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The Good Faith Thaumatrope: Substantive Standards and Rhetorical Devices in Corporate Law

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The Good Faith Thaumatrope: Substantive Standards and Rhetorical Devices in Corporate Law

Sean J. Griffith*

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I. Introduction

The Delaware courts are remaking corporate law.

Although state corporate governance innovations have recently been overshadowed by federal reforms, most notably the Sarbanes-Oxley Act of 2002 and the steady stream of proposed rules by the Securities and Exchange Commission and other regulatory bodies, corporate governance is still fundamentally a product of state law. Delaware is by far the nation's leading producer. And Delaware has been busy.

Over the last few years, the Delaware courts have approached corporate governance questions with renewed attention and creativity. Plaintiffs have been winning a higher proportion of decisions in derivative litigation,⁴ and although not all such decisions make new law, a line of cases has recently emerged seems to announce the establishment of a new fiduciary duty—the duty of good faith. The Delaware Court of Chancery recognized good faith as a separate standard of fiduciary duty most explicitly in *In re the Walt Disney Company Derivative Litigation*,⁵ in which the court refused to dismiss a claim that could not have resulted in liability under either of the traditional fiduciaries—care and loyalty—because the claim raised doubts concerning the good faith of the defendant directors.⁶ Several other decisions show a similar willingness to recognize claims under good faith alone,⁷ and although the status of good faith is yet to be definitively addressed by the Delaware Supreme Court, a leading member of that court

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¹ See Pub. Law No. 107-204, 15 U.S.C. §§7201 et seq. (2003) (the Sarbanes Oxley Act). For some recent regulatory rule proposals, see e.g., Security Holder Director Nominations, SEC Rel. No. 34-48626 (Oct. 14, 2003); Implementation of Standards of Professional Conduct for Attorneys, SEC Rel. No. 33-8186; 34-47282 (Jan. 29, 2003); Standards Relating To Listed Company Audit Committees, SEC Rel. No. 33-8173; 34-47137 (Jan. 8, 2003); Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Rel. No. 33-8154; 34-46934 (Dec. 2, 2002).

² See Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) (refusing to apply a federal fiduciary duty principle under rule 10b-5 in the absence of an express Congressional mandate because such an "extension of the federal securities laws would overlap and quite possibly interfere with state corporate law"); Cort v. Ash, 422 U.S. 66, 84 (1975) (stating that "[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, *state law will govern the internal affairs of the corporation*") (emphasis added). See also Business Roundtable, 905 F.2d 406 (D.C. Cir. 1990) (striking down SEC attempt to force corporations to adopt governance rule of one vote per share).

³ The number of major firms incorporating in Delaware and the willingness of other states to be guided by Delaware has established Delaware law as national corporate law. *See* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 Am. J. COMP. L. 329, 350 (2001) ("The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law."). *See also* Guhan Subramanian, *The Disappearing Delaware Effect*, 46 J.L. ECON. & ORG. (forthcoming 2004) (CITE STATISTICS).

⁴ In 2002, for example, plaintiffs won 72% as opposed to the usual 52% of the reported decisions at Chancery. *See infra* XX.

⁵ 825 A.2d 275 (Del. Ch. May 2003) (hereinafter *Disney*).

⁶ See discussion at infra XX-XX.

⁷ See infra cases cited at XX-XX.

has spoken favorably of good faith as an area of innovation in corporate law. We are witnessing, in other words, the emergence of a new jurisprudence of good faith.

Good faith, of course, is not entirely new to corporate law. It has long been cited as the fundamental undergirding of the traditional fiduciary duties of care and loyalty. What the emerging jurisprudence of good faith does differently, however, is to turn good faith from a background principle into a basis of decision. This shift in the doctrinal role of good faith points to a new standard for director liability and a new basis for judicial intervention in corporate governance. It promises succor to dying claims and offers a pressure point for shareholder plaintiffs to spur corporate governance reform. As a distinct doctrinal standard, the duty of good faith signals movement at the frontier of the business judgment rule and a rebalancing of board authority and judicial accountability.

The extent to which judicial intervention under the flag of good faith will displace the deference traditionally accorded to directors under the business judgment rule is, at this point, still unclear. In the words of Chief Justice Veasey, "the jurisprudence on good faith is unresolved." Unanswered questions include: What, after all, does good faith mean? How does it operate as a standard of review? How will it interact with the business judgment rule? And how is it likely to evolve?

This Article aims to answer these questions. In it, I will argue that the emerging duty of good faith is best understood as a principle of interpretation rather than a substantive standard. Good faith, in other words, is not now and is not likely ever to develop into a distinct line of doctrine involving sub-rules and multi-part tests. Instead, the pattern in the good faith cases is to raise issues under both the duty of care and the duty of loyalty but, rather than following either traditional analysis through to a conclusion, to mix the issues together and, in doing so, identify a basis for liability under the duty of good faith.

This mode of analysis, involving the oscillation between two distinct doctrinal categories, I call "Thaumatrope analytics." The term refers to a toy, involving a handle and a frame, into which a child would insert a card with a different image on each side—a horse and a man, for example, or a bird and a cage—and by spinning the handle produce in the frame a third image that was a composite of the other two—the man atop the horse or the bird in the cage. Good faith, I argue is simply the application of the Thaumatrope to the duties of care and loyalty. Spinning the two together, the composite image—of a poor decision-making process mixed with hints of self-dealing—may trigger liability under something the judiciary now calls "good faith."

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⁸ E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, XXX - 448 (2003) (discussing the fiduciary duty of good faith as an area of growth and progress in corporate law) [hereinafter Veasey, *State-Federal Tension*].

⁹ See infra at XX-XX (discussing role of traditional fiduciary duties of care and loyalty).

¹⁰ Veasey, *supra* note 8, at 448.

¹¹ The device was brought into the legal literature by Leon Lipson to criticize Cardozo's analysis in the *Allegheny College* opinion. Leon S. Lipson, *The Allegheny College Case*, 23 YALE L. REP. 8, 11 (1977).

By understanding good faith in this way, I do not mean to denigrate its significance in corporate law. It is, like "intermediate scrutiny" of takeovers, ¹² a doctrinal development responding to a specific context. ¹³ The duty of good faith emerged in the context of corporate crisis, when a series of scandals—including frauds and failures at Enron, Worldcom, Tyco, and Adelphia, celebrity insider trading, and corruption in the IPO market—drew American corporate governance into question and plunged previously settled questions into heated debate. Post-Enron, the responsiveness (or laxity) of the states, Delaware in particular, in matters of corporate governance was hotly contested. The duty of good faith emerged from this environment of *sturm und drang* as a new interpretive tool for courts to use in passing judgment on the conduct of directors. It may be wielded aggressively or with restraint, as context requires.

In stressing both interpretive flexibility and contextual contingency, my analysis of good faith differs significantly from analyses that seek to locate a substantive principle of law in the emerging fiduciary duty. But in arging that that good faith lacks a substantive principle of its own, I do not mean to suggest that it is unprincipled. Thaumatrope analytics can be defended when the concepts underlying the categories are related. And the duties of loyalty and care, I argue, are interconnected. Although each duty approaches the question from a different angle, the duties of care and loyalty both endeavor to answer whether the directors are really working in the best interests of the corporation. Because both lines of analysis get at the same fundamental question, it is possible that there will be situations in which the question can be answered without checking all of the boxes under either traditional duty. This is the principle, grounded on the interconnectedness of care and loyalty, upon which the Thaumatrope of good faith is based.

Finally, although the good faith Thaumatrope will be attacked by those who would prefer to regulate conduct through rule-like standards, ¹⁵ I argue that it should be celebrated as a triumph of common law flexibility. The good faith Thaumatrope provides the judiciary with a tool to respond to situations of scandal and crisis on an as-needed basis without upsetting the long-term balance between authority and accountability. The business judgment rule remains intact, as does the ability of the judiciary to intervene when circumstances suggest that the board has deviated from best interests of the corporation. Furthermore, the ability of the Delaware judiciary to develop and use such subtle interpretive devices lends additional support to the contention that state fiduciary

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¹² See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (announcing standard of enhanced or intermediate scrutiny for takeover defenses); Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995) (modifying enhanced scrutiny standard for takeover defenses).

¹³ See infra XX (discussing takeover jurisprudence as contextually contingent).

¹⁴ An excellent example of such an analysis is that of Professor Sale. *See* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004) [hereinafter Sale, *Good Faith*].

¹⁵ See, e.g., Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 COLUM. L. REV. 1908 (1998) (critiquing Delaware law for producing indeterminate standards rather than clear rules). On the convergence of standards and rules, see generally Louis Kaplow, Standards Versus Rules: An Economic Analysis, 42 DUKE L.J. 557, 560 (1992) (adopting a definition of rules and standards "in which the only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act").

duty law, and not federal rule-making, is the best source of corporate governance regulation.

In developing this account of the emerging jurisprudence of good faith, this Article proceeds as follows: Part II situates good faith amid existing corporate governance regulatory structures under state law, including the fiduciary duties of care and loyalty and the business judgment rule. Part III traces the emergence of good faith jurisprudence through a line of cases under Delaware law. It evaluates various attempts to import a distinct substantive content into the meaning of good faith, then argues that the duty of good faith is best understood as an interpretive principle rather than a substantive standard. Part IV further develops my account of good faith as an interpretive principle, by showing how good faith analyses oscillate between concerns more typically raised under the duties of care and loyalty. Part IV also emphasizes the contextual contingency of good faith interpretations, emphasizing the importance of the recent environment of corporate scandal. Part V seeks to predict the future of good faith jurisprudence in corporate law, drawing on an analogy to Delaware's takeover jurisprudence, and ultimately assesses the good faith Thaumatrope, asking whether it is a development to be celebrated or regretted. The Article then closes, in Part VI, with a brief conclusion.

II. State Law Corporate Governance

Corporate governance can be defined broadly as the set of rules structuring the relationship between corporate constituencies. Although rules bearing on this relationship can and do come from a variety of sources—including, for example, federal environmental law and labor law the fundamental subject of the rules, the corporation itself, is a creation of state corporation law. And the basic governance principle of state corporate law is board authority.

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¹⁶ This definition follows the model of the corporation as a nexus of various contracting parties. *See* Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991). *See also* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. Rev. 1 (2002) (arguing that the board of directors is the center of these interconnected contracts).

¹⁷ See, e.g., Comprehensive Environmental Compensation and Liability Act ("CERCLA"), 42 U.S.C. §§ 9601-9675 (2000).

¹⁸ See, e.g., Employee Retirement Income Security Act ("ERISA"), 26 U.S.C. §§ 410-11 (2000).

¹⁹ See, e.g., Delaware General Corporation Law ("DGCL"), § 101 ("Any person... may incorporate or organize a corporation under this chapter....").

²⁰ DGCL 141(a) ("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."). *See also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.") (Del. 1985), cited with approval in Omnicare v. NCS Healthcare, 818 A.2d 914, 947 (Del. 2003).

Although founded on a basis of shareholder consent,²¹ once the board is elected, there is very little constraint on the ability of the board of directors to govern the corporation.²² Boards typically exercise this authority by hiring, monitoring, and advising the firm's top officers and managers,²³ but even this is not required.²⁴ Boards could choose not to appoint officers or hire managers. The directors could run the corporation themselves. And, apart from the few formal requirements of the corporate charter, 25 they could make up the rules as they went along. The first principle of state law corporate governance, in other words, is that the board of directors is corporate governance.

States could change this, of course. The allocation of management authority to the board of directors is not a constitutional mandate, and the Delaware statute invites limitation and qualification of board authority.²⁶ The legislature could amend the statute to alter the primacy of director decision-making or, less radically, to impose mandatory corporate governance requirements thus reducing board authority.²⁷ But state legislatures in general, and Delaware in particular, rarely impose mandatory governance terms.²⁸ Furthermore, state corporation statutes are broadly enabling, permitting firms maximum opportunity to opt out of statutory governance terms.²⁹ State corporation law is, in this

²¹ The importance of shareholder consent can be seen in the annual election of directors, one of the few mandatory terms of state corporate law. DGCL 211(b). See also Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

²² See Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547 (2003).

²³ [CITATION PENDING: finance article re: friendly boards and monitoring v. advising functions, how board constrains mgmt.]

²⁴ DGCL §142(d) ("A failure to elect officers shall not dissolve or otherwise affect the corporation."). ²⁵ See DGCL §102 (requiring that the charter list the name and address of the corporation, its authorized

²⁶ See DGCL § 141 (providing for board discretion in management "unless otherwise required by this title").

²⁷ The Sarbanes-Oxley Act is the most prominent example on the federal level. Through it, Congress imposed substantive corporate governance terms mandating the creation of wholly independent audit committees, prohibiting corporations from purchasing non-audit services from their auditing firms, prohibiting corporate loans to officers, requiring executive certification of financial statements, and compelling forfeiture of CEO and CFO incentive compensation in the event of a material financial restatement. See Sarbanes Oxley Act, supra note 1. Notwithstanding their possible merits, each of these terms imposes substantive corporate governance terms on the board, a governance choice that, but for the mandatory term, the board would be free to decide in its sole discretion.

²⁸ See EASTERBROOK & FISCHEL, supra note 16, at 2 ("The corporate code in almost every state is an 'enabling' statute. An enabling statute allows managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator."). See also Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 939 (2003) (Veasey, C.J., dissenting) ("The beauty of the Delaware corporation law, and the reason it has worked so well for stockholders, directors and officers, is that the framework is based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis.").

²⁹ The mandatory terms that remain in state statutes generally focus on the role shareholder voting. In Delaware, for example, shareholders must vote annually on the election of directors (DGCL §211(b)) and have the right to vote by proxy (DGCL §212(b)). In addition, amendment of the certificate of incorporation requires at least a majority vote of shareholders (DGCL §242(b)(2)) as do sales of substantially all assets and most mergers (DGCL §251(c)).

way, contractual.³⁰ Legislatures leave corporate governance as a matter to be decided between shareholders and their board.³¹

States nevertheless retain, in their courts, a second means of influencing corporate governance. State courts may apply standards of fiduciary duty to constrain corporate boards.³² Just as mandatory terms constrict the space of board governance, judicial accountability limits board authority.³³ Yet, unlike statutory governance mandates, states *do* in fact police board authority through fiduciary duty standards. The most significant state law governance constraints thus emerge from courtrooms rather than legislatures.³⁴

State courts examine corporate governance in the context of shareholder suits for breach of fiduciary duty, 35 traditionally divided into the duties of loyalty and care. 36 The

Neither discretion nor accountability can be ignored because both promote values essential to the survival of business organizations. Unfortunately, they are ultimately antithetical: one cannot have more of one without also having less of the other. At some point, directors cannot be made more accountable without undermining their discretionary authority.

Id., at 573 (citation omitted). Professor Bainbridge's discussion of corporate governance as a balance between authority and accountability draws upon Kenneth Arrow's work on organizational decision-making. *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68-70 (1974) (identifying the basic decision-making structures of 'consensus' and 'authority.').

³⁰ State statutes generally permit firms to opt out of most statutory provisions and choose their own governance terms. *See* DEL. CODE ANN. tit. 6, § 15-103 (2002) (stating policy "to give maximum effect to the principle of freedom of contract"). Commentators differ with respect to the significance of those provisions that do not permit opting out. *Compare* Bernard S. Black, *Is Corporate Law Trivial?: A Political And Economic Analysis*, 84 Nw. U.L. Rev. 542, 544 (articulating bases for believing that rules that are mandatory in form are unimportant in substance and challenging proponents of the significance of mandatory corporate law terms to prove that seemingly mandatory terms are "not market mimicking, avoidable, changeable, or unimportant") (1990) *with* Lucian Ayre Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1821 (1989) (asserting that corporate law has "always included a significant body of mandatory rules"); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1482 (1989) (noting that corporations "will be governed by very extensive mandatory legal rules even in Delaware, which is probably the least regulatory of states").

³¹ See generally Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1 (1990) (arguing in favor of opt out rules).

³² Directors propose corporate governance terms by drafting and proposing amendments to the charter. Shareholders accept or reject the firm's corporate governance choices by voting for or against charter amendments or, more fundamentally, by buying or selling shares.

³³ See Bainbridge, supra note 22stating:

³⁴ See Ian Ayres, Making a Difference: The Contractual Contributions of Easterbrook and Fischel, 59 U. Chi. L. Rev. 1391, 1404 (1992) ("The non-trivial default rules of corporate law will often be muddy gap-fillers that ask courts to balance the costs and benefits of contractual obligations under particular contingencies. Muddy defaults make contractual obligations contingent on circumstances ... that are verifiable by courts ex post, but prohibitively costly to identify ex ante."); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. Cin. L. Rev. 1061, 1074 (2000) ("[T]he statute does not deal with the fiduciary principles that provide the foundation of corporate law.... As a practical matter, the interpretation and application of these fiduciary principles is the heart of corporate law, yet the Delaware statute provides almost no guidance on the subject.").

³⁵ This context is a significant limitation of the courts' role in corporate governance. There is no direct judicial review of a firm's governance. Shareholders do not have a cause of action for sub-optimal governance. Instead, the shareholder challenge to the board's decision-making must be couched in terms of

duty of loyalty, in its simplest formulation, is a proscription against director conflict of interest and self-dealing.³⁷ Meanwhile, the duty of care, stated on its own terms,³⁸ requires simply that directors in control of the corporate enterprise exercise the same level of care that would be expected of an ordinarily prudent person in the conduct of her own affairs.³⁹ These fiduciary duties—and the power of courts to hold boards accountable for failing to fulfill them—constrain the authority of directors. It is not true that directors can do whatever they please. Rather, everything directors do must be consistent with their fiduciary duties.

