
DELAWARE DIRECTORS' FIDUCIARY DUTIES: THE FOCUS ON LOYALTY

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I. INTRODUCTION

The University of Pennsylvania has had an illustrious reputation ever since it was founded in 1749 by Benjamin Franklin¹ and the Law School was established in 1850 by Professor George Sharswood.² As I prepared for my lecture today, however, I was keenly aware that the first lectures in the law delivered at the University of Pennsylvania were in 1790.³ Those law lectures were presented by James Wilson, a signer of the Declaration of Independence and a Justice on the first United States Supreme Court.⁴ In fact, Wilson's views on the law were presented in lectures to President George Washington and the members of his Cabinet.⁵

Penn's tradition of academic excellence continues. The Institute for Law and Economics (the "Institute")⁶ is a good example. For more than twenty-five years it has demonstrated the benefits of a cross-disciplinary perspective. As Dean Michael Fitts has stated, the Institute "combines Penn's greatest strengths in the Law School, the Wharton School, and the Department of Economics to focus on complex questions that concern all

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1. Timeline of University History, University Archives and Records Center, University of Pennsylvania, *available at* <http://www.archives.upenn.edu/histy/genlhistory/timeline.html> (last visited Feb. 23, 2009).

2. History of the Law School, University Archives and Records Center, University of Pennsylvania, *available at* <http://www.archives.upenn.edu/histy/features/schools/law.html> (last visited Feb. 23, 2009).

3. *Id.*

4. *Id.*

5. *Id.*

6. *See* University of Pennsylvania Law School, Institute for Law & Economics, <http://www.law.upenn.edu/academics/institutes/ile/> (last visited Feb. 23, 2009) (describing the Institute).

of these fields.”⁷ Two of the great strengths in the Law School are the co-directors of the Institute, Professors Edward B. Rock and Michael L. Wachter. I congratulate them on the Institute’s remarkable achievements and thank them for honoring me with the invitation to speak today.

Ed Rock is not only one of the most respected professors of corporate law in the United States but he has a well-deserved international reputation. More than a decade ago, he wrote a brilliant law review article entitled *Saints and Sinners: How Does Delaware Corporate Law Work?*⁸ He concluded that Delaware fiduciary law is best understood as a set of parables or folktales of good and bad managers and directors. According to Professor Rock, the tales that are told in the Delaware judicial opinions collectively describe the role of directors.

I must admit that when I first read the title, I thought Professor Rock would cast the Delaware judiciary in the role of “saints” with the litigants playing the “sinners.” In that article, Professor Rock concludes that the Delaware judges on the Supreme Court and the Court of Chancery are good storytellers and notwithstanding “the fact specific, narrative quality of Delaware judicial opinions, over time [those decisions] yield reasonably determinative guidelines.”⁹

In reaching that conclusion, Professor Rock successfully asks, analyzes, and answers several questions, including what he describes as “the mushiness of Delaware fiduciary duty case law.”¹⁰ Because I graduated from this law school, I immediately recognized “mushiness” as a sophisticated legal term of art. Consequently, just like a law student writing an exam answer, I knew I could not leave the title of my speech with a mushy reference to fiduciary duty. So, I amended the title to include a “focus on loyalty.” In my remarks this afternoon, I will briefly describe why loyalty is now the central theme in the Delaware judiciary’s stories or opinions about the fiduciary duties of directors.

I am sure that when most of you think of legal stories, the opinions by the Delaware Supreme Court and the Court of Chancery are not foremost in your mind. Instead, you may think of literature about the law such as *To Kill a Mockingbird*,¹¹ *Twelve Angry Men*,¹² *The Caine Mutiny*¹³ or novels

7. INSTITUTE FOR LAW & ECONOMICS, 2006-2007 ANNUAL REPORT 5 (2007), available at <http://www.law.upenn.edu/academics/institutes/ile/AnnualReports/2006-2007AnnualReport.pdf>.

8. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

9. *Id.* at 1017.

10. *Id.* at 1101.

11. HARPER LEE, *TO KILL A MOCKINGBIRD* (J.B. Lippincott Co. 1960) (telling the story of a lawyer from a small town in Alabama who decides to defend an unpopular client).

12. REGINALD ROSE, *TWELVE ANGRY MEN, A PLAY IN THREE ACTS* (Dramatic Publ’g. Co. 1955) (portraying the story of a dissenting juror in a murder trial).

by John Grisham.¹⁴ You may also think of movies such as *A Civil Action*,¹⁵ *Kramer vs. Kramer*¹⁶ or perhaps, given the topic of my remarks, *Wall Street*¹⁷ with Michael Douglas as Gordon Gekko.

You may also think of Shakespeare because Shakespeare often referred to the law in his plays. The persuasiveness of legal references by Shakespeare is understandable. London was home to the four Inns of Court. They were the institutions that trained trial lawyers—known in England as barristers.

Many historians contend that Shakespeare had extensive contact with the legal world of London. Seven of Shakespeare's plays were performed at the Inns of Court.¹⁸ *The Merchant of Venice*¹⁹ and *Measure for Measure*²⁰ were Shakespeare's two primarily "legal" plays. From a legal perspective, there are parallel themes in both plays: the tension between justice and the letter of the law. In the end, both plays temper a strictly legalistic approach with equitable principles. We all remember that Shylock was entitled to his pound of flesh—as long as he did not draw any blood.²¹

The Merchant of Venice is often viewed as dramatizing the struggle of the Court of Chancery in England for the supremacy of its equity jurisdiction.²² Interestingly, the Delaware Constitution of 1792 created a separate court of equity that still exists.²³ The equitable struggles described by Shakespeare are relevant today because the Delaware Court of Chancery has been vested with all of the historic equitable powers that were extant in

13. HERMAN WOUK, *THE CAINE MUTINY, A NOVEL OF WORLD WAR II* (Doubleday 1952) (detailing the story of a naval captain who is discharged by his executive officer).

14. See generally John Grisham, *Author Spotlight*, Random House, Inc. Academic Resources, http://www.randomhouse.com/acmart/catalog/author.pperl?authorid=11178&view=full_sptlight (last visited Feb. 23, 2009) (outlining John Grisham's career as an author).

15. *A CIVIL ACTION* (Touchstone Pictures 1998) (relaying the story of families that filed suit against two companies that dumped toxic waste and caused their children's deaths).

16. *KRAMER VS. KRAMER* (Columbia Pictures 1979) (telling the story of a divorced man who must fight in court for the custody of his child).

17. *WALL STREET* (Amercent Films 1987) (depicting the story of a young stock broker and his ordeal with illegal insider trading).

18. See DANIEL J. KORNSTEIN, *KILL ALL THE LAWYERS? SHAKESPEARE'S LEGAL APPEAL* 13-15 (Princeton Univ. Press 1994) (explaining the role of the law in Shakespeare's works).

19. WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE* (telling the story of a merchant who must default on his loan for his friend's love).

20. WILLIAM SHAKESPEARE, *MEASURE FOR MEASURE* (portraying the story of the Duke of Vienna's absence that left the strict Angelo in charge).

21. SHAKESPEARE, *THE MERCHANT OF VENICE*, *supra* note 19, at act 4, sc. 1.

22. KORNSTEIN, *supra* note 18, at 65-66 (discussing the legal references in Shakespeare's book, *THE MERCHANT OF VENICE*).

