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You Gotta Have Faith: Good Faith in the Context of Directorial Fiduciary Duties and the Future Impact on Corporate Culture

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YOU GOTTA HAVE FAITH: GOOD FAITH IN THE CONTEXT OF DIRECTORIAL FIDUCIARY DUTIES AND THE FUTURE IMPACT ON CORPORATE CULTURE

I. INTRODUCTION

"The point is, ladies and gentlemen, greed is good. Greed works, greed is right. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed in all its forms, greed for life, money, love, knowledge, has marked the upward surge of mankind[,] and greed . . . will save . . . the USA."[1] These are the immortal words of Gordon Gekko, the corporate raider from the movie Wall Street whose insatiable greed eventually led to his fall from spectacular wealth to an equally spectacular demise. Gekko represents the premier capitalist who reached his fabulous position in America's elite through deceitful and illegal schemes. Such a story is entertaining in the gleam of Hollywood, but what happens when reality mimics the movies?

Over the past few years corporate scandals have rocked the very core of the American capitalist system and have raised many questions regarding proper corporate governance. Everyone remembers the highly publicized financial scandals involving WorldCom, Qwest, Global Crossing, Tyco, and Enron, which ultimately cost shareholders $460 billion.[2] However, these particular scandals represent only a small portion of the corporations that have been investigated for dishonesty and fraud. In fact, since the Enron scandal broke in 2000, sixty-one companies have been investigated for their indiscretions.[3]

Corrupt officials who looted their companies of assets and opportunities fueled many of these companies' falls from the highest echelon of American corporations. Meanwhile the companies' boards of directors buried their heads in the sand, unwilling to prod into the destructive behavior of the top officials that was crippling the very company that shareholders had entrusted the

1. WALL STREET (Oaxatal Productions, Inc. 1987), *available at* http://allmoviescripts.com/scripts/7622567143f65e0111fbe9.html.

2. *See* David L. Cotton, *Fixing CPA Ethics Can Be an Inside Job*, WASH. POST, Oct. 20, 2002, at B2.

3. *See* CITIZEN WORKS, THE CORPORATE SCANDAL SHEET, *at* http://www.citizenworks.org/corp/corp-scandal.php. THE CORPORATE SCANDAL SHEET provides a synopsis of each of the corporate scandals and the catalysts that caused them.

directors to monitor. As a result, large numbers of employees lost their jobs and company shareholders lost hundreds of billions of dollars in wealth.

There has been a marked shift within the courts during the past few years to focus on the good faith of corporate directors. This shift is perhaps a direct corollary to the inappropriate directorial conduct that fueled the recent collapses of several Fortune 500 companies. In recent cases, the court system has warned directors that such egregious conduct will not be tolerated and will expose the directors to personal liability.

Originally, the duties of care and loyalty subsumed the duty of good faith.[4] However, Delaware and other states have recently enacted new provisions that have thrust the duty of good faith into the limelight as the central focus in a court's fiduciary duty inquiry. These provisions have substantially lessened the presence of directors' fiduciary duties and the inherent potential exposure to personal liability. However, an integral component within each of these protective statutes is the concept of good faith.

Recent cases have made it clear that a lack of good faith will take a director's conduct out of the protection of both the business judgment rule and the protective provisions. The courts have put directors on notice that a lack of good faith will expose them to personal liability. In addition, although not discussed in great detail in this Comment, the good-faith standard is a key component in the new Sarbanes-Oxley Act and the proposed listing requirements of self-regulatory organizations such as the NYSE and NASDAQ.[5]

In addition to recent statutory developments in Delaware, the courts and Congress have also made efforts to enhance the scrutiny on director conduct. While some commentators have characterized such moves as a drastic shift in the way the legislative and judicial branches approach corporate conduct, these measures are more properly viewed as a wake-up call in response to the recent deplorable conduct of several directors and top officials that has recently come into the public consciousness. Despite the increased scrutiny, the business judgment rule continues to drape a security blanket over business decisions, encouraging bold entrepreneurialism and risk-taking, a centerpiece for American business.

This Comment will discuss the standards set forth in several landmark cases in the past fifty years such as *Graham v. Allis-Chalmers Manufacturing Co.*,[6] *Smith v. Van Gorkom*,[7] *Aronson v. Lewis*,[8] and *In re Caremark*

4. Arthur Fleischer, Jr. & Alexander R. Sussman, *Directors' Fiduciary Duties in Takeovers and Mergers*, 1388 PLI/CORP 911, 918 (2003).

5. E. Norman Veasey, *Policy and Legal Overview of Best Corporate Governance Principles,* 56 SMU L. REV. 2135, 2144 (2003).

6. 188 A.2d 125 (Del. 1963).

7. 488 A.2d 858 (Del. 1985).

8. 473 A.2d 805 (Del. 1984).

International Inc. Derivative Litigation.[9] These cases show the evolution in director expectations and the good-faith principle that has led to the shift in focusing on directors' good faith, which is evident in the recent cases of *McCall v. Scott*,[10] *In re the Abbot Laboratories Derivative Shareholders Litigation*,[11] and *In re Walt Disney Co. Derivative Litigation.* [12]

Ultimately, the goal of the array of new measures put into place in response to the recent corporate scandals is to increase the involvement and accountability of corporate directors. Bill Donaldson, Chairman of the SEC, recently expressed the aspirations of Congress and the courts that "in the [end] it's going to be the human characteristic" that regains trust in the corporate culture and the markets.[13] In a recent article, Delaware Chief Justice E. Norman Veasey noted that directors are currently expected to be "skeptical, probe, ask questions, and put management to its proof."[14] Furthermore, Chief Justice Veasey articulates that a director must embody the qualities of "integrity, expertise, diligence, good faith, independence and professionalism" and maintain "a coherent economic rationale dedicated to the best interests of stockholders."[15]

This Comment is divided into five parts, the first of which will outline the business judgment rule and the fiduciary duties. This section will demonstrate the deference that courts give to business decisions and the reluctance of the judiciary to second-guess directors' judgment. Secondly, the Comment will show the progression of the good-faith principle, both in the context of judicial analyses of fiduciary duty and through the enhanced scrutiny associated with takeovers. Next, it will focus on three recent cases that applied the good-faith concept in taking director conduct outside the protection of not only the business judgment rule but also out of the safety of new exculpatory provisions. Part Four will demonstrate how the focus on the good faith of the director is consistent with the purpose of the business judgment rule and how good faith promotes business by deferring to director decisions absent egregious conduct. Finally, this Comment will focus on the potential impact that the good-faith analysis could have in future litigation and the corporate culture.

9. 698 A.2d 959 (Del. Ch. 1996).

10. 239 F.3d 808 (6th Cir. 2001).

11. 325 F.3d 795 (7th Cir. 2003).

12. 825 A.2d 275 (Del. Ch. 2003).

13. Deborah Solomon, *SEC Acts to Give Audit Panels More Power Over Accountants*, WALL ST. J., Apr. 2, 2003, at C5.

14. Veasey, *supra* note 5, at 2146.

15. E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 445 (2003).

II. THE BUSINESS JUDGMENT RULE AND ITS EFFECT ON CORPORATE GOVERNANCE

The directors of a corporation are responsible for directing the management and affairs of everyday business. These duties are an integral component in maintaining an effective and profitable company. In many circumstances, directors face decisions that they are not intimately informed about, and have limited, if any, expertise. These tough decisions, however, must be made in order for a business to prosper in the market and thrive against competition. In such situations, directors will likely be called on to weigh the corporate policies and goals in making the most profitable business decision.[16] A good director is generally one who can consider the needs of a business on one hand; the risks involved in meeting those needs on the other; and somehow create a viable balance of the two that will create a long-term strategy for the corporation to succeed.[17] If a director fails to use the requisite care in making appropriate judgments in the best interests of the shareholder, she could be subject to a derivative suit brought by the disadvantaged shareholders.

A. *Shareholder Derivative Suits*

Shareholders have an important right to bring a derivative action on the company's behalf to recoup assets from a director in retribution for any improper conduct. When investors purchase stock in a company they gain contractual rights to ownership; however, they entrust the directors to make decisions in their best interest.[18] One of the rights that a stockholder obtains when she invests in a corporation through stock purchase is the ability to bring a derivative suit against directors and officers on behalf of the corporation in the event of wrongdoing.[19] The plaintiff must assert particular facts that show that a director breached his duties to the shareholder.[20] A derivative suit differs from other types of suits because even if the stockholder qualifies for the privilege to litigate and ultimately wins the action, the award or equitable relief will not benefit the individual shareholder; it will benefit the

16. *See* E. Norman Veasey & Julie M. S. Seitz, *The Revised Model Business Corporation Act: Comment and Observation: The Business Judgment Rule in the Revised Model Act, the* Trans Union *Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1484 (1985). Such tough decisions could include "acquisitions, sales of assets, entrance into new lines of business, declaration of dividends, capital investment, incurring or avoiding debt, issuance of stock, [and] mergers." *Id.*

17. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

18. *See* COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, CORPORATE DIRECTOR'S GUIDEBOOK 3 (3d ed. 2001).

19. *See* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 3 (4th ed. 1993 & Supp. 1995).

20. *Id.* at 14.

corporation.[21] The derivative action is a very important aspect in corporate law because most shareholder claims against directors take this form.[22] A formidable defense against such actions involves the directors' assertion that their actions are protected by the business judgment rule.