But just as fiduciary duty constrains boards, the business judgment rule constrains courts. Although it has spawned considerable academic disagreement regarding its

a breach of fiduciary duty, and state courts will not intervene in the firm's governance unless the directors' actions constitute a breach of fiduciary duty.

³⁷ A comprehensive statement of duty of loyalty principles appears in *Guth v. Loft*:

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

5 A.2d 503, 510 (Del. 1939) (emphasis added).

³⁸ That is, without application of the business judgment rule. *See infra* note XX and accompanying text. ³⁹ Briggs v. Spaulding, 141 U.S. 132, 152 (1891) (requiring that directors act as would "ordinarily prudent and diligent men... under similar circumstances"); Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 264 (2d Cir. 1984) (stating that "[i]n simplest terms, the duty of care requires that directors exercise the care that an ordinary prudent person would exercise under similar circumstances"); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del., 1963) (stating that "directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances"). As discussed in the following pages, however, application of the business judgment rule changes the liability standard under the duty of care from negligence—that is, reasonableness or ordinary prudence—to gross negligence. Aronson v. Lewis, 473 A.2d 805, 812 ("While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.") (footnote omitted). A shift in the standard of liability does not necessarily imply a shift in the standard of care. See Melvin A. Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 FORDHAM L. REV. 437 (1993) (distinguishing the duty of care, as standards of conduct, from the business judgment rule, as a standard of review). However, a reduction in probable liability for carelessness may have an impact on director incentives to take care, thereby resulting in a de facto shift in the standard of care.

³⁶ See Cede & Co. v. Technicolor, 634 A.2d 345, 367 (Del. 1993) ("Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders. Each of these duties is of equal and independent significance.") (citation omitted); Victor Brudney, Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. REV 595, 599 n.9 (1997) ("Legal conventions divide fiduciary obligations into obligations of loyalty and obligations of care."). For discussion of the "triad" of fiduciary duty, including good faith as a distinct fiduciary duty alongside loyalty and care, see *infra* at note XX.

precise meaning and rationale,⁴⁰ the practical effect of the business judgment rule is well known: it shields boards of directors from judicial second-guessing.⁴¹ The business judgment rule operates both as an evidentiary presumption, allocating to the shareholder plaintiff the burden of alleging facts establishing a breach of fiduciary duty,⁴² and as a substantive standard, setting the level of carelessness or disloyalty that a plaintiff must establish to rebut the application of the rule and cause a court to intervene.⁴³ If the plaintiff cannot plead facts sufficient to overcome the substantive standards of the rule,⁴⁴

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

Id., at 123.

[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 taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted). The discussion of the rule in *Aronson* emphasizes the relationship between the business judgment rule and board authority: "The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a)." *Id.* This emphasis is consistent with Professor Bainbridge's thesis that the business judgment rule is fundamentally a doctrine of judicial abstention in recognition of director primacy. *See* Bainbridge, supra note XX.

⁴⁰ See, e.g., R. Franklin Balotti & James J. Hanks, Jr., Rejudging the Business Judgment Rule, 48 Bus. Law. 1337 (1993) (finding the most justifications for the rule unpersuasive); Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, ___ Vand. L. Rev. ___ (forthcoming 2004) (noting that "[c]ountless cases have invoked [the business judgment rule] and countless scholars have analyzed it. Yet, despite all the attention lavished on it, the business judgment rule remains poorly understood.") (footnotes omitted); Kenneth B. Davis, Jr., Once More, the Business Judgment Rule, 2000 Wis. L. Rev. 573 (noting the lack of consensus among scholars as to the meaning of the rule in spite of "thousands of pages of corporate law scholarship and commentary" devoted to it); Peter V. Letsou, Implications Of Shareholder

Diversification On Corporate Law And Organization: The Case Of The Business Judgment Rule, 77 Chi.-Kent. L. Rev. 179, 179 (2001) ("there is no single formulation of the nearly two-century-old business judgment rule"); Henry G. Manne, Our Two Corporation Systems: Law and Economics, 53 Va. L. Rev. 259, 270 (1967) (stating that the business judgment rule is "one of the least understood concepts in the entire corporate field").

⁴¹ See ROBERT C. CLARK, CORPORATE LAW §3.4 (1986):

The presumption aspect of the rule is clear in the *Aronson* formulation of the rule:

⁴³ As a substantive standard, the business judgment rule is a standard of judicial review of board conduct, distinct from the standard of conduct that directors are expected to uphold in the discharge of their duties. However, because courts will only review director conduct that fails to meet the requirements of the business judgment rule, the standard of review is often taken as a *de facto* level of care for the standard of conduct. *See* Eisenberg, *supra* note 39 (distinguishing standards of conduct and standards of review). *Accord* William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. LAW. 1287 (2001).

⁴⁴ These claims are most often evaluated at the motion to dismiss stage with moderate scrutiny of the factual support for the plaintiff's allegations. *See, e.g.*, Orman v. Cullman, 794 A2d 5, 15 (Del. Ch. 2002) (emphasizing that the plaintiff's claim must be must be supported by facts and not mere conclusory assertions). The principle source of facts available to plaintiffs at this pre-discovery stage in the litigation would be media accounts, public filings, and board minutes. *Id.*, at 16, n. 9.

the business judgment rule will be held to apply with the typical effect that the board wins, the shareholder loses, and the court stays out of it. 45

Although the business judgment rule applies equally to each fiduciary duty as an evidentiary presumption, as a substantive standard the rule applies differently depending upon which of the directors' fiduciary duties is under review. ⁴⁶ A plaintiff challenging the board's actions under the duty of care must allege facts that show the board's conduct rises (or falls) to the level of "gross negligence." ⁴⁷ By contrast, a plaintiff challenging the board's actions under the duty of loyalty does not bear the burden of establishing a gross conflict of interest. Any material conflict of interest on the part of the board will rebut the business judgment rule and require the board to establish that the challenged decision or transaction was either approved by disinterested directors, ratified by shareholders, or fair to the corporation.⁴⁸ Thus, the pleading standards for a plaintiff seeking to overcome the presumption of the business judgment rule in a claim under the duty of care are much more demanding than those for a plaintiff seeking to overcome the presumption in a claim under the duty of loyalty. This has led to the recognition that, as a practical matter, 49 the business judgment rule is a near-complete shield for duty of care claims. 50

⁴⁵ See also Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001) ("If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule operates to provide substantive protection for the directors and for the decisions that they have made.")

⁴⁶ See CLARK, supra note XX, at 124, n.7 ("The 'gross negligence' formulation is concerned only with adjusting the business judgment rule to the fiduciary duty of care; the duty of loyalty... is another matter."). ⁴⁷ See Aronson, 473 A.2d 805, at 812 ("While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence."), cited approvingly in Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) ("We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.").

⁴⁸See Del. Code Ann. Tit. 8, § 144(a) (2003) (providing that conflict of interests transactions are not void or voidable if they are either approved, ratified, or fair); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (establishing standard of entire fairness: "[w]hen directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

⁴⁹ As a matter of *theory*, it is at least possible for a board's decision-making to be so bad as to rise to the level of gross negligence. As Chancellor Allen noted, however, this is a theoretical matter of dubious relevance:

There is a theoretical exception to [the business judgment rule] that holds that some decisions may be so 'egregious' that liability . . . may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in [Delaware]. . . . Thus, to allege that a corporation has suffered a loss . . . does not state a claim for relief against that fiduciary no matter how foolish the investment.

Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) (Allen, C.).

⁵⁰ See Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 242 (noting that although agency costs may be understood as the sum of managerial selfishness and managerial foolishness, legal liability attaches only to selfishness since "[t]he liability standard that corporate law applies to managerial decisions is, realistically, no liability at all for mistakes, absent fraud or conflict of interest"). Roe further states:

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

Id., at 243.

Unfortunately for would-be plaintiffs, corporate governance matters generally arise under the duty of care rather than the duty of loyalty. Unless the board is selfishly motivated,⁵¹ the way it chooses to govern the corporation—the decisions it makes, and the mechanisms it devises for monitoring and advising its officers—can only raise the issue of the board's prudence under the duty of care. And, applying the business judgment rule standard of gross negligence to the issue, courts will rarely have the opportunity to intervene in a firm's governance decisions and mechanisms. The business judgment rule, in other words, constrains the ability of state courts to exert a role in corporate governance.

The business judgment rule thus operates as the frontier of state involvement in corporate governance. But it is a moving frontier. Like all judicially created doctrines, the business judgment rule expands and contracts. Broad interpretations of the business judgment rule leave little space for judicial supervision of corporate governance, but narrow constructions increase the scope of judicial review of corporate governance. Movement in the business judgment rule signals movement in the state law review of corporate governance.

And the business judgment rule has been moving.

An empirical review of Delaware corporate law decisions since 1995 reveals a significant shift in favor of pro-plaintiff outcomes starting in late 2001 and lasting through 2002.⁵² Table One below, reports the win-rates of plaintiffs and defendants in shareholder litigation at the Court of Chancery, ⁵³ from [1995] through [2004].

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⁵¹ Governance terms could raise loyalty issues if, for example, a board was bribed by a corporate constituency to adopt a term putting that constituency's interests ahead of the corporation's shareholders. Or, perhaps more plausibly, a board may adopt governance terms to increase its own power relative to shareholders. Provisions that impair shareholder voting rights, including the creation of high-vote dual-class stock and the adoption of staggered boards, empower boards vis-à-vis shareholders by eroding the consent mechanism on which board authority is based. See supra note XX and accompanying text. The adoption of self-serving governance terms raise the problem of what Easterbrook & Fischel have called "latecomer terms" and what Professor Gordon has referred to as "opportunistic amendment." See Easterbrook & Fischel, supra note XX; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1578-81. In spite of shareholder approval requirements for charter amendments, opportunistic amendment may succeed due to shareholders' collective action problems and the board's ability to engage in strategic behavior such as tying the adoption of dual class stock to an increased dividend. *See* Gordon, at 1578-81 (discussing strategic use of "sweeteners," "add-ons," and "chicken" tactics). In such contexts, corporate governance may be most appropriately evaluated under the rubric of the duty of loyalty.

⁵² Compiling data from WESTLAW and Lexis, I gathered all Delaware Chancery and Supreme Court opinions in derivative or direct shareholder litigation from [1995] through [2004]. Separating irrelevant opinions, I was left with [X] opinions, which I reviewed and categorized as plaintiff or defendant victories. Because of the posture of derivative litigation, in which a plaintiff is generally able to extract a favorable settlement provided it can survive the ultimate dismissal motion, an opinion denying any part of the motion to dismiss thus allowing the litigation to continue was counted as a plaintiff victory. Defendant victories thus included only those final motions in which the defendant prevailed in the entirety.

⁵³ There were not enough Delaware Supreme Court opinions to yield enough an adequate sample.

DELAWARE COURT OF CHANCERY

	1996		1997		1998		1999		2000		1990-2000	
Total	21		24		18		32		36		232	
π	10	48%	12	50%	8	44%	17	53%	17	47%	119	51%
Δ	11	52%	12	50%	10	56%	15	47%	19	53%	113	49%

	1/01	-9/01	10/01 -	- 12/02	1/03 –	12/03	1990-2003		
Total	19		3	2	1	9	302		
π	8	42%	23	72%	6	32%	156	52%	
Δ	11	58%	9	28%	13	68%	146	48%	

This concededly blunt empirical measurement of outcomes nevertheless reveals a significant shift in win-ratio starting in late $2001.^{54}$ In the Court of Chancery, the general run of decisions is fairly evenly divided between plaintiffs and defendants (π =52%; Δ =48%), but was significantly skewed in 2002 when plaintiffs prevailed in twenty-three out of thirty-two decisions (72%).⁵⁵ This may be evidence of increasing judicial attention to plaintiff claims and an increasing willingness, on the part of the judiciary, to push at the bounds of the business judgment rule and become involved in corporate governance.

However, in spite of this greater volume of pro-plaintiff outcomes, most of these cases fail to advance a basis for any sustained increase in judicial involvement in corporate governance. They do not, in other words, make new law but, in resolutely fact-specific opinions, ⁵⁶ merely deny dismissal on the basis of longstanding corporate law

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⁵⁴ Measurement and comparison of win-rates can indicate "quiet revolutions" in law. *See generally* James A. Henderson, Jr. & Theodore Eisenberg, *The Quiet Revolution In Products Liability: An Empirical Study Of Legal Change*, 37 UCLA L. REV. 479 (1990) (using empirical study of win-rates in litigation to show a major shift in products liability); Vicki Schultz & Stephen Petterson, *Race, Gender, Work, And Choice: An Empirical Study Of The Lack Of Interest Defense In Title Vii Cases Challenging Job Segregation, 59 U. CHI. L. REV.* 1073 (1992) (using empirical study of win-rates to show that the goals of anti-discrimination laws have not been attained).

⁵⁵ Interestingly, however, there seems to have been a pro-defendant backlash the following year, with defendants winning thirteen of nineteen decisions, or 68%, in 2003.

⁵⁶ See, e.g., Saito v. McKesson HBOC, 806 A.2d 113, 118 (Del. 2002) (overruling the denial of a books and records request on the basis of "credible evidence of possible wrongdoing"); *Texlon v. Meyerson*, 802 A.2d 257, 265 (Del. 2002) (reversing summary judgment in a derivative suit alleging director conflict of interest and remanding for trial on the question whether the non-conflicted directors were in fact dominated and controlled by the interested director). Neither *McKesson* nor *Texlon* provide any additional basis for narrowing the scope of the business judgment rule. They simply apply existing procedural and evidentiary rules to order further proceedings. Moreover, in neither case does the Supreme Court hold that the board has acted properly or improperly in a way that would allow boards to structure their behavior in future

principles.⁵⁷ These decisions thus increase the settlement values for individual plaintiffs without necessarily improving corporate governance prospects more generally.⁵⁸

There is, however, a line of cases in the post-2001 cluster that does seem to offer a new doctrinal standard to shift the frontier of the business judgment rule and reset the fundamental balance of authority and accountability. These are the cases developing the fiduciary duty of good faith.

III. The Jurisprudence of Good Faith

The development of a new fiduciary duty suggests a fundamental revision of judicial involvement in corporate governance and thus a rebalancing of board authority and judicial accountability. To what extent will the fiduciary duty of good faith allow judicial intervention to displace the deference traditionally accorded to directors under the business judgment rule? More basically, what does good faith mean? How will it operate as a standard of review?

This Part endeavors to answer these questions. It first traces the development of good faith in recent Delaware jurisprudence. It then explores the meaning of the emerging fiduciary duty, examining whether the courts really mean good faith to become a substantive principle or whether it is not, in fact, used as something much more subtle and elusive—a principle of interpretation rather than a standard of law.

A. The Emergence of a New Doctrinal Analysis

cases. The rulings are resolutely fact-specific. In *Texlon*, the Court holds that the plaintiff has raised enough facts to get to trial and, in *McKesson*, that the proper purpose of the plaintiff's request is adequate to compel additional discovery.

⁵⁷ The theme most commonly sounded in this cluster of opinions is director independence. *See, e.g., Biondi* v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003) (finding special litigation committee had failed to prove independence given the public statements of its chairman that the defendant CEO would be vindicated); Krasner v. Moffett, 826 A.2d 277, 288 (Del. 2003) (reversing dismissal of shareholder suit on basis that two member independent committee out of seven member board was inadequate to remove the taint of conflict); In re Oracle Derivative Litigaiton, 824 A.2d 917, 937-42 (Del. Ch. 2002) (evaluating the independence of a board committee's members and allowing the nexus of "institutional loyalty," to Stanford University, to stand in for traditional indicia of "domination and control"). Strine's opinion in Oracle changed the meaning of "independence" by importing into the analysis "other bias-creating factors." Oracle, at 939, n. 55. But the Krasner opinion may come closest to altering the doctrinal function of independence. By raising the possibility that a committee, even if wholly independent, might be disempowered from approving conflict of interest transactions merely because its members constituted less than a quorum of the total board, the Delaware Supreme Court has hinted at a rule that would take the business judgment rule off of the table for boards with fewer disinterested and independent directors than it would need to meet its quorum requirements regardless of the independence of the directors that remained. Taking this suggestion seriously, the *Krasner* opinion can be read to create a serious incentive for corporations to nominate and elect majority-independent or at least quorum-independent boards. See Krasner, at 288.

⁵⁸ The longer a claim survives dismissal, the higher the probability of a favorable settlement for plaintiffs. *See generally* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7J. L. E CON. & ORG. 55 (1991) (discussing settlement dynamics).

In spite of being much discussed, the precise doctrinal role of good faith is not settled. The Delaware Supreme Court has suggested, in dicta, that good faith stands apart from the duties of care and loyalty, ⁵⁹ but the separate status of good faith has not been unambiguously accepted. ⁶⁰ And the same jurists occasionally speak both ways on the issue. ⁶¹ Worse still, whatever the ultimate relationship of good faith to the traditional fiduciary duties, no Delaware opinion has yet explicated the precise meaning of the standard of good faith. ⁶² But notwithstanding the lack of a clear definition or doctrinal role for good faith, many recent corporate law decisions discuss it. ⁶³ And, more

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⁵⁹ See, e.g., Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) ("The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith."); McMullin v. Beran, 765 A.2d 910, 920 (Del. 2000) ("[T]he shareholder plaintiff must effectively provide evidence that the defendant board of directors, in reaching its challenged decision, breached any one of its 'triad of fiduciary duties, loyalty, good faith or due care.") (emphasis original, citations omitted); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty."); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty-good faith, loyalty or due care."). However, following these citations of the "triad" of fiduciary duties back to their source in Aronson, this addition of good faith to the duties of loyalty and care may originally have been the result of a confusion between the categories of fiduciary duty and the means by which a plaintiff can rebut the business judgment rule, formulated in Aronson to involve considerations of care, loyalty and good faith. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), discussed at supra note XX. See also In re Gaylord Container Corp. Shareholders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (arguing that good faith, correctly understood, is a component of the duty of loyalty).