23. DEL. CONST. of 1792, art. VI, § 1.

England's Court of Chancery prior to the American Revolutionary War.²⁴ The Delaware Court of Chancery and the Delaware Supreme Court have repeatedly tempered a strictly legalistic approach with equitable principles. As the Delaware Supreme Court stated in *Schnell v. Chris-Craft Industries*—"inequitable action does not become permissible simply because it is legally possible."²⁵

"One of the fundamental tenets of Delaware corporate law provides for a separation of control and ownership."²⁶ What has been called a "cardinal precept" of the Delaware General Corporation Law's statutory scheme is the provision in section 141(a) that "directors, rather than shareholders, manage the business and affairs of the corporation."²⁷ Section 141(a) of the Delaware General Corporation Law states in pertinent part:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.²⁸

For more than a century, Delaware courts have tempered law with equity by recognizing that the directors' exercise of this statutory power to manage "carries with it certain fundamental fiduciary obligations to the corporation and its shareholders."²⁹ "An underlying premise for the imposition of fiduciary duties is a separation of legal control from beneficial ownership."³⁰ Equitable principles act in those circumstances to protect the stockholder beneficiaries who are not in a position to directly manage the corporation for themselves.

It should come as no surprise that the fiduciary duties of directors of Delaware corporations are an equitable response to the power that is conferred upon directors as a matter of statutory law. It should also come as no surprise that those equitable fiduciary duty precepts date back to a decision by the Lord Chancellor of England in 1742. In *Charitable Corp. v. Sutton*, the Lord Chancellor explained that corporate directors were both agents and trustees required to act with "fidelity and reasonable

24. See RANDY J. HOLLAND, THE DELAWARE STATE CONSTITUTION: A REFERENCE GUIDE 133-35 (Greenwood Press 2002) (discussing the jurisdiction and decision process of the Court of Chancery); see also *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) (explaining that the Delaware Court of Chancery has the right to determine fair value during appraisal under § 262).

25. *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971).

26. *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998).

27. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); see also DEL. CODE ANN. tit. 8, § 141(a) (2008) (stating same).

28. DEL. CODE ANN. tit. 8, § 141(a).

29. *Aronson*, 473 A.2d at 811 (citing *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939)).

30. *Malone*, 722 A.2d at 9.

diligence.”³¹ Ever since the *Sutton* decision, courts have consistently stated that directors of corporations are fiduciaries who must comply with the duties of care (described as reasonable diligence in the *Sutton* decision) and loyalty (described as fidelity in *Sutton*).³²

II. BUSINESS JUDGMENT RULE

Corporate litigation usually involves a shareholder challenge to a board of directors’ business decision. Shareholder lawsuits frequently seek monetary damages for financial harm that was allegedly caused by the directors’ actions. “Stockholders can enforce directors’ fiduciary duties through either a direct suit on behalf of that stockholder, where there is damage personal to that stockholder, or through a derivative suit to enforce the directors’ duties on behalf of the corporation.”³³

Delaware courts are aware that shareholder investments will only be maximized if disinterested directors carefully act in good faith to assess the relative risks and rewards of business matters.³⁴ Delaware courts also recognize, however, that boards of directors would never pursue a rational but risky business strategy, in an effort to increase shareholder wealth, if financial failure would automatically result in their own personal monetary liability.³⁵

It is inevitable that some business decisions will not result in financial success, even though the directors properly discharged all of their fiduciary duties.³⁶ That brings me to the business judgment rule. The business judgment rule seeks to promote the full and free exercise of the statutory managerial power granted to Delaware directors while at the same time protecting the legitimate expectation of shareholder investors.³⁷

The business judgment rule also traces its origins to the 1742 decision of the Lord Chancellor in *Charitable Corp. v. Sutton*.³⁸ In that decision,

31. *Charitable Corp. v. Sutton*, 2 Atk. 400, 406, 26 Eng. Rep. 642, 645 (Ch. 1742); see also Marcia M. McMurray, *A Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 605 nn.1-2 (1987) (explaining *Charitable Corp. v. Sutton*’s description of directors as both agents and trustees).

32. Constance Frisby Fain, *Corporate Director and Officer Liability*, 18 U. ARK. LITTLE ROCK L. REV. 417, 419-20 (1996).

33. Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 400 (2007) (citing DEL. CT. CH. R. 23.1).

34. Randy J. Holland, *An Introduction to Delaware Corporation Law Directors’ Fiduciary Duties*, 19 CIV. & COM. L.J. 92, 97 (2008) (Taiwan).

35. *Id.*

36. *Id.*

37. *Id.*; see also *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981) (describing the business judgment rule as a standard to review director decisions).

38. *Charitable Corp. v. Sutton*, 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).

the Lord Chancellor of England expressed the court's reluctance to second guess the business decisions of corporate directors and articulated what is considered to be the first pronouncement of the business judgment rule.³⁹

The Lord Chancellor wrote:

[Directors] are most properly agents to those who employ them in this trust, and who empower them to direct and superintend the affairs of the corporation. In this respect they may be guilty of acts of commission or omission, of mal-feasance or non-feasance. Now where acts are executed within their authority, . . . though attended with bad consequences, it will be very difficult to determine that these are breaches of trust. For it is by no means just in a judge, after bad consequences have arisen from such executions of their power, to say that they foresaw at the time what must necessarily happen; and therefore were guilty of a breach of trust.⁴⁰

Delaware amended its Constitution in 1897 to permit incorporation under general law and enacted the General Corporation statute in 1899. The Delaware Court of Chancery began to adjudicate disputes involving the internal affairs of corporations incorporated in Delaware.⁴¹ Because the Chancellor—as opposed to a jury—would hear and resolve disputes before the Court of Chancery, a body of case law began to develop as the Chancellor wrote opinions explaining his reasoning.⁴²

The idea that directors of Delaware corporations owed fiduciary duties to the stockholders was probably first expressed in *Bodell v. General Gas & Electric Corp.*, a 1926 decision of the Court of Chancery that was affirmed by the Delaware Supreme Court.⁴³ Chancellor James L. Wolcott wrote that “[t]here is no rule better settled in the law of corporations than that directors in their conduct of the corporation stand in the situation of

39. 1 DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 9 (5th ed. 1998 & Supp. 2002).

40. *Sutton*, 2 Atk. at 405, 26 Eng. Rep. at 644 (citations omitted).

41. Donald F. Parsons Jr. & Joseph R. Slights III, *The History of Delaware's Business Courts: Their Rise to Preeminence*, BUS. L. TODAY, March/April 2008, at 21, 22 (describing the role of the Delaware Court of Chancery).

42. *Id.* at 22. The position of Chancellor was established in the Delaware Constitution of 1792. The Chancellor remained the sole judge of the Court of Chancery under the Delaware Constitution of 1897. In 1939, the Delaware legislature created the position of vice chancellor. Today, there is one Chancellor and there are four vice chancellors. *Id.* at 21-22.