B. The Business Judgment Rule

Reluctance toward second-guessing business decisions dates back more than 250 years in English law to *The Charitable Corp. v. Sutton*,[23] and the 1829 Louisiana Supreme Court decision in *Percy v. Millaudon*[24] instituted the business judgment rule in American jurisprudence.[25] Inherent in any business decision is the assumption of risk, and the business judgment rule is a presumption that protects a director from personal liability in shareholder suits.[26] The business judgment rule also shields directors in cases where a shareholder seeks an injunction against a decision.[27]

Four points sum up the rationale and the necessity for the business judgment rule in corporate law jurisprudence.[28] First, the courts recognize that even the most honest and well-intentioned director can make an improvident decision.[29] Second, the courts recognize the inherent risk involved in business decisions; therefore, the rule alleviates the fear of judicial second-guessing and allows the directors broad discretion in making company policy.[30] Third, the rule keeps courts from ruling on business decisions when they are less equipped to handle such decisions than the directors.[31] Finally, the business judgment rule ensures that directors, and not shareholders, control the corporation.[32]

The business judgment rule is basically an "uncodified equitable doctrine to be applied by the courts on a case-by-case basis."[33] Delaware incorporates the majority of corporations in the United States today; therefore, the Delaware court system has developed substantial familiarity with issues relating to

21. *See id.* at 710.
22. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).
23. 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).
24. 8 Mart. (n.s.) 68 (La. 1829).
25. BLOCK, ET AL., *supra* note 19, at 5.
26. Veasey & Seitz, *supra* note 16, at 1487.
27. *Id.*
28. BLOCK ET AL., *supra* note 19, at 7.
29. *Id.*
30. *Id.* at 7–8.
31. *Id.* at 8.
32. *Id.* at 10.
33. BLOCK ET AL., *supra* note 19, at 44. The American Bar Association did attempt to codify the rule in § 8.30 of the Model Business Corporation Act; however, it noted that the court's job was to "delineate the differences, if any, between that rule and the standards of director conduct." *Id.* at 44.

corporate affairs and governance.[34] Accordingly, when looking for guidance on an issue regarding corporation law the first place to turn should be the opinions of the Supreme Court of Delaware. One of the most classic and enduring articulations of the business judgment rule is the 1927 decision of *Bodell v. General Gas & Electric Corp*.[35] The Supreme Court of Delaware expanded upon *Bodell* and has provided the most oft-cited expression of the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[36] If the conditions of the rule are met, the court will apply the rule and not substitute its judgment for that of the board unless a plaintiff can show that the directors breached their duties of care, loyalty, or good faith.[37]

A number of cases show the deference that courts give to director decisions even when such decisions are imprudent. One example is *Kamin v. American Express Co*.[38] In *Kamin*, American Express acquired shares in a corporation for around $30 million, only to sell the shares three years later for $4 million.[39] Instead of selling the shares on the open market at a loss, thereby reducing tax liability by $8 million, American Express decided to distribute the shares as a special dividend to shareholders to avoid the loss in net income.[40] The distribution to shareholders had the effect of forfeiting the opportunity to take the tax loss and could even be seen as wasting corporate assets. The board, however, claimed that it was acting in the shareholders' interests by keeping reported earnings high.[41] Despite the obvious foolishness of the decision, the court upheld the directors' ability to make an informed business decision without judicial judgment, as long as the decision had been made in good faith.[42] The court refused to impose liability without a showing of self-dealing, even if the directors had made a mistake, or, in hindsight, the

34. *Id.* at 2.

35. 140 A. 264 (Del. 1927). The *Bodell* court articulates that the overall principle of the business judgment rule is that a business decision will not be reviewed by the courts as long as the acts of the directors "were performed in good faith, in the exercise of their best judgment, and for what they believe[] to be the advantage of the corporation and all its stockholders." *Id.* at 268.

36. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

37. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001). The *Cede* court was the first to speak of the directors' fiduciary duties as a "triad," which included a duty of good faith along with duties of care and loyalty. *Cede*, 634 A.2d at 361.

38. 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976).

39. *Id.* at 809.

40. *Id.* at 809–10.

41. *See id.* at 811.

42. *Id.* at 812.

shareholders would have preferred the directors to have taken a different course of action.[43]

Although the courts have shown general deference to the decisions of directors, they have differed in their articulation of what actions would fall outside the rule's protection.[44] Some courts hold that no decision will be second-guessed unless the judgment was "tainted by fraud, conflict of interest, or illegality;" others say, "unless the alleged defect in the directors' judgment rises to the level of fraud;" or, "unless it rises to the level of gross negligence."[45] Furthermore, courts have given certain board decisions, such as dividend policies, decisions regarding what products to manufacture, or personnel decisions, broad deference even beyond the generous boundaries of the business judgment rule and do not subject them to judicial review no matter how ill-advised.[46]

Despite the obvious implications to the business community, the courts are quick to point out that the business judgment rule is a standard of judicial review and is not meant to be a standard of business conduct.[47] The rule is not meant to be a guide for director's conduct but instead serves as a defense against judicial scrutiny assuming directors follow certain conditions.[48] A shareholder can rebut the rule in two ways, and the underlying notion is that directors will not be liable for their decisions unless they breached their duties of care or loyalty.[49]

1. The Duty of Loyalty

The first way a shareholder can rebut the business judgment rule is to show that a director made a decision specifically to further his own self-interest and not for the shareholders' benefit.[50] In a famous opinion, the Michigan Supreme Court pointed out that "[a] business corporation is organized and carried on primarily for the profit of the stockholders."[51] Directors are required to act, individually and as a group, in good faith and in the best

43. Kamin v. American Express Co., 383 N.Y.S.2d 807, 812 (N.Y. Sup. Ct. 1976) (holding that the board will not be held liable just because they "may be mistaken, that other courses of action might have differing consequences, or that their action might benefit some shareholders more than others . . . so long as it appears that the directors [were] acting in good faith.").

44. ROBERT CHARLES CLARK, CORPORATE LAW § 3.4 (1986).

45. *Id.*

46. *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1664 (2001).

47. BLOCK ET AL., *supra* note 19, at 3–4.

48. *Id* at 3.

49. *See* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 291 (1994). Inherent in these fiduciary duties are the requirements for a disinterested director to act with reasonable diligence and good faith. *Id.*

50. *See* BLOCK ET AL., *supra* note 19, at 124.

51. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

interests of the company, which is the duty of loyalty that is owed to the shareholders.[52] The duty of loyalty imposes personal liability if a director uses his power for his own pecuniary benefit.[53] At common law a transaction involving conflicts of interest was void or voidable. Modern courts have been more lenient, but they still require the self-dealing director to act with the utmost good faith and scrupulous fairness.[54] A director who has a financial or personal interest in a transaction must disclose her interest and all the relevant material facts to the board and then gain approval by a majority vote of disinterested directors.[55] The duty of loyalty also requires that a director give the corporation a chance at a business opportunity before pursuing it herself.[56]

If a board, or individual member, fails to satisfy one of these requirements, the director's actions will be held to the more demanding review of the entire fairness test.[57] The court will then require the board to show that the decision was a product of both fair price and fair dealing.[58] The underlying principle of the duty is that a director cannot personally prosper at the detriment of the shareholders who have entrusted her with the well-being of the corporation. In addition to the duty of loyalty, fiduciaries have a duty of care to the corporation and its shareholders.

2. The Duty of Care

The second alternative available to the shareholder is to show that the directors did not exercise sufficient care under the circumstances.[59] The obligation to make prudent business decisions usually involves consultation with management and the strategic goals of the company.[60] The directors owe

52. *See* COMMITTEE ON CORPORATE LAWS, *supra* note 18, at 10. The duty requires that the directors do not take advantage of the shareholders through fraudulent or unfair transactions. *Id.*

53. *Id.* The duty of loyalty can be divided into three subsections consisting of 1) interested director transactions, 2) usurpation of corporate opportunity, and 3) executive compensation. BLOCK ET AL., *supra* note 19, at 126.

54. Most state statutes allow a transaction involving a conflict of interest if it is approved by a majority of disinterested directors or shareholders or if it is fair to the corporation. *See* BLOCK ET AL., *supra* note 19, at 130–38.

55. COMMITTEE ON CORPORATE LAWS, *supra* note 18, at 10–11.

56. *Id.* at 11. Courts differ on the exact test to determine what constitutes a corporate opportunity and the steps an employee must take before taking the opportunity for herself; however, the bottom line is "that a corporate fiduciary should not serve both corporate and personal interests at the same time." Northeast Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146, 1150 (Me. 1995).

57. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

58. *See id.;* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). If the directors fail to prove the intrinsic fairness of the transaction, they could be liable not only to compensate the company and shareholders but also to rescind the transaction and pay damages. BLOCK ET AL., *supra* note 19, at 17.

59. *See* BLOCK ET AL., *supra* note 19, at 32.

60. COMMITTEE ON CORPORATE LAWS, *supra* note 18, at 3.

a duty of care to the shareholders to act as a normally prudent person in the same position would in exercising decision-making and oversight functions.[61] The plaintiff must show facts to overcome the business judgment rule presumption, and the directors will be held personally liable if they cannot then prove that they exercised the requisite care.[62] The Supeme Court of Delaware recently reiterated the applicable liability standard related to a director's duty of care, which is "predicated upon concepts of gross negligence."[63]

The oversight function requires the directors to pay attention to the "corporate systems and controls, policy issues and other recurring matters, as well as discrete attention to matters suggesting a need for inquiry."[64] Directors are required to actively participate in company decisions and to properly inform themselves before making such decisions.[65] In complying with this duty, they should gather information from management, corporate committees, or other experts employed by the company in advance to allow time for reflection on the information before making a decision.[66] Furthermore, directors must ensure that compliance systems are in effect, and if they become aware of any problems, they must make further inquiry to ensure management is dealing with the problem appropriately.[67] The duty of care requires a director to be intimately informed about the decisions and business practices of the company entrusted to her care. Recently the courts have spoken about a duty of good faith and have inquired into a director's good faith in their fiduciary duty analyses.

