the intent to “violate applicable positive law” (such as Sarbanes-Oxley or SRO rules),²⁷⁸ or failures to act, by intentionally and consciously disregarding a duty when under a known duty to act.²⁷⁹ Importantly, the opinion expressly noted that these were but three potential formulations of conduct not in good faith, and were not the exclusive standards under which a director’s good faith could be measured.²⁸⁰ Citing the Delaware Supreme Court’s decision in *White v. Panic*, *Disney IV* also explained that an act constituting waste could not be deemed to be taken in good faith.²⁸¹

In formulating good faith as an overarching requirement for director conduct, Chancellor Chandler explained that good faith’s independent significance is to remind directors that failure to act in good faith can result in personal liability.²⁸² Accordingly, the understanding that good faith is an independent basis for imposing personal liability on directors frees good faith from the confines of Delaware’s fiduciary duty framework that the state’s courts have grappled with over the years:

In the end, so long as the role of good faith is understood, it makes no difference whether the words “fiduciary duty of” are placed in front

275. *Disney IV*, 2005 WL 1875804, at *36.

276. *Id.* at *1. Chancellor Chandler suggested that some of this difficulty in defining “good faith” rather than “bad faith” could be due to business judgment rule’s presumption that directors act in good faith. *Id.* at *35.

277. *Id.* at *36.

278. *Id.*

279. *Id.*

280. *See id.* (“There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.”).

281. *Id.* at *32 (citing *White v. Panic*, 783 A.2d 543, 553-55 (Del. 2001)).

282. *See id.* at *35 n.453 (citing *In re Emerging Communications*, 2004 WL 1305745, at *38).

of “good faith,” because acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable [under DGCL § 102(b)(7)] because they are disloyal to the corporation.²⁸³

In addition to fleshing out the concept of good faith, *Disney IV* clarified the relationship between good faith and the business judgment rule.²⁸⁴ The threshold for determining if the rule applies is not the presumption that directors acted in good faith but is whether directors acted on an informed basis.²⁸⁵ Further, citing Justice Jacob’s opinion in *In re Emerging Communications*, Chancellor Chandler reiterated that the application of the business judgment rule and the determination as to whether directors can be exculpated for a breach of duty are to be made for each individual director, rather than making a determination at the level of the board as a whole.²⁸⁶

Based on this formulation of good faith and 9,360 pages of transcripts taken in the thirty-seven day trial, Chancellor Chandler determined that each defendant director had met their fiduciary duties to Disney.²⁸⁷ Much of this analysis rested on the court’s factual findings that differed significantly from the allegations plaintiffs made throughout the litigation.²⁸⁸

With respect to Eisner, Chancellor Chandler found that contrary to plaintiffs’ allegations that Eisner acted unilaterally in hiring Ovitz, Eisner minimally involved some members of the compensation committee, who performed independent analyses of the financial terms of the draft employment agreement and engaged a compensation expert, Graef Crystal, with whom they analyzed the financial terms of the draft of the Ovitz Employment Agreement (“OEA”).²⁸⁹ Importantly, Chancellor Chandler found that Ovitz’s employment was not a “done deal” before the compensation committee and full board approved the terms of his employment with the company.²⁹⁰

Despite the finding that Eisner only minimally involved the compensation committee in the negotiations with and hiring of Ovitz, Eisner’s “usurping” of the board’s role did not violate the law.²⁹¹ While Eisner’s actions were not the basis for liability, he failed in many ways to “comport with how fiduciaries of Delaware corporations are expected to

283. *Id.* at *36 n.463.

284. *Id.* at *31.

285. *Id.* at *31 n.407 (citing *Smith v. Van Gorkom*, 488 A.2d 858, 899 (Del. 1985)).

286. *Id.* at *31 (citing *In re Emerging Communications*, 2004 WL 1305745, at *38).

287. *Id.* at *1; *see id.* at *37-51.

288. *See id.* at *3-30; *see also* discussion *supra* Part IV.B.

289. *Id.* at *42-43.

290. *Id.* at *8-10.

291. *Id.* at *41.

act.”²⁹² Chancellor Chandler determined, however, that Eisner discharged his fiduciary duties because he was the most informed member of the board and he subjectively believed that he was acting in the best interests of Disney.²⁹³

Similarly, allegations that Eisner agreed to help Ovitz obtain a termination (“NFT”), allowing him to collect \$38 million upon his departure, were unsupported.²⁹⁴ Not only did Eisner have the power to terminate Ovitz under Disney’s governing instruments, but Eisner consulted Disney general counsel Sandy Litvack for a determination as to whether Ovitz could be terminated for cause.²⁹⁵ Litvack was adequately informed and Chancellor Chandler agreed with Litvack’s conclusion that Disney was bound by the terms of the NTF and Ovitz could not be terminated for cause (thereby avoiding payment under the NFT), so there was no waste.²⁹⁶ On these facts, Eisner was not liable for a breach of good faith, but the court cautioned that this situation presented a prime example of when personal liability premised on a breach of good faith might apply:

It is precisely in this context – an imperial CEO or controlling shareholder with a supine or passive board – that the concept of good faith may prove highly meaningful. The fiduciary duties of care and loyalty, as traditionally defined, may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests they are there to protect.²⁹⁷

With respect to the other members of Disney’s compensation committee and their role in hiring Ovitz, Chancellor Chandler found that they too, were adequately informed and acted in good faith.²⁹⁸ In challenging the compensation committee’s actions, plaintiffs’ arguments mirrored those made about TransUnion’s directors in *Smith v. Van Gorkom*:²⁹⁹ that members of Disney’s compensation committee acted without enough deliberation and without sufficient documentation in making their deci-

292. *Id.*

293. *Id.* at *39-41. Chancellor Chandler’s criticisms of Eisner were abundant. “Despite all of the legitimate criticisms that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom, I nonetheless conclude, after carefully considering and weighing all the evidence, that Eisner’s actions were taken in good faith.” *Id.* at *41.

294. *Id.* at *50-51.

295. *Id.* at *48-51, 20.

296. *Id.* at *50.

297. *Id.* at *40 n.487.

298. *Id.* at *42-47.

299. 488 A.2d 858, 874-75 (Del. 1985).

sion to approve the hiring of Ovitz.³⁰⁰ The Chancery Court distinguished the actions of Disney's compensation committee members from the TransUnion directors on several grounds.³⁰¹ Primarily, the nature and magnitude of the transactions were fundamentally different: TransUnion directors were given no reason and just one day's notice of a meeting called to approve a merger to sell the company, compared to the Disney compensation committee's decision to hire an executive for compensation that was "not economically material to the [c]ompany."³⁰² Further, unlike the TransUnion directors, members of the compensation committee knew of the proposal to hire Ovitz in advance and had some details of the OEA prior to the meeting.³⁰³ At the committee meeting, the Disney compensation committee worked from a term sheet and heard a presentation summarizing the analyses of both compensation expert Crystal and two members of the compensation committee, contrasted with TransUnion directors who approved a merger without any documentation about the merger agreement and in reliance on a misleading presentation by management.³⁰⁴ Although Crystal did not present his report to Disney's compensation committee personally, the committee reasonably believed the analysis was within his competence, particularly because he had evaluated executive compensation for Disney before, and they believed Crystal had been selected with reasonable care.³⁰⁵ Based on these reasonable beliefs, the compensation committee was entitled to rely on Crystal's opinions under DGCL § 141(e).³⁰⁶ Finally, members of Disney's compensation committee knew that the overall response to hiring Ovitz was positive, as opposed to the TransUnion directors who approved the merger knowing that senior management opposed it.³⁰⁷ Notwithstanding the conclusion that members of Disney's compensation committee were informed and acted in good faith, Chancellor Chandler counseled directors as to better practices that would help the court determine that their actions were legally defensible, "[i]t would have been extremely helpful to the Court if the minutes had indicated in any fashion that the discussion relating to the OEA was longer and more substantial than the discussion relating to the myriad of other issues brought before the compensation committee that morning."³⁰⁸ As for the remaining members of the board and their approval of the OEA, under the compensation committee's charter, the board had no duty to review and approve

300. *Disney IV*, 2005 WL 1875804, at *44.

301. *Id.*

302. *Id.* at *44, 46. Chancellor Chandler detailed specific facts about Disney's 1996 revenues (\$19 billion) and operating revenues (over \$3 billion) used to determine that the OEA was not economically material to the company. *Id.* at *44 n.533.

303. *Id.* at *45.

304. *Id.*

305. *Id.* at *46.

306. *Id.*

307. *Id.*

308. *Id.* at *45 n.539.

the OEA.³⁰⁹ They were informed and acted in good faith in what they believed were the best interests of the company.³¹⁰

Finally, the members of Disney's board at the time of Ovitz's termination were absolved from liability because they had no duty in connection with Ovitz's termination.³¹¹ Under Disney's governing instruments, either Eisner or the board could remove inferior officers, so the board had no duty to act when Eisner terminated Ovitz.³¹² Further, the board had no independent duty to approve the payment of the NFT, because it was a term of the OEA that had been properly approved by the compensation committee prior to Disney's decision to hire Ovitz.³¹³

By characterizing good faith as a ubiquitous requirement for director conduct, the Chancery Court has increased the likelihood that corporate directors could be personally liable for their actions or failures to act in good faith. Notably, the court has announced this formulation of good faith while avoiding a decision to hold directors liable. *Disney IV* is an excellent example of what former Chief Justice Veasey described as a "genre of Delaware opinion" that teaches without imposing liability.³¹⁴ In *Disney IV*, Chancellor Chandler reiterated the importance of opinions as a means of providing specific guidance to directors to encourage better director processes and higher standards for director conduct:

Are there many aspects of Ovitz's hiring that reflect the absence of ideal corporate governance? Certainly, and I hope that this case will serve to inform stockholders, directors and officers of how the Company's fiduciaries underperformed. As I stated earlier, however, the standards used to measure the conduct of fiduciaries under Delaware law are not the same standards used in determining good corporate governance.³¹⁵

V. ARE DELAWARE COURTS READY TO FORCE DIRECTORS OUT-OF-POCKET FOR ACTIONS NOT IN GOOD FAITH?

Today's modern corporate climate, marked by scandals, legislative and regulatory reform, and increased scrutiny of directors' processes, presents a challenge to corporate directors. In the face of mounting pressure to conform to aspirational ideals of corporate conduct and the increasing interest of institutional investors to force directors to pay out-of-pocket for corporate failures, directors must consider the possibility that they could be held personally liable for their actions.