43. See generally *Bodell v. Gen. Gas & Elec. Corp.*, 132 A. 442 (Del. Ch. 1926), *aff'd*, 140 A.2d 264 (Del. 1927) (recognizing that directors owed a fiduciary duty to the stockholders); see also Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 981-82 (1994) (detailing the evolution of director fiduciary duty).

fiduciaries” and, while “not trustees in the strict sense of the term, . . . they have often been described as such” for convenience.⁴⁴

In 1931, building on *Bodell*, the Court of Chancery “articulated what it considered the elemental requirements for invoking the Delaware business judgment rule—good faith and a ‘bona fide[]’ purpose.”⁴⁵ In *Cole v. National Cash Credit Ass’n*, Chancellor Wolcott stated that “[t]here is a presumption that the judgment of the governing body of a corporation . . . is formed in good faith and inspired by a bona fide[] purpose.”⁴⁶ The court explained the underlying premise of the rule by referencing Professor Thompson’s textbook *Works on Corporations*, which used language similar to the 1742 decision in *Sutton*:

Courts of equity . . . cannot be called upon to control the discretion of the managing bodies of corporations; otherwise, they would be choked with applications of recalcitrant stockholders. The action of a board of directors may be ill-advised or apparently unprofitable, but this furnishes no ground for invoking the restraining powers of the court.⁴⁷

In 1984, the Delaware Supreme Court refined the business judgment rule in what is now a seminal case—*Aronson v. Lewis*.⁴⁸ In *Aronson*, the Delaware Supreme Court held that the business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.”⁴⁹ A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter’s decision “can be attributed to any rational business purpose.”⁵⁰

The directors of Delaware corporations stand in a fiduciary relationship not only to the stockholders, but also to the corporations upon whose boards they serve. The directors’ fiduciary responsibilities to both the corporation and its shareholders have frequently been described as a “triad”: due care, loyalty, and good faith.⁵¹

44. *Bodell*, 132 A. at 446.

45. Horsey, *supra* note 43, at 984 (citing *Cole v. Nat’l Cash Credit Ass’n*, 156 A. 183, 188 (Del. Ch. 1931)).

46. *Cole*, 156 A. at 188; *see also* Horsey, *supra* note 43, at 984.

47. *Cole*, 156 A.2d at 188 (quoting *Donald v. Am. Smelting & Ref. Co.*, 48 A.2d 786, 788 (N.J. Ch. 1901), *rev’d*, 48 A.2d 771 (N.J. 1901)); *see also* Horsey, *supra* note 43, at 984-85.

48. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

49. *Aronson*, 473 A.2d at 812 (citing *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971); *Robinson v. Pittsburgh Oil Ref. Corp.*, 126 A.2d 46, 49 (Del. Ch. 1924) (reaffirming the view in *Aronson*)).

50. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

51. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“good faith may be described

“The business judgment rule ‘operates as both a procedural guide for litigants and as a substantive rule of law.’”⁵² “As a procedural guide, the business judgment presumption is a rule of evidence that places the initial burden of proof on the plaintiff.”⁵³ To rebut the presumptive applicability of the business judgment rule, a shareholder plaintiff has the burden of proving that the board of directors, in reaching its challenged decision, violated one of its fiduciary responsibilities: due care, loyalty, or good faith.⁵⁴

If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule operates to provide substantive protection for the directors and for the decisions that they have made.⁵⁵ “If a plaintiff successfully rebuts the business judgment rule, the burden then shifts to the defendant directors to prove that the transaction was fair to the stockholders.”⁵⁶ The directors must show that “the transaction was the product of fair dealing and fair price.”⁵⁷

Although the fiduciary duties of a Delaware director are unremitting, the exact course of conduct that must be followed to properly discharge their responsibilities “will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders.”⁵⁸ To understand the fiduciary duties of directors today, in particular, the focus on loyalty, we must examine the evolution of Delaware’s jurisprudence regarding directors’ responsibilities to act with

colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty”); see also Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U. L. REV. 701, 742 (2008) (“A modern understanding of Delaware director fiduciary duties normally begins with the Delaware Supreme Court’s view in the 1993 *Cede* case . . . that collectively treated good faith, loyalty, and due care as the ‘triads’ of fiduciary duty”) (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993)).

52. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) (emphasis omitted) (citing *Cede*, 634 A.2d at 360; *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995)).

53. *Cinerama*, 663 A.2d at 1162 (emphasis omitted).

54. *Cede*, 634 A.2d at 361.

55. If the presumption of the business judgment rule is rebutted, however, the burden shifts to the director defendants to prove that the challenged transaction was “entirely fair” to the shareholder plaintiffs. Burden shifting does not create *per se* or automatic liability on the part of the directors. An initial judicial determination that a given breach of a board’s fiduciary duties has rebutted the presumption of the business judgment rule does not preclude a subsequent judicial determination that the board of directors’ action was entirely fair. See *Cede*, 634 A.2d at 361 (stating “[i]f the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the ‘entire fairness’ of the transaction to the shareholder plaintiff.” (citing *Nixon v. Blackwell*, 626 A.2d 1366, 1377 (Del. 1993))).

56. Grossman, *supra* note 33, at 401 (citing *Cede*, 634 A.2d at 361).

57. *Id.*

58. *Malone v. Brincat*, 722 A.2d 5, 10 (1998).

care, loyalty, and good faith. We will do that by reviewing several well-known Delaware corporate decisions or stories.

A. *Duty of Loyalty*

The fiduciary duty of loyalty as a concept in Delaware corporation law has been traced back to *Guth v. Loft*, in which the Delaware Supreme Court held that “[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.”⁵⁹ The duty of loyalty is premised on the idea that directors are fiduciaries who have a “quasi-trustee and agency relationship” to the corporation and its stockholders.⁶⁰ In *Guth v. Loft*, the Delaware Supreme Court recognized:

A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty[; he or she does this] affirmatively to protect the interests of the corporation committed to his [or her] charge⁶¹

The importance of focusing on the fiduciary duty of loyalty was made clear in *Aronson* when the Delaware Supreme Court stated that the protections of the business judgment rule “can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment.”⁶² From the standpoint of interest, *Aronson* held that “directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.”⁶³ Accordingly, *Aronson* held that “if such director interest is

59. *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939); *see also* *Schoon v. Smith*, 953 A.2d 196, 206 (Del. 2008) (stating same).

60. *Schoon*, 953 A.2d at 206 (citing *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985)).

61. *Id.* (quoting *Guth*, 5 A.2d at 510).

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

63. *Id.* (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); *David J. Greene & Co. v. Dunhill Int’l, Inc.*, 249 A.2d 427, 430 (Del. Ch. 1968)); *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964); *see also* DEL. CODE ANN. tit. 8, § 144 (stating that a contract or transaction between a corporation and a director or officer, or between a corporation and any other corporation in which one or more of its directors or officers are directors or officers, or have a financial interest, is not void solely because of this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director’s or officer’s votes are counted for such purpose, if: (1) the material facts as to the director’s or officer’s relationship or interest are disclosed to or known by the authorizing body (the board, a committee, or the shareholders), and (2) the authorizing body in good faith authorizes the contract or transaction by a majority of the disinterested members, or (3)

present, and the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application.”⁶⁴

The pronouncements in the 1984 *Aronson* opinion were completely consistent with the Delaware Supreme Court’s 1983 decision the year before in *Weinberger v. UOP*.⁶⁵ *Weinberger* is a decision about a corporation, Signal, which was the majority shareholder of a subsidiary, UOP.⁶⁶ Signal eliminated UOP’s minority shareholders by a cash-out merger.⁶⁷ The antagonists in that story were directors named Charles S. Arledge and Andrew J. Chittea who sat on the boards of both Signal and UOP.⁶⁸ Chittea and Arledge did a valuation report for the benefit of the parent, Signal.⁶⁹ That report was never disclosed to either the UOP directors or minority shareholders prior to their approval of the merger at a lower price.⁷⁰

Since the study was prepared by two UOP directors, Chittea and Arledge, using UOP information for the exclusive benefit of Signal and nothing was done to disclose the report to the outside UOP directors or the minority shareholders, the Delaware Supreme Court had to decide if there was a breach of fiduciary duty.