III. THE PROGRESSION OF THE PRINCIPLE OF GOOD FAITH IN THE BUSINESS JUDGMENT RULE ANALYSIS

Historically, the director's duty of good faith was "subsumed in a court's inquiry into the director's satisfaction of her duties of care and loyalty."[68] If the court found that the director did not satisfy one of those duties, there was no need to determine whether there also was a violation of the duty of good faith.[69] Alternatively, if there was no breach of either of those duties it was

61. *See id.* at 8.

62. BLOCK ET AL., *supra* note 19, at 53–54.

63. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). Gross negligence in the corporate context refers to "reckless indifference to or a deliberate disregard" for stockholders' interest or "actions which are 'without the bounds of reason.'" BLOCK ET AL., *supra* note 19, at 64–65 (citation omitted).

64. COMMITTEE ON CORPORATE LAWS, *supra* note 18, at 3.

65. *Id.* at 8.

66. *Id.* at 8–9.

67. *Id.* at 9–10.

68. Fleischer & Sussman, *supra* note 4, at 918.

69. *Id.* at 985.

uncommon for courts to perform a separate inquiry on the issue of good faith.[70] However, as a result of relatively new statutes in corporation law, the duty of good faith has become an integral component in determining director liability in recent decisions. The courts have also provided a definition of good faith as it applies to corporate governance.

A. The Definition of Good Faith

Several commentators have inquired into the definition of good faith and its practical significance in a court's analysis. A recent Delaware case cited the Black's Law Dictionary definition for bad faith as "not simply bad judgment or negligence, but . . . the conscious doing of a wrong because of dishonest purpose or moral obliquity; . . . different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will."[71] Additionally, the Delaware Court of Chancery suggested that the

> good faith iteration's utility may rest in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.[72]

More generally, the overall concept of good faith is found in the typical codification of director conduct, which requires a director to act with the honest belief that she is acting in the best interests of the corporation.[73] Accordingly, if directors act with this requisite good faith, courts still give deference to their decisions, and are reluctant to second-guess their judgment.[74] Several early cases laid the foundation for the good-faith principle that courts apply today in the corporate context.

70. *Id.*

71. Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199, 1208 n.16 (Del. 1993) (quoting BLACK'S LAW DICTIONARY 72 (5th ed. 1983)).

72. Nagy v. Bistricer, 770 A.2d 43, 48 n.2 (Del. Ch. 2000).

73. Veasey, *supra* note 15, at 444–45. A New York court described good faith as

> an intangible and abstract quality with no technical meaning or statutory definition. It encompasses, among other things, an honest belief, the absence of malice and the absence of a design to defraud or to seek an unconscionable advantage. An individual's personal good faith is a concept of his own mind and inner spirit and, therefore, may not conclusively be determined by his protestations alone.

Doyle v. Gordon, 158 N.Y.S.2d 248, 259–60 (N.Y. Sup. Ct. 1954).

74. Veasey, *supra* note 15, at 445.

B. Evolution of the Good-Faith Standard

The beginning of the good-faith standard can be traced back to the early Delaware case *Graham v. Allis-Chalmers Manufacturing Co.*,[75] which was the first time that a Delaware court recognized the director's duty to act in an informed and prudent manner.[76] In *Graham*, the plaintiffs could not prove that the directors had actual knowledge of wrongdoing or even knowledge of facts that should have put them on notice of the occurrence of illegal actions within the corporation.[77] The plaintiffs, therefore, argued that the directors were liable for their failure to take reasonable steps to learn of and prevent the activity.[78] The court articulated that "[i]f [the director had] recklessly reposed confidence in an obviously untrustworthy employee, ha[d] refused or neglected cavalierly to perform his duty as a director, or ha[d] ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him."[79] The court, however, stopped short of imposing a duty upon the board to install a law compliance program absent red flags.[80] Even though the court did not impose liability in this case, *Graham* heightened the duties expected of directors by requiring them to act in a careful and prudent manner. While this case was groundbreaking, courts did not, until recently, embrace the precedent for a heightened standard set forth in *Graham*.[81]

Before *Aronson v. Lewis*,[82] a 1984 decision, the expectations of directors were unclear, and their legal obligation to the shareholders via their fiduciary duties imposed almost no repercussions on them for misconduct.[83] In *Aronson*, the Supreme Court of Delaware emphasized the importance of a directorial process that requires the board to avail itself of all available information before making a decision in good faith, thus affirming the *Graham* decision.[84] The court articulated that directors could be held liable for gross negligence for

75. 188 A.2d 125 (Del. 1963).

76. Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule,* 19 DEL. J. CORP. L. 971, 985 (1994).

77. *Graham,* 188 A.2d at 127.

78. *See id.*

79. *Id.* at 130.

80. *See id.* at 130–31.

81. In fact, before the mid-eighties courts had applied the business judgment rule in a manner to completely bar shareholder claims against directors for breaching their fiduciary duty of care. *See* Horsey, *supra* note 76, at 977.

82. 473 A.2d 805 (Del. 1984).

83. Professor George W. Dent, Jr. attributed the decline of enforcement to a misunderstanding of the law. He stated that cases were dismissed under the rule before the court even really inquired about whether or not the directors acted reasonably and with due diligence. George W. Dent, Jr., *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care,* 61 B.U. L. REV. 623, 647 (1981).

84. *Aronson,* 473 A.2d at 812.

failing to inform themselves of all material information reasonably available to them.[85] The significance of the *Graham* decision had largely been ignored until the *Aronson* court reiterated the enhanced expectations of corporate directors.[86]

The decision in *Smith v. Van Gorkom* [87] resolved the issue concerning what amount of inquiry would satisfy the informational component of decision making. In *Van Gorkom*, shareholders brought a derivative suit against the board for agreeing to a shareholder-approved merger that would have given the shareholders a premium for their shares over the market price at that time.[88] Although shareholders were to receive a price greater than fair market value, the court imposed liability on the directors because they made the decision too hastily (after only a two-hour meeting), without the appropriate information available (they did not read the merger agreement), and without reasonably attempting to ask the appropriate questions to get that information (they did not try to find out how the agreed price was derived, nor did they hire their own expert to give an opinion on an appropriate price).[89] Similar to the *Aronson* court, the *Van Gorkom* court required the directors to have all the information reasonably available to them before making the decision.[90]

Many scholars at the time attacked the *Van Gorkom* holding, hailing it as the worst decision in corporate history.[91] Scholars feared that *Van Gorkom* would lead to a decline in willing and qualified candidates for director positions.[92] Therefore, in response, many states enacted exculpatory clauses that permit stockholders to include a provision in the certificate of incorporation that protects directors from personal liability despite a breach of fiduciary duty.[93]

85. *Id.*

86. Horsey, *supra* note 76, at 986.

87. 488 A.2d 858 (Del. 1985).

88. *Id.* at 864–70.

89. *Id*. at 868–70.

90. Contrast this with ALI principles, which only require directors to be informed to the extent that they reasonably believe to be appropriate under the circumstances. ALI-ABA COURSE OF STUDY MATERIALS: CORPORATE GOVERNANCE: CURRENT AND EMERGING ISSUES § 4.01(C)(2) (1997).

91. *See generally* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 676 (2002). Some feared that the decision would lead to costly and time-consuming procedures that would ultimately harm the shareholder, and others agreed with the directors' conduct and believed that it did not even rise to ordinary negligence let alone the requisite gross negligence. Many also doubted the utility in analyzing a decision that presented a premium over market price that would ultimately be voted on and decided by the shareholders anyway. *See* Gevurtz, *supra* note 49, at 299.

92. *See* E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U. J.L. & POL'Y 1, 11 (2003).

93. *See infra* notes 125–28 and accompanying text.

Nonetheless, following the corporate collapses of the late 1990s, spurred in large part by deficient directors and management, the Court of Chancery bolstered *Graham* in its decision in *In re Caremark International Inc. Derivative Litigation*.[94] In *Caremark*, the court noted that even an ill-advised decision would be protected assuming it was made from a process that was "deliberately considered in good faith or was otherwise rational."[95] In dicta, Chancellor Allen reiterated a statement made in *Graham*, namely that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." [96] However, Allen took an extra step, a step the *Graham* court was unwilling to take, and said that *Graham* could no longer be interpreted to mean that a board had no obligation to create an information-gathering system and monitoring mechanisms to ensure corporate law compliance.[97] Allen stated that it was necessary for the board to assure itself in good faith that information and reporting systems are accurately and promptly providing the relevant information for the board to make an informed decision, and that if the directors failed to do so they could be held liable for illegal conduct.[98] However, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."[99] Although this analysis was dictum in *Caremark*, Chief Justice Veasey has noted that the expectations of directors have progressed from *Graham* to *Caremark*.[100] The courts' progression to relying on the principle of good faith is not limited to cases involving fiduciary duty, but it also stretches to takeover attempts.

94. 698 A.2d 959 (Del. Ch. 1996).

95. *Id.* at 967 (holding that "[d]irector liability for a breach of the duty to exercise appropriate attention may . . . follow *from a board decision* that results in a loss because that decision was ill advised or 'negligent.'" In addition "liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.").

96. *Id.* at 969 (quoting Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963)).

