Meaningful Good Faith: Managerial Motives and the Duty to Obey the Law

Peter C. Kostant
New York Law School

Follow this and additional works at: https://digitalcommons.nyls.edu/nyls_law_review

Part of the Banking and Finance Law Commons, Business Organizations Law Commons, Law and Economics Commons, and the Legal Remedies Commons

Recommended Citation

This Article is brought to you for free and open access by DigitalCommons@NYLS. It has been accepted for inclusion in NYLS Law Review by an authorized editor of DigitalCommons@NYLS.
ABOUT THE AUTHOR: Peter Kostant is a Visiting Professor at New York Law School. I wish to thank Dean Richard Matasar, Associate Dean Carol Buckler, and Professor Faith Stevelman, Director of the Center on Business Law and Policy, for agreeing to sponsor this symposium and to all the participants for agreeing to attend and present papers. I would also like to thank my research assistants, Caitlin Trow, Erin Olshever, Erica Bonnett, and Lyndsay Ruotolo, for providing valuable assistance. In addition, Polina Mzhen of the New York Law School Law Review helped make organizing this symposium a pleasure.
MEANINGFUL GOOD FAITH: MANAGERIAL MOTIVES AND THE DUTY TO OBEY THE LAW

I. INTRODUCTION

First, a word about how Mickey Mouse got his name into the title of this symposium. Any student of corporate law knows that fiduciary duties, notably the duty of care and the duty of loyalty, represent core concepts of that discipline, and that the jurisprudence of Delaware is carefully studied, and dominates the entire field. Therefore, corporate scholars were excited to learn from the Delaware Supreme Court, in the 1993 Cede & Co. v. Technicolor, Inc. case, that there were not just two fiduciary duties, but rather a “triad” of duties, including a third fiduciary duty, the duty of good faith. Shortly thereafter, between 2003 and 2006, during the later innings of the In re Walt Disney Co. litigation, both the Chancellor and the Supreme Court of Delaware stressed that good faith was indeed an important fiduciary duty with binding power, and that its violation could strip directors of the formidable protection of the business judgment rule and corporate charter exculpation provisions that exempt directors from liability for monetary damages. As one commentator:

1. On Friday, November 13, 2009, New York Law School hosted a symposium entitled The Delaware Fiduciary Duty of Good Faith after Disney: Meaningful or Mickey Mouse? The idea, which I hope underscores the magnitude of the dispute over the importance of the doctrine, originated from my reading of the fanciful title of the article by James D. Cox and Eric Talley, entitled Hope and Despair in the Magic Kingdom: In Re Walt Disney Company Derivative Litigation, in The Iconic Cases in Corporate Law 30 (Jonathan R. Macey ed., 2008). Delaware Chancellor William Chandler seemed amused by the title when he agreed to participate in the symposium; he was later forced to withdraw, not because of its title, but because of a conflicting commitment. It seems that I am not the only person to think this way. See Wendi J. Powell, Casenote & Comment, Corporate, Government and Fiduciary Duty: The “Micky [sic] Mouse Rule” or Legal Consistency, Protection of Shareholder Expectations, and Balanced Director Autonomy, 14 Geo. Mason L. Rev. 799 (2007).

2. The two traditional fiduciary duties of senior corporate managers are the duty of care and the duty of loyalty. See Robert Charles Clark, Corporate Law 123, 141 (1986). The duty of care requires that directors and officers “must exercise that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances.” Id. at 123. The duty of loyalty “prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions.” Id. at 141.

3. 634 A.2d 345, 361 (Del. 1993). Two years later, in Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995), the Delaware Supreme Court explained that to rebut the presumptions of the business judgment rule “a shareholder plaintiff assumes the burden of providing evidence that the board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties: good faith, loyalty, or due care." Id. at 1164.