The Supreme Court began its analysis in *Weinberger* by quoting the classic language of *Guth v. Loft*, which the court stated required no embellishment: “The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.”⁷¹ The Delaware Supreme Court then concluded that “[g]iven the absence of any attempt to structure this [merger] transaction on an arm’s length basis, Signal [could not] escape the effects of the conflicts it faced, particularly when its designees on UOP’s board [i.e., Chittea and Arledge] did not totally abstain from participation in the matter.”⁷²

In *Weinberger*, the Supreme Court held “[t]here is no ‘safe harbor’ for such divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent

if the contract or transaction is fair as to the corporation as of the time it is authorized by the relevant body).

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

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

66. *Id.* at 702-03.

67. *Id.* at 703.

68. *Id.* at 705.

69. *Id.*

70. *Id.* at 707.

71. *Weinberger*, 457 A.2d at 710 (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)).

72. *Id.*

fairness of the bargain.”⁷³ The Supreme Court further held that “[t]he requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he [or she] has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.”⁷⁴

In *Weinberger*, the Delaware Supreme Court also stated unequivocally that:

There is no dilution of this obligation where one holds dual or multiple directorships, as in a parent-subsiary context. Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure or the directors’ total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies.⁷⁵

The Supreme Court’s reference in *Weinberger* to an independent negotiating structure was highlighted in footnote 7. In that now famous footnote, the Delaware Supreme Court stated “the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm’s length.”⁷⁶ For the last twenty-five years, the Delaware courts have emphasized the importance of independent directors in safeguarding the interests of shareholders by preserving the integrity of the corporate governance process.

The takeover era of the 1980s gave rise to a good example. In *Unocal Corp. v. Mesa Petroleum*, the Delaware Supreme Court addressed two fundamental questions.⁷⁷ First, did the board of directors have the power and duty to oppose a takeover threat that it reasonably perceived to be harmful to the corporate enterprise? Second, was such action entitled to the protection of the business judgment rule? The Supreme Court answered both questions in the affirmative.⁷⁸ The court concluded:

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board’s

73. *Id.* (citing *Gottlieb v. Heyden Chem. Corp.*, 91 A.2d 57, 57-58 (Del. 1952)).

74. *Id.* (citing *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (Del. 1952); *Bastian v. Bourns, Inc.*, 256 A.2d 680, 681 (Del. Ch. 1969), *aff’d*, 278 A.2d 467 (Del. 1970); *David J. Greene & Co. v. Dunhill Int’l, Inc.*, 249 A.2d 427, 431 (Del. Ch. 1968)).

75. *Weinberger*, 457 A.2d at 710-11 (internal citations omitted) (citing *Levien v. Sinclair Oil Corp.*, 261 A.2d 911, 915 (Del. Ch. 1969); *Warshaw v. Calhoun*, 221 A.2d 487, 492 (Del. 1966)).

76. *Id.* at 709 n.7.

77. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

78. *Id.* at 958.

duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.⁷⁹

The Delaware Supreme Court continued its analysis in *Unocal* by explaining that there are “certain caveats to a proper exercise of this function.”⁸⁰ The court stated that there is an “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.”⁸¹ Therefore, “there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred” upon directors.⁸²

Accordingly, in *Unocal*, the Delaware Supreme Court created a procedural paradigm shift in Delaware corporate law. The court held that before the business judgment rule applies to the adoption of a defensive mechanism, the initial burden will be on the directors rather than the shareholders. First, the “directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.”⁸³ Directors “satisfy that burden ‘by showing good faith and reasonable investigation.’”⁸⁴ Second, the directors must show that the defensive mechanism was “reasonable in relation to the threat posed.”⁸⁵ The Delaware Supreme Court explained that proof is materially enhanced where a majority of the board favoring the proposal consisted of outside independent directors.⁸⁶

Unocal is a significant decision for many reasons. For our purposes, however, two are important. First, *Unocal* caused the procedural paradigm shift and introduced the concept of enhanced judicial scrutiny prior to applying the business judgment rule because of loyalty concerns. Most importantly, those loyalty concerns were non-financial—that is, the personal self-interest of directors who may want to entrench themselves in office. Second, *Unocal* once again focused on independent directors as the guardians of the board’s decision-making process.

Since *Unocal*, in other contexts, Delaware courts pay particular

79. *Id.* at 954; *see also* Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980) (stating “[b]ecause the rule presumes that business judgment was exercised, the plaintiff must make a showing from which a factfinder might infer that impermissible motives predominated in the making of the decision in question,” and explaining that a plaintiff’s claim that the directors’ motive was to retain control of the corporation is not sufficient to rebut the presumption of the business judgment rule).

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

81. *Id.*

82. *Id.*

83. *Id.* at 955 (citing *Cheff v. Mathes*, 199 A.2d 548, 554-55 (Del. 1964)).

84. *Id.* (quoting *Cheff*, 199 A.2d at 555).

85. *Id.*

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

attention and give weight to decisions made by directors who are found to be independent. This has been noted in the demand context:

In derivative litigation, before initiating an action a shareholder must first demand that the board of directors bring suit on behalf of the corporation. If the shareholder alleges sufficient facts to create a reasonable doubt that the majority of the directors are Independent, he [or she] is entitled to proceed with the litigation without making any demand, as this would be considered futile. . . . When a shareholder makes a [pre-suit] demand, instead of deciding on its own whether to comply, the board may delegate to a special committee of Independent Directors the task of evaluating the appropriate course of action.⁸⁷

Interestingly, despite the Delaware Supreme Court's emphasis on the importance of independent directors, the Delaware General Corporation statute does not refer to independent directors.⁸⁸ That statute addresses only the "narrower concept of 'interested directors.'"⁸⁹ Accordingly, in Delaware, we find that the characteristics of directorial independence are ascertained solely from judicial opinions.⁹⁰

It has frequently been noted that, although director interest and director independence are methods of challenging a director's loyalty, the difference between interest and independence is significant.⁹¹ "A director is interested in a given transaction if she stands to gain monetarily from it in a way that other shareholders do not."⁹² The Delaware courts have developed independence, however, to be more encompassing than mere financial interest.⁹³ Independence "examines whether a director, although lacking in a financial self-interest, is somehow [connected] to an individual who is interested, or whose decisions are not based on the corporate merits, but rather are influenced by 'personal or extraneous considerations.'"⁹⁴

In determining independence, the judicial inquiry goes beyond the strict type of financial ties that make a director interested.⁹⁵ Instead, in

87. Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERKELEY BUS. L.J. 315, 321-22 (2005).

88. See Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 465 (2008) ("[I]t may be surprising to note that the Delaware General Corporation Law . . . does not contain a single reference to independent directors.").

89. *Id.*

90. *Id.*

91. *Id.* at 466 (citing William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 997-98 (2003)).