97. *Id.* at 969–70. *But see* MODEL BUS. CORP. ACT § 8.31(a)(2)(iv) (2002), which has been adopted by many states and is closer to the *Graham* interpretation than *Caremark*. The section states that a director may be held liable for inattention "when particular facts and circumstances . . . materialize that" would put "a reasonably attentive director" on notice of the need for further inquiry. *See also id.* § 8.01 official cmt. ("[D]irectors should not be held personally responsible for actions or omissions of officers, employees, or agents of the corporation so long as the directors have relied reasonably").

98. *Caremark,* 698 A.2d at 970.

99. *Id.* at 971.

100. Veasey, *supra* note 15, at 446.

C. Good Faith in Takeovers

Although the good-faith standard has become more prominent in the last few years, its evolution was also evident in the 1980s and 1990s during the hostile takeover phenomenon.[101] For example, as a result of that evolution, courts apply the business judgment rule to a board's decision to accept or reject a takeover offer, and the board is not obligated to negotiate or to sell the company simply because a premium offer has been made.[102] Furthermore, directors will be exonerated from any challenge if the board makes a good-faith and informed decision that a sale is not in the company's best interests.[103] In fact, the board, as a fiduciary, is required to oppose any offer that it feels is not in the best interests of the corporation and its shareholders.[104]

Despite the general deference in this area, business judgment rule jurisprudence has gradually developed a more rigorous scrutiny of board decisions involving defensive actions taken by the board to block a takeover.[105] Courts require this enhanced analysis because of the possibility that a board may be acting in its own interest, rather than those of the company and its shareholders.[106] In *Unocal Corp. v. Mesa Petroleum Co.*,[107] the Delaware Supreme Court affirmed the board's basic duty of ensuring that its decisions are in the best interests of the shareholders.[108] However, in light of the potential conflict of interest, the court imposed a more intrusive two-prong test.[109] First, the board must have "reasonable grounds for believing that a

101. *Id.*

102. *See, e.g.,* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1383 (Del. 1995) (holding that the board may deny a "third party's unsolicited acquisition proposal or offer." (quoting Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 43 n.13 (Del. 1994))); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989) (holding that the board's refusal of an offer is a valid decision under its business judgment).

103. *See* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1055 (Del. Ch. 1996) (holding that directors are free to decline to negotiate the sale of a company subject to the conditions of good faith).

104. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985) (holding that "the board had both the power and duty to oppose a bid it perceived to be harmful to the corporate enterprise."); Gilbert v. El Paso Co., 575 A.2d 1131, 1146 (Del. 1990).

105. Fleischer & Sussman, *supra* note 4, at 921.

106. *Unocal,* 493 A.2d at 954.

107. 493 A.2d 946 (Del. 1985).

108. *Id*. at 955.

109. Fleischer & Sussman, *supra* note 4, at 921. The two-part test in *Unocal* was later rearticulated by the court in *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994), where the court stated that "[t]he key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decision making process . . . including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing."

danger to corporate policy and effectiveness existed."[110] This prong requires the board to inform itself fully, and any defensive action taken must be the result of careful evaluation of the various alternatives available.[111] The board also must have responded in good faith to a perceived threat and not for the purposes of entrenching itself in office.[112] Second, the board must justify the reasonableness of the tactics used in response to the threat the takeover posed to the corporation's interests.[113] The board will satisfy the *Unocal* requirements "by showing good faith and reasonable investigation."[114] The enhanced scrutiny standard created a mechanism for future litigation involving defensive measures employed to resist a corporate takeover.

The progeny of *Unocal* continued to hold directors to a heightened standard of conduct in regard to takeovers. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[115] the court developed a modified version of the enhanced scrutiny test to deal with the issue of directors who were determined to sell the corporation to a new owner.[116] The *Revlon* court noted that if a sale of the corporation is inevitable, the director's duty changes from the preservation of the company to the maximization of shareholder value.[117] However, the directors are not always obligated to accept the highest bid, but rather to seek out, in good faith, the best transaction that would maximize shareholder interest.[118]

110. *Unocal,* 493 A.2d at 955. *See also* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1985). Threats sufficient to satisfy the standard include: "coercion, price inadequacy, insufficient time or information for shareholders to assess price adequacy, the failure to provide shareholders an option to remain equity holders in the corporation, and the effect of a change in control upon corporate culture." BLOCK ET AL., *supra* note 19, at 251.

111. Fleischer & Sussman, *supra* note 4, at 921.

112. *Unocal*, 493 A.2d at 954.

113. *Id*. at 955. The *Unocal* court mentions *Cheff v. Mathes*, an early Delaware Supreme Court case in which the court did not even give the board the business judgment rule presumption of good faith. Instead, the directors were responsible for proving that they had a reasonable belief that the shareholders' interests were in danger and that their actions did not have the primary purpose of self-interest. This holding, however, proved to have less impact than anticipated because liability could only be imposed if self-interest was the board's only purpose. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 696 (2002).

114. *Unocal,* 493 A.2d at 955 (quoting Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964)).

115. 506 A.2d 173 (Del. 1985).

116. *Id.* at 176.

117. *See id.* at 182. This duty arises in two situations: 1) when a corporation initiates a bidding process to sell itself or reorganize, or 2) when a corporation, in response to an offer, abandons its long-term strategy and seeks to break up the company. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).

118. Citron v. Fairchild Camera and Instrument Corp., 569 A.2d 53, 71 (Del. 1989) (holding that the board was properly motivated and acted in good faith in choosing between two bidders).

Subsequent cases reiterated the authority of the board in making decisions concerning mergers and takeovers.[119] In addition, courts repeated the deference to these decisions as long as they were made "within a range of reasonableness" that included a good-faith analysis of alternatives available to the board.[120] In general, the court will not second-guess the board's judgment if the directors' defensive actions meet the standards discussed. However, the business judgment rule protection is lost if the board breaches one of the triad of fiduciary duties[121] or does not meet the *Unocal* or *Revlon* standards.

Even if one of these standards is not met, the board's decision is still not necessarily invalidated but will instead be subject to review under the stricter entire-fairness test.[122] In contrast to the business judgment rule, the entire-fairness test does not offer directors the benefit of any presumptions.[123] Rather, the board must demonstrate the "utmost good faith" and "scrupulous inherent fairness" of the transaction requiring the satisfaction of both fair price and fair procedure.[124] Recently, courts have made good faith the central concept in corporate jurisprudence.

IV. RECENT INTERPRETATIONS OF THE PRINCIPLE OF GOOD FAITH

The court's determination of a director's good faith has become central to the duty of care and loyalty analyses. Due to the outcry of concern over the potential effect of the enhanced duties expected of directors, many states enacted protective provisions. One such example is section 102(b)(7) of the Delaware General Corporation Law, which allows shareholders to adopt a provision that will exonerate directors from personal liability for violations of

119. *See, e.g., Time Inc.*, 571 A.2d at 1154 (holding that "Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. . . . [and t]hat duty may not be delegated to the stockholders.").

120. Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1388 (Del. 1995).

> [T]he 'range of reasonableness' standard is a need of the board of directors for latitude in discharging its fiduciary duties . . . when defending against perceived threats. [I]f the board of directors' defensive response is not draconian (preclusive or coercive) and is within a 'range of reasonableness,' a court must not substitute its judgment for the board's.

Id. (citing Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45–46 (Del. 1994)).

121. Justice Horsey first observed the triad of fiduciary duties, which refers to the duties of care, loyalty, and good faith, in his opinion in *Cede & Co. See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

122. *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999); *Unitrin*, 651 A.2d at 1377 n.18.

123. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (holding that the standard is "uncompromising").

124. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983). *See also Cede & Co.*, 634 A.2d at 361.

the duty of care.[125] However, if directors fail to act in good faith, they will not enjoy the protection of this exculpatory provision and will be subject to liability.[126] In addition, the good-faith language is prevalent in several other important corporate provisions. Section 141(e) of the Delaware Code allows directors to rely in good faith on corporate books, officers, committees, or properly chosen experts.[127] Also, directors may not be indemnified under section 145 of the Delaware Code if they did not act in good faith.[128] In fact, good faith has become the overarching concept in both inquiries of the duties of due care and loyalty instead of being subsumed within them.[129] A director's failure to exercise good faith would disqualify her from the shelter of the protective provisions and the business judgment rule.

The courts have hinted at corporate governance reform that "mandates that directors proactively inform themselves about corporate developments and aggressively intervene to understand reported troublesome corporate behavior that is not voluntarily brought before the board by management."[130] Vice Chancellor Strine observed in an August 2002 article that, due to the recent *Caremark* decision and corporate exculpatory charter provisions, courts will focus on a director's good faith instead of a gross negligence standard.[131] In fact, the recent trend in director scrutiny has seemingly merged the doctrine of good faith and the duty of care because the duty of care presently adds little to no practical significance to the directorial role.[132]

Due to the prevalent "good faith" language in the Delaware Code that would take a director's conduct outside of these rules' protection, Delaware

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125. DEL. CODE ANN. tit. 8, § 102(b)(7) (2002).

126. *See* Veasey, *supra* note 15, at 447.

127. DEL. CODE ANN. tit. 8, § 141(e).

128. DEL. CODE ANN. tit. 8, § 145(a). Indemnification refers to the ability of a corporation to reimburse a director, officer, employee, or agent for any "expenses (including attorneys' fees), judgments, fines and amounts paid in settlement" that were incurred during a suit against her. *Id.* See BLOCK ET AL., *supra* note 19, at 941–65, for a complete discussion of indemnification principles.