4. The Disney saga began when the Disney board of directors hired a new president, Michael Ovitz, who was a close personal friend of the company’s imperial Chief Executive Officer, Michael Eisner. The hiring decision did not work out and Ovitz left Disney after about a year, collecting a $140 million payout. Shareholders brought derivative suits against the board alleging that both the decisions to hire and fire Ovitz breached fiduciary duties. The entire litigation took a decade to conclude. See In re Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998) (dismissing complaint); Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (granting plaintiff’s leave to re-plead in part); In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003) (denying motion to dismiss); In re Walt Disney Co. Derivative Litig., No. 15452, 2004 WL 2050138 (Del. Ch. Sept. 10, 2004) (granting in part and denying in part defendant Ovitz’s motion for summary judgment); In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (affirming decision of Chancellor).

5. See Disney, 825 A.2d 286; Disney, 906 A.2d 27.
observed, for the first time, the elusive duty of good faith was actually “doing some work” in a contested transaction, and seemed to add some “doctrinal teeth.”

Numerous scholars wrote law review articles about this new fiduciary duty. There seemed to be little doubt that something new and meaningful was occurring in corporate law.

Later in 2006, sudden doubts arose not only about the importance of this new fiduciary duty, but about whether the duty even existed. In Stone v. Ritter, the Delaware Supreme Court again examined the contours of the fiduciary duty of good faith and announced that it was not a separate duty, but rather part of the traditional duty of loyalty, and that its breach did not alone state a cause of action.

Two years later, in Lyondell Chemical Co. v. Ryan, the Delaware Supreme Court seemed to reduce the duty even further. Perhaps, despite all the excitement that Disney had generated, it really was Mickey Mouse after all? The current absence of agreement among scholars about the scope and relative importance of the doctrine of good faith makes the topic ripe for discussion from varied perspectives, and that is the reason for this symposium.


8. See Sale, supra note 7; Loewenstein, supra note 7; Griffith & Steele, supra note 7; Griffith, supra note 7; Eisenberg, supra note 7.


10. 970 A.2d 235 (Del. 2009).

One group of judges and scholars suggested that the importance of focusing on the duty of good faith may be greatly exaggerated. For example, Vice Chancellor Leo Strine, writing with a team of scholars and practitioners, recently argued at substantial length, that a duty of good faith adds nothing new to the traditional fiduciary duty of loyalty. Professor Sean Griffith suggested that a strong reading of Stone could mean that the enormous traditional protection of corporate management contained in the business judgment rule remained intact. Professor William Bratton, a participant at this symposium, notes in his essay that, early in the Disney saga, the Delaware courts “inadvertently summoned the good faith genie out of the lamp” and that in Lyondell, the court “completes the job [of getting it back in] for now.” A leading Delaware practitioner, John Reed, suggested that the duty of good faith is of little practical importance because it only applies to the extremely rare circumstance in which a board acts without self-dealing but with the actual knowledge that it was not discharging its fiduciary duties. Finally, Professors James D. Cox and Eric Talley observed, in their article Hope and Despair in the Magic Kingdom that in the final Disney holding, the conduct that was alleged to have violated the duty of good faith did indeed get the protection of the business judgment rule.

Other scholars, and indeed some of the same scholars when in a different mood, are more optimistic that the doctrine of good faith may still contain substance, and could be important in explaining what senior corporate managers must do: most importantly, that directors’ motives in approving transactions can be scrutinized and that directors must obey positive law, regardless of the possibility of opportunistically making profits. Professors Cox and Talley suggest that good faith may represent a transcendent “Über Duty,” and that Disney’s good faith may have “placed a new bottle on the scales of justice; it is a bottle that is still sufficiently empty that subsequent judicial applications may fill it not with the stale bromides of the past, but rather a rich blend of substantive reference points that will guide future mediations

(addressing the reasons for the Lyondell holding and the development of the Revlon rule over the past twenty-five years); See Alan R. Palmiter, Duty of Obedience: The Forgotten Duty, 55 N.Y.L. SCH. L. REV. 457 (2010–11) (analyzing the duty of obedience, examining how it has evolved in Delaware law over the years); Robert B. Thompson, The Short, But Interesting Life of Good Faith as an Independent Liability Rule, 55 N.Y.L. SCH. L. REV. 543 (2010–11) (analyzing how the doctrine of good faith gained prominence during recent years and what its eclipse tells us about the evolution of the law of fiduciary duty).