⁶⁰ See, e.g., Orman v. Cullman, 794 A.2d 5, 14, n.3 (Del. Ch. Feb. 26, 2002) (stating that "the duty to act in 'good faith' is merely a subset of a director's duty of loyalty").
⁶¹ Justice Jacobs, for example, when still a Vice Chancellor wrote noted in his opinion in Emerald Partners

v. Berlin that "doctrinally [the] obligation [to act in good faith] does not exist separate and apart from the fiduciary duty of loyalty." 2001 Del. Ch. LEXIS 20, at *86, n.63 (Del. Ch. Feb. 7, 2001). A few years later, having been appointed to the Supreme Court, but sitting by designation at the Chancery Court, Jacobs retreated from these statements, stating that the defendant may have breached his fiduciary duty of loyalty "and/or" good faith and noting "[t]he Court employs the 'and/or' phraseology because the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and good faith." In re Emerging Communications, 2004 Del. Ch. LEXIS 70, at *142, n.184 (Del. Ch. May 3, 2004) [hereinafter *Emerging*]. Similarly, it was Chancellor Chandler who confidently announced in *Orman* that good faith was merely an aspect of the duty of loyalty, see supra note 60, then allowed the plaintiffs in Disney to survive dismissal on the basis of good faith when the question of loyalty was not properly before the court. See infra XX. One explanation for this wavering is the intervening Supreme Court opinion in Emerald Partners v. Berlin that vacated Jacobs' opinion, which Chandler had cited in Orman, and spoke of good faith as one of a "triad" of fiduciary duties, alongside care and loyalty. 787 A.2d 85, 90 (Del. 2001). See supra note 59. Another explanation is that the context had significantly shifted between the Chancery Court opinions in *Emerald Partners* and *Orman*, on the one hand, and *Emerging* and *Disney*, on the other. The shift in context foregrounded previously backgrounded discourses concerning board deference versus judicial intervention in corporate governance and pushed the Delaware judiciary to adopt a more flexible approach to fiduciary duty. See infra XX.

⁶² See, e.g., Veasey, State-Federal Tension, supra note XX, at 448 (noting that "the jurisprudence of good faith is unresolved.").

⁶³ See, e.g., cases cited supra at notes 59-61. See also Scattered Corp. v. Chicago stock Exchange, Inc., 701 A.2d 70, 75 (Del. 1997) (stating that when "an otherwise independent-appearing board or committee [fails] to act independently [it amounts to] a failure to carry out its fiduciary duties in good faith" potentially supporting a claim of wrongful dismissal").

importantly, the fiduciary duty of good faith has appeared as the *ratio decidendi* in two recent decisions: *In re: Abbott Laboratories Derivative Shareholders Litigation*⁶⁴ and *In re the Walt Disney Company Derivative Litigation*.⁶⁵

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1. Abbott

In *Abbott*, ⁶⁶ the Seventh Circuit applied Delaware law to find that the defendant directors had breached their duty of good faith by consistently failing to comply with government regulation of the firm's products thereby causing a large fine to be assessed against the corporation. ⁶⁷ The opinion is interesting not because it clarifies any of the substantive questions surrounding the duty of good faith—which it does not, claiming instead to apply *Caremark*, ⁶⁸ a case that discussed good faith but that was in fact decided under the duty of care ⁶⁹—but rather because it illustrates the likely procedural posture of good faith claims.

The Abbott corporation had adopted an indemnification provision under §102(b)(7) of the Delaware General Corporation Law, a so-called "102(b)(7) provision," promising that the corporation would pay for any liabilities incurred by its directors in derivative litigation provided that, as the statute requires, the liabilities do not result from breach of the duty of loyalty or conduct in bad faith. For corporations that have adopted such provisions, derivative claims not involving allegations of disloyalty or bad faith cannot result in shareholder recovery since any payment made by directors into the

We find that six years of noncompliance, inspections, 483s, Warning Letters, and notice in the press, all of which then resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately \$250 million in corporate assets, *indicate that the directors' decision to not act was not made in good faith* and was contrary to the best interests of the company.

⁶⁴ 325 F.3d 795 (2001).

^{65 825} A.2d 275 (Del. Ch. May 2003) (hereinafter *Disney*).

⁶⁶ 325 F.3d 795 (2001).

⁶⁷ *Id.*, at 799-801. Evidence of board awareness of the regulatory non-compliance taken together with the failure to act was construed by the court to establish a lack of good faith:

Id., at 809 (citation omitted) (emphasis added).

⁶⁸ In re Caremark Int'l, 698 A.2d 959 (Del. Ch., 1996).

⁶⁹ It is often forgotten that Chancellor Allen said everything he needed to say to uphold the settlement, which was the actual holding of the opinion, at the outset, stating that "there is a very low probability... that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise." *Id.*, at 961. The rest of the opinion is technically dicta, including the much cited discussion of good faith, in which Allen stated:

a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.

Id., at 970

⁷⁰ Under §102(b)(7), there are four enumerated exclusions to the ability of a corporation to eliminate or limit director liability, including (i) breach of the duty of loyalty, (ii) acts or omissions not in good faith or involving intentional misconduct or knowing violations of law, (iii) unlawful payment of dividends; or (iv) self-interested transactions. See DGCL §102(b)(7).

corporation would be paid immediately back to the directors as a result of the corporation's indemnification obligations. Recognizing the futility of this cyclical wealth transfer—to allow such claims proceed would impose defense costs on the corporation without any benefit to shareholders—Delaware courts grant immediate dismissal of shareholder claims raising only duty of care issues against corporations with 102(b)(7) provisions. As though the business judgment rule were not obstacle enough, the dynamics of 102(b)(7) provisions present another hurdle to duty of care claims and thus give shareholder plaintiffs another reason to draft pleadings under the duty of loyalty.

Unfortunately for the shareholder plaintiffs in *Abbott*, there was no apparent basis to allege a breach of the duty of loyalty. Eleven of the thirteen members of the Abbott board were independent of management, ⁷³ and no facts suggested conflict or domination and control. ⁷⁴ The plaintiff could only frame their claim under the duty of care as conduct involving "gross negligence." As a result, the defendants moved for dismissal on the basis of the firm's 102(b)(7) provision. ⁷⁶

Rather than grant the defendants' motion to dismiss, however, the Seventh Circuit in *Abbott* interpreted the complaint to draw into question the good faith of the board and allowed the plaintiffs to survive dismissal on that basis. The court's opinion offers very little analysis of the meaning of good faith. Instead, the court focuses on the board's persistent failure to comply with regulators over a course of three years and the costs of its inaction, an analysis which is difficult to distinguish from the kinds of questions raised under the duty of care or, in extreme cases, the doctrine of waste. The *Abbott* court's analysis of good faith is thus less important than its reasons for performing it. When corporation has a 102(b)(7) provision, courts must overlook bad corporate governance not under the duty of loyalty, unless the court can construe the conduct to implicate the board's good faith.

2. Disney

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⁷¹ See, e.g., Emerald Partners v. Berlin, 787 A.2d 85, 91-92 (Del. 2001) (further specifying that the corporation's rights under the 102(b)(7) provision is "in the nature of an affirmative defense").

⁷² See supra XX.

⁷³ *Abbott*, 325 F.3d 795, 801.

⁷⁴ *Id.*, at 807.

⁷⁵ *Id.*, at 802.

⁷⁶ See supra XX. Defendants argument to this effect is at 325 F3d 810.

⁷⁷ *Abbott*, 325 F.3d 795, 807-810.

⁷⁸ Id., at 802-809. (ultimately concluding that the facts supported an inference of "a sustained and systematic failure of the board to exercise oversight").

⁷⁶ The analysis in *Abbott* essentially repeats the analysis in *Caremark*. The analysis and holding in *Caremark*, however, were under the duty of care. *See supra* note 69. As discussed in the text, because of the 102(b)(7) provision, the duty of care was not a possible basis for decision in *Abbott*. In following the *Caremark* analysis but claiming to reach its decision under the duty of good faith, the *Abbott* court merely performed duty of care analysis under a different name.

performed duty of care analysis under a different name.

See Grimes v. Donald, 673 A.2d 1207, 1215 (Del. 1996) (stating that the business judgment rule will apply to compensation decisions made by an independent board "unless the facts show that such amounts, compared with the services to be received in exchange, constitute waste or could not otherwise be the product of a valid exercise of business judgment") (citation omitted).

Disney arose with precisely the same procedural posture as *Abbott*. By the end of the litigation, the shareholders seemed to have nothing left but a duty of care claim, yet the board of directors was protected by a 102(b)(7) provision.⁸¹ However, as in *Abbott*, the court invoked good faith to rescue the shareholders' claim from dismissal, holding that the plaintiffs had pleaded "particularized facts sufficient to raise ... a reason to doubt that the action was taken honestly and in good faith." Unlike *Abbott*, however, the

Disney opinion provides several clues to the meaning of good faith.

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

Not surprisingly, this rather lavish compensation package became the subject of a shareholder derivative suit against the Disney board, which wended its way through the Delaware courts for years. After an initial dismissal by the Court of Chancery in 1998, ⁸⁷ the case reached the Delaware Supreme Court in 2000 in *Brehm v. Eisner*. ⁸⁸ Although *Brehm* overturned the lower court's dismissal of the complaint, ⁸⁹ the opinion was, if not

⁸¹ Disney, 825 A.2d 275, at 286 (Del. Ch. May 2003).

 $^{^{82}}$ Id.

⁸³ *Id.*, at 287.

⁸⁴ Arguably, the most glaring error in the negotiation of the contracts was that the employment agreement created incentives for Ovitz to seek a no-fault termination rather than a long term relationship with the company. The Chancery Court summarized the situation as follows:

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

Disney, 825 A.2d 275, at 283.

⁸⁵ *Id.*, at 282-285.

⁸⁶ The measure is approximate due to the problem of valuing the equity and the options. \$140 million is the plaintiff's measurement of the total cost and may be high. *See* Disney, at 289 n.32 (declining to decide the question of value).

⁸⁷ In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 1998 Del. Ch. LEXIS 186 (Del. Ch., 1998).

^{88 746} A.2d 244 (Del. 2000).

⁸⁹ *Brehm*, at 248 ("in the interests of justice, we reverse only to the extent of providing that one aspect of the dismissal shall be without prejudice, and we remand to the Court of Chancery to provide plaintiffs a reasonable opportunity to file a further amended complaint consistent with this opinion").

downright hostile to the plaintiffs' claim, 90 at least highly sympathetic to the lower court's impulse to dismiss. 91 Although fully cognizant of the rather dramatic loss to the corporation and its shareholders resulting from the Ovitz debacle, 92 Chief Justice Veasey nevertheless used the occasion to reaffirm the limited space for judicial intervention in corporate governance. Writing for the Court, he emphasized that:

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the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability. ⁹³

Further emphasizing board authority over judicial accountability, the Chief Justice rejected the plaintiffs' assertion that the board's decision-making had violated a principle of *substantive* due care by plainly stating that no such principle exists. ⁹⁴ In refusing to recognize a principle of substantive due care, Veasey reaffirmed the traditional doctrinal paradigm that provided for weak scrutiny of the content (as opposed to the process) of board decisions under the duty of care but stronger scrutiny (to test for substantive fairness) under the duty of loyalty. He was not inclined to recognize a new conception of fiduciary duty that would tempt the court to attach liability to poor outcomes.

⁹⁰ The court disparaged the plaintiffs' complaint as a "pastiche of prolix invective" and "permeated with conclusory allegations." *Brehm*, at 249.

The opinion noted that "the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious... and ... the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory." Brehm, at 249.

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

Brehm, at 264. It is worth noting the appearance of "good faith" at the end of this quotation. Chief Justice Veasey's view, at least in *Brehm*, seems to have been that good faith is whatever is beyond the substantive standard of gross negligence, such as irrationality or waste. There is, however, some tension between this view and Veasey's strident rejection of the principle of substantive due care. It may simply be that Veasey is willing to concede that there may be some decisions that are so irrational that they lack the character of business decisions and therefore also lack good faith. Mrs. Pritchard aside, however, such decisions are exceedingly rare in corporate law. *See* Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

⁹¹ *Id.*, at 248.

⁹³ Brehm, at 256.

⁹⁴ Chief Justice Veasey stated:

Nevertheless, the court below had erred in construing the plaintiffs' complaint and, in spite of viewing the error as largely harmless, ⁹⁵ the Supreme Court granted plaintiffs the opportunity to replead. ⁹⁶ The plaintiffs took advantage of this opportunity and, having profited from additional discovery under a books and records action, ⁹⁷ found themselves in Chancery Court in early 2003, once again facing a motion to dismiss. ⁹⁸ In order to survive the motion, plaintiffs had either to draw the board's loyalty into question by showing that the directors were not disinterested and independent or show that "the challenged transaction was otherwise [not] the product of a valid exercise of business judgment."

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Having failed to muster any evidence casting doubt on the loyalty of the board—apart from Eisner, everyone on the Compensation Committee and the board as a whole was disinterested in the Ovitz hiring; 100 Eisner did not participate in the Compensation Committee's review of the Ovitz contracts; 101 and there was no evidence to support a claim that Eisner dominated or controlled either the board or the Compensation Committee 102—the plaintiffs could only argue that the hiring and firing of Ovitz was not a valid exercise of business judgment. They were left, in other words, with only a duty of care claim. To survive, they would have to rebut the substantive standard of "gross negligence," 103 which the Supreme Court had already more or less rejected. 104 Worse

Brehm at 262

⁹⁷ See DGCL §220 (providing stockholder rights to inspection of corporate books and records). The board minutes showed that the board "did not ask any questions about the details of Ovitz's salary, stock options, or possible termination. The Old Board also did not consider the consequences of a termination, or the various payout scenarios that existed." Disney, at 281. Instead, the Court emphasized, "[f]inal negotiation of the employment agreement was left to Eisner, Ovitz's close friend for over twenty years." Id. The board minutes also revealed that the board was never made aware of the redrafting of the critical non-fault termination provision between the initial and final drafts of the employment agreement. *Disney* at 282. And, in connection with ultimate severance of Ovitz from the company, the board minutes showed that "although the Board knew that Eisner was working to complete a non-fault termination, [it] was never told the terms and did not ask." Sale, at 123 (citation omitted).

⁹⁵ *Disney*, at 260-261 (holding that "the reading given by the Court of Chancery to this aspect of the amended complaint was too restrictive because the Court's reading fails to appreciate the breadth of the allegation" but noting that "[w]e regard the Court's language as harmless error").

⁹⁶ The Supreme Court elaborated the standards for an adequate pleading, noting that:

the complaint must allege particularized facts (not conclusions) that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter (in this case the cost calculation) that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud.

⁹⁸ note that this is a motion to dismiss for failure to make demand, which the plaintiffs must answer by showing that demand would be futile.

⁹⁹ Disney, at 285, quoting Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

 $^{^{100}}$ PIN

¹⁰¹ PIN

¹⁰² PIN

¹⁰³ See supra XX (discussing the substantive standard of the business judgment rule in the duty of care context).

still, Disney had adopted a 102(b)(7) provision entitling the defendant directors to immediate dismissal of claims raising only duty of care issues. 105

Chancellor Chandler rescued the plaintiffs from this predicament by reading the complaint to draw the good faith of the board into question, ¹⁰⁶ the effect of which was to bar application of both the business judgment rule and the corporation's 102(b)(7) charter provision. ¹⁰⁷ This aspect of the opinion, in which the Delaware Chancellor confirmed the *Abbott* court's reading of the effect of good faith, deserves some emphasis. Regardless of whether good faith is interpreted as a separate fiduciary duty or some aspect of either traditional duty, ¹⁰⁸ it plainly has a distinct doctrinal effect. If good faith were merely synonymous with the duty of loyalty, the *Disney* opinion would have been nothing more than a one page dismissal of the plaintiffs' claim since the duty of loyalty had not been raised. With no possible basis under either care or loyalty, ¹⁰⁹ the Chancery Court allowed the plaintiffs' claim to proceed under good faith alone. ¹¹⁰ *That* is significant, regardless of whether good faith is ultimately recognized as a separate fiduciary duty or compartmentalized as an aspect of the duty of loyalty.

Having allowed the plaintiffs' claim to survive on the basis of something called "good faith," the Chancellor had next to show what that something was. If good faith is to be in some way distinct from the traditional duties of care and loyalty, what exactly does it mean? How does one test for it? How will courts analyze the good faith of directors? Without giving a definitive answer to these questions, Chancellor Chandler performed an analysis of the good faith of the Disney board by alternating between issues traditionally raised in analyses under the duty of loyalty, on the one hand, and the duty of care, on the other.

In the portion of the opinion focusing on issues traditionally considered in a duty of loyalty analysis, the core concern is the relationship between Eisner and Ovitz. Beginning in the recitation of facts but continuing throughout the opinion, the Chancellor expresses skepticism at the role the friendship between the two men might have played in the corporation's decision-making.¹¹¹ The opinion emphasizes the friendship over and over again, repeating the word "friend" or "friendship" fifteen times, always in reference

¹⁰⁷ See DGCL §102(b)(7)(ii) (providing that indemnification provisions shall not eliminate or limit director liability for conduct "not in good faith"); *Aronson*, 473 A.2d 805, at 814 (stating that the business judgment rule will not apply to conduct in bad faith).