129. In the comment of § 8.30 of the Model Business Corporation Act, the authors note:

> director[s] shall act in good faith coupled with conduct reasonably believed to be in the best interests of the corporation. This mandate governs all aspects of directors' duties: the duty of care, the duty to become informed, the duty of inquiry, the duty of informed judgment, the duty of attention, the duty of loyalty, the duty of fair dealing, and, finally, the broad concept of fiduciary duty that the courts often use as a frame of reference when evaluating a director's conduct.

CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: STATUTES, RULES AND FORMS 106 (Jeffrey D. Bauman ed., 2003 ed.).

130. Fleischer & Sussman, *supra* note 4, at 981.

131. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371, 1386 (2002).

132. *See generally* Creighton Condon, *Keeping the "Good" Faith: The Evolving Duties—and Potential Personal Liability—of Corporate Directors*, 7 No. 2 M & A LAW. 1 (June 2003).

courts have recently focused on the good faith of the director. In addition, courts have focused on whether directors' fiduciary duty violations also were made in bad faith, which has led to the inquiry of whether directors will be held to an independent duty of good faith.[133] Courts have also shown that these exculpatory provisions will not be upheld in instances in which directors "consciously and intentionally disregard[] their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[134] Directors who consciously disregard risks or knowingly put their heads in the sand to avoid taking action call into question their good faith.[135]

Since *Aronson*, Delaware courts have consistently held directors liable for breaching their duty of care when acting in a grossly negligent manner described as "a devil-may-care attitude or indifference to a duty amounting to recklessness."[136] In recent cases, however, courts have made the distinction between "gross negligence amounting to recklessness," which is a due care violation sheltered by the provisions, and "conscious disregard of known risks," or bad faith, which falls outside all of these protective provisions.[137] This distinction is evident in three recent decisions involving derivative actions against directors for breaching their fiduciary duties. In each case, the court not only denied defendant's motion to dismiss, but also precluded the 102(b)(7) provision, allowing shareholders to proceed with their case.

A. Recent Cases Utilizing the Good-Faith Standard

The first example in the recent triad of derivative cases in which the court relied on the good-faith standard is *McCall v. Scott.*[138] In *McCall*, the directors knew of schemes instituted by management to improperly increase revenue and did nothing to quash the fraud or even discourage it.[139] In addition, directors even provided incentives for employees to commit fraud, which led to lawsuits, loss of goodwill, and declines in stock value due to state and federal investigations.[140] The Sixth Circuit, applying Delaware law, found that the directors' fiduciary duties included not only due care and loyalty but also the duty of good faith.[141] The court further asserted that while duty of care

133. Fleischer & Sussman, *supra* note 4, at 985.

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

135. *Id*.

136. Fleischer & Sussman, *supra* note 4, at 986 (quoting William T. Allen et. al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1300 (2001)).

137. *Id.*

138. 239 F.3d 808 (6th Cir. 2001).

139. *Id.* at 813–15.

140. *Id.*

141. *Id.* at 818.

claims alleging that only grossly negligent conduct are precluded by the 102(b)(7) waiver provision, claims based on reckless or intentional misconduct are not protected.[142] The court found that if directors consciously disregarded known risks, there would be a likelihood of liability for breach of fiduciary duty.[143] Furthermore, the duty of good faith may be breached where stockholders suffer due to a director's conscious disregard of known risks because such actions cannot be made in good faith.[144]

Another example is *In re Abbot Laboratories Derivative Shareholders Litigation.*[145] In *Abbot*, the directors, over a six-year period, failed to fix safety violations despite thirteen FDA inspections of its facilities that resulted in continual notices of the problems being sent to the directors.[146] The plaintiffs presented facts that the directors were aware of the problems and took no action to remedy them, leading to the largest civil fine ever imposed by the FDA and the suspension of the company's products.[147] The Seventh Circuit, following the reasoning in *McCall,* stated that a complaint, which sufficiently pleads facts of bad faith by the directors, falls outside of an exculpatory provision's protection.[148] Therefore, the court ruled against the directors because their failure to act exhibited a lack of good faith.[149]

The most recent illustration, *In re Walt Disney Co. Derivative Litigation*,[150] is a May 2003 decision in the Delaware Court of Chancery. The CEO of Disney, Michael Eisner, hired Michael Ovitz, a longtime personal friend, to become the company's new president.[151] In approving the appointment, the board's conduct was inappropriate for several reasons, including the fact that the board met for less than an hour (and spent most of its time on two other issues), relied on a summary of the employee agreement's terms (which had not been finalized at the time of the board's meeting), and did not consult an expert for advice on the compensation arrangement.[152] In essence, the board gave the CEO free reign to negotiate at will with a close friend without any

142. *Id.*

143. McCall v. Scott, 239 F.3d 808, 818 (6th Cir. 2001).

144. *See id.*

145. 325 F.3d 795 (7th Cir. 2003).

146. *Id.* at 799–801.

147. *Id.* at 809.

148. *Id.* at 811.

149. *Id.* The court reasoned that a "sustained and systematic failure of the board to exercise oversight," in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses, establishing a lack of good faith.

Id. at 809.

150. 825 A.2d 275 (Del. Ch. 2003).

151. *Id.* at 279.

152. *Id*. at 279–85.

board scrutiny. In addition, after Eisner admitted that hiring Ovitz was a mistake, he unilaterally negotiated a severance package worth $140 million without the participation of the board.[153] The board also failed in this transaction because it did not insist on the use of an impartial attorney who would have advised the board that it could seek a termination based on fault, which would have saved Disney the exorbitant "pay-off" to Ovitz.[154]

The *Disney* court again focused on whether or not the board's actions were honest and made in good faith. At issue in *Disney* was executive compensation, a matter that courts historically have refused to second-guess. There is no bright-line dollar limit to executive compensation, and as Chancellor Chandler noted "large, heavy ships can float."[155] In a recent article, however, Chief Justice Veasey pointed out that there are limits that revolve around the processes the board incorporates in coming to a decision and the board's good faith, which "requires an honesty of purpose and eschews a disingenuous mindset of appearing or claiming to act for the corporate good, but not caring for the well-being of the constituents of the fiduciary."[156] Veasey further stated that reckless or irresponsible conduct could lack good faith even absent self-dealing or fraudulent conduct.[157]

The *Disney* court also noted that an exculpatory provision eliminating or limiting liability did not apply to either a breach of the director's duty of loyalty to stockholders or acts or omissions not made in good faith or that entail intentional misconduct or a knowing violation of the law.[158] Even though the court was reluctant to second-guess the decisions of independent directors, "the facts belie[d] any assertion that [the Disney directors] exercised *any* business judgment or made *any* good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders."[159] Essentially, the directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude."[160] The court concluded that the directors were deliberately indifferent to acting in good faith and with

153. *Id.* at 283–85.

154. *Id* at 286–88.

155. Veasey, *supra* note 15, at 447 (citing *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 350 (Del. Ch. 1998)).

156. E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, 38 WAKE FOREST L. REV. 839, 850–51 (2003).

157. *Id.*

158. *Walt Disney Co.*, 825 A.2d at 286.

159. *Id.* at 287.

160. *Id.* at 289. *See also* Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *9, *12 (Del. Ch. Aug. 24, 2004). The *Elkins* court used the *Disney* standard and denied several of the directors' motions to dismiss due to the fact that there was sufficient evidence that they entered into several agreements in "blind faith"; therefore, their conduct was not in good faith and was not protected by exculpatory provisions. *Id.* at *12, *15.

appropriate care to advance corporate interests, thereby placing their conduct outside the business judgment rule's reach.[161]

The court also concluded that the facts supported an inference that Ovitz's negotiations of his employment and termination agreements breached his duty of loyalty. While the court acknowledged his right to seek the best agreement possible for himself, he had the duty of negotiating honestly and with good faith so that he would not be advantaged at the shareholders' expense.[162]

Disney, along with *Abbot* and *McCall*, makes it clear that intentional and reckless conduct showing a disregard for obvious risks constitutes bad faith and will not be protected by the business judgment rule or exculpatory provisions. This new focus on directors' good faith is a step in the right direction to provide a tangible standard that directors can use as a model for their own conduct.

V. GOOD FAITH: THE UTILITY IN A BUSINESS JUDGMENT RULE ANALYSIS AND PROMOTION OF BUSINESS

The focus on a director's good faith provides a more comprehensible and precise standard of review for courts to follow. The courts have been inconsistent with their articulation of the exact standard of conduct that is expected of directors. Many courts continue to look to Delaware for guidance because Delaware incorporates the majority of corporations in America. However, even Delaware has not provided a consistent definition for the standard of care that will subject directors to liability. Over time, the standard has gone through an array of principles including: "gross and palpable overreaching," "bad faith . . . or a gross abuse of discretion," gross negligence, fraud, misconduct or abuse of discretion, and "reckless indifference to or a deliberate disregard of the stockholders."[163] In addition, the review of whether a decision was made in bad faith was limited to those decisions that seem so far beyond reasonable judgment that they were "inexplicable on any ground other than bad faith."[164]

The recent focus on good faith simplifies the articulation of a director's fiduciary duties by merging the duties of care and loyalty. The business judgment rule limits a director's liability assuming she was disinterested and

161. *Walt Disney Co.*, 825 A.2d at 289.

162. *Id.* at 291.

163. Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984) (citations omitted).