13. Pace Symposium, supra note 6.
15. Pace Symposium, supra note 6 (comments of John Reed).
16. Cox & Talley, supra note 1, at 43.
17. See id. at 43–45. Cox and Talley title the final section of their article: “Does Disney Mark a Sea Change for Fiduciary Law?” Id. at 43. Their answer seems to be “Maybe.” Id. at 43–45.
18. Id. at 44.
of disputes regarding executive compensation.”19 Former Vice Chancellor Stephen Lamb described good faith as “the DNA of the Business Judgment Rule.”20 Professor Alan Palmiter, a participant at this symposium, writes about a dormant duty of obedience that may have been resuscitated and renamed the duty of good faith. He calls the substance of this duty the “invisible ‘dark matter’ of the corporate fiduciary universe,” and explains that “its existence [is] inferable by imagining the universe populated only by care and loyalty as those duties are generally understood.”21 Proponents of managerial accountability in corporate governance look for meaning in the doctrine of good faith because the traditional fiduciary duties of care and loyalty in reality do little to discipline boards.22 Prior to 1985, corporate directors were virtually never found liable for violating the duty of care unless accompanied by allegations of self-dealing (i.e., duty of loyalty violations). After the stunning decision in Smith v. Van Gorkom in 1985, which held directors liable for monetary damages because they had been grossly negligent in violation of their duty of care,23 the Delaware legislature promptly overruled the judiciary. Delaware adopted a provision that would allow corporations to adopt charter provisions to exculpate directors for duty of care violations.24 Most corporations adopted these amendments,25 and most other state legislatures followed Delaware.26 Just as exculpation for gross negligence made the duty of care protections trivial, Delaware courts also tended to define self-dealing so narrowly that the duty of loyalty provided minimal protection to corporations and their constituents.27 Even with self-dealing, it was generally easy to have non-interested directors sanitize

19. Id. at 45.

20. Pace Symposium, supra note 6 (comments of Stephen Lamb, former Delaware Court of Chancery Vice Chancellor).

21. Palmiter, supra note 11, at 473.

22. See William A. Klein & John C. Coffee, Jr., Business Organization and Finance: Legal and Economic Principles (10th ed. 2007). “[V]iolations of the duty of loyalty may be extremely difficult to detect” and “may to a significant extent embody an unattainable ideal.” Id. at 39. Also, for the duty of care, “reported cases in which liability has in fact been imposed are remarkably few and generally have involved” allegations of self-dealing. Id. at 156.

23. 488 A.2d 858 (Del. 1985).


26. See id.

27. One notorious example occurred in Kahn v. Sullivan, 594 A.2d 48, 59–63 (Del. 1991). Occidental Petroleum, a company dominated by its CEO, Armand Hammer, paid $85 million to establish the Armand Hammer Museum of Art and Cultural Center. One scholar has called this a “temple of opportunism,” and observed that the Delaware courts refused to intervene because of the purported charitable intent. Adam Winkler, Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History, 67 Law & Contemp. Probs. 109, 118 (2004). The Delaware Supreme Court approved a “meager” settlement to the shareholder challenge to the transaction because, given the protection of the business judgment rule, plaintiffs’ challenges had “little chance of success.” Kahn, 594 A.2d at 63.
otherwise tainted transactions, leaving corporate directors with little meaningful accountability. Criticizing corporate governance, Justice Stevens recently wrote in dissent that: “In practice . . . many corporate lawyers will tell you that these rights [i.e., shareholder voting and derivative suits] are so limited as to be almost nonexistent, given the internal authority wielded by boards and managers and the expansive protections afforded by the business judgment rule.” Given the weakness of traditional remedies, the duty of good faith, whether as one of a triad of fiduciary duties or as part of a more robust duty of loyalty, can be of great importance. As Disney made clear, the duty of good faith cannot be satisfied if directors: act in subjective bad faith; consciously disregard their duties; are motivated by an actual intent to harm the corporation; or cause the corporation to violate positive law. As I suggest in Parts II and III of this essay, this new focus on the motives of directors and the express fiduciary duty to avoid knowing violations of law could be crucial for corporate governance because neither violation is subject to the protections of the business judgment rule or charter exculpation provisions.