¹⁰⁴ See Brehm, at 267.

¹⁰⁵ See supra TAN and notes 70-72.

¹⁰⁶ *Disney*, at 286.

¹⁰⁸ See supra XX (noting the debate on this point).

¹⁰⁹ There was no basis under the duty of loyalty because it had not been raised on appeal and no basis under the duty of care because the court was prevented—by the business judgment rule and the 102(b)(7) provision—from reaching it.

¹¹⁰ See Disney, at 286 (stating that in order to proceed on a claim under good faith, "plaintiffs must plead

¹¹⁰ See Disney, at 286 (stating that in order to proceed on a claim under good faith, "plaintiffs must plead particularized facts sufficient to raise ... a reason to doubt that the action was taken honestly and in good faith").

¹¹¹ See, e.g., Disney, at 279 (noting, for the first time, that Ovitz had "been Eisner's close friend for over twenty-five years."). This fact is then emphasized several times in the opinion, which repeats the word "friend" or "friendship," always in reference to the Eisner-Ovitz relationship, fifteen times.

to the Eisner-Ovitz relationship and usually accompanied by remarks expressing thinly veiled displeasure if not outright criticism. For example, in describing the negotiation of the initial employment agreement, Chancellor Chandler notes that the board "passed off the details to Ovitz and his good friend, Eisner." Later, in connection with Ovitz's termination, the Chancellor again emphasized the personal relationship, noting "[Ovitz's] good friend came to the rescue, agreeing to Ovitz's request for a non-fault termination" and pointing out that "Eisner [handed] his personal friend, Ovitz, more than \$ 38 million in cash and the three million ... stock options."

It is well recognized that a close personal relationship between a fiduciary and a third party can raise doubts concerning the loyalty of the fiduciary to her intended beneficiary. However, the only member of the Disney board to stand in such a relationship to Ovitz was Eisner. Moreover, none of the usual indicia of "domination or control" that would allow one director's conflict to spread to others seem to have been present. These factors are never discussed in the opinion, which if anything suggests a healthy degree of skepticism on the part of the Compensation Committee, three of whose members raised objections to Eisner's recommendation that they hire Ovitz. Insofar as Chandler is doing duty of loyalty analysis, in other words, the analysis is highly incomplete. Without more, we can only conclude that the duty of loyalty analysis would have failed. We are never given more, however, because the board never follows the loyalty issues through to a conclusion. The Chancellor is not raising the Eisner Ovitz friendship to prove a breach of the duty of loyalty, but rather as a relevant component of the analysis of good faith.

In the portion of the opinion focusing on issues traditionally considered in a duty of care analysis, Chancellor Chandler subjects the board's process in approving the Ovitz contracts to withering criticism. Critiquing the approval of Ovitz's initial employment contract, the Chancellor emphasized that it had been approved without the entire board or

¹¹⁴ Id., at 289. The role of the Eisner-Ovitz friendship in the transaction is again described with disapproval when the court describes Ovitz as having gone "to his close friend, Eisner, and, working together, they developed a secret strategy that would enable Ovitz to extract the maximum benefit from his contract, all without board approval." Id., at 291.

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

¹¹² Disney, 287. The Court repeated its emphasis on this point, noting that "[n]egotiation over the remaining terms took place solely between Eisner, Ovitz, and attorneys representing Disney and Ovitz." *Id.*

¹¹³ Id., 288.

Non-monetary conflicts of interest are increasingly finding their way into corporate law fiduciary relationships as well. *See, e.g.*, In re Oracle Derivative Litigaiton, 824 A.2d 917 (Del. Ch. 2002), discussed at *supra* note 57.

¹¹⁶ See supra notes XX – XX.

See Disney, at 287.

¹¹⁸ See Disney at 287 n. 30, stating:

any committee having had any role in the signing or negotiations. Reciting a series of facts recalling Trans Union's two hour board meeting in *Van Gorkom*, the court stressed that the "[b]oard and the compensation committee ... each spent *less than an hour* reviewing Ovitz's possible hiring. Twice the court cites with approval the plaintiff's allegation that the board behaved "blindly" and once refers to the board as "ostrich-like." According to the court's reading of the factual allegations, the board "chose to remain invisible in the process... [and] (1) failed to ask why it had not been informed, (2) failed to inquire about the conditions and terms of the agreement; and (3) failed even to attempt to stop or delay the termination until more information could be collected...."

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As in *Van Gorkom*, such allegations would typically form the basis of a complaint under the duty of care. The Chancery Court's analysis, however, does not ask whether the board behaved in a "negligent *or grossly negligent* manner" thus failing to satisfy the duty of care. As in its treatment of the duty of loyalty concerns, the court failed to follow the traditional lines of analysis through to a conclusion, perhaps because the business judgment rule and the 102(b)(7) provision would have kept it from getting very far under the duty of care. Instead, rather than focusing on the weaknesses of the board's process as indications of gross negligence or lack of care, the court took these facts to indicate a breach of the board's duty of good faith.

¹¹⁹ Disney at 288 (describing the process and stating that "the board apparently took no action; no questions were asked").

¹²⁰ See Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (holding a board liable under the duty of care in connection with the approval of a merger).

Disney, at 299 (emphasis added). The court further emphasized that "neither the Old Board nor the compensation committee reviewed the actual draft employment agreement. Nor did they evaluate the details of Ovitz's salary or his severance provisions. No expert presented the board with details of the agreement, outlined the pros and cons of either the salary or non-fault termination provisions, or analyzed comparable industry standards for such agreements. Notwithstanding this alleged information vacuum, the Old Board and the compensation committee approved Ovitz's hiring, appointed Eisner to negotiate with Ovitz directly in drafting the unresolved terms of his employment, never asked to review the final terms, and were never voluntarily provided those terms." *Id.* (footnote omitted). Again, these concerns echo the Supreme Court's concerns eighteen years earlier in Van Gorkom, where the Trans Union merger was approved without a draft merger agreement or a written summary and without an expert fairness opinion. *See* Van Gorkom, 488 A.2d 858.

¹²² Disney at 277, 289.

¹²³ Id., at 288.

¹²⁴ Id., at 289.

¹²⁵ Id., at 289, emphasis added.

¹²⁶ See supra note XX. Chandler's awareness of this dynamic is evident in his statement in *Disney*, at 290 ("Where a director consciously ignores his or her duties to the corporation ... the directors actions are either 'not in good faith' or 'involve intentional misconduct.' Thus, plaintiff's allegations support claims that fall outside the liability waiver provided under Disney's certificate of incorporation.") (footnote omitted).

¹²⁷ Id. The court stated:

the facts alleged... suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct... that may not have been taken honestly and in good faith to advance the interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant

The Chancery Court in *Disney* ultimately denied defendants' motion to dismiss on the basis of good faith. What then does good faith really mean? We still cannot say, but Chancellor Chandler's analysis of good faith can be summarized (somewhat glibly) as follows. First, recite facts that draw both the duty of care and the duty of loyalty into question. But, rather than pursuing either traditional analysis through to a conclusion, alternate between the two and, in so doing, blend the issues together. Having thus formed a composite picture of the board's conduct, state that the analysis raises doubts concerning the good faith of the defendant directors. It is also worth noting, in *Disney* at least, that neither care nor loyalty alone would have allowed the plaintiffs to survive the motion to dismiss. Good faith analysis, however, did.

3. Reader's Digest

Lest *Disney* appear to be *sui generis*, it is worth pointing out that very similar analytic techniques appear just beneath the surface of the Supreme Court's decision in *Levco Alternative Fund v. Reader's Digest Association*, ¹²⁹ in which the court performed a good faith analysis without naming it as such.

In the events leading up to the opinion, the Reader's Digest Association ("RDA") proposed a recapitalization to its shareholders. The effect of the proposed recapitalization would have been to eliminate RDA's dual capital structure—two classes of shares, one with voting rights and the other without, but otherwise identical—in favor of a single class of common stock with one vote per share. However, the proposed recapitalization created a conflict of interest problem, since a control group stood to gain \$100 million cash in a buyback of shares unavailable to any other RDA shareholders. The control group buyback would thus result in a \$100 million decrease in the equity interests of the non-voting shareholders.

directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.

¹²⁸ Disney, at 291 (further noting that "[t]he practical effect of this ruling is that defendants must answer the new complaint and plaintiffs may proceed to take appropriate discovery on the merits of their claims."). ¹²⁹ 803 A.2d 428 (Del. 2002).

 $^{^{130}}$ *Id.* at *2. The recapitalization also would have added anti-takeover provisions. *See supra* TAN and notes XX – YY (addressing this).

¹³¹ The control group consisted of two large funds that together owned fifty percent of RDA's voting shares: the DeWitt Wallace Reader's Digest Fund and the Lila Wallace Reader's Digest Fund. In connection with the recapitalization, RDA would purchase 3,636,363 shares held by the funds. As a result of the repurchase and recapitalization, the funds would go from holding 50% of RDA voting rights to 14%. 403 A 2d 428

¹³² *Id.* The Court explicitly emphasized the already-tenuous financial condition of the corporation in connection with the additional debt burden required to buy shares back from the controlling group. See id at *6 (noting the company's "tenuous financial condition, having recently committed to a large acquisition, incurring additional debt in order to pay \$100 million to its class B shareholders").

In a somewhat cryptic order enjoining the proposed recapitalization, ¹³³ the Supreme Court emphasized two elements of the transaction. First, in treating the share buyback as the "key to the recapitalization," ¹³⁴ the court focused on the conflict inherent in taking an action to benefit a control group to the exclusion of, and at the expense of, other shareholders. ¹³⁵ Second, the court criticized the process undertaken by the board and its committees in approving the transaction, admonishing the board for failing to engage a financial advisor to provide a fairness opinion specifically addressing the interests of the non-voting shareholders. ¹³⁶

As would later appear in *Disney*, the Supreme Court's analysis of these issues fluctuated between considerations traditionally raised under duty of loyalty (the interest of the controlling shareholders in the buyback) and duty of care analyses (the information asked for and obtained by the committee). Having opened both cans of worms, the court ultimately followed neither analysis through to a conclusion. The court never fully addressed the influence of the controlling shareholders' interest on the committee, nor did it analyze whether the board's process fell short of the standard of care. Instead, it blended both sets of issues in enjoining the proposed recapitalization. This is similar to the good faith reasoning that later emerged in the Chancery Court's *Disney* opinion. Moreover, when the *Reader's Digest* court addressed the board committee's claim that it acted in the best interests of the corporation, ¹³⁸ it did so with evident skepticism, noting that the committee's belief was "*perhaps* in good faith."

Is this "perhaps" meant to imply skepticism of the board's good faith? There is, at any rate, ample reason to be skeptical. It addition to the \$100 million give-away to the control group, the recapitalization adds anti-takeover provisions in a manner reminiscent

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¹³³ The Reader's Digest opinion is unclear, among other things, on the standard of review applied by the court. Plaintiffs challenged both the fairness of the transaction and the process of the board committee in agreeing to it. Reversing the Chancery Court on the question whether the entire fairness standard was appropriate, the Supreme Court acknowledged that the burden of showing fairness, although it rested initially with the defendants, would shift if the committee was genuinely independent. In reviewing the committee's actions, however, the Court found them to be "flawed both from the standpoint of process and price." Id., at *5. The Court then employed the analysis described in the text, mixing duty of loyalty issues with duty of care issues to review the conduct of the committee.

¹³⁵ The crux of the Court's reasoning with respect to process was that the committee failed to consider the "specific impact" of the reorganization on *each* of the former classes of shareholders, focusing instead on the effect of the transaction on RDA as a whole. *See* 403 A2d 428 (stating that although the committee "believed it was operating in the interests of the corporation as an entity, … the committee's functioning, to the extent it was required to balance the conflicting interests of two distinct classes of shareholders was flawed").

¹³⁶ Id. at *6-7 ("To the extent that the directors did not secure sufficient information concerning the effect of the recapitalization premium on the Class A shareholders, a serious question is raised concerning the discharge of their duty of care.").

¹³⁷ Id., at *7 (stating that "where, as here, the need for protection outweighs possible detriment to the defendants if the transaction does not proceed immediately the injunction should issue").

¹³⁸ See RDA. at *6.

¹³⁹ *Id*.

of what Professor Gordon has referred to as "opportunistic amendment." Like a legislator adding pork to an appropriations bill, a board engages in opportunistic amendment when it packages charter terms that harm shareholder welfare along with terms that have positive or ambiguous welfare effects. In *Reader's Digest*, the proposed recapitalization packaged a staggered board and the elimination of shareholder ability to act by written consent, well-recognized anti-takeover provisions, with increased voting power. An awareness of the potential for opportunism beneath the surface of such a charter amendment may have caused the Supreme Court in fact to doubt the good faith of the RDA board.

Notwithstanding the possibility of such unvoiced concerns and regardless, ultimately, of what the Supreme Court meant to say in its *Reader's Digest* order, the fact remains that the court plainly performed the kind of analysis that would soon appear in *Disney* under the rubric of good faith. It raised the same questions of loyalty and care and addressed them in the same way—that is, by oscillating between each traditional analysis without resolving either one. Whether the court named its analysis "good faith" or not is unimportant. *Reader's Digest* can thus be read as a decision that rests, either explicitly or implicitly, on the fiduciary duty of good faith.

Nevertheless, even after all of the discussion in all of these cases, we still have not been told what good faith means.

B. Good Faith as a Substantive Principle

In spite of ample evidence of an emerging jurisprudence of good faith in recent case law, the actual content of that jurisprudence—the set of principles under which it operates—remains tantalizingly unclear. If good faith is to form the basis for greater judicial review of corporate governance, we must understand what it means in order to predict in which situations it will arise. When will it apply? How will courts use the principle of good faith to intervene in corporate governance?

Informally, one might understand good faith as simply doing the job right, performing one's obligations adequately. This seems to be the meaning of good faith as a background principle of relational contracting—when I make a long term promise that I know does not specify every contingency, it is understood that I will act in good faith to

¹⁴⁰ See Gordon, supra note 51, at 1578-81 (discussing strategic use of "sweeteners," "add-ons," and "chicken" tactics).

¹⁴¹ See WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1767 (unabridged ed. 1966) (defining "pork barrel" as "a government project or appropriation yielding rich patronage benefits" and "pork" as "money grants, public works, or government jobs used by politicians as patronage with more regard to political advantage than to the public good").

 ¹⁴² See Gordon, supra note 51, at 1578 (noting that "insiders can bundle a wealth-reducing amendment with ... an unrelated proposal that increases shareholder wealth").
 143 See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, The Powerful Antitakeover Force

of Staggered Boards: Theory, Evidence, and Policy, 54 STAN. L. REV. 887 (2002) (discussing the antitakeover effect of staggered boards and the inability of shareholders to act by written consent)

144 See RDA, at *2 (describing the terms of the recapitalization plan).

resolve unforeseen contingencies according to the spirit of the initial promise—that is, the promise to perform fully and adequately—rather than insisting on the letter of the formal contract. 145 Good faith as a standard of conduct in the corporate context may thus mean that directors will exercise their oversight role in accordance with shareholders' best interests. 146

As a standard of review, however, defining good faith as doing the job right is question begging and inconsistent with the business judgment rule. ¹⁴⁷ First, it leaves open the issue of when a job is done "right" or an oversight role is "adequately fulfilled." Second, it involves courts in answering that question. These answers have traditionally turned on the director's duty of care and have been protected by the business judgment rule. 149 If good faith is to mean something distinct from the duty of care and an attempt to delineate the limits of due care—and it must if Justice Veasey's rejection of the principle of substantive due care in *Brehm* is to be upheld—then it must involve more than the outward bounds of care or doing what is right. Distinguishing good faith from substantive due care thus requires an additional element apart from an outcome that looks bad from an ex post point of view.

A plausible suggestion for the additional element is some kind of mental state. Directors would thus breach their good faith duties when they made an unfortunate decision with a particular intent, perhaps deliberate indifference or recklessness. Articulating this theory of good faith, Professor Sale has stated that:

¹⁴⁵ See, e.g., Uniform Commercial Code § 1-102(3) (2001). See also STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT (1995); Claire Moore Dickerson, From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm, 22 FLA. ST. U. L. REV. 955 (1995) (describing good faith in various areas of law); Victor P. Goldberg, Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith, 35 U.C. DAVIS L. REV. 319 (2002) (tracing judicial development of good faith in commercial contracts). ¹⁴⁶ See, e.g., Gagliardi v. TriFoods Int'l, Inc., 1996 Del. Ch. LEXIS 87, at *11 n.2 (Del. Ch. July 19, 1996)

^{(&}quot;By 'bad faith' is meant a transaction that is authorized for some purpose other than a genuine attempt to advance corporate welfare....").

in text or footnote develop parallel to eisenberg's distinction of standard of conduct, standard of review. ¹⁴⁸ It is may be difficult to define good faith in a way that is not question-begging. Professor Sale summarizes a set of cases as follows:

Fiduciaries acting in good faith abide by the norms of corporate governance and comply with legal standards while performing their jobs. Egregious or conspicuous failures to do so are subject to liability under the duty of good faith.

Hillary A. Sale, Delaware's Good Faith, 89 CORNELL L. REV. 456, 485 (2004). However, if good faith is to be treated as a separate legal standard, then defining good faith by reference to existing legal standards is circular. Moreover, the norms of corporate governance, in Delaware at least, reaffirm the authority of directors to govern the corporation at their discretion, thus emptying these norms of useful content to import into a definition of good faith. Professor Sale is, of course, aware of the circularity and questionbegging aspects of good faith. As discussed at infra XX-XX, she seeks to answer these questions on the basis of scienter, arguing that directors fail to fulfill their duties in good faith "when they abdicate, subvert, or ignore these responsibilities, or act with deliberate indifference toward them." Id., at 486.