164. BLOCK ET AL., *supra* note 19, at 37 (quoting *In re* J.P. Stevens & Co. S'holders Litig., 542 A.2d 770, 780–81 (Del. Ch. 1988)). *See, e.g.*, Muschel v. W. Union Corp., 310 A.2d 904, 908 (Del. Ch. 1973) (holding that a gross disparity in price paid and a fair price for the stock of an acquired corporation could be construed as beyond an error of judgment and arising to bad faith); Aronoff v. Albanese, 446 N.Y.S.2d 368, 371 (N.Y. App. Div. 1982) (holding that a great disparity in the value of assets given in comparison to the benefits the company received signals bad faith).

made an informed decision in good faith.[165] One commentator broke down the duty of good faith into three substantive elements.[166] First, the director must be disinterested in the transaction by "neither appear[ing] on both sides of the transaction nor expect[ing] to derive any personal benefit from it in the sense of self-dealing."[167] Second, the director must be independent and not dominated by another person.[168] The director is considered independent if she can make her decision "based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[169] If the director cannot exercise free judgment or is influenced by an interested party, she cannot possibly act in good faith.[170] Finally, the conduct cannot be "egregious," which is a decision made "that . . . no person of sound ordinary business judgment would countenance."[171] As Chancellor Allen has observed, the rare case that looks at the irrationality of a decision is really a way of analyzing bad faith.[172]

Consistent with the purpose of the business judgment rule, the focus on a director's good faith gives deference to business decisions. The overall premise of the business judgment rule is that, absent the egregious case of bad judgment or when there is evidence of bad faith, courts will not second-guess the soundness of business decisions.[173] This idea is important because exposing director decisions to any additional scrutiny would have a negative effect on business as a whole. Directors would be inclined to be risk-averse and constantly second-guess their own judgment if they knew that each judgment could be unfairly scrutinized. Any judicial allowance for review would upset the system of free enterprise and bold entrepreneurial spirit, which has become the cornerstone of American business. Furthermore, judges are not trained to make such decisions and have no place in reviewing business

165. BLOCK ET AL., *supra* note 19, at 3.

166. Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, A Commentary*, 41 BUS. LAW. 1237, 1248 (1986).

167. *Id*. at 1248 (quoting *Aronson*, 473 A.2d at 812).

168. *Id*. at 1249.

169. *Aronson*, 473 A.2d at 816 (holding that the business judgment rule will still insulate the board's decision from judicial review unless the plaintiff can show that a majority of the board was interested and/or lacked independence. In order to prove the directors were not independent, the plaintiff must establish personal or business relationships by which the directors are either beholden to or controlled by the interested party).

170. Hansen, *supra* note 166, at 1249.

171. *Id.*

172. *See* Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1246 (Del. 1999) (holding that "[t]he presumptive validity of a business judgment is rebutted in those rare cases where the decision under attack is 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'" (quoting *In re* J.P. Stevens & Co., Inc., 542 A.2d 770, 780-81 (Del. Ch. 1988))).

173. *See* Bodell v. Gen. Gas & Elec. Corp., 140 A. 264, 268 (Del. 1927).

decisions as a whole, no matter how foolish the decision may appear in hindsight.

The concentration on a director's good faith eliminates the need for the subjective determination of what conduct constitutes gross negligence in the context of a duty of care inquiry. Corporate exculpatory provisions will absolve a director of any liability, even if her conduct is grossly negligent, as long as her good faith is uncompromised.[174] Therefore, in practice the only worthwhile inquiry in the context of a director's duty of care is into the director's good faith. The oft-cited duty of care requirement, which mandates that a director exercise the "amount of care which ordinarily careful and prudent men would use in similar circumstances," is misleading.[175] The search for directors who have been held liable for "negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack."[176]

In the decision-making context, the final result of a decision is not the focus of a court's analysis, and therefore, there is no need for a court to inquire into whether a decision was one of "an ordinarily prudent person . . . in a like position and under similar circumstances."[177] Rather, the *process* is the key component, and a good faith undertaking by the directors is required.[178] If a lack of good faith yields an egregious result, the directors will not meet the standards set forth by the business judgment rule.[179]

A case illustrative of a board decision in which the process was so foolish that even the business judgment rule did not insulate it is *Litwin v. Allen*.[180] The court held the directors of Guaranty Trust Company liable for the decision to purchase $3 million of debentures.[181] The purchase agreement gave the seller the option to repurchase the debentures at the sale price within six months.[182] This option put the risk of loss on Guaranty Trust if the debentures declined, which they did.[183] In addition, Guaranty Trust did not realize any potential for profiting because if the debentures appreciated, the seller could exercise the option to repurchase.[184] Therefore, the situation was a no-win for Guaranty Trust. The court noted that while the director's honesty was unquestioned, honesty was not enough: "[T]here must be diligence, and that

174. McCall v. Scott, 239 F.3d 808, 818 (6th Cir. 2001).
175. BAINBRIDGE, *supra* note 113, at 242–43.
176. Hansen, *supra* note 166, at 1245.
177. *Id.* at 1246 (citation omitted).
178. *Id.* at 1248.
179. *See* Veasey, *supra* note 15, at 447.
180. 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940).
181. *See id.* at 699–701.
182. *Id.* at 691.
183. *Id.* at 697–98.
184. *Id.* at 698.

means care and prudence, as well."[185] Some processes that yield a decision may be so foolish that even the business judgment rule will not protect the directors from judicial review; however, these cases are extremely rare.[186] Nonetheless, *Litwin* stands as precedent for the idea that directors will be held liable for making decisions that are beyond a range of reasonableness and that are so egregious their good faith is compromised.[187]

Even out of the decision-making context, directors are only held liable for obvious failures to exercise any oversight and supervision.[188] A typical example is *Francis v. United Jersey Bank*.[189] In *Francis,* the director allowed her two sons to use the company to make unlawful payments to themselves.[190] The court found her liable because she exercised no attention at all to the affairs of the corporation.[191] The court stated that directors have a constant obligation to inform themselves about the activities of the corporation and must not ignore corporate misconduct only to claim that because they did not see the misconduct, they did not have a duty to look.[192] Again, the precedent set forth by *Francis* has a minimal reach that extends only to those directors who remain oblivious to their duties and simply exercise no oversight.

The court should be cautious and broadly construe the good-faith standard in favor of the director because it is not the job of the court to second-guess business decisions, especially with the aid of hindsight. Shareholders are quick to question the soundness of a business decision after the market tests its utility; however, the good-faith standard should not be used to heighten the degree of scrutiny for business decisions not complicated by conflicts of interest. The heightened scrutiny of *Unocal* and its progeny, along with the entire-fairness test articulated in *Weinberger,* are undoubtedly necessary in transactions involving conflicts of interest; however, such a rigid standard has no place in evaluating the conduct of good-intentioned and disinterested directors. The good-faith standard can have a marked impact in corporate jurisprudence and the corporate culture as a whole if used appropriately.

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185. Litwin v. Allen, 25 N.Y.S.2d 667, 699 (N.Y. Sup. Ct. 1940). The court held in this case that there was more than a "question of business judgment as to which men might well differ. The directors plainly failed in this instance to bestow the care which the situation demanded." *Id.*

186. *See* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051–52 (Del. Ch. 1996) ("There is a theoretical exception . . . that some decisions may be so 'egregious' that liability for losses they cause may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments . . . .").

187. *See* Hansen, *supra* note 166, at 1249.

188. *Id.* at 1247.

189. 432 A.2d 814 (N.J. 1981).

190. *See id.* at 818–19.

191. *See id.* at 819–20.

192. *Id.* at 823.

VI. WHERE CAN THE GOOD-FAITH ANALYSIS BE USED AND WHAT IS ITS FUTURE IMPACT ON THE BUSINESS JUDGMENT RULE?

The evolving standard of good faith will likely change the expectations of the corporate culture. In the wake of Enron and other prominent corporate catastrophes, the focus on a director's good faith is a necessary component of a court's analysis. Good faith likely will become the central concept in the judicial review of suits against directors for breach of their fiduciary duties. A lack of good faith brings their conduct outside of both the business judgment presumption and the protective provisions adopted by many states limiting the director's exposure to liability but still requiring that their actions be made in good faith.

Although this Comment's main focus is not on recent legislation, the evolution of the good-faith concept can also be seen in several recently adopted acts. These acts are a response to the lamentable behavior of many directors who have been the subject of much controversy in the past few years.[193] Veasey noted "the utter failure to follow the minimum expectations of the evolving standards of director conduct, the minimum expectations of Sarbanes-Oxley, or the NYSE or NASDAQ Rules . . . might . . . raise a good faith issue."[194] In addition, Veasey has observed that these requirements have likely "enhanced the expectations of minimal director conduct."[195] It is the role of the board to ensure all of the enhanced mandated "corporate governance principles are carried out and followed through in good faith."[196] Overall, the heightened scrutiny on director conduct is likely to have a marked impact in several areas, including: decreasing the pool of qualified candidates for director positions, increasing litigation against current officials, restraining

193. Veasey, *supra* note 5, at 2138.

194. Veasey, *supra* note 15, at 446. The Sarbanes-Oxley Act holds directors to a heightened degree of censure, oversight, and qualifications. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(c)–(e), 116 Stat. 745, 750–52 (2002) (codified in scattered sections of 15, 18, 28, and 29 U.S.C.A.). The Board must have five financially literate members, and all of the members must serve the corporation on a full time basis. § 101(e)(1), (3). This requirement ensures that the directors have an intimate knowledge of the corporation's dealings and any potential warning signs. The Act also outlines several expectations now required of boards: 1) it must register public accounting firms, 2) establish or adopt "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers," 3) conduct inspections of accounting firms, 4) conduct investigations and disciplinary proceedings, and impose appropriate sanctions, 5) perform such other duties or functions as necessary, 6) "enforce compliance with [the] Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto," and 7) "set the budget and manage the operations of the Board and the staff of the Board." § 101(c).