92. *Id.* (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

93. *Id.*

94. Rodrigues, *supra* note 88, at 466 (quoting *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993)).

95. *Id.*

examining challenges to a director's independence, "Delaware courts broaden the inquiry" into the more subjective types of ties that can generate what has been called "a sense of 'beholdeness.'"⁹⁶ Three cases provide illustrative examples: *Martha Stewart*,⁹⁷ *Biondi v. Scrushy*,⁹⁸ and *Oracle*.⁹⁹

In the *Martha Stewart* derivative litigation, the Delaware Supreme Court held that independence is a fact-specific determination and that Delaware courts must make that determination by answering two inquiries: "independent from whom and independent for what purpose?"¹⁰⁰ To show lack of independence, a shareholder-plaintiff's complaint must raise a reasonable doubt about a director's independence by alleging that a director is so "'beholden' to the interested director that his or her discretion would be sterilized."¹⁰¹

In the *Martha Stewart* case, the Supreme Court agreed with the Court of Chancery's conclusion that the plaintiff must plead facts that would support an inference that because of the nature of the relationships, the non-interested directors would risk their own reputations rather than their relationship with the interested director.¹⁰² In the *Martha Stewart* appeal, the Delaware Supreme Court held "[a]llegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends'" were insufficient, without more, to support a reasonable inference that a majority of the *Martha Stewart Living Omnimedia* board was not independent.¹⁰³ The dismissal of that derivative complaint was affirmed.¹⁰⁴

*Biondi v. Scrushy*¹⁰⁵ was a derivative action involving the HealthSouth Corporation scandals. The HealthSouth board's special litigation committee moved to dismiss the suit, which alleged that executives sold shares of HealthSouth's stock while they were in possession of material non-public information and thereby injured the company.¹⁰⁶ The special litigation committee initially consisted of two directors who were closely tied to the CEO Richard M. Scrushy, the target of many of the allegations

96. *Id.*

97. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040 (Del. 2004).

98. *Biondi v. Scrushy*, 820 A.2d 1148 (Del. Ch. 2003).

99. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

100. *Beam*, 845 A.2d at 1049-50.

101. *Id.* at 1050.

102. *Id.* at 1052.

103. *Id.* at 1051.

104. *Id.* at 1057.

105. *Biondi v. Scrushy*, 820 A.2d 1148 (Del. Ch. 2003).

106. *Id.* at 1149.

made in the complaint.¹⁰⁷

HealthSouth Director Jon Hanson was the Chairman of the National Football Foundation and College Hall of Fame, Inc. (“NFFCHF”) and Director Larry D. Striplin was on NFFCHF’s board. Scrushy was also on the NFFCHF board. “HealthSouth had been an important donor to the NFFCHF while Hanson was its chair.”¹⁰⁸ In addition, “Striplin and Scrushy had longstanding personal ties to each other and to college football in Alabama, where one college has a Scrushy-Striplin field.”¹⁰⁹ Consequently, the alleged independence of the HealthSouth board’s special litigation committee did not survive judicial scrutiny by the Court of Chancery in light of the relationship the committee members had with the insiders who allegedly engaged in wrongdoing.¹¹⁰

Later that same year, the Court of Chancery declined to accept the recommendation of a special litigation committee in *In re Oracle Corp. Derivative Litigation*.¹¹¹ I am sure that many of you noticed that as a loyal alumnus I am wearing a University of Pennsylvania necktie. The *Oracle* litigation involved different types of ties to a different university.

In *Oracle*, the Court of Chancery did not question whether the members of the special litigation committee had acted in good faith and diligently conducted their investigation.¹¹² Because the independence inquiry in the derivative litigation context asks a different question, “whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind,” the Court of Chancery held that the committee failed to satisfy the test for independence.¹¹³

The *Oracle* special litigation committee consisted of only two members, both of whom were professors at Stanford University. The derivative action was brought against “another Stanford professor with professional ties to one of the committee members, a Stanford alumnus who had directed millions of dollars in contributions to Stanford and served on a Stanford advisory board with one of the committee members, and Larry Ellison, the CEO, who had donated millions of dollars to Stanford.”¹¹⁴ Vice Chancellor Strine, another graduate of the Law School

107. *Id.* at 1156-57.

108. Paula J. Dalley, *The Business Judgment Rule: What You Thought You Knew*, 60 CONSUMER FIN. L.Q. REP. 24, 28 (2006).

109. *Id.*

110. *Id.*

111. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 948 (Del. Ch. 2003).

112. *Id.* at 947.

113. *Id.* at 920 (quoting *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001), *rev'd in part on other grounds*, 817 A.2d 149 (Del. 2002) (internal quotes omitted)); *see also* Dalley, *supra* note 108, at 28 (stating same).

114. Dalley, *supra* note 108, at 28.

here at Penn, wrote in *Oracle*:

It is no easy task to decide whether to accuse a fellow director of insider trading. For Oracle to compound that difficulty by requiring [special litigation committee] members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law was unnecessary and inconsistent with the concept of independence recognized by our law. The possibility that these extraneous considerations biased the inquiry of the [special litigation committee] is too substantial for this court to ignore.¹¹⁵

In both *Biondi* and *Oracle*, the Court of Chancery relied upon non-pecuniary bases for finding a lack of independence and addressed the effects that relationships, both social and professional, can have on directors' decision-making processes.¹¹⁶ Such considerations are now frequently raised to challenge director independence in connection with whether demand is excused in a derivative suit or whether a board decision should be protected by the business judgment rule.¹¹⁷ The extent to which personal relationships compromise director independence is now an important loyalty issue that is continuing to develop in Delaware fiduciary duty law.¹¹⁸

B. *Duty of Care*

I am going to return to the duty of loyalty, but before I do, I want to review what has happened to the duty of care. To receive the business judgment rule's presumptive protection, directors must inform themselves of all material information and then act with care.¹¹⁹ In Delaware, the applicable standard of care is gross negligence.¹²⁰ Interestingly, in the 1742 *Sutton* decision, the Lord Chancellor determined that the directors of the Charitable Corp. had failed to monitor the corporation's loan procedures in making unsecured loans to directors.¹²¹ He held the directors liable for the resulting losses after concluding that their actions constituted gross negligence.¹²²

115. *Oracle*, 824 A.2d at 921.

116. Dalley, *supra* note 108, at 29.

117. *Id.*

118. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1055 n.44 (Del. 2004) (citing the *Oracle* case for its procedural treatment of the issues of independence).

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

120. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

121. Horsey, *supra* note 43, at 973 (1994) (citing Charitable Corp. v. Sutton, 2 Atk. 400, 406, 26 Eng. Rep. 643, 645 (Ch. 1742)).