II. MANAGERS’ MOTIVES MATTER

Unlike natural persons, corporations do not have consciences to limit their wrongdoing. As Baron Thurlow wrote more than two hundred years ago, one looks in vain for a corporation’s conscience. This truism was recently reiterated by Justice Stevens, who explained that corporations have “no consciences, no beliefs, no feelings, no thoughts, [and] no desires.” Accordingly, whatever motivates corporations comes from the intentions of a small group of human beings, the powerful corporate senior managers. The most important of these are the corporate directors. We cannot really call directors the agents of the corporation, for they do not act for corporations, but rather make corporations act. Therefore, it is disturbing that traditional Delaware law has largely refused to analyze the motives of corporate boards. The few Delaware cases that purport to scrutinize the motivation of corporations’ boards apply a test that is so permissive that the scrutiny provided is rendered meaningless. Therefore, the traditional absence of focus on the motives of senior managers made them far less accountable for their decisions.


30. See John C. Coffee, Jr., “No Soul To Damn: No Body to Kick”: An Unscandalized Inquiry Into the Problem of Corporate Punishment, 79 Mich. L. Rev. 386 (1980–81) (“Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?”) (quoting Edward, First Baron Thurlow).


32. See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).
This point was vividly made in the seminal Delaware Supreme Court case, *Sinclair Oil Corp. v. Levien.* In a famous law review article written thirty-five years ago, *Federalism and Corporate Law—Reflections upon Delaware,* Professor Bill Cary strongly criticized Delaware jurisprudence and the weakness of fiduciary duty protection, giving the *Sinclair* decision one of his fullest treatments. In reversing the ruling of the Chancellor, the Delaware Supreme Court deferred to the judgment of what Cary characterized as an “indentured” board. Sinclair controlled the board of a 97% owned subsidiary, Sinven, which was Sinclair’s only non-wholly-owned subsidiary. Over the course of six years, the Sinclair-controlled Sinven board stripped Sinven of $108 million, paid out in dividends that represented $38 million in excess of the subsidiary’s revenues. This appears to have been done in order to fund profitable ventures for Sinclair’s other wholly-owned subsidiaries. Plaintiffs in that derivative suit, representing the minority shareholders, claimed that the Sinven board’s motivation was not to further the best interests of Sinven but rather to benefit the interests of Sinclair’s other subsidiaries.

Ruling for the plaintiffs, the Delaware Chancellor refused to defer to the business judgment of the subsidiary’s “captive” board and instead applied the test of “intrinsic fairness” to the transaction—a test that the Sinven board’s decision failed to pass. The Delaware Supreme Court reversed, applying the business judgment rule and holding that, under this rule, “the motives for causing the declaration of dividends are immaterial unless the plaintiff can show that the dividend payments resulted from improper motives and amounted to waste.” For the supreme court, all that mattered was that the 3% share minority received its pro rata 3% of the dividends. The failure of Sinven’s board to adhere to its duty to protect the viability and interests of the Sinven entity did not so much as warrant examination, even after a full trial on the merits. Thus, by its reasoning, because a finding of waste is a necessary precondition for an examination of motive, and because to constitute waste, a decision must be so irrational that it has no conceivable justifiable business purpose, there will virtually never be an examination of motive. The various *Disney* decisions by the Chancellor and Delaware Supreme Court do not directly analyze this problem, or cite *Sinclair,* but the clear language of the *Disney* opinions recognize that, in order to

33. See id.


35. *Id.* at 679–80.