195. Veasey, *supra* note 5, at 2145.

196. *Id.* at 2146.

exorbitant compensation agreements to top executives, and proving a formidable action in the upcoming litigation of many of corporate scandals.

A. Decrease in the Pool of Qualified Candidates for Directorial Positions

The focus on the concept of good faith in the context of fiduciary duty coupled with the newly enacted measures from Congress and the self-regulatory organizations is likely to shrink the pool of qualified candidates willing to serve on corporate boards.[197] In addition, even those directors who still desire to serve on corporate boards will be limited in the number of boards they can adequately and effectively serve on due to the increased time demands on boards to focus on "accountability mechanisms related to compensation, crisis management, accounting and auditing issues."[198] These initiatives increase the responsibilities of directors and heighten the degree of care expected of them. Therefore, many candidates will likely shy away from taking on these duties. Hopefully the willing candidates that do fill these positions will fulfill their duties responsibly and productively so that the market will regain its faith in corporations.

Board members are usually well-educated and extremely sophisticated individuals and expect to be compensated as such. The problem is that sophistication and knowledge are useless if board members do not attend meetings and do not care enough about the company to prod into the daily occurrences in order to make decisions that will improve the company. The recent corporate scandals, most notably Enron,[199] provide a comprehensive template on what directors should not do. The highly publicized corporate scandals of Enron, WorldCom, and others led to public outrage and corporate governance reform, which inspired a host of emerging new requirements from legislators, regulators, and the stock exchanges. The boards now face unprecedented scrutiny, increased risks and responsibilities, and tough new standards for their skills and independence.

197. Veasey, *supra* note 15, at 448.

198. Jerri Stroud, *Boardroom Activism Drives Up Director Pay*, ST. LOUIS POST-DISPATCH, Aug. 8, 2004, at E4 (quoting Joel Seligman, Dean of Washington University School of Law).

199. Many of Enron's board members missed a majority of the board meetings. Marianne M. Jennings, *Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance—Restoration of Active Virtue in the Corporate Structure to Curb the "Yeehaw Culture" in Organizations,* 3 WYO. L. REV. 387, 403 (2003). In addition, the board's function became one of merely putting its stamp of approval on transactions without making any inquiry despite being warned about a transactions' high risk. *Id*. at 405. Such incidents include: the February 1999 audit committee meeting in which the board was told Enron's accounting methods pushed the limits of legally accepted methods, meetings between 1999–2001, in which the board was told gross revenues were doubling and tripling, generated by off-the-book entities run by their CFO, the board's continual waiver of its own conflict of interest policy to run more off-the-book entities, and the fact that it accepted management's word that a whistle-blower memo was nothing and dismissed it with no investigation. *Id*. at 404–05.

Enron board members averaged $380,000 in total cash and equity compensation each year.[200] This amount did not even include the money they were paid for attending meetings during the year,[201] nor did it include the money board members made through indirect channels.[202] The public became outraged at such ludicrous numbers when the scandals were brought into the limelight. However, even today the average corporate director at a large corporation in the United States receives $154,016 per year in compensation for her services.[203] In comparison to Enron's figures this amount may not seem absurd, but compared to an average employee's salary this figure is still quite high, especially when one considers the fact that a director's duties only consist of a few days of work per year.

Directors' salaries are also expected to double or triple in the next ten years due to the fact that serving on a board has become a larger time commitment.[204] Therefore, there are still significant incentives for qualified candidates to accept director positions; however, it is clear that more is expected of them than the directorial inattention evident in the recent corporate scandals. As one corporate director acknowledged: "It's very serious business," and finally directors "are paying attention to what they should have been paying attention to all along."[205] Those boards that did not pay attention to fraudulent conduct and the corporate officials responsible for such dishonest conduct will now face increased scrutiny and a heightened exposure to discipline.

200. Reed Abelson, *Enron Board Comes Under a Storm of Criticism*, N.Y. TIMES, Dec. 16, 2001, § 3, at 4.

201. Jennings, *supra* note 199, at 403.

202. Douglas M. Branson, *Enron — When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 1019 (2003). Enron conducted many transactions involving conflicts of interest with its board members. *Id.* Such incidents include: paying Lord John Wakeham, a chartered accountant, $72,000 per year for consulting services; hiring Board member John Urquhart and his Connecticut based consulting firm for $493,914 in 2000; giving $70,000 to Board member Charls Walker, a tax lobbyist, which was paid to firms he controlled; buying equipment from National Tank Company, whose director Herbert Winokur also served in the years 1997-2000; donating $50,000 to George Mason University and its Mercatus Center headed by board member Dr. Wendy Gramm; and contributing more than $600,000 to the Andersen Cancer Center, over which two Enron board members, Dr. Charles LeMaistre and Dr. John Mendelson, had at various time presided as president. *Id.*

203. Press Release, Pearl Meyer & Partners, Calm Before the Storm — Average Board Pay at Largest 200 Companies Stays Flat at $154K (Mar. 27, 2003), *at* http://www.pearlmeyer.com/prcurart35.html.

204. *See* Stroud, *supra* note 198 (opinion of Todd McGovern, regional compensation leader with Mellon Financial Corp. of Pittsburgh).

205. *Id.* Gwendolyn King, director of Monsanto Co. and three other companies, opined about the role of corporate directors in today's corporate culture. *Id.*

B. *Increase in Litigation Against Current Officials*

Courts are opening the door for increased litigation against directors and officers, and corporate lawyers are likely to accept the challenge of representing shareholders who lose assets as a result of dishonest corporate conduct. Likely, the focus of litigation against corporate directors will concentrate on inadequate oversight.[206] The courts have made it clear that exculpatory provisions will not protect directors' conduct if it was so egregious that it lacked good faith and was contrary to the best interests of the shareholder.[207] In addition, Delaware enacted new legislation that makes it easier for stockholders to obtain books and records of the corporation if they have a proper interest in obtaining information on the corporation's operations.[208] This provision will make it easier for shareholders to examine the exact steps and processes taken by the board in making decisions that impact the corporation. An increase in the availability of information further bolsters the recommendation to directors that they ensure the installation of appropriate information systems in the company and avail themselves of all possible information before making a decision in the company's best interests.

Another possible impact of the recent focus on good faith is an increase in litigation pursuing officers in fraud cases.[209] Perhaps as a direct response to the appalling conduct of many top officials, Delaware recently enacted legislation that would subject officers to the personal jurisdiction of the Court of Chancery in the same manner as directors.[210] Therefore, stockholders will likely have a cause of action against top officials involved in fraudulent schemes or wasting company assets. In response, top officials should be concerned with ensuring that their conduct can survive good-faith scrutiny.

Insurance carriers may also disclaim coverage due to the recent focus by some courts upon the exclusions for willful or intentional misconduct.[211] Corporations and directors protect themselves from personal liability through such coverage; however, actions made in bad faith will likely not be protected. Boards failing to meet these minimal requirements will likely be forced to pay for their indiscretions out of their own pocket instead of relying on indemnification or insurance. In fact, the move toward holding inept directors personally responsible for failing to exercise the requisite care in their decision making has recently become a reality as former directors of both Enron and

206. Veasey, *supra* note 5, at 2145.

207. *See supra* notes 125–28 and accompanying text.

208. DEL. CODE ANN. tit. 8, § 220 (2003).

209. Veasey, *supra* note 15, at 448.

210. DEL. CODE ANN. tit. 10, § 3114 (2003).

211. Fleischer & Sussman, *supra* note 4, at 983. Directors' and officers' liability insurance reimburses the corporation for any indemnification payment made to an officer or director and also covers the officials in situations where the corporation does not offer indemnification. BLOCK ET AL., *supra* note 19, at 941.

WorldCom agreed to personally compensate shareholders for losses incurred as a result of their failure to monitor the illegal activity within the corporation.[212] These settlements are "highly unusual" and reiterate the premise that a director must carry out her duties with the utmost professionalism and good faith or face exposure to potential personal liability.[213] The scrutiny on officials' good faith could also spill over from the area of decision making and into the relatively untouched area of executive compensation.

C. Executive Compensation Agreements

The good-faith standard could have a substantial influence on litigation involving executive compensation. The corporate culture saw a huge increase in executive compensation in the 1990s, and the insatiable greed for lavish indulgences permeated it at levels never before seen. Few questioned the exorbitant payments being made to executives during the economic boom because everyone was prospering; however, when the bubble burst, the lofty salaries became an issue.

Many of Wall Street's brightest stars such as Kenneth Lay of Enron, Dennis Kozlowski of Tyco, and Bernhard Ebbers of WorldCom, who made millions of dollars throughout the 1990s, plummeted back to reality as their companies' stocks crashed and their own names became headline news in ongoing fraud investigations.[214] Today, the public even views such prominent executives such as Jack Welch of General Electric as "greedy robber barons" despite the fact that it was only a few years ago that the market hailed them as "entrepreneurial geniuses."[215] As shareholder wealth quickly disintegrated in the bear market of 2000-02, the question of why these executives made so much money was on everyone's mind.

Recently, three corporate law scholars, Professor Lucien Bebchuk, Professor Jesse Fried, and David Walker, attempted to answer the question that so often came up in conversation.[216] Their article theorizes that top officials are so highly compensated because they exert so much control over their companies and the boards of directors that they can siphon money to

212. Greg Farrell, *Ex-Directors Could Pay Out of Own Pockets: Move in WorldCom Suit Unusual*, USA TODAY, January 7, 2005, at 3B; Matt Krantz & Greg Farrell, *Ex-Enron Officials OK $168M Payment: 10 Ex-Directors to Contribute $13M*, USA TODAY, January 10, 2005, at 6B.