122. *Id.*

The duty of care requires that directors inform themselves of all material information reasonably available before voting on a transaction.¹²³ To become informed, a board can retain consultants or other advisors and can be protected by relying on statements, information, and reports furnished by those advisors, if their reliance is in good faith and the advisors were selected with reasonable care.¹²⁴

The most significant duty of care case is the 1985 decision of *Smith v. Van Gorkom*.¹²⁵ The Delaware Supreme Court held that the board of Trans Union had breached its duty of care in approving a merger.¹²⁶ Trans Union's Chairman and CEO, Van Gorkom, brought about the sale with the help of another inside director, Bruce Chelberg.¹²⁷ The remainder of the board was not informed of the proposal until the day before the buyer's deadline to accept it.¹²⁸ The board approved the sale based on a twenty-minute presentation by Van Gorkom, supported by Chelberg, as well as the advice of Trans Union's legal counsel and the directors' "knowledge of the market history of the Company's stock."¹²⁹

The Delaware Supreme Court concluded that Trans Union's board was not entitled to the presumption of the business judgment rule because the board had failed to act on an informed basis.¹³⁰ After finding that the Trans Union directors had breached their duty of care in approving the sale of the corporation, the Delaware Supreme Court took "the unprecedented step" of holding all of Trans Union's directors jointly and severally liable for more than \$23 million.¹³¹

The *Van Gorkom* decision caused concern—some have called it panic—in the board rooms of Delaware corporations throughout the United States, because directors feared for their own personal liability. In 1986, section 102(b)(7) of the Delaware General Corporation Law was enacted by the Delaware Assembly.¹³² That enactment was in response to the Delaware Supreme Court's decision in *Van Gorkom* and followed a directors' insurance liability crisis.¹³³

123. *Van Gorkom*, 488 A.2d at 872 (quoting *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971)).

124. DEL. CODE ANN. tit. 8, § 141(e) (2008); Grossman, *supra* note 33, at 402.

125. 488 A.2d 858; Grossman, *supra* note 33, at 402.

126. *Van Gorkom*, 488 A.2d at 893.

127. *Id.* at 868.

128. *Id.*

129. *Id.* at 869.

130. *Id.* at 893.

131. Darian M. Ibrahim, *Individual or Collective Liability for Corporate Directors?*, 93 IOWA L. REV. 929, 935 (2008).

132. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008) (enacted 1986).

133. See *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) ("[A]s a matter of the public policy of this State, Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following a directors and officers insurance liability crisis and the 1985

The Delaware Supreme Court explained in *Emerald Partners v. Berlin* that:

[t]he purpose of Section 102(b)(7) was to *permit shareholders*—who are entitled to rely upon directors to discharge their fiduciary duties at all times—to adopt a provision in the certificate of incorporation to exculpate directors from any personal liability for the payment of monetary damages for breaches of their duty of care, but not for duty of loyalty violations, good faith violations and certain other conduct.¹³⁴

After section 102(b)(7) was enacted, the shareholders of almost all Delaware corporations approved charter amendments containing these exculpatory provisions with full knowledge of their import—that directors would not have to pay money damages for duty of care violations, i.e., gross negligence.¹³⁵ “Since its enactment, Delaware courts have consistently held that the adoption of a charter provision, in accordance with section 102(b)(7), bars the recovery of monetary damages from directors for a successful shareholder claim that is based exclusively upon establishing a violation of the duty of care.”¹³⁶

In *Malpiede v. Townson*, the Delaware Supreme Court was asked to decide if a shareholder complaint that asserts *only* a due care claim is dismissible once the corporation’s section 102(b)(7) provision is properly invoked.¹³⁷ The court’s answer was yes, even though a care violation would rebut the presumption of the business judgment rule and require the board to prove entire fairness.¹³⁸

The rationale of *Malpiede* constitutes judicial cognizance of a practical reality: unless there is a violation of the duty of loyalty or the obligation to act in good faith, a trial on the issue of entire fairness is unnecessary, because a section 102(b)(7) provision will exculpate director defendants from paying monetary damages if the failure to demonstrate entire fairness is exclusively attributable to a violation of the duty of care.¹³⁹ Since almost all Delaware corporations have adopted 102(b)(7) provisions, monetary damages cannot be recovered even if a violation of the duty of care is established. “This has led several commentators to conclude that the fiduciary duty of care exists only as an aspirational and

Delaware Supreme Court decision in *Smith v. Van Gorkom*.”).

134. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

135. *Id.*

136. *Id.* at 91.

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

138. *Id.* at 1094.

139. *Id.* at 1094-95; *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223-24 (Del. 1999) (discussing the liability shield provided under the certificate of incorporation provision pursuant to 102(b)(7)).

unenforceable standard,”¹⁴⁰ except in actions for injunctive relief, or as a means for Delaware courts to “shame” directors who are grossly negligent and thereby inspire other directors not to repeat those same careless mistakes.¹⁴¹

III. COMPLAINTS CHALLENGING LOYALTY

The effect of the Delaware Supreme Court’s holding in *Malpiede* is that the duty of care is no longer a litigation focus in actions for damages against the directors of Delaware corporations that have a section 102(b)(7) charter provision. Instead, shareholders’ complaints now attempt to allege facts that, if true, constitute breaches of loyalty or good faith. Let me give two examples that were explained in *Malpiede*.

In *Malpiede*, the Supreme Court distinguished *McMullin v. Beran*.¹⁴² In *McMullin*, the majority of a subsidiary’s board had ties to the parent corporation and was alleged to have influenced a hasty sale that was critical to the parent’s cash flow needs.¹⁴³ The Supreme Court explained that the complaint in *McMullin* survived a motion to dismiss, even though the corporation had a 102(b)(7) provision, because the shareholder complaint in *McMullin* alleged facts that, if true, described a duty of care violation that could be attributed to the subsidiary board of directors’ divided loyalties.¹⁴⁴

The *Malpiede* decision also discussed complaints that alleged director violations of their duty of disclosure.¹⁴⁵ The directors’ duty of disclosure is not an independent duty but the application in a specific context of the board’s fiduciary duties of care, good faith and loyalty.¹⁴⁶ The duty of disclosure requires directors to fully and fairly disclose all material information within the board’s control when it seeks shareholder action.¹⁴⁷ In *Malpiede*, the Delaware Supreme Court reaffirmed the holding in *Arnold v. Society for Savings Bancorp, Inc.* that disclosure violations that are only attributable to a failure to exercise care are protected by 102(b)(7).¹⁴⁸

140. Grossman, *supra* note 33, at 403.

141. See generally David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001) (discussing the growing prevalence of opinions written to “shame” offenders).

142. *McMullin v. Beran*, 765 A.2d 910 (Del. 2000).

143. *Id.* at 915-16.

144. *Malpiede*, 780 A.2d 1075, 1093.

145. *Id.* at 1085-89.

146. *Id.* at 1086 (citing *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995)).

147. *Id.* (citing *Stroud v. Grace*, 606 A.2d 75, 84-85 (Del. 1992)); see also Grossman, *supra* note 33, at 408.

148. *Malpiede*, 780 A.2d 1075, 1086; *Arnold v. Soc’y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1287 (Del. 1994); see also Grossman, *supra* note 33, at 408.

Therefore, unless a complaint relates a disclosure violation to a breach of loyalty, it will be dismissed after *Malpiede*.

A. *Care and Good Faith*

The holding in *Malpiede* explains why shareholder complaints have moved away from alleging care violations only and now focus on the duty of loyalty and good faith. Once again, I will postpone my return to the duty of loyalty to briefly address directors' fiduciary responsibility to act in good faith.

In several cases in the 1990s, the Delaware Supreme Court began referring to directors' fiduciary duties as a "triad": care, loyalty, and good faith.¹⁴⁹ Those cases suggested or implied that good faith was an independent fiduciary duty. Increasingly, shareholder-plaintiffs seeking monetary damages alleged that directors did not act in good faith because, like loyalty, it was another way to get around the exculpation of section 102(b)(7) provisions.