37. See Robert Thompson, *Mapping Judicial Review: Sinclair v. Levien,* in *The Iconic Cases in Corporate Law* 82 (Jonathan R. Macey ed., 2008); see also *Sinclair,* 280 A.2d at 721 (stating Plaintiff’s argument that the dividends “resulted from an improper motive—Sinclair’s need for cash”).


40. See id.
satisfy the duty of good faith, directors must be motivated by the intention of benefiting the corporation. Moreover, courts will scrutinize these motives.

The discussion of motive in *Disney* is so different from that of earlier cases, such as *Sinclair*, that it appears that *Disney* silently overruled this line of thinking. *Sinclair* made the examination of motive a vestigial part of its purported test for breach of a fiduciary duty, and then ignored motive in its analysis. *Disney*, on the other hand, carefully analyzed the motives of the board in order to determine if they had breached fiduciary duties. Motive was no longer linked to waste, and a badly motivated decision that benefitted the corporation could still amount to a breach of fiduciary duty. Today, under the rubric of good faith, the focus is on whether the board intended to further the entity’s long-term interests. *Disney* is the culmination of a trend that began in the late 1980s. In 1989, Chancellor Allen, in *In re RJR Nabisco, Inc.* carefully examined the motivation of a board of directors in rejecting what may have been a higher takeover bid. Chancellor Allen explained that directors’ motives that constituted any of the Seven Deadly Sins could violate their fiduciary duty, even if those activities benefitted the corporation. He concluded, after a thorough review of all the allegations, that the board was not in fact motivated by such “sinful” motives as pride or an attempt to avoid shame in deciding to accept one bid instead of another.

Since *Disney*, several recent Delaware cases have discussed the motives of directors, noting that conduct that is beneficial to the corporation but done with an improper motive would violate the duty of good faith, as would the reckless or conscious disregard of one’s duties or a systemic disregard of risk. Certain conduct, including the back-dating of stock options, which was arguably not a violation of the traditional pre-*Stone v. Ritter* duty of loyalty because it was approved by disinterested directors, would constitute a violation of good faith. This broader judicial focus on motives may represent a trend that goes beyond the Delaware courts. In 2005, the Third Circuit in *Cantor v. Perelman* refused to read *Sinclair* narrowly as requiring a showing of harm to the beneficiaries in order to constitute a breach of a fiduciary duty.

**III. THE DUTY TO OBEY POSITIVE LAW**

Few could disagree with the suggestion that it is of the utmost importance that corporations obey the law. In fact, “many of the most shocking examples of corporate misbehaviors involve conduct that violates existing law.” Nevertheless, at least in the pre-*Disney* era, actual case law supporting this non-controversial proposition was

42. *See* id. at *16.
43. *See* Eisenberg, *supra* note 7, at 57.
scarce. In a leading corporate law treatise, Dean Robert C. Clark wrote that “clear and explicit legal authority is hard to come by.” 49 Another commentator on corporate crime, John C. Coffee, wrote in 1980 that there were no modern cases imposing liability on corporate managers for corporate violations of positive law. 50 Similarly, Professor Kent Greenfield concluded that “there is no consensus on the question of whether there is an obligation, enforceable within corporate law, on the part of the firm and its managers to obey the law.” 51

Not only is there little clear authority for an obligation that corporate managers must cause the corporation to obey the law, but some prominent commentators viewed corporate compliance with the law and the penalty for non-compliance merely as a price to consider in determining profitability. Then Professor, now Judge, Frank Easterbrook and Professor Daniel Fischel wrote in a famous article that corporate decisions on whether or not to obey the law should depend on a cost-benefit analysis. They concluded that “managers not only may but should violate the rules when it is profitable to do so.” 52 Professor Norwood P. Beveridge explained that, under the net loss rule, even if it could be proven that a corporate manager intentionally caused the corporation to violate the law, thereby forfeiting the protection of the business judgment rule, the director would generally be liable only to the extent that losses for the transaction exceeded gains. 53