213. Farrell, *Ex-Directors Could Pay Out of Own Pockets*, *supra* note 212.

214. Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 130–31 (2003).

215. *Id.* at 131.

216. Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

themselves almost at will.[217] Such a powerful and improper influence allows the officials to dictate the terms of their own compensation, which will be the highest amount they can take without triggering what the authors call public "outrage."[218] In addition, the top officials will engage in "camouflage" to conceal large payments from investors and minimize the possibility of causing such an outrage.[219]

An example of camouflage includes stock options that tie executive compensation to the company's stock price but do not take any money directly from the company.[220] Instead, the executive is compensated by exercising her options at well below the market price and profiting from the spread between the prices. Such tactics led to several top officials looting their companies by posting artificial profits and assets to keep the stock price up long enough for them to sell their shares on the open market and make a significant profit just before the stock plummeted.[221] In fact, it seems that performance has little, if anything, to do with how much money an executive can make in a year, which is why even in the bear market many corporate officials were receiving exorbitant paychecks. The economist John Kenneth Galbraith pointed out "[t]he salary of the chief executive of the large corporation is not a market reward for achievement," but rather "a warm personal gesture by the individual to himself."[222]

The recent corporate scandals seemed to affirm the very premises that these scholars had previously written about, and such foresight is not due to the novelty of the thesis. The authors themselves point out that there is nothing new to the ideas that many top officials are greedy, that they are not effectively controlled by their boards, and that they overpay themselves for the services they provide. Even in the wake of all the corporate scandals, in 2004 the average CEO still received more than $9 million in compensation.[223]

There is a belief in the corporate culture that there is no limit to what compensation committees can give top executives because it is nearly impossible to judge the exact dollar value that a top executive has to the

217. *See id.* at 754–56.

218. *See id.* at 756.

219. *See id.*

220. *See id.* at 762–63.

221. Margaret M. Blair, *Directors' Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 889 (2003).

222. JOHN KENNETH GALBRAITH, ANNALS OF AN ABIDING LIBERAL 79 (Andrea D. Williams ed., 1979).

223. CNNMoney, *Report: More Cash for CEOs* (April 4, 2004), *at* http://money.cnn.com/2004/04/04/news/fortune500/ceo_pay/. According to the survey conducted by Pearl Meyer & Partners, this figure is actually down eight percent from 2003. *Id.*

company's overall performance.[224] There is no statutory limitation or certain dollar amount that is too high; however, judicial review will likely focus on the board processes for figuring compensation, which are governed by a duty of good faith.[225] This principle has been proven in the recent *Disney* case, which is still ongoing in the Delaware Court of Chancery. It is possible that directors could be held liable for approving a compensation agreement without first taking appropriate measures to consider whether the agreement is in the best interests of the corporation. The board should consult comparable officer's salaries and experts to determine what would be a fair agreement between the corporation and the executive candidate. Failure to employ such methods could call the board's good faith into question.

The shareholder can also attack the terms of an executive compensation arrangement on the grounds that it is so unfavorable to the corporation that no director of ordinary sound business judgment would have voted in favor of it, and it is therefore a waste of corporate assets.[226] If reasonable persons could differ as to whether a compensation agreement is favorable to the corporation, it will generally be upheld under the business judgment rule.[227] Again, the good faith of the decision is an integral component of this analysis because "if there [was] a good faith judgment that in the circumstances the transaction [was] worthwhile, there should be no finding of waste."[228] *Disney* involves a claim for waste of corporate assets due to the large sums of money paid to Ovitz for which the corporation received little if any benefit.[229] If the Disney board is held liable in this case, it would set a precedent that future boards need to scrutinize the stipulations of executive compensation agreements and ensure their fairness.

Thirty years ago a corporate insider wrote:

> While ostensibly the seat of all power and responsibility, directors are usually the friends of the chief executive put there to keep him safely in office. They meet once a month, gaze at the financial window dressing . . . listen to the chief and his team talk superficially about the state of the operation, ask a couple of dutiful questions, . . . and adjourn until next month.[230]

Hopefully, the focus on a director's good faith along with the newly proposed acts will spawn a resurgence of ethical conduct in corporations, and boards will

224. *See* Veasey, *supra* note 5, at 2141. *But see* Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962) (noting that while a large amount of deference is ordinarily given to decisions of directors, it is clear that there are compensation payments so large that they are unconscionable).

225. Veasey, *supra* note 5, at 2141.

226. *Saxe,* 184 A.2d at 610.

227. *Id.*

228. Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (emphasis omitted).

229. *In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 291 (Del. Ch. 2003).

230. ROBERT TOWNSEND, UP THE ORGANIZATION 49 (1970).

assume the duty of maximizing shareholder value, which is supposed to be their primary concern. While the standard of good faith's long-term impact on executive compensation is unknown, these new initiatives should prove influential in the upcoming litigation of the corporate scandals.

D. Litigation Involving Corporate Scandals

The good-faith analysis could prove to be instrumental in the upcoming litigation of the economic disasters of Enron, WorldCom, and others. In WorldCom, for example, the Thornburgh Report[231] alleges that WorldCom used fraudulent accounting to cover up financial problems and failed to monitor or influence the actions of management.[232] The board members apparently continually approved actions with little or no inquiry into their potential impact on the corporation.[233] Therefore, their primary goal was to please industry analysts by meeting or beating earnings estimates, which caused a rise in stock price.[234] Similarly, the Powers Report[235] alleges that Enron was managed toward the market expectations in an attempt to take advantage of short-term profits.[236] In addition, Enron allegedly met its earnings estimates by using an elaborate business scheme wrought with conflicts of interest and potential fraudulent conduct.[237] The common thread in both of these debacles, and likely others, is that officers abused the corporation's assets and directors were content to watch and allow it to happen.[238] As recent cases have shown, such conduct is not appropriate and could subject directors to liability. In addition, with the enactment of new provisions geared at officials, greed-driven management could also be subject to similar censure.

VII. CONCLUSION

While the good-faith analysis does impose a heightened level of directorial conduct, it is important to note that the requirements are not unreasonable. The judicial review in this area is not intended to minimize risk-taking or to raise individuals' concerns over the increased liability exposure. The business

231. First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re* WorldCom Inc. (Bankr. S.D.N.Y. 2002) (No. 02-15533 (AJG)), *available at* http://news.findlaw.com/hdocs/docs/worldcom/thornburgh1strpt.pdf.

232. *See id.* at 8.

233. *Id.* at 6–7.

234. *See id.* at 8.

235. William C. Powers, Jr. et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (Feb. 1, 2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf.

236. *See id.* at 151.

237. *Id.* at 151–52.

238. Veasey, *supra* note 5, at 2138.

judgment rule remains unchanged and remains a formidable barrier protecting directors' decisions from second-guessing by the courts even for gross negligence or recklessness where their wrongdoing is unwitting or unintentional. The court's job is to analyze the processes incorporated by the directors in their decision making and oversight duties.[239] This is the area in which the expectations of directors have consistently evolved, and presently the focus is on the good faith of the board in initiating appropriate processes.[240]

The good faith concept is an essential component in director conduct and must be considered when analyzing directors' processes and motivations to ensure they are "honest and are not disingenuous or reckless."[241] The concept of good faith is not fully developed in case law; however, it is clear that "reckless, disingenuous, irresponsible, or irrational conduct . . . [can] implicate concepts of good faith."[242] The recent decisions in *McCall, Abbott,* and *Disney* represent egregious breakdowns in board review and inaction to issues of which the board was aware.

The newly proposed provisions enacted by Congress and self-regulatory organizations coupled with the new focus of good faith in the fiduciary duties of both officers and directors will hopefully improve the current state of corporate ethics. There are also commentators who have made recommendations for improving the ethical situation of corporate governance. The Principles of Corporate Governance adopted by the Business Roundtable[243] in May 2002 and the recommendations of the ABA Task Force on Corporate Responsibility[244] are key guides for the aspirations of corporate governance. The heightened standards only impose a duty to exercise good-faith judgment in business decision making.

> [I]ndependent directors who exercise skepticism, diligence and a willingness to ask tough questions, to insist that management present to the board (or an appropriate committee) matters of potential materiality to the corporation, who fully inform themselves with respect to matters presented to the board (including decisions not to act), and who seek the advice of independent experts (including executive compensation experts) when it is appropriate to do so, should continue to enjoy all the protections afforded by the business judgment rule and exculpatory clauses.[245]

239. *Id.* at 2146.

240. *Id.*

241. Veasey, *supra* note 15, at 447.

242. *Id.*

243. The Business Roundtable, *Principles of Corporate Governance* (May 14, 2002), *available at* http://www.businessroundtable.org/document.cfm/704.

244. Report of the American Bar Association Task Force on Corporate Responsibility (Mar. 31, 2003), *available at* http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf.

245. Fleischer & Sussman, *supra* note 4, at 983.

Courts have made it clear, however, that directors will be held liable for a lack of good faith where they consciously or intentionally disregard their duties.[246]

The potential difficulty for directors is the manner in which judges and juries may evaluate their conduct in the context of good faith given the imprecise and subjective boundary between good faith and bad faith.[247] Therefore, caution is left to the courts to only impose liability in cases involving obviously egregious or illegal conduct. Courts should not impose a rigid standard on disinterested decisions because the effect upon the corporate culture would be negative, leaving unqualified and risk-averse individuals in positions that demand bold risk-takers. Recent corporate greed forced a shift within the court systems to hand down harsher punishments for improper conduct; however, heed should be taken to ensure the pendulum does not shift too far in the other direction or the results could be equally disastrous.

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246. *Id.* at 990.

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

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