The *Walt Disney Co. Derivative Litigation*¹⁵⁰ involved a controversy about "the hiring and firing of Michael Ovitz as Disney's president."¹⁵¹ In October 1995, Michael Ovitz and Disney entered into an employment agreement under which Ovitz would serve as Disney's president for five years.¹⁵² Disney terminated Ovitz a little more than a year later in December 1996.¹⁵³ Despite Ovitz's short tenure, under the terms of the employment agreement he received a severance package valued at approximately \$130 million.¹⁵⁴

In a derivative complaint, the shareholder-plaintiffs:

alleged that the compensation committee of the Disney board, and the board itself, had failed to adequately consider the employment, compensation, and termination of Michael Ovitz as President of Disney in 1995-1996. According to the complaint, the board and committee had considered Ovitz's employment and compensation only briefly and had failed to act in his termination

149. See Bishop, *supra* note 51, at 742 (describing modern day fiduciary duties as the triad of good faith, care, and loyalty); see, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) ("The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith." (citing *Malone v. Brincat*, 722 A.2d 5, 10 (1998))).

150. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006).

151. Kay Xixi Ng, *Inside the Boardroom: A Proposal to Delaware's Good Faith Jurisprudence to Improve Board Passivity*, 6 DEPAUL BUS. & COM. L.J. 393, 406 (2008).

152. *Disney*, 906 A.2d at 41.

153. *Id.* at 45-46.

154. *Id.* at 35; see also Ng, *supra* note 151, at 406 (describing Ovitz's severance package).

at all.¹⁵⁵

The *Disney* complaint used lack of good faith to rebut not only the presumptions of the business judgment rule, but also the application of a section 102(b)(7) exculpatory charter provision.¹⁵⁶ In denying a motion to dismiss the complaint, the Court of Chancery “held that the plaintiff had alleged sufficient facts to raise a ‘reason to doubt whether the board’s actions were taken honestly and in good faith,’ as required for the application of the business judgment rule,” and if those allegations were true, “the directors were not entitled to the protection of the exculpatory clause in Disney’s charter.”¹⁵⁷

When the trial in *Disney* concluded, “the Chancellor ruled in favor of the Board.”¹⁵⁸ Nevertheless, the *Disney* case, like *Van Gorkom*, created “considerable consternation” with corporate board rooms because it permitted a claim of bad faith, i.e., lack of good faith, to survive a motion to dismiss and to go forward in a trial against the Disney directors.¹⁵⁹

In challenging the board actions that led to Ovitz’s brief but lucrative tenure at Disney, the plaintiffs contended that gross negligence (care) was on a continuum and that at some point, a board’s lack of care could become so egregious that it constituted bad faith.¹⁶⁰ The Delaware Supreme Court rejected that contention and held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (gross negligence).¹⁶¹

In the *Disney* decision, the Delaware Supreme Court emphasized that from a legal standpoint, directors’ duties of care and good faith are distinct.¹⁶² The Court noted that Delaware’s legislative history and its common law jurisprudence draw clear distinctions between the duties to exercise due care and to act in good faith.¹⁶³ It also noted that highly significant legal consequences result from that distinction.¹⁶⁴

In particular, the Delaware Supreme Court recognized that the Delaware General Assembly had addressed the difference between bad faith and a failure to exercise due care in two separate statutory contexts.¹⁶⁵

155. Dalley, *supra* note 108, at 27.

156. *Id.*

157. *Id.* (quoting *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003)).

158. *Id.*

159. *Id.* at 28.

160. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64-65 (Del. 2006).

161. *Id.* at 66.

162. *Id.* at 65.

163. *Id.*

164. *Id.*

165. *Id.*

“The first is Section 102(b)(7) of the DGCL,”¹⁶⁶ which has already been discussed. As I have emphasized, that statute authorizes Delaware corporations, through a provision in the certificate of incorporation, to exculpate their directors from monetary damage liability for a breach of the duty of care.¹⁶⁷ Section 102(b)(7) has several exceptions, however, including most relevantly, “for acts or omissions not in good faith.”¹⁶⁸ Thus, as we know, a corporation can exculpate its directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith.

“A second legislative recognition of the distinction between fiduciary conduct that is grossly negligent and conduct that is not in good faith, is Delaware’s indemnification statute,” which is found in section 145 of the Delaware General Corporate Law.¹⁶⁹ Under section 145, a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith.¹⁷⁰

The Delaware Supreme Court decision in *Disney* provided important future guidance for directors of Delaware corporations by identifying three examples of conduct that would establish a failure to act in good faith: first, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation; second, where the fiduciary acts with the intent to violate applicable positive law; and third, where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his or her duties.¹⁷¹

B. Loyalty and Good Faith

In Shakespeare’s play *King Henry VI, Part 2*, the King asks, “O, where is faith? O, where is loyalty?”¹⁷² A few months after explaining the distinction between care and good faith in *Disney*, the Delaware Supreme Court addressed the relationship between the directors’ duty of loyalty and good faith. In doing so, the Supreme Court answered the King’s question when it decided *Stone v. Ritter*.¹⁷³ That clarification came in the context of deciding directors’ oversight responsibilities.

166. *Disney*, 906 A.2d at 65.

167. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008).

168. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2008).

169. *Disney*, 906 A.2d at 65; DEL. CODE ANN. tit. 8, § 145 (2008).

170. DEL. CODE ANN. tit. 8, § 145; *see also* *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 211-13 (Del. 2005) (discussing the right to indemnification under section 145).

171. *Disney*, 906 A.2d at 67.

172. WILLIAM SHAKESPEARE, *THE SECOND PART OF KING HENRY THE SIXTH* act 5, sc. 1.

173. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

Stone was a derivative action.¹⁷⁴ In 2004, AmSouth and AmSouth Bank paid \$40 million in fines and \$10 million in civil penalties to resolve regulatory and government investigations relating to the failure by bank employees to file suspicious activity reports that were required by the federal Bank Secrecy Act and several anti-money laundering regulations.¹⁷⁵ The complaint in *Stone* alleged that the directors breached their fiduciary duties by not properly discharging their oversight responsibilities.¹⁷⁶

The issue of directors' fiduciary obligations in exercising oversight responsibility was initially addressed by the Court of Chancery over a decade earlier in *In re Caremark International Inc. Derivative Litigation*.¹⁷⁷ Because the *Caremark* case was not appealed, however, the subject had not been addressed by the Delaware Supreme Court. In *Caremark*, the Court of Chancery held:

Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.¹⁷⁸

In *Stone*, consistent with its opinion *Disney*, the Delaware Supreme Court held that *Caremark* articulates the two “necessary conditions for assessing director oversight liability”:¹⁷⁹ (1) the directors utterly failed to implement any reporting or information system or controls or (2) having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.¹⁸⁰

In *Stone*, the Delaware Supreme Court held that “[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.”¹⁸¹ That holding required the Delaware Supreme Court “to clarify a doctrinal issue that was critical to understanding fiduciary liability” under the *Caremark* standard.¹⁸²

The Delaware Supreme Court explained that the terminology used in

174. *Id.* at 364.

175. *Id.* at 365.

176. *Id.* at 364.

177. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

178. *Id.* at 971.

179. *Stone*, 911 A.2d at 365.

180. *Id.* at 370.

181. *Id.*

182. *Id.* at 369.