This uncertainty during the pre-Disney era went beyond case law. For example, the Revised Model Business Corporation Law (RMBCA) and the American Law Institute (ALI) Principles of Corporate Governance offer little meaningful support for a management duty to obey the law. Section 2.02(b) of the RMBCA allows the corporation to exculpate intentional violations of civil law. 54 Moreover, while sections 2.01(b) and (b)(1) of the ALI Principles of Corporate Governance state that “the corporation, in the conduct of its business . . . is obliged, to the same extent as a natural person, to act within the boundaries set by law,” 55 the obligation is largely meaningless because it is placed upon the fictitious entity, which has “no soul to be

49. Id. at 686.
50. Coffee, supra note 30.
53. Norwood P. Beveridge, Does the Corporate Director Have A Duty Always to Obey the Law, 45 DePaul L. Rev. 729 (1996).
54. See Cynthia Williams, Corporate Compliance with the Law in An Era of Efficiency, 76 N.C. L. Rev. 1265, 1315 (1998). Williams also notes that ALI Principles of Corporate Governance section 7.19 does not allow for exculpation of knowing and culpable violations of the law. Note that Delaware also does not allow this. See id. at 1312.
damned, and no body to be kicked.” The official comment to the rule explains that the section imposes this obligation on the corporation itself, but not on the officers or directors who cause the corporation to act.

Ironically, corporate managers often argue that legal violations are caused by the managers’ purported fiduciary duty to enhance profits. The absence of a clear positive fiduciary duty to obey the law allows managers to blame what Dean Clark refers to as the “devil” of a fiduciary duty to maximize profit and “the unfortunate fact that if they do not take advantage of lax legal enforcement they may be ousted by aggressive managers who will.”

A clear enforceable duty on directors not to allow violations of the law is especially important given the notoriously difficult problem of enforcing criminal law against corporations. Reasons for this problem include the difficulty of proving that corporate action was willful or knowing; the difficulty of establishing penalties that are severe enough to deter misconduct without shifting the hardship to relatively blameless shareholders, some of whom did not even own their shares at the time of the illegal conduct; shifting the hardship to other blameless third parties; and the impossibility of incarcerating and the difficulty of shaming a fictitious person.

A primary motivation of senior managers is to keep profits increasing, a motivation that, as Professor John C. Coffee has explained, can lead to downward pressure on operating employees to cut corners in order to beat the competition. Boards and senior officers do not tell employees to violate the law; instead they intensify pressure on subordinates, who are encouraged to “cope” with the regulations, while avoiding the situation in which precise information about specifics filters back up to them. This structure could change materially if management has a clear fiduciary duty not to allow the corporation to violate the law. The Delaware Supreme Court in *Stone v Ritter* placed the duty of good faith within the duty of loyalty. *Stone* can be read to hold that violations of good faith for failure to monitor are difficult to establish because the case seems to require systemic and egregious breaches. Nevertheless, the difficulty of establishing a breach of the duty to monitor does not weaken the good faith duty not to affirmatively violate the law. Moreover, in the post-*Disney* and post-*Stone* era, this newly defined and clarified aspect of the good faith duty is actually being enforced by Delaware courts. While Chancellor

---

56. Coffee, supra note 30, at 386 (citation omitted).
57. Am. Law Inst., supra note 55, § 2.01 cmt. j. See Greenfield, supra note 51, at 1298 (discussing comment j); Williams, supra note 54, at 1305 (discussing comment j).
58. Clark, supra note 2, at 686.
60. Id.
61. Id. at 399–400.
62. Id.
63. 911 A.2d 362, 369–70 (Del. 2006).
64. See id. at 364–65.
Strine and his co-authors argue in a recent law review article that this aspect of good faith, the duty to obey the law, has always existed in Delaware jurisprudence, they do not support this contention by citing any cases. The actual Delaware cases clearly enforcing this duty, some of which were in fact written by Vice Chancellor Strine himself, all come after Disney.