¹⁴⁹ Cognizant of the clash between the business judgment rule and extensive review of the board's oversight duties, Chancellor Allen further noted in Caremark that "[s]uch a test of liability - lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight – is quite high." 698 A.2d, at 971.

¹⁵⁰ See supra note 94.

Good faith based liability... moves the bar from negligent behavior to deliberately indifferent, egregious, subversive, or knowing behavior, and thereby raises issues related to the motives of the actors. ... Two of the cases ... that discuss good faith indicate that a breach of the duty requires motive-based allegations of severely reckless or seemingly intentional behavior. Situations involving deliberate indifference or abdication would also cross the line. ¹⁵¹

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In order to define the requisite mental state of recklessness or deliberate indifference, Sale argues that the courts should follow the lead of the securities laws and, in particular, the development of scienter in litigation under rule 10b-5. She then offers several situations that illustrate a state of mind, whether intentional disregard or extreme recklessness, that would enable a court to find good faith liability without focusing on the outcome of the decision alone. This focus would carve a space for good faith outside of the traditional fiduciary categories of care and loyalty.

Although treating good faith as the outgrowth of a core principle of scienter accords with the language of several cases developing good faith, ¹⁵⁶ it overlooks the

Under such a standard, known or obvious infractions of corporate rules or governance standards, or failures to create such standards, would be actionable. Fiduciaries who fail to perform assigned tasks and to set up mechanisms to ensure that they are aware of such tasks would also be actionable. And, of course, good faith reliance on the reports or information of others would still defeat such claims.

Although a breach of good faith need not be intentional or conscious, it does require some sort of obvious, deliberate, or egregious failure. ...[M]otive is relevant, but not required. Intentional misstatements or omissions are actionable and intentional breaches of fiduciary duties should be as well. But, as the Disney cases make clear, allegations of unintentional but flagrantly reckless actions or inactions are also problematic and, if proved, are breaches of good faith responsibilities.

¹⁵¹ See Sale, 89 Cornell L. Rev. 456, 488-89 (footnotes and citations, to Scattered 701 A.2d 70 and Caremark, 696 A.2d 959, omitted).

¹⁵² See id., at 889-94. Elaborating the use of scienter, Professor Sale states:

Id., at 490

¹³³ These include situations in which the directors (1) "benefited in a concrete and personal way from the purported fraud," (2) "engaged in deliberately illegal behavior," (3) "knew facts or had access to information" that indicated the information they relied upon was inaccurate," or (4) failed "to check on information they had a duty to monitor." Sale, at 491-93 (quoting Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000)).

¹⁵⁴ In Professor Sale's words:

Id., at 493-94.

¹⁵⁵ In Professor Sale's view, defining good faith as a separate and distinct standard of care is important because the traditional categories of care and loyalty have hardened into status-based analyses that fail to spur boards to innovate optimal corporate governance.

The value of a separate good faith duty... is in its potential for addressing those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts. And, of course, its real value is not simply in the compensation it can provide to, for example, Disney shareholders, but in the ex ante role it can play in changing the behavior and incentives of corporate fiduciaries and, thereby changing corporate governance.

Id., at 494.

¹⁵⁶ In *Disney*, Chancellor Chandler repeatedly uses the language of scienter, including his statement that:

pattern of analysis the good faith jurisprudence. It credits what courts *say*, in other words, without paying adequate attention to what they *do*. As noted above, what courts have been doing in the good faith cases is raising issues under each of the traditional fiduciary duties, mixing the issues together, then concluding that the board's conduct has thrown good faith into doubt. This pattern is not reducible to scienter or any other substantive principle. Moreover, the resolute fact-specificity of Delaware jurisprudence continually frustrates attempts to crystallize fiduciary standards into solid rules. And it would be ironic indeed if in the same year that Delaware eschewed doctrinal stability in its change-of-control paradigm, it adopted a standard of good faith based on a rigid core of scienter.

But if good faith cannot be condensed into any neatly articulable principle or reasonably lucid core concept, what is it? It must, after all, mean *something* given the importance it has assumed in recent corporate law jurisprudence, having become the explicit basis of several decisions and, perhaps, the implicit basis of others. What does good faith mean? Can it be understood in a way that is not reductive? Can it be given meaning in a way that does not narrow it to a substantive principle with a rigid doctrinal core?

C. Good Faith as a Principle of Interpretation

Good faith, in my view, is not now and is not likely ever to become a solid doctrine of sub-rules and multi-part tests. It is more subtle and elusive. It has, at its center, the core concern of all corporate law jurisprudence—the question whether directors are really doing their best in acting for the corporation—but in seeking an answer, it blends questions generally thought to arise under the duty of care with those arising under the duty of loyalty and is confined to the analytics of neither of the traditional duties. Good faith is, instead, a loose principle of interpretation that courts can

the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company

Disney, at 289. See also Emerging, 2004 Del. Ch. LEXIS 70, at *142-43 (May 3, 2004) (citing Professor Sale's article with approval and criticizing directors for "consciously disregarding" shareholder interests when they "knew, or at the very least had strong reasons to believe," that a transaction was unfair).

157 See generally Lawrence A. Cunningham & Charles M. Yablon, Delaware Fiduciary Duty Law After QVC And Technicolor: A Unified Standard (and the End of Revlon Duties?), 49 BUS. LAW. 1593 (1994) (attempting, heroically, to organize fragmented doctrine into a single coherent standard). At the end of their analysis, the authors accurately predicted what would come of their prediction:

Predicting the course of Delaware law from prior case law is like watching clouds. They seem, at times, to take on recognizable shapes and forms, even to resemble something familiar. But you know that whatever shapes you think you see can vanish in a puff of wind.

Id., at 1626.

¹⁵⁸ See Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (2003). For a full discussion of the *Omnicare* opinion and its treatment of prior doctrine, see Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare*, 29 J. CORP. L. 569 (2004).

wield to find liability or enjoin actions that do not quite fit within other doctrinal categories.

As principle of interpretation, good faith is highly flexible and fact-specific. Outcomes depend not only upon the facts of the case itself, which may raise various issues typically considered under the duty of loyalty or care, but are also guided by the world outside the courtroom. This broader interpretive context—the general corporate environment and the relative power of various discourses concerning the alternative systems of corporate governance—has a significant influence on the use of good faith as an interpretive device. As an interpretive tool designed to respond to a particular interpretive context, the development of good faith jurisprudence from *Disney* and similar cases echoes the development of takeover jurisprudence from *Unocal*. Each emerged in a unique interpretive moment, which as I argue below, permitted courts to inject additional constraints on board authority for as long as needed and no longer. This flexibility and contextual contingency of good faith thus prevents it from becoming a foothold in a lasting judicial assault on board authority. A new substantive standard would have resulted in a permanent reconfiguration of the business judgment rule. A loose principle of interpretation, by contrast, may result in only temporary judicial incursions into the space of board authority.

I develop my account of good faith as a principle of interpretation in the next Part. In it, I emphasize the pattern of analysis in the good faith cases over the language of the courts in those cases. Following this pattern, I elaborate the interpretive mechanism underlying several of the recent good faith decisions. What the cases have in common, I argue, is oscillation between elements of the duty of care and the duty of loyalty. This pattern of oscillation I refer to as "Thaumatrope analytics." I then connect Thaumatrope analytics to existing theories of adjudication in arguing that an underlying relationship between traditionally opposed doctrinal categories—in this case care and loyalty—provides a principled basis for the oscillation in the analysis. I then describe the contextual contingency of good faith jurisprudence and argue that such analytics are not likely to become pervasive but rather to be applied on an as-needed basis, when shifts in interpretive context—as occurred in the recent environment of corporate scandal—raises the rhetorical costs of applying traditional doctrine.

IV. Thaumatrope Analytics

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

In the *Disney* opinion, for example, Chancellor Chandler analyzed the board's good faith by emphasizing elements both of loyalty and care. Loyalty issues were implicated by the personal friendship between Eisner and Ovitz, a fact that the Chancellor

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¹⁵⁹ See infra XX.

repeated many times over. ¹⁶⁰ Nevertheless, this aspect of duty of loyalty analysis, essentially involving a conflict between a director's personal and professional motives, was never fully pursued. ¹⁶¹ Instead, the court mentioned the conflict, then proceeded to another aspect of the case, mentioned it again, then moved on again, over and over, several times throughout the opinion. ¹⁶² Having thus repeatedly raised duty of loyalty concerns without pursuing them, the Chancellor switched tracks and focused attention on weaknesses in the board's decision-makig processes, issues that would ordinarily raise concerns under the duty of care. ¹⁶³ It is in this context that we are told that the board as a whole had a relatively small role in the negotiations, ¹⁶⁴ that the meetings were too short, ¹⁶⁵ and that the board did not ask enough questions. ¹⁶⁶ Once again, the court does not pursue these concerns to an ultimate conclusion, but rather recites them and moves on. The point, we are given to understand by the end of the opinion, is that taken together, these concerns implicate the board's duty of good faith. ¹⁶⁷

Similarly, in *Reader's Digest*, the Supreme Court oscillated between an emphasis on the conflict of interest inherent in the buyback of the control group's shares and the process failures of the board structures approving the buyback and recapitalization. The question of conflict of interest, of course, ordinarily belongs to loyalty analyses, while issues of board process are analyzed under the duty of care. In *Reader's Digest*, the court again blended these issues, again without settling either one. By the time it added that the board acted "*perhaps* in good faith," the court had elicited skepticism on precisely that point by raising doubts regarding the board's conduct under both the duty of loyalty and the duty of care.

These analyses of good faith are based on the oscillation between two pre-existing doctrinal standards, care and loyalty. Neither traditional standard would have enabled the plaintiffs to prevail, but when spun together, the elements of each analysis make the board appear to have done something sufficiently blameworthy to rule in the plaintiffs' favor. Such tactics have a rich rhetorical history, recalling the optical illusion produced by the Thaumatrope. As described by Leon Lipson:

A Thaumatrope is a device in which two objects are painted on opposite sides of a card, for example, a man and a horse or a bird and a cage, and the card is fitted into a frame with a handle. When the handle is rotated

¹⁶³ See supra TAN and notes [119-127].

¹⁶⁸ See supra TAN and notes XX-YY.

¹⁶⁰ See supra TAN and notes [111-118].

¹⁶¹ See supra TAN and notes [XX-XX].

¹⁶² PINS.

¹⁶⁴ Disney, at 288.

¹⁶⁵ Id., at 299.

¹⁶⁶ Id., at 288-289.

¹⁶⁷ Id., at 290.

¹⁶⁹ 803 A.2d 428, at *6 (Del. 2002).

¹⁷⁰ Lipson borrowed the metaphor from the philosophical work of Richard Whately. See Leon S. Lipson, The Alleghney College Case, 23 Yale L. Rep. 8, 11 (1977).

rapidly, the onlooker sees the two objects combined into a single picture the man on the horse's back or the bird in the cage. 171

Following Lipson, ¹⁷² the analogy of a Thaumatrope is most often used by commentators to describe, often critique, the opinions of Judge Cardozo. Here I wish to argue that the emerging jurisprudence of good faith operates as a Thaumatrope, but I do not wish to import the implicit critique.

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

The emerging jurisprudence of good faith is not creating a new substantive standard. It is importing an interpretive principle. The interpretive principle underlying the jurisprudence of good faith is, to name it, an application of Thaumatrope analytics in corporate law.

A. **Principled Oscillation**

The suggestion that good faith operates as a principle of interpretation oscillating between two substantive doctrinal principles, neither of which alone would result in liability opens the court to a charge of unprincipled decision-making. Take a losing claim under both loyalty and care, the objection goes, mix the rhetoric of both principles and suddenly you've got a winning claim?

Thaumatrope analytics, however, only appear unprincipled if the two doctrinal categories between which the analysis oscillates are viewed as rigidly formalistic and hermetically sealed. But care and loyalty, in fact, are not mutually exclusive. They can

¹⁷¹ Id.

¹⁷² Lipson used the Thaumatrope to criticize the legal reasoning in the *Allegheny College* opinion, in which Judge Cardozo oscillated between the principles of contract and the principles of promissory estoppel to provide relief for the college:

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

Leon Lipson, The Allegheny College Case, 23 Yale L. Rep., at 11.

¹⁷³ See, e.g., William Powers, Jr., Thaumatrope, 77 TEX. L. REV. 1319 (1999) (review of CARDOZO by Andrew L. Kaufman); Dan Simon, The Double-Consciousness of Judging: The Problematic Legacy of Cardozo, 79 OR. L. REV. 1033 (2000); Mike Townsend, Cardozo's Allegheny College Opinion: A Case Study In Law As An Art, 33 Hous. L. Rev. 1103 (1996);

instead be described as what Professor Balkin has referred to as "nested oppositions" that is, opposed concepts that also have "a relation of dependence, similarity, or containment."174

An analysis of nested oppositions allows ossified categories to be deconstructed and reconstructed in a way that emphasizes similarities as well as differences. 175 Doctrinal categorizations and other decision-making heuristics 176 tend to be built on conceptual oppositions. Conceptual oppositions are established by opposing two terms in a particular context. The context of the opposition is crucial since the concepts are not logically related—and therefore not contradictory—except in a specific context. 177 Balkin illustrates the importance of context with the colors red and green:

If we say that red and green are opposite colors in a traffic light, we are not saying that they logically contradict each other. Rather, they are opposed with respect to the meanings these colors are given in traffic signals. The context of conventions concerning traffic signals makes them opposites. In another context, they may be seen as similar to each other. For example, red and green are both colors of the natural spectrum, or colors associated with Christmas, while lavender and brown are not. Thus red and green are seen as different in some contexts, and are seen as having similar properties in others. 178

A nested opposition is a conceptual opposition each of whose terms contains the other, whether through similarity to the opposite, overlap, being a special case of the opposite, or a relation of historical dependence or transformation.¹⁷⁹ Deconstructive analysis seeks to reinterpret conceptual oppositions as nested oppositions, thus revealing "similarities where before we saw only differences, or historical or conceptual dependence where before we saw only differentiation."180

Nested oppositions appear throughout legal doctrine. Balkin gives the example of negligence and strict liability which appear as alternate liability rules, growing out of opposed principles—fault and compensation. 181 Balkin, however, shows that many of the sub-rules and standards of each rule implicate questions ordinarily raised under its opposite. 182 Similarly, in constitutional law, Professor Nice has found a "third strand" of

¹⁷⁴ J.M. Balkin, Nested Oppositions, 99 Yale L. J. 1669, 1671 (1990).

¹⁷⁵ See, e.g., J.M. Balkin, Deconstructive Practice and Legal Theory, 96 YALE L. J. 743 (1987) (describing applications of deconstructive techniques to legal reasoning). ¹⁷⁶ See, for example, Professor Paul's discussion of the "two-fer", infra.

¹⁷⁷ Balkin, Nested Oppositions, supra note 174, at 1674-75. The distinction between logical contradiction and conceptual opposition, the latter of which depends upon context while the former does not, is occasionally overlooked. See, e.g., T. SEUNG, STRUCTURALISM AND HERMENEUTICS 12-17 (1982) (providing examples from philosophy).

Balkin, Nested Oppositions, supra note 174, at 1674.

¹⁷⁹ Id., at 1676.

¹⁸⁰ Id.

¹⁸¹ Id., at 1683.

¹⁸² Id., at 1683-84. For example, Balkin points out that negligence doctrine includes bright line rules which determine liability without regard to fault while strict liability doctrine returns to fault issues in analyzing

equal protection jurisprudence that applies the logic of Thaumatrope analytics on the bases of nested oppositions, or what she refers to as "co-constitutive categories." ¹⁸³ Her survey of recent Supreme Court interpretations of the fourteenth amendment finds numerous examples where the court goes beyond the formalistic doctrinal categories of fundamental rights versus suspect classifications by focusing on the relationship between the rights and the class. ¹⁸⁴ According to Nice, the co-constitutive relationship between fundamental rights and suspect classes explains the Supreme Court's oscillation between the two traditional categories and the resulting creation of a third analytic category between them:

The third strand of equal protection analysis recognizes that rights and classes are mutually constitutive in that rights are partially marked, defined, and constructed by the classes who do and do not hold them, just as rights partially mark, define and construct those classes. ... The third strand recognizes the interdependence, rather than separation and isolation, of rights and the classes of right-holders and non-right-holders.¹⁸⁵

Nice develops this analysis of equal protection jurisprudence by integrating the two traditional lines of analysis and inquiring into the ways in which each category contains elements that "marks, defines, and constructs the meaning" of the other. 186

If terminology such as "nested oppositions" and "co-constitutive categories" seems to obfuscate rather than clarify the basic principle of similarity underlying Thaumatrope analytics, the rhetorical technique can be explained more simply. Using the modest terminology of a "Two-Fer," my colleague Professor Paul has argued that such

Nice, Antinomies, at 1415-16.

causation along the lines of foreseeability. *See also* J.M. Balkin, *The Crystalline Structure of Legal Thought*, 39 RUTGERS L. REV. 1, 4-13 (describing oppositions in legal rule choices).

¹⁸³ See Julie A. Nice, The Emerging Third Strand in Equal Protection Jurisprudence: Recognizing the Co-Constitutive Nature of Rights and Classes, 1999 U. ILL. L. REV. 1209 (1999) [hereinafter Nice, Third Strand]; Julie A. Nice, Equal Protection's Antinomies and the Promise of a Co-Constitutive Approach, 85 CORNELL L. REV. 1392 (2000) [hereinafter Nice, Antinomies].