309. *Id.* at *47.

310. *Id.*

311. *Id.* at *49.

312. *Id.*

313. *Id.*

314. Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at *1406.

315. *Disney IV*, 2005 WL 1875804, at *47.

Well before the onset of this new climate, the Delaware courts began cautiously exploring the notion of good faith as a standard for director conduct. Through an ongoing, proactive tutorial to stockholders on how to overcome procedural obstacles in the state's courts and have legitimate claims heard on the merits, Delaware's courts have been setting the stage for cases to come before them that allow them to explore and refine the concept of good faith. Over the past nine years, the courts have engaged in an ongoing discourse as to what directors' obligation to act in good faith requires and whether directors will be personally liable for failing to conform to this evolving standard. The most recent chapter in Delaware's exploration, *Disney IV*, offers detailed guidance to corporate directors on the Chancery Court's formulation of good faith as a ubiquitous requirement for director conduct that transcends the duties of loyalty and due care. Importantly, even though *Disney IV* did not result in personal liability for defendant directors, it provides guidance to all corporate directors on how meet their legal obligation to act in good faith and how to comport with the higher standards of corporate conduct envisioned by aspirational ideals.

Under *Disney IV*, affirmative acts such as intentionally acting with a purpose other than in the best interests of the corporation or by violating applicable positive law, such as Sarbanes-Oxley or SRO rules, or failures to act evidencing an intentional and conscious disregard of a duty to act, will evidence a conduct undertaken in bad faith.³¹⁶ Meeting the obligation to act in good faith is crucial for directors to enjoy Delaware's procedural and statutory protections and avoid potential personal liability under state law. First, a failure to act in good faith will allow a plaintiff to overcome the presumption of the business judgment rule and establish demand futility under the second prong of *Aronson*.³¹⁷ Second, a failure to act in good faith will prevent directors from utilizing several statutory protections. Directors who fail to act in good faith in reliance on corporate records, executives, committees of the board or experts will not be protected in their actions under DGCL § 141(e).³¹⁸ Approval of interested-director transactions not made in good faith will also be unprotected under DGCL § 144(a).³¹⁹ Further, failing to act in good faith will prevent statutory indemnification under DGCL § 145.³²⁰ Most importantly, a failure to act in good faith is not exculpable under DGCL §

316. *Id.* at *35.

317. *Id.* at *32-33; *see also supra* Part III.A.1.

318. DEL. CODE ANN. tit. 8, § 141(e) (2005); *Disney IV*, 2005 WL 1875804, at *46; *In re Emerging Communications, Inc. S'holders Litig.*, No. Civ.A. 16415, 2004 WL 1305745, at *39-40 (Del. Ch. June 4, 2004); *see supra* notes 262-67 and accompanying text; *see also* Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1443.

319. DEL. CODE ANN. tit. 8, § 144(a) (2001); Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1443.

320. *See* DEL. CODE ANN. tit. 8, § 145 (2001); Veasey & Di Guglielmo, *Retrospective*, *supra* note 10, at 1443.

102(b)(7).³²¹ Even without these protections, however, a director still might avoid personal liability for a failure to act in good faith if the corporation carries director's and officer's ("D &O") insurance.³²² Under public policy, *willful* conduct cannot be insured under a D & O policy; but often directors can still be covered under D & O insurance when statutory indemnification is unavailable.³²³ Assuming that there is adequate coverage for any monetary judgment or settlement and the director's failure to act in good faith is not willful; directors acting in bad faith may be able to escape personal liability under the corporation's D & O policy.³²⁴ This assumption, however, ignores one of the salient features of the modern corporate climate: the increased interest of institutional investors in forcing directors to pay out-of-pocket for corporate failures.³²⁵ Arguably, any amount of insurance will be irrelevant to a sophisticated plaintiff who wants to "inflict [a] significant [amount of] financial pain" on corporate directors.³²⁶

Ultimately, how the Delaware Supreme Court will respond to the Chancery Court's *Disney IV* formulation on good faith remains to be seen. Until an appeal of *Disney IV* or another case with the requisite factual and procedural posture necessary to allow the Delaware Supreme Court to consider directors' good faith, corporate directors must understand the formulation of good faith as the overarching, ubiquitous obligation described in *Disney IV* as Delaware's most current guidance on the standards of conduct necessary to discharge their obligations and avoid personal liability.

321. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); *Disney IV*, 2005 WL 1875804, at *36 n.463.

322. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 412-15 (2005).

323. *Id.* at 413

324. *See id.* at 412-15

325. *See supra* INTRODUCTION.

326. Shawn Young, *WorldCom Deal Was a Difficult Balancing Act*, WALL ST. J., Jan. 13, 2005, at B6.