The Disney cases do not address the fiduciary duty to obey positive law as part of their holdings because there were no serious allegations of the board violating the law. Nevertheless, in the expansive discussion of the elements of the fiduciary duty of good faith, both the Chancellor and the Delaware Supreme Court make it certain that this duty exists. This express language is virtually unprecedented in the Delaware case law and represents a turning point. In Disney, the Delaware Supreme Court explained that all knowing violations of law constitute subjective bad faith. This dicta has been applied in Delaware cases following Disney. For example, in the Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies, Inc. opinion in 2004, Vice Chancellor Strine held that “a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes the illegal activity would result in profit for the entity.” This position was reiterated in the Chancery Court in Desimone v. Barrows in 2007. Important cases in other jurisdictions have followed Delaware.

This new good faith focus in Delaware case law may be melding the duty to obey positive law with a close examination of managerial motives to broaden possible liability beyond just violations of positive law to include violations of recognized norms of acceptable behavior. Thus, back-dating options, while technically legal because of independent director approval, could still violate the duty of good faith. Similarly, Chancellor Chandler found the board of director’s issuance of cheap stock causes the “judicial nostril [to] smell something fishy.”

Not all commentators favor an absolute fiduciary duty to comply with positive law. Some critics of the expanding doctrine of good faith now concede that “conduct

65. See Strine et al., supra note 12, at 633.

66. See, e.g., Metro Commc’n Corp. BVI v. Advanced Mobilecomm Techs., Inc., 854 A.2d 121 (Del. Ch. 2004); Desimone v. Barrows, 924 A.2d 908 (Del. Ch. 2007). See also infra text accompanying notes 69–70.


68. Disney, 906 A.2d at 67. Under the rubric of good faith, Delaware case law now clearly stresses that, regardless of motive, a director who consciously disregards his duties to the corporation and its shareholders may suffer a personal judgment for money damages. One way that a director can violate the duty is to act “with intent to violate applicable positive law.”

69. 854 A.2d at 131.

70. 924 A.2d at 934.

71. See, e.g., In re Abbot Labs. Derivative S’holders Litig., 325 F.3d 795, 803 (7th Cir. 2003); McCall v. Columbia, 239 F.3d 808, 818 (6th Cir. 2001).

intended to violate . . . positive law now constitutes bad faith” and is non-exculpable.73

In a recent article, a group of legal and financial scholars complain that the new expanded and open-ended fiduciary duty will reduce the discretion of boards of directors; allow courts to evaluate substantive board decisions, making boards more accountable to judicial review; make directors liable for malum prohibitum violations; increase the number of derivative suits; and constitute a “wealth transfer” from corporations to plaintiffs’ lawyers.74 I agree with these scholars about the likelihood of these effects, but, unlike them, I see these effects as largely beneficial.

Reducing the discretion of boards to violate legal norms, and making it less likely that corporations will externalize costs to third parties and society, is certainly not a bad thing. A two-prong judicial review of corporate decision-making to ensure that it is both motivated by an intention to benefit the corporation itself and that in benefiting the corporation it does not violate positive law seems laudatory. Potential liability for causing clear malum prohibitum violations seems appropriate, especially when we remember that most federal securities, antitrust, Employment Retirement Income Security Act (ERISA), and Occupational Safety & Health Administration (OSHA) law violations are malum prohibitum. Rather than decrying an increase in litigation, more litigation can generate clear legal precedent, which is a public good. A body of common law, closely adapted to evolving business practices, helps to establish and enforce appropriate norms of acceptable behavior.

The duty of good faith should also help clarify the role of corporate lawyers. Writing in the wake of the Enron debacle, Professor Jeffrey Gordon observed that all too often corporate attorneys assisted senior managers “to create endless shells under which to hide and move the peas.”75 Now if directors, especially independent directors, recognize their potential liability for violating the law, they are likely to ask corporate lawyers to help steer them away from potential legal violations that breach their fiduciary duties. Corporate lawyers will still serve the corporate client, but the new emphasis will be on compliance rather than on avoiding compliance.76

The recent Sarbanes-Oxley legislation requires that lawyers for companies registered under the Securities Exchange Act of 1934 must report evidence of legal violations in order to remedy wrongdoing.77 Significantly, this reporting duty for