Caremark and in *Stone*—which described the lack of good faith as a “necessary condition to liability”—was intentional.¹⁸³ The purpose of that phraseology was “to communicate that a failure to act in good faith is not conduct that results . . . in the direct imposition of fiduciary liability.”¹⁸⁴

In *Stone*, the Delaware Supreme Court further explained that “[t]he failure to act in good faith may result in liability because the requirement to act in good faith ‘is a subsidiary element,’ i.e., a condition, ‘of the fundamental duty of loyalty.’”¹⁸⁵ Because a showing of bad faith conduct, as described in *Disney* and *Caremark*, is essential to establish director oversight liability, it followed that the fiduciary duty violated by that conduct is the duty of loyalty.¹⁸⁶

Stone’s explanation of what constitutes a failure to act in good faith resulted in two doctrinal consequences.¹⁸⁷ The first consequence was that, “although good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”¹⁸⁸ Only directors’ violation of the latter two duties may directly result in liability, whereas a failure to act in good faith may result in liability, but indirectly.¹⁸⁹

The second doctrinal consequence was a recognition that “the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest.”¹⁹⁰ The duty of loyalty also includes cases where the fiduciary fails to act in good faith.¹⁹¹ The Delaware Supreme Court reiterated in *Stone* what the Court of Chancery had stated in *Guttman v. Huang*: “A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”¹⁹²

In *Stone*, the plaintiffs’ complaint equated a bad outcome with bad faith.¹⁹³ The problem with the plaintiffs’ argument in *Stone* was “a failure to recognize that the directors’ good faith exercise of oversight responsibility may not invariably prevent employees from violating

183. *Id.*

184. *Id.*

185. *Stone*, 911 A.2d at 369-70 (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

186. *Id.* at 370.

187. *Id.*

188. *Id.* (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993)).

189. *Id.*

190. *Id.*

191. *Stone*, 911 A.2d at 370.

192. *Id.* (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

193. *Id.* at 373.

criminal laws, or from causing the corporation to incur significant financial liability.”¹⁹⁴ In fact, both of these unfortunate acts had also occurred in *Graham* and *Caremark*.¹⁹⁵

You will recall that in the 1742 *Sutton* decision, the Lord Chancellor stated that “it is by no means just in a judge, after bad consequences have arisen from [any exercise of] power, to say [the fiduciary] foresaw at the time what [would] happen, and therefore [was] guilty of a breach of trust.”¹⁹⁶

In *Stone* in 2006, the Delaware Supreme Court held that “in the absence of red flags, good faith in the context of oversight must be measured by the directors’ actions ‘to assure a reasonable information and reporting system exists’ and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome.”¹⁹⁷ The current financial crisis creates a perfect storm for examination by the Institute for Law and Economics with experts from the Law School, the Department of Economics, and the Wharton School. Undoubtedly, that cross-disciplinary analysis will be looking for red flags that were missed from all three perspectives.

The *Stone* decision brings us back to the duty of loyalty today. After the Delaware Supreme Court’s decisions in *Stone* and *Disney*, it is now clear that fiduciary misconduct that implicates the duty of loyalty includes not only “disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interests of the corporation),”¹⁹⁸ but also bad faith (i.e., “intentional dereliction of duty or conscious disregard of one’s responsibilities”¹⁹⁹ or “fiduciary conduct motivated by actual intent to do harm”²⁰⁰).

The other Delaware cases I have discussed also lead to another conclusion. The business judgment rule ensures that courts will respect the business decisions of directors unless the directors: (1) were interested in the decision;²⁰¹ (2) lacked independence to objectively evaluate the merits of the decision;²⁰² (3) failed to act in good faith in making the decision;²⁰³

194. *Id.*

195. *Id.*

196. *Charitable Corp. v. Sutton*, 2 Atk. 400, 405, 26 Eng. Rep. 642, 644 (Ch. 1742).

197. *Stone*, 911 A.2d at 373 (quoting *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 967-68, 971 (Del. Ch. 1996)).

198. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 66 (Del. 2006).

199. *Id.* at 64.

200. *Id.* at 66.

201. *See, e.g., Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (holding that where the directors are interested in the transaction, they have the burden of showing utmost good faith and the fairness of the bargain).

202. *See, e.g., In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) (holding that the Board’s special litigation committee failed the test of independence); *Biondi v. Scruschy*, 820 A.2d 1148 (Del. Ch. 2003) (finding that the HealthSouth board’s

or (4) otherwise acted in a manner not attributable to any rational business purpose or that constituted gross negligence.²⁰⁴

Most corporations, however, have a charter provision, authorized under section 102(b)(7) of the Delaware General Corporation Law, which eliminates or limits directors' personal liability to the corporation and its stockholders for money damages for a breach of the fiduciary duty of care.²⁰⁵ Therefore, plaintiffs must allege and prove a breach of the fiduciary duty of loyalty, which now includes the obligation of good faith, in order for the court to hold the directors personally liable.²⁰⁶ Consequently, stockholder plaintiffs must bring an action premised on the theory that the director defendants "breached their duty of loyalty by engaging in intentional, bad faith, or self-interested conduct that is not immunized by the exculpatory charter provision" permitted by section 102(b)(7).²⁰⁷

IV. CONCLUSION

As you can see from my remarks this afternoon, Professor Rock was exactly right in three respects. First, Delaware fiduciary duty law is best understood as "a set of parables" about good and bad directors.²⁰⁸ Second, Delaware judicial opinions over time yield reasonably determinative, normative guidelines for directors.²⁰⁹ And third, therefore, Delaware's fiduciary duty law is not mushy or blurred.²¹⁰ In fact, with my remarks I have tried to suggest to you that the focus of Delaware's fiduciary duty law is sharp and that focus is on loyalty.

In the 1742 *Sutton* decision, the Lord Chancellor held that directors

special litigation committee was not independent where committee members had a relationship with the insiders allegedly engaged in the wrongdoing).

203. See, e.g., *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (requiring a good faith effort to ensure effective reporting systems are in place in the absence of red flags).

204. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (setting the applicable standard of care as gross negligence); see also *In re Lear Corp. S'holder Litig.*, 2008 WL 4053221, at *9 (Del. Ch. Sept. 2, 2008) ("[D]irectors' decisions will be respected by courts unless the directors . . . act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process" (quoting *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000))).

205. DEL. CODE ANN. tit. 8, § 102(b)(7) (2008).

206. See *Stone*, 911 A.2d at 367 (discussing the burden of the plaintiff in a derivative action).

207. *McMillan v. Intercargo Corp.*, 768 A.2d 492, 495 (Del. Ch. 2000); see also *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001) (explaining what the plaintiffs must plead in order to support a claim that is not barred by the 102(b)(7) exculpatory provision).

208. See *Rock*, *supra* note 8, at 1016 (discussing the Delaware opinions in the context of parables of good and bad managers in conjunction with good and bad lawyers).

209. See *id.* at 1017.

210. See *id.* at 1101.

had a fiduciary duty of fidelity.²¹¹ Fidelity is derived from the Latin word *fidelis*, meaning loyal or faithful.²¹²

Today is Veteran's Day. We honor the memory of the brave men and women who fought for our freedom. In reflecting on Veteran's Day, I was reminded of the motto of the United States Marine Corps: *Semper Fidelis*, always loyal. That is a good motto for the directors of Delaware corporations—always be loyal—and that is the moral of my story today.

211. *Charitable Corp. v. Sutton*, 2 Atk. 400, 406, 26 Eng. Rep. 642, 645 (Ch. 1742).

212. MERRIAM-WEBSTER COLLEGIATE DICTIONARY 465 (11th ed. 2003).