¹⁸⁴ See Nice, Antinomies, at 1392 (stating that "co-constitutive theory explores both how law shapes society and how society shapes law"); Nice, *Third Strand*, at 1215 (defining the co-constitutive thesis with respect to equal protection to mean "both that rights construct the classes of people who hold (and do not hold) them and that the status and conduct of these classes construct the meaning of rights. Because rights and classes are mutually constitutive, the Court can plausibly integrate its consideration of them."). ¹⁸⁵ Nice, *Third Strand*, 1223-24.

¹⁸⁶ *Id.*, at 1225. Professor Nice states the analysis more broadly as follows:

I suggest that co-constitutive theory offers and approach for disrupting and transcending the antinomies. Put simply, co-constitutive theory suggests that the antinomic alternatives are not mutually exclusive, contradictory, or even dichotomous. At a minimum, then, the choices posed are unnecessary ones. Moreover, the choices posed are harmful because eventually they impair our ability to understand more comprehensively the complex interactions, including the simultaneous, ongoing, and mutual constitution of law and society.

analytic techniques are pervasive throughout the law as well as in everyday reasoning. ¹⁸⁷ In his words:

Suppose you were on a diet and had two rules for yourself. One rule was that you would allow yourself a small dessert after dinner if you had skipped lunch on the same day. The other was that you would allow yourself dessert if you had run your typical four miles that day. It is 8 p.m. and that small bowl of frozen yogurt is quite tempting. You reflect back on your day and recall that you had a dry bagel, nothing on it, and black coffee at noontime. You also cut your run short after 3 ½ miles. May you indulge?¹⁸⁸

Paul's answer, thankfully perhaps, is that you may. His reasoning, similar to Nice's account of co-constitutive categories and Balkin's nested oppositions, is that "the reason behind both the no-lunch rule and the four mile requirement is the same." Where the background rationale for both rules is the same and the dieter has come close, but not quite succeeded, under each rule, the background rationale may have been satisfied without formalistically satisfying either rule. Have the ice cream, Paul says, because you have satisfied the reason behind the rules even if you have not fully satisfied either of the two rules. From this seemingly frivolous example, Paul argues that similar principles may often inform judicial analyses of legal problems, citing examples from both constitutional and international law.

If a mode of analysis that oscillates between two conceptual categories—what I have called "Thaumatrope analytics"—can be defended when the concepts underlying the categories are nested oppositions or co-constitutive, the question remains whether the duty of loyalty and duty of care can in fact be treated as nested oppositions. If there is a relation of similarity, overlap, or historical dependence, what is it? How deep are the similarities? How distinctive are the differences? If Thaumatrope analytics are to be appropriate, questions such as these define the contours of its use. Are Thaumatrope analytics appropriate between the duties of care and loyalty? And, if so, what is the limit

Id., at 1016.

¹⁸⁷ Jeremy Paul, *Changing the Subject: Cognitive Theory and the Teaching of Law*, 67 BROOK. L. REV. 987, 1011 (2002).

¹⁸⁸ Id., at 1013-14.

¹⁸⁹ Id., at 1014.

¹⁹⁰ In Professor Paul's words, "the combination of a light lunch and an almost full workout is quite likely to be a greater net contribution to weight loss than either one alone. Even though the rules crafted for the diet are separate, it would be rather stubborn to insist on keeping them that way." *Id.* ¹⁹¹ *Id.*, at 1017.

¹⁹² In describing the Two-Fer, Professor Paul similarly asks:

How did the two requirements get set up in the first instance? Are they aimed at producing the same goals? Did the decision-maker consider and reject a broad standard for grouping all considerations into a more open-ended balancing test? Will the number of cases presenting the "two-fer" swamp the basic rules? Is there a meaningful way to cabin the "two-fer" exemption within the particular context?

to good faith as a doctrinal principle? How can we predict when the Delaware bench will spin the Thaumatrope?

At first glance, the duties of care and loyalty appear quite distinctive. They seem to raise different issues and to ask different questions in resolving them. As noted above, the basic concern under the duty of care is prudence while under the duty of loyalty it is fidelity. The question of prudence depends upon whether the directors have conducted themselves in the management of the corporation as an ordinary person would in the management of her own affairs. The issue of fidelity, by contrast, involves whether the directors have put their own interests ahead of corporate interests and is generally answered by pointing to an unmitigated conflict of interest. These appear as different questions with distinctive lines of inquiry.

A bit of digging beneath these surface differences, however, reveals the richly interconnected roots of the two doctrinal paradigms. Start with the duty of care: directors must conduct themselves as ordinarily prudent persons conducting their own affairs. So far so good, but a moment's reflection reveals that an ordinarily prudent person becomes an ordinarily prudent director only once we assume an element of loyalty. How do ordinarily directors conduct their affairs? Delaware law assumes, first and foremost, that they investigate the terms of a potential transaction and that they act "in a deliberate and knowledgeable way in identifying and exploring alternatives." For this reason, duty of care analyses focus primarily on the decision-making process. ¹⁹⁷ Nevertheless, this formulation still begs the question of the ultimate purpose of the process. What is the investigation for? What are its guiding principles? It is impossible to evaluate whether a decision-making process was in fact reasonable without first knowing to what end the process is meant to be employed.

The overall purpose of the due care investigation is to determine which of a variety of alternatives is *in the best interests of the corporation*. Now pause for a moment to consider what a funny way this is of characterizing what an ordinarily prudent person would do *in the conduct of her own affairs*. We might typically assume that an ordinarily prudent person, in evaluating a set of alternatives, picks the one that provides the most benefit and the least cost to *herself*. A director's decision-making process, however, can be evaluated only by changing the referent from herself to the corporation. The question of prudence, in other words, is framed with a tacit element of loyalty. We are not asking, even in looking only to the decision-making process, whether it was designed to maximize the benefit to the director herself (or to her family or alma mater or

¹⁹³ See supra notes 35-39 and accompanying text.

¹⁹⁴ See supra notes 38-39 and accompanying text.

¹⁹⁵ See supra note 37 and accompanying text (explaining that conflicts of interest can be managed or mitigated through a variety of traditional means).

¹⁹⁶ Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989).

¹⁹⁷ See Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Due care in the decisionmaking context is *process* due care only."). *Accord* Hansen, The ALI Corporate governance Project: Of the Duty of Due Care and the Business Judgment Rule, a Commentary, 41 Bus. Law. 1237, 1241 (1986) (noting that the standard of care "is applied to the decision-making process and not to its result").

¹⁹⁸ Model Business Corporation Act, Section 8.30(a).

some other non-corporate constituency), but rather whether it was designed to maximize the benefit to the corporation. Until we have substituted the corporation for the individual, we cannot even ask whether the director has followed a reasonable process in making the decision. The process can only be evaluated once we have understood its purpose. The directors must be making the decision and designing their decision-making process to benefit the corporation, not themselves, but in taking this as the goal of the process, we have founded the duty of care analysis on an element of the duty of loyalty.

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

Not infrequently, the facts [in a duty of care case] suggest that the directors were actually being sued and held liable because of wrongful self-interested conduct—for a violation of the fiduciary duty of loyalty—and the courts' take about duty of care is simply a way of letting the plaintiffs win without having to prove all the elements of a wrongful conflict of interest transaction. ²⁰¹

The duty of care, in other words, contains within itself an assumption that the decision-maker is motivated by the corporation's business purpose. This tacit subordination of self-interest to corporate interest is generally discussed under the duty of loyalty but without it analyses under the duty of care do not make sense.

Now come to the duty of loyalty. The duty of loyalty turns on the problem of conflict between the director's personal versus fiduciary interests. This includes situations where the director diverts corporate cashflows or investment opportunities to herself, lavishes corporate assets and perquisites on herself, and causes the corporation to take an action to protect her position or reputation rather than maximizing corporate wealth. None of these transactions would raise an eyebrow if they were entered into at

¹⁹⁹ The information gathered to make a decision to benefit oneself is different from the information gathered for a decision to benefit someone or something else. With different objectives, one asks different sorts of questions. For example, a person designing a transaction to maximize benefits to oneself might care about individual income tax consequences, while someone designing a transaction to maximize benefits to the corporation will care only about the corporate level consequences.

²⁰⁰ See, e.g., Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L. J. 1078, 1100 (1968) (discussing a case that is apparently a duty of care case but noting that "the facts are heavy with the odor of self-dealing…") (cited in CLARK, *infra* note 201). ²⁰¹ ROBERT C. CLARK, CORPORATE LAW 126 (1986).

²⁰² See generally E. Norman Veasey, *Duty of Loyalty: the Criticality of the Counselor's Role*, 45 BUS. LAW. 2065, 2071-72 (1990) (stating that "even if the business judgment rule is applicable... a directorial decision cannot be allowed to stand if it ... cannot be attributed to any rational business purpose") (internal quotations omitted).

²⁰³ These categories of self-dealing roughly correspond to Professor Clark's four paradigmatic cases of self-

²⁰³ These categories of self-dealing roughly correspond to Professor Clark's four paradigmatic cases of self-dealing—(1) basic self-dealing, (2) executive compensation, (3) the taking of corporate or shareholder property, and (4) corporate action with mixed motives. *See* Clark, *supra* note XX, at 142-147.

arms-length with a third party. The basic self-dealing problem is that the transaction is not arms length and involves, in some way, the director dealing with herself through the corporation she controls. The intuition that causes us to recognize this as an obvious problem is that the corporation, that collection of wealth belonging to people *other than* the director, is likely to get a raw deal in this kind of bargain. To protect these *other* people from getting a bad deal, we proscribe transactions of this type or, at the very least, permit directors to enter into them only after satisfying procedural safeguards. ²⁰⁴

Now step back for a moment. We are worried about the directors' loyalty because we are concerned that their disloyalty will result in a poor bargain for the corporation. We are concerned, in other words, that the directors will strike bargains for the corporation that an ordinarily prudent person would not strike for herself. This can be seen most clearly if the non-arms-length transactions that raise duty of loyalty concerns are imagined as arms-length transactions with third parties. Would an ordinarily prudent person lease a corporate asset to a third party at exceedingly generous terms? Would an ordinarily prudent person lavish compensation on a third party and permit the third party to divert corporate investment opportunities? Would an ordinarily prudent person permit a third party to hide behind anti-takeover devices and "just say no" to a wealth-enhancing acquisition? These are duty of loyalty concerns framed as duty of care questions. The phrasing is natural because, at its core, the duty of loyalty is just a bet that some situations are likely to lead to careless or imprudent transactions for the corporation, which is to say that the duty of care is a motivating concern for the duty of loyalty. Here again the duties overlap.

The core question is whether a particular decision or a particular transaction is likely to be beneficial to the corporation. Whether the question is confronted from the angle of the duty of care or the duty of loyalty is just a difference in approach. To put it in another way, the fundamental question underlying both duties really is good faith. Are the directors really doing their best in acting for someone else? Arguably, that is the only question in all of corporate law. It is simply asked in different ways in different contexts. ²⁰⁸

Taking this view of the fundamental question of corporate law shows that the duty of care and the duty of loyalty are indeed nested oppositions. They are co-constitutive.

²⁰⁵ See, e.g., Lewis v. S.L.&E., Inc., 629 F.2d 764 (2d Cir. 1980) (self-dealing in leasing of property).

²⁰⁴ See supra note 20 and accompanying text.

²⁰⁶ See, e.g., Broz v. Cellular Information Systems, Inc., 673 A.2d 148 (Del. 1996) (corporate opportunities).

²⁰⁷ See generally Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545 (D.Del. 1995) (federal court applying Delaware law to allow a board to remain independent after receiving and rejecting a takeover offer); Paramount Communications v. Time, 571 A.2d 1140 (Del. 1990) (permitting the Time board to retain its poison pill and reject Paramount's hostile bid).

²⁰⁸ This view has been attributed to Samuel Arsht, a leader in the Delaware bar, who is said to have proposed that the Delaware law be simplified to the principle "Directors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith." Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?* 44 UCLA L. REV. 1009, 1015 (1997) (noting Professor Rock's agreement with this principle as "a completely accurate description of Delaware fiduciary duty law").

Their meanings overlap as both seek to answer the fundamental question of the good faith of corporate directors.

Uncovering the nested opposition between the duty of care and the duty of loyalty enables one to recognize the principle underlying a Thaumatropic analysis. Because both duties get at the same fundamental question, it is possible that there will be situations in which it is possible to answer the fundamental question without checking all of the boxes for liability under either traditional standard. This is the key to the Thaumatrope. Each side of the card might be different, but the spinning of the card reveals a relationship between the two sides within the frame of the device. So the picture becomes a man atop a donkey or a bird in a cage. If the pictures, however, are not related, then the Thaumatrope fails. There probably are not many cards with a book on one side and a hedge on the other. There must be a relationship between the two sides or oscillating between them is meaningless, lacking unity and coherence, unprincipled.

So too with the Thaumatrope as a mode of legal reasoning. There must be an underlying relationship between the two standards, whether described as a relationship of nested opposition or co-constitutive categories, lest the analysis prove unprincipled and meaningless. It is only because the duty of care and the duty of loyalty are nested oppositions that it is possible for a judge to threaten to impose liability, as Chancellor Chandler does in *Disney*, because director conduct raises issues under a composite of both notwithstanding the fact that all elements of liability have been satisfied under neither.

B. Interpretation and Context

The Thaumatrope stands for an interpretive device, not a separate legal standard. It suggests a way of reading a plaintiff's complaint and offers a tool to assess the blameworthiness of a defendant's conduct. Skilled plaintiffs' lawyers may be able to construct a Thaumatrope in any pleading, simply by raising issues under both the duty of care and the duty of loyalty. It is the bench, however, that decides whether to spin the handle and blend the issues in an analysis of good faith. This raises the basic question: When will the judiciary spin the Thaumatrope?

Before we can get at that question, however, we need a digression on interpretation, text, and context.

Interpretation is the reading of texts to yield meaning. The text—whether it is a pleading, a legal standard, a poem, or a traffic signal—is what is given to the reader to interpret. Interpretation is exogenous and purposive: it comes from outside the text

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²⁰⁹ I use text, context, and meaning in the same way as Professor Lessig. *See* Lawrence Lessig, Understanding Changed Readings: Fidelity and Theory, 47 Stan. L. Rev. 395, 402 (1995). ("By 'text,' I mean any artifact created at least in part to convey meaning; by 'context,' I mean just the collection of understandings within which such texts make sense."). Rather than narrowly defining "meaning," Lessig leaves it up to our conventional understanding in seeking to elaborate on how meanings are made. Id. 401-402.

and guides the process by which the reader arrives at meaning. Moreover, the act of interpretation takes place in a context, a set of explicit or implicit understandings that guide the interpretive process.

Change in either text or context may change a resulting interpretation. Texts can be revised—pleadings amended, poems rewritten. And interpretive contexts can shift as underlying discourses are opened to debate and settled understandings become contestable. It means something different, for example, to say "the World Trade Center terrorist attack" today than it meant anytime between February 26, 1993 and September 11, 2001, yet the words used—the text—are precisely the same. This is an example of changed meaning as a result of historical events, but such shifts may also be brought about through scientific innovation or the efforts of activists and "change entrepreneurs" who fight to move public perceptions of an issue. 212

Texts, then, appear in contexts, and within any particular context, the text may be contested or uncontested, and the dispute (or lack thereof) may be foregrounded or backgrounded. When a backgrounded uncontested discourse becomes a foregrounded contested discourse, it becomes a less stable foundation for interpretation. In adjudication the appearance of a contested discourse in the interpretive context threatens to impose rhetorical costs on the decision-maker. If a judge bases a decision on a contested discourse, she may appear to decide the controversy according to her personal politics, rather than principles of law. ²¹³

Central to the interpretive context of corporate law adjudication is the extent to which courts may intervene in the decision-making of corporate boards. Chief Justice Veasey has described corporate law's "defining tension" as "the tension between

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²¹⁰ RICHARD A. POSNER, LAW AND LITERATURE 209-210 (stating that "interpretation is always relative to a purpose that is not given by the interpretive process itself but that is brought in from the outside and guides the process").

A discourse is contestable if it provokes the concession that reasonable minds can differ. In the words of Professor Lessig:

In any context, legal or not, within any discourse, whether cultural or scientific or social, some things are argued about; most things are not. Some things are up for grabs; others are taken for granted. We argue about what law applies; we don't argue about what law is. We argue about how a text should be read; we don't argue about whether reading is possible. We argue about whether I should wear a tie; not about whether I should wear a dress. Not that we couldn't argue about these matters -- obviously, we could. ... But... in each of these cases -- and more generally, always -- there is the normal against which exceptions get drawn. There is a space within which disagreement occurs, and a border that is not crossed. Disagreeing with someone about abortion makes you an opponent; disagreeing with someone about whether children should be tortured makes you an alien.

Lessig, *Understanding Changed Readings, supra* note 209, at 411 (1995). *See also* Lawrence Lessig, *Erie-Effects of Volume 110: An Essay on Context in Interpretive Theory*, 110 HARV. L. REV. 1785, 1803-1807 (1997) (describing the movement of discourses between categories of contested and uncontested and foregrounded and backgrounded).

²¹² See Lessig, Erie-Effects, supra note 211, at 1805, 1807 (putting both Catherine MacKinnon and Oliver Wendell Holmes into the category of "change entrepreneur").