74. Id. at 593.
77. 15 U.S.C. § 7245 (2010); 17 C.F.R. § 205.3(b) (2010).
corporate lawyers expressly includes evidence of violations of fiduciary duties, which *Disney* explains includes intentional violations of positive law by officers or directors.\(^\text{78}\)

Given the difficulty of enforcing criminal law against corporations, the recovery of legal fees by plaintiffs’ attorneys in successful derivative suits against corporate directors who breach their fiduciary duty by violating the law does not seem to be a harmful wealth transfer. In fact, this enhanced scrutiny by motivated private attorneys general\(^\text{79}\) is likely to result in greater corporate compliance with the law. To the extent that these lawsuits chill any incentive for directors to use their discretion to favor questionable activities that may constitute legal violations, this seems to properly align the incentives. As Professor Mel Eisenberg has explained, the use of derivative suits to generate proper legal norms of behavior utilizes the expressive function of law for an efficient result.\(^\text{80}\)

IV. CONCLUSION

Anyone reading the articles and essays for this symposium would agree that some of the breadth and contours of the corporate doctrine of good faith are uncertain. Currently, good faith in Delaware is not a separate fiduciary duty and its breach alone does not constitute a cause of action. A broad reading of the recent Delaware *Lyondell* decision may describe a rather toothless remedy of limited applicability.\(^\text{81}\)

Nevertheless, several aspects of the duty of good faith continue to have powerful importance, even if subsumed into a broadened duty of loyalty. First, by carefully examining the motivation of boards, corporate entities and their constituents should gain some protection from the opportunism of powerful insiders. Second, by clearly making it a breach of fiduciary duty for managers to knowingly violate positive law, society is protected from the harm of unlawfully generated corporate externalities. In a leading corporate law casebook, Professors William Allen, Reinier Kraakman, and Guhan Subramanian have criticized the structure of Delaware’s good faith duty and section 102(b)(7) as being “somewhat incoherent.” They question why liability for gross negligence can be exculpated, but not liability for inattention so profound as to constitute lack of good faith.\(^\text{82}\) The answer, at least in part, is that corporate directors have duties that go beyond the corporation, such as the duty to obey the law, and no one, certainly not shareholders voting to approve charter amendments, has the power to immunize directors from liability for violating these duties, especially if this might encourage these harmful actions. While section 102(b)(7), of course, does not allow exculpation of third-party claims, as a practical matter such claims are rare and

\(^{78}\) See supra note 77 and accompanying text.

\(^{79}\) A private citizen who commences a lawsuit to enforce a legal right that benefits the community as a whole.


\(^{81}\) See *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

exceedingly hard to bring. Third parties are much more likely to be protected as a kind of third party beneficiary of shareholder suits.

Fiduciary duties provide vague but powerful protections for corporations, their constituents, and society. Good faith helps to allow the fiduciary duties of care and loyalty to adapt in different contexts to do their work. In recent years, the duty of good faith has been described as part of the duty of care (Caremark),\textsuperscript{83} as an independent fiduciary duty (Cede and Disney), and now as part of the duty of loyalty (Stone). Good faith does for all of fiduciary duty what the Japanese concept of Umami, the fifth flavor, does for the other four flavors.\textsuperscript{84} Just as Umami provides savor to the taste that is generated by the four flavors, good faith allows the duties of care and loyalty to provide protection both within and without the corporate entity, adaptive to changing circumstances. The duty of good faith is likely to take on new names and nuanced characteristics, but it is unlikely to disappear.

\textsuperscript{83} In re Caremark Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

\textsuperscript{84} See, e.g., Robert Krulwich, Sweet, Sour, Salty, Bitter. . . and Umami, NPR (Nov. 5, 2007, 1:43 AM), http://www.npr.org/templates/story/story.php?storyId=15819485. A Japanese term that means “delicious,” Umami is often referred to as the “fifth taste” and has been known to intensify the savoriness of the other four tastes. Id.