²¹³ See Deborah Hellman, The Importance of Appearing Principled, 37 Ariz. L. Rev. 1107 (1995).

deference to directors' decisions and the scope of judicial review."²¹⁴ While the scope of judicial intervention in board decision-making is certainly a basic issue in corporate law, the situation is generally not tense. The fundamental choice of Delaware on the question of judicial review of business decisions is well known: there is hardly any.²¹⁵ The business judgment rule applies to limit the ability of courts intervene in corporate decision-making and thus become "super-directors."²¹⁶ Delaware's basic choice, a robust

vision of the business judgment rule and maximum respect for the principle of board authority, is so well known that it has become almost completely backgrounded.

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This is not to say that the choice has not met criticism. The business judgment rule and the reasons supporting it have generated persistent criticism from a variety of academics, but in spite of the tenor of their critiques, referring to Delaware as a "pygmy" and "the brothel of corporate law," these would-be change entrepreneurs have been generally unsuccessful in shifting the relevant consensus regarding the business judgment rule. The principle of judicial deference to board decision-making and all of its attendant bases, although contested, is thus backgrounded in the context of any particular corporate law dispute.

Until recently. In the wake of the accounting debacles at Enron and WorldCom, ²¹⁹ the looting of Tyco and Adelphia, ²²⁰ the allegations of celebrity insider trading, ²²¹ and revelations of conflict of interest in analyst recommendations, ²²² much

²¹⁴ E. Norman Veasey, The Defining Tension in Corporate Governance in America, 52 Bus. Law. 393, [PIN] (1997).

²¹⁵ See Stephen M. Bainbridge, The Business Judgment Rule as an Abstention Doctrine, ___ VAND. L. REV. ____, ___ (forthcoming 2004).

²¹⁶ See Brehm, at 266 ("To rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation."); In re RJR Nabisco, Inc. Shareholders Litigation, (Del. Ch. Jan. 31, 1989) ("To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors."). ²¹⁷ William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L. J. 663, 684 (1974) (arguing for an "escape from the present predicament in which a pygmy among the 50 states prescribes, interprets and indeed denigrates national corporate policy").

²¹⁸ Lawrence E. Mitchell, The Sarbanes-Oxley Act and the Reinvention of Corporate Governance, 48 Villanova L. Rev. 1189, 1189 n.2 (arguing that "the laxity of Delaware law... with [its] shameful and disingenuous opinions... can no longer be in dispute").

²¹⁹ See William W. Bratton, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) (analyzing both the immediate and root causes of the accounting fraud and resulting collapse at Enron); Simon Romero & Riva D. Atlas, *Worldcom's Collaps: The Overview*, N.Y. TIMES, July 23, 2002, at C1 (describing the fraud and collapse at Worldcom).

²²⁰ See Peter Grant and Christine Nuzum, *Adelphia Founder And One Son Are Found Guilty*, WALL ST. J., July 9, 2004, at A1 (reporting developments in criminal trials of Adelphia executives accused of corporate looting); Mark Maremont & Jerry Markon, Former Tyco Executives Are Charged: New York Prosecutors Say Ex-CEO, Finance Officer Ran "Criminal Enterprise', Wall St. J., Sept. 13, 2002, at A3 (describing allegations that former CEO and CFO stole more than \$170 million from the company, engaged in illegal stock sales and committed accounting fraud to cover up their activities).

²²¹ See Matthew Rose and Kara Scannell, *Executives on Trial: Lawyers for Stewart, Bacanovic Vow to Appeal*, WALL. St. J., Mar. 8, 2004, at A1 (describing conviction of Martha Stewart on obstruction of justice charged in connection with the government's investigation of her insider trading).

that had been taken for granted or commonly accepted regarding the operation of American business was drawn into question. Taken together, these events are said to have created an environment of scandal and mistrust. In this environment, the voices of would-be change entrepreneurs were suddenly heard. Law reviews hosted symposia on reforming American corporate governance. Legal academics of board deference testified in Washington. Editorials and features on corporate reforms began to appear regularly in the *Wall Street Journal*. The American corporate governance system was thrown into stark relief. All of the principles that had formed the background context of corporate law adjudication were suddenly foregrounded and broadly debated, ultimately leading to a Presidential promise, Congressional legislation, and a host of administrative and other rule-making proposals.

²²² See Ann Davis and Susanne Craig, Analyze This: Research Is Fuzzier Than Ever, WALL St. J., Apr. 26, 2004, at C1 (describing and critiquing the outcome of investigations into investment analyst conflicts of interest).

²²³ See generally Ronald Alsop, Reputations of Big Companies Tumble in Consumer Survey, WALL. St. J., Feb. 19, 2004, at B1 (reporting on results of a Harris Interactive/ Reputation Institute poll that found 75% of respondents felt that the image of large corporations was either "not good" or "terrible."); Julie Rawe, Heroes to Heels, TIME, Jun. 17, 2002, at 48 (outlining improprieties at Tyco, Enron, Global Crossing and Adelphia and describing the contribution of these activities to environment of scandal and distrust).

²²⁴ See, e.g., Symposium: Securities Regulation and Corporate Responsibility, 55 ADMIN. L. REV. 211 (2003); Symposium: Crisis in Confidence [subheading], 35 CONN. L. REV. 915 (2003); Symposium: Enron and its Aftermath, 76 St. John's L. REV. 671 (2002); Symposium: Enron: Lessons and Implications, 8 STAN. J. L., BUS. & FIN. 1 (2002); Symposium: On Enron, Worldcom, and Their Aftermath, 27 VERMONT L. REV. 817 (2003); Symposium: Lessons From Enron, How Did Corporate and Securities Law Fail?, 48 VILLANOVA L. REV. 989 (2003).

²²⁵ See, e.g., Testimony of John C. Coffee, Jr., Auditors and Analysts: An Analysis of the Evidence and Reform Proposals in Light of the Enron Experience (U.S. senate Committee on Banking, Housing and Urban Affairs, March 5, 2002); Testimony of John H. Langbein, What's Wrong With Employer Stock Pension Plans (U.S. Senate Committee on Governmental Affairs, Jan. 24, 2002); Testimony of Frank Partnoy, Enron and the Derivatives World (U.S. Senate Committee on Governmental Affairs, Jan. 24, 2002). This testimony is collected in NANCY B. RAPOPORT & BALA G. DHARAN, EDS., ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (2004).

²²⁶ See, e.g., Paul Volcker & Arthur Levitt, Jr., In Defense of Sarbanes-Oxley, WALL ST. J., June 14, 2004 (editorial); John Thain, Sarbanes-Oxley: Is the Price Too High, WALL ST. J., May 27, 2004 (editorial); G. Bennett Stewart III, Debating Sarbanes-Oxley: Why Smart Managers Do Dumb Things, WALL ST. J., June 2, 2003 (editorial); Stan O'Neal, Risky Business, WALL ST. J., April 24, 2003 (editorial); Max Baucus, Charles E. Grassley & John McCain, A Second Betrayal, WALL ST. J., March 13, 2003 (editorial); Arthur Levitt, Jr., The SEC's Repair Job, WALL ST. J., Feb. 10, 2003 (editorial).

²²⁷ See White House Office of Communications, Remarks By The President On Corporate Responsibility, New York, July 09, 2002, available online at 2002 WL 1461845 (speech by President George W. Bush, detailing his "10-point Accountability Plan for American Business").

²²⁸ See, e.g., Pub. Law No. 107-204, 15 U.S.C. §§7201 et seq. (2003) (the Sarbanes Oxley Act). See also discussion of Sarbanes Oxley Act at supra note 27.

²²⁹ See supra note 1 (describing recent rule-making proposals by the Securities and Exchange Commission). Other standards-setting and self-regulatory bodies have also been making rule changes, often at the urging of the SEC. See, e.g., Public Company Accounting Oversight Board, *An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*, PCAOB Release No. 2004-001, March 9, 2004, available online at http://www.pcaobus.org/rules/Release-20040308-1.pdf; Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the NASD and NYSE, Securities Exchange Act Release No. 34-45,908, 67 Fed. Reg. 34,968-01 (May 15, 2002) (approving new NASD and NYSE regulations).

I cite this chapter in our recent history not to argue that these reforms were right or wrong, good or bad. My only purpose here is to illustrate the emergence of a national debate about issues that had previously been heralded by relatively few academics. In the environment of scandal and crisis that emerged in the fall of 2001 and spring of 2002, these issues moved from the background to the foreground of the public agenda. The principles of board authority versus judicial (or administrative) accountability were openly debated. This threatened to impose rhetorical costs on judicial decision-makers who hewed to the older, now openly contested discourses. The rote application of board deference would make a judicial body appear lax and unresponsive to the national debate or, worse, beholden to managerial interests.

As evidence that these issues attracted the attention of the Delaware judiciary, consider two addresses, later published as law review articles, by Chief Justice Veasey. In an address given at the University of Pennsylvania Law School on December 8, 2000 and published in that Law Review in June 2001, Veasey emphasized the principle of judicial non-intervention in board decision-making. ²³⁰ He drew upon his court's opinion in Brehm to illustrate a situation in which the court would not find liability in spite of disapproving of the firm's corporate governance practices. 231 Veasey further described how the Council of Institutional Investors—would be change entrepreneurs ²³²—lobbied the court to define and adopt a standard of director independence. ²³³ In spite of finding aspects of the proposal "interesting," Veasey argued that the court had to refuse the Council's request because "it is not the province of the courts to 'legislate' or otherwise impose such rules."²³⁴ Corporate governance standards would not be incorporated into the law of fiduciary duty on the view that "[c]odes of best practices or corporate bylaws...—not judicial fiat—are the appropriate intracorporate vehicle to establish this type of protocol." Veasey went on to describe what he saw as good corporate governance practices, but emphasized repeatedly that these were aspirational ideals to be decided upon by individual boards, not legal mandates ordered by the court.²³⁶

Now fast forward two years to an address given by the same Justice at the University of Iowa Law School on March 6, 2003 and printed in the *Journal of*

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²³⁰ E. Norman Veasey, Should Corporation Law Inform Aspirations for Good Corporate Governance Practices or Vice Versa?, 149 U. Pa. L. Rev. 2179 (2001). Chief Justice Veasey repeated the principle of judicial non-intervention several times. *See*, *e.g.*, *id.* at 2179-80 ("The private ordering aspect of [judge-made law] must provide ex ante the contractual stockholder protections deemed important, as distinct from ex post judicial rewriting of the contractual framework."), 2180 ("[C]ourts should be reluctant to interfere with business decisions and should not create surprises or wild doctrinal swings in their expectations of directorial behavior."); and 2181 ("Courts do not reach out to monitor boards or to resolve disputes.").

²³² See supra note 212 and accompanying text (describing role of change entrepreneurs).

²³³ Id., at 2182-83.

²³⁴ Id., at 2183.

²³⁵ Id

²³⁶ Id., at 2188-2191. Veasey emphasized: "These are recommended protocols offered as an aspirational matter only. They do not necessarily drive liability considerations, and they do not portend how a case will be decided." Id. at 2190. After his list of corporate governance suggested, he emphasized again: "these suggestions are purely aspirational and not necessarily liability-related." Id., at 2191.

Corporation Law in spring 2003. 237 In this post-scandal address, Veasey's tone is considerably more cautionary, emphasizing the responsibilities of directors rather than the restraints on the judiciary, pointing out that "directors must be careful and work hard to understand the facts behind that which they are deciding", 238 and underscoring that the lack of a bright line rule about excessive compensation "does not mean there are no limits."²³⁹ Although he does not suggest that courts "second-guess" business decisions, ²⁴⁰ the address emphasizes the flexibility of common-law adjudication, its dynamism, and ability to "flow with the times." The Disney litigation is again mentioned as an example, but this time to illustrate how directors may sometimes go too far. 242 And much of the address is devoted to the jurisprudence of good faith, which Veasey suggests may incorporate the emerging consensus on best corporate governance practices.²⁴³ After suggesting that "the utter failure to follow the minimum expectations of the evolving standards of director conduct, the minimum expectations of Sarbanes-Oxley, or the NYSE or NASDAQ Rules... might ... raise a good faith issue,"244 Veasey repeats that "it is arguable—but not settled—that the issue of good faith may be measured... against the backdrop of Sarbanes-Oxley and the SRO requirements."245

The differences between the two addresses could hardly be more pronounced. In the winter of 2000-2001, the Chief Justice lectured on judicial restraint, non-intervention in corporate affairs, and the difference between corporate governance aspirations and corporate law standards. In the spring of 2003, the same Justice lectured on director responsibilities, available avenues of judicial review of certain board decisions, and the incorporation of corporate governance standards into corporate law fiduciary duties. On the last point, the two lectures could not be more different. Prior to the scandals, Chief Justice Veasey sought to delineate a firm boundary between corporate governance practices and corporate law requirements. After the scandals, the Chief Justice offered a conception of good faith that could import settled best practices regarding corporate governance into the standards of fiduciary duty. The very issues advocated by the Council of Institutional Investors and other would-be change entrepreneurs without much success prior to the corporate crises of late 2001 and 2002 were suddenly taken much more seriously after events rendered them foregrounded and contested.

The increasing sensitivity of the Delaware judiciary to board misconduct can also be seen quantitatively in the win ratio of plaintiffs in derivative litigation following the corporate scandals. A review of the data presented in Table One, above, reveals a

²³⁷ E. Norman Veasey, State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors, 28 J. Corp. L. 441 (2003).
²³⁸ Id., at 445.

²³⁹ Id., at 447. In the next breath, he suggests that there may be greater space to review compensation matters: "Judicial review of these kinds of director decisions is not about dollar amounts in isolation." Id. ²⁴⁰ See id., at 445-446 ("no one suggests that the courts should second-guess the merits of [the board's] business decisions").

²⁴¹ Id., at 446.

²⁴² Id., at 447.

²⁴³ Id., at 446-448.

²⁴⁴ Id., at 446.

²⁴⁵ Id., at 448.

significant "Enron-effect." ²⁴⁶ Immediately following Enron, when corporate governance was most hotly debated, leading to the enactment, in June 2002, of the Sarbanes-Oxley Act, plaintiffs prevailed in twenty-three out of thirty two, or 72%, of decisions at Chancery. This data suggests that the foregrounding of corporate governance issues as a result of the corporate governance scandals may have had an effect on the outcome of adjudication in the nation's most significant corporate law courts, as judges sought to increase relief to plaintiffs and to find means of increasing the accountability of boards to courts.

The Disney litigation straddles this shift in interpretive context. The different outcomes in the Disney cases make sense considering the tendency of the court to act aggressively in times of controversy and scandal. The initial Chancery Court opinion as well as the Supreme Court's opinion in *Brehm*, both of which were decided against the shareholder plaintiffs, were solidly pro-defendant. Confronting the issues in February 2000, twenty-one months before the fall of Enron and the unraveling of corporate America, ²⁴⁷ Justice Veasey stressed that although the Disney corporation fell far short of ideal corporate governance, there was little the court could do since the plaintiffs' claims were squarely covered by the business judgment rule. When the plaintiffs' repleaded claims came before the Chancery again, in the summer of 2003, the most important factual difference may have been extraneous to the case itself. Instead, it may have been the environment of corporate misfeasance in which the court confronted, once again, corporate governance mechanisms that were far short of standard and producing a substantive outcome that was plainly detrimental to shareholders. It is in this new corporate environment that the business judgment rule was narrowed and the fresh doctrinal standard of good faith was invented.

All of this supports the notion that the Delaware judiciary was cognizant that something had changed in the interpretive context. 248 The world—or at least as much of it as matters to corporate law decision-makers—had become more skeptical about our system of corporate governance. Board oversight and board authority had failed to prevent some spectacular failures and policy mavens were actively debating what ought to be done "to prevent future Enrons." This pushed backgrounded discourses about the balance between authority and accountability into the foreground and raised the rhetorical stakes of falling back on simple board deference. Moreover, it is worth noting that this is not the first time that backgrounded discourses have shifted to the foreground in corporate law. Professor Roe has documented several instances, including the passage of the Federal Securities Laws in the 1930s when the "populist and progressive goal of superseding lax state corporation laws with more stringent federal standards" was nearly realized and again in the 1970s when the prospect of federal chartering was brought back

²⁴⁶ See supra XX.

I am using November 2001, when Enron restated earnings for three years, as the "unraveling of Enron." ²⁴⁸ Accord Lyman P.Q. Johnson & Mark A. Sides, The Sarbanes-Oxley Act and Fiduciary Duties, 30 Wm. Mitch. L. Rev. [] (2004) (arguing that extrajudicial pronouncements by Chief Justice Veasey and Vice Chancellor Strine signal that "Delaware judges are fully aware of corporate misconduct and its pernicious effects on our corporate law system, and Delaware judges intend to creatively deploy their arsenal of doctrinal concepts to reinvigorate their assessment of corporate decision-makers"). ²⁴⁹ Harvey L. Pitt, *How to Prevent Future Enrons*, WALL ST. J., Dec. 11, 2001, at A18.

by William Cary, Joel Seligman, and Ralph Nader.²⁵⁰ Although Roe refuses to "psychoanalyze the Delaware players" to determine the effect of this shift in interpretive context, he finds in their remarks and their subsequent actions an awareness of the new environment, when previously backgrounded discourses were shifted into the foreground and, for a time at least, hotly contested.²⁵¹

Some have suggested that the responsiveness of the Delaware courts to the interpretive context has a strategic element related to the "race" debate. To paraphrase the claim: the Delaware courts know that their bread is buttered by keeping Delaware a popular state for incorporation and, in order to stem threats of Federal preemption, respond quickly to perceptions that Delaware is lax or unresponsive. However, for the purposes of the thesis of this Article, I do not need to say whether the Delaware judiciary acts strategically to avert federal preemption or in a genuine effort to tighten the standards of fiduciary duty in response to perceived weaknesses in corporate governance. It is enough that the environment existed, that the judiciary knew it, and that they reacted. They reacted by altering the frontier of the business judgment rule, constraining board authority with a new mechanism of accountability—the jurisprudence of good faith.

The emerging jurisprudence of good faith is the Delaware judiciary's reaction to recent shifts in the interpretive context. Enron and WorldCom and Adelphia and the long list of recent corporate scandals moved the backgrounded discourses regarding board authority versus judicial accountability into the foreground. In this environment, a corporate court would appear lax and unresponsive if it simply recited the business judgment rule and left shareholders at the mercy of whatever sub-standard corporate governance mechanisms had been adopted by their boards. This appearance would have been rhetorically costly to Delaware judges in particular, who faced threats of Federal preemption and equally threats to their own sense of accomplishment in steering economic activity in the right direction. So Delaware created the jurisprudence of good faith.

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²⁵⁰ See Mark J. Roe, *Delaware's Competition*, 117 Harv L Rev 588, 602-604 (2003) (describing various efforts to end Delaware's primacy in corporate law).

²⁵¹ See Roe, supra note 250, at 604-607 (describing evidence of Delaware law-makers' consciousness of the federal pre-emption threat).

²⁵² See, e.g., , Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 603 (2002) (arguing that the Delaware's fact-specific and somewhat indeterminate corporate law jurisprudence "benefits Delaware by reducing the threat of federal intervention, which presents... perhaps the most serious threat to Delaware's dominance."); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625 (2004) (arguing that the threat of federal preemption of state corporate law promotes pro-shareholder innovations in state corporate law); Roe, *supra* note 250, at 592 (arguing that "federal authorities set the broad boundaries... within which the states can move" in creating corporate law, but remaining agnostic regarding whether states innovation is strategically motivated to forestall federal pre-emption or genuinely motivated to improve corporate governance). *See also* Johnson & Sides, *supra* note XX (arguing that the Delaware judiciary's pronouncements amount "to a 'pledge' of action, designed, in part, part to reassure the SEC that the traditional makers of corporate law are attending to the problem. [T]he hope is to preserve Delaware's central role in corporate jurisprudence by forestalling further congressional action and possibly curbing the most expansive reading of the SEC's mandate to regulate under Sarbanes-Oxley.").

V. Thaumatropic Regulation

The good faith Thaumatrope now appears as a steam valve for the rhetorical costs of a change. It arose in a moment of crisis and gave courts an additional angle of approach to board decision-making and an additional constraint on board authority. How pervasive will it become in corporate law adjudication?

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This is a question, of course, that only the courts can answer, but there is some basis for a prediction. If the good faith Thaumatrope is fundamentally a pressure valve for changed interpretive contexts, we can guess that it will only apply when a newly foregrounded discourse generates considerable steam. This does not happen every day. It did, however, happen in the mid-1980s in the context of corporate defenses to hostile takeovers. That episode in corporate law history may contain a lesson to assist in the evaluation of good faith in corporate governance.

A. The Future and Past of Good Faith: the Takeover Precedent

The good faith Thaumatrope establishes a mode of analysis in which existing standards, loyalty and care, are blended to produce a basis for review somewhere in between the two doctrinal categories. The fashioning of an intermediate standard out of pre-existing doctrine is not without precedent in Delaware jurisprudence. It has happened before, in the context of takeovers, where interestingly, the underlying basis was also an analysis of good faith.

The jurisprudential context of takeovers is slightly different from that of ordinary corporate governance decisions.²⁵⁴ Takeover cases arose when the board of a target company underwent a defensive restructuring or adopted anti-takeover provisions in response to an unwanted takeover offer,²⁵⁵ and plaintiffs typically sought not to impose liability on directors, but to enjoin either the restructuring transaction or the use of the takeover defenses.²⁵⁶ The judicial standards of review applied in such cases were entire

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The business judgment rule has traditionally operated to shield directors from personal liability arising out of completed actions involving operational issues. When the business judgment rule is applied to defend directors against personal liability, as in a derivative suit, the plaintiff has the initial burden of proof and the ultimate burden of persuasion. In such cases, the business judgment rule shields directors from personal liability if, upon review, the court concludes the directors' decision can be attributed to any rational business purpose.

²⁵⁴ A board's responsibilities can be loosely divided between the oversight of operational matters, which on a day-to-day basis are under the authority of senior managers, and the undertaking of extraordinary transactions, such as mergers and acquisitions, over which boards are expected to exert a more active role. *See* E. Norman Veasey, The Defining Tension in Corporate Governance in America, 52 Bus. Law. 393, 394 (1997) (dividing corporate governance issues into "enterprise issues," "ownership issues," and "oversight issues").

²⁵⁵ See, e.g., cases cited infra at notes XX-YY.

²⁵⁶ This distinction was stressed by the Delaware Supreme Court in Unitrin in suggesting that the scrutiny accorded by courts to either type of claim would be different:

fairness review and the business judgment rule. Entire fairness review applied to conflict of interest situations where the board could not be shown to be independent—as, for example, when a board approved a transaction involving a corporation in which its members had a material interest. Entire fairness review applied, in other words, when significant duty of loyalty concerns were raised. The business judgment rule, by contrast, was the default standard applied to all other transactions, shielding both the directors and the transaction from judicial scrutiny except in those exceedingly rare situations where the board did not fulfill its duty of care in approving the transaction. That is, the business judgment rule applied when the only serious issues were under the duty of care. Thus, in takeover cases, just as in the corporate governance context, the doctrinal dichotomy was founded on the duty of care—under which business judgment rule deference would apply—and the duty of loyalty—under which entire fairness review was triggered.

Also like the emerging jurisprudence of good faith, the jurisprudence of takeovers did not develop in isolation. As takeover activity exploded in the 1980s, takeover battles were fought not only in boardrooms and courtrooms, but also in the media, in public opinion and in state legislatures. Many of the deals were financed by high-yield (and highly controversial) debt instruments, pejoratively referred to as "junk bonds," which commentators feared would bankrupt America and destroy industry. The takeover era generated its own highly-charged vocabulary, filled with "raiders," "white knights," "crown jewels," "shark repellants," "poison pills," and "scorched earth defenses." The financiers who engineered these acquisitions were vilified in the mainstream press and media for getting rich while the deals they made resulted in plant closures and layoffs, leaving ordinary workers without jobs. This Manichean view of takeovers was vividly portrayed in the seductively evil personage of Gordon Gekko, portrayed by Michael Douglas, in the film *Wall Street*, which interestingly mixed insider trading with hostile takeovers, greed and sexual immorality. Even without the sex, popular opinion was strongly opposed to takeovers, with 58% of respondents to a 1987 Harris pole stating that

Conversely, in transactional justification cases involving the adoption of defenses to takeovers, the director's actions invariably implicate issues affecting stockholder rights. In transactional justification cases, the directors' decision is reviewed judicially and the burden of going forward is placed on the directors. If the directors' actions withstand Unocal's reasonableness and proportionality review, the traditional business judgment rule is applied to shield the directors' defensive decision rather than the directors themselves.

Unitrin, Inc. v. American General Corp., 651 A.2d 1361, 1374 (Del. 1995).

²⁵⁷ See, e.g., Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) (describing the "exacting standards" of entire fairness).

²⁵⁸ *Id.*, at 1280.

²⁵⁹ See, e.g., Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985), discussed at *supra* notes 120-121.

²⁶⁰ See Robert A. Taggart, Jr., The Growth of the 'Junk' Bond Market and Its Role in Financing Takeovers, in ALAN J. AUERBACH, ED., MERGERS AND ACQUISITIONS 5 (1988).

²⁶¹ See, e.g., JOHN C. COFFEE, LOUIS LOWENSTEIN & SUSAN ROSE-ACKERMAN, EDS., KNIGHTS, RAIDERS, AND TARGETS 3, n.1 (1988) (translating this vocabulary).

²⁶² [PRESS CITATIONS PENDING]

²⁶³ WALL STREET (Twentieth Century Fox 1987).

they viewed takeovers as harmful while only 8% thought they were beneficial. ²⁶⁴ Management, of course, was even more opposed to hostile takeovers and, riding the wave of public suspicion of high finance, pushed states to adopt anti-takeover legislation. ²⁶⁵ This ability to unite the interests of wealthy, campaign-donating corporate managers with rank-and-file voters was a politician's dream. In the words of Professor Roe: "legislators who do managers' bidding do not have to fear reprisal from voters. It is the opposite. Politicians who bash Wall Street and thwart takeovers are rewarded by the average voter." On the other side of the debate were the academics and shareholder-rights advocates who viewed anti-takeover devices as impediments to the transfer of resources to their most valued uses, hindrances on the ability to discipline and replace ineffective management, and obstacles to the maximization of shareholder welfare through sales at a control premium. ²⁶⁷

The Delaware courts decided fiduciary duties in takeovers in the context of this highly charged and highly public debate concerning the social and economic effects of takeovers. The *legal* question before them, however, was more narrow. As a matter of corporate law fiduciary duty, the question was to what extent an incumbent board of directors could resist an unwanted takeover offer and, relatedly, according to what standard would courts evaluate this resistance. These questions again seemed to resolve into a set of dichotomies. Was the board's resistance prudent or selfish? That is, was resistance an outgrowth of the duty of care or an infringement of the duty of loyalty? And, in another binary opposition, would the court deciding this question apply deference under the business judgment rule or scrutiny under the entire fairness standard?

Prior to *Unocal*, courts treated board actions in the takeover context with roughly the same deference as board decision-making in any other context. Under the "business purpose" standard announced by in *Cheff v. Mathes*, ²⁶⁸ courts permitted the defensive actions of target boards provided that the board could attribute some benefit to the corporation from resistance. ²⁶⁹ This is not to suggest that courts were unaware of the

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²⁶⁴ "Who Likes Takeovers?" FORBES, May 18, 1987, pp 12-13.

²⁶⁵ See Roberta Romano, The Future of Hostile Takeovers: Legislation and Public Opinion, 57 U. CIN. L. REV. 457, 461 (1988) (describing the adoption of anti-takeover statutes by state legislatures: "The statutes are typically enacted rapidly, with virtually unanimous support and little public notice, let alone discussion. They are frequently pushed through the legislature at the behest of a major local corporation that is the target of a hostile bid or apprehensive that it will become a target.") (footnotes omitted).

²⁶⁶ Mark J. Roe, *Takeover Politics*, in MARGARET M. BLAIR, ED., THE DEAL DECADE, 321, 331 (1993).
²⁶⁷ See, e.g., Lucian Arye Bebchuk, The Case Against Board Veto in Corporate Takeovers, 69 U Chi L Rev 975, (2002) (arguing that boards should not be able to block non-coercive bids); Frank Easterbrook & Daniel Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981) (arguing for board passivity in the face of takeovers); Bengt Holstrom & Steven Kaplan, Corporate Governance, and Merger Activity in the United States: Making Sense of the 1980s and 1990s, 15 J. Econ. Perspec. 121 (2001) (describing the takeover debate); Michael Jensen, *The Takeover Controversy: Analysis and Evidence*, in KNIGHTS, RAIDERS AND TARGETS 314, 329- 37 (J. COFFEE ET AL. EDS., 1988) (describing motives and effects of bust-up takeovers).

²⁶⁸ 199 A.2d 548, 554 (1964).

²⁶⁹ See id., at 554 (stating that "if the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course").

potential conflict of interest that a takeover bid presented to incumbent directors—that is, the loss of their board seats and control over the corporation—and the resulting self serving motivation on the part of the board to resist takeovers in order to remain in control.²⁷⁰ Nevertheless, courts refused to treat the mere presence of an entrenchment motive as an adequate basis to overcome the basic principle of board authority.²⁷¹ Indeed, even where facts supported the inference of an entrenchment motivation, courts upheld board actions unless entrenchment could be shown to be either the *only* motivation or the *predominant* motivation of the board.²⁷² The business purpose test, in other words, operated exactly like the business judgment rule unless loyalty issues clearly dominated. Summarizing this line of jurisprudence in *Pogostin v. Rice*, the Delaware Supreme Court held that the "bedrock" principle of the business judgment rule was "equally applicable in the context of a takeover." ²⁷³

I further instruct you that a director may properly decline to adopt a course of action which would result in a shift of control, so long as his actions can be attributed to a rational business purpose. In other words, so long as other rational business reasons support a director's decision, the mere fact that a business decision involves a retention of control does not constitute a showing of bad faith to rebut the business judgment rule. That rule is rebutted only where a director's sole or primary purpose for adopting a course of actin or refusing to adopt another is to retain control.

²⁷⁰ See, e.g., Bennet v. Propp, 187 A2d 405 (Del. 1962) (finding a conflict of interest on the part of a board that used corporate funds to repurchase in order to protect its own control). Commentators continue to emphasize the potential for such selfish motivations on the part of target directors. See generally William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 26 DEL. J. CORP. L. 859, 862-63 (2001) (discussing "cases where the directors have no direct pecuniary interest in the transaction but have an 'entrenchment' interest, i.e., an interest in protecting their existing control of the corporation" and noting that "the corporation law has always been concerned ... with whether directors have acted to advance their personal self-interest by entrenching themselves in office"); Ronald J. Gilson, Lipton and Rowe's Apologia for Delaware: A Short Reply, 27 DEL. J. CORP. L. 37, 41 (2002) ("Target management's efforts to block a takeover may reflect a good faith effort to secure a better price for shareholders, or it may reflect entrenchment--a preference of target management to maintain the status quo.").

The apparent willingness of the *Bennett* court to acknowledge a target board's conflict of interest in the takeover context was later narrowed to the facts of the case, and the opinion was given an interpretation to make it consistent with the sole or primary purpose element of the business purpose test. See Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir. 1980) (discussing Bennett and stating that "a reading of the opinion as a whole reveals that the court felt that there was no reason other than control for the actions in question. We do not see how Benett's failure to use the talismanic phrase "sole or primarly motive in any way renders it inconsistent with Cheff.").

²⁷² See Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980) (upholding trail court instructions to jury that, under Delaware law, an entrenchment motivation is insufficient, but rather that entrenchment must be the sole or primary motivation). In Johnson, the trail judge had instructed the jury as follows:

Id., at 292. Upholding those instructions, the appellate court noted that "the plaintiff must make a showing from which a fact-finder might infer that impermissible motives predominated in the making of the decision in question." Id. (emphasis added).

²⁷³ 480 A.2d 619, 624, 627 (1984). The Pogostin court further described the role of the business judgment rule in a shareholder's challenge of a board's takeover decision:

an informed decision to reject a takeover proposal, hostile or friendly, will not excuse demand absent particularized allegations of a breach of fiduciary duty, such as selfdealing, fraud, overreaching, or lack of good faith. ... It is the plaintiff's burden to allege with particularity that the improper motive in a given set of circumstances, i.e., perpetuation of self in office or otherwise in control, was the sole or primary purpose of the wrongdoer's conduct.

The criticism of the pre-*Unocal* takeover cases is now familiar. If boards need only recite a rational business purpose in order to receive judicial deference for their takeover defenses, then one might expect boards to be quite inventive in finding such justifications. Indeed, because business purpose justifications should be available almost always, at least for a well-advised board, the business purpose test provided essentially no constraint on the ability of boards to resist takeovers. The result of that, commentators have tirelessly pointed out, is that management will be free to entrench itself, impeding the efficient allocation of resources and reducing shareholder welfare by reducing the number of wealth-maximizing takeovers.

What is worth emphasizing from these cases, however, and what sometimes gets lost in the policy-based critiques of the doctrine is the underlying basis of the judicial inquiry: good faith. By asking whether a board has a business purpose for resisting takeover, the court is inquiring into *why* the board is resisting and whether its actions are really in the corporation's best interests. That is, the court is inquiring into the board's good faith. This is made explicit in the cases: The analyses start from the "presumption that directors form their judgment *in good faith*." If plaintiffs succeed in showing a potential entrenchment motivation, "the directors satisfy their burden *by showing good faith* and reasonable investigation." Moreover, "the mere fact that a business decision involves a retention of control does not constitute a showing of *bad faith* to rebut the business judgment rule." At a minimum, the Delaware cases require that the *plaintiff must show some sort of bad faith* on the part of the defendant."

The good faith analyses of the pre-*Unocal* takeover cases, however, do not share the Thaumatrope analytics of the *Disney* case. They do not oscillate between duty of care issues and duty of loyalty issues. Instead, they raise both sets of issues and seek to assign dominance. In resisting takeover, a board could have two motivations, one permissible and one impermissible. The permissible motivation involved the execution of a business purpose consistent with the board's view of the best interests of the company, and, as long as the board fulfilled the procedural duty of care in formulating that opinion, resulted in deference under the business judgment rule. The impermissible motivation could be any human interest other than business purpose, such as Mrs. Pritchard's grief-stricken drinking, ²⁸⁰ or more commonly, entrenchment, raising duty of loyalty concerns.

Id., at 627.

²⁷⁴ See Carney, Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model, 1988 Wis. L. Rev. 385, 427 (1988) ("Because [the claim that the takeover bid threatened management's beneficial plans for the corporation] could nearly always be made, the Delaware courts seemed to be closing their eyes to questions of management disloyalty.").

²⁷⁵ See commentary cited at supra note 267.

²⁷⁶ Kors v. Carey, 158 A.2d 136, 142 (Del. Ch. 1960) (emphasis added).

²⁷⁷ Cheff, at __(emphasis added).

Johnson, at __ (quoting trail court's jury instructions) (emphasis added).

²⁷⁹ *Id.*, at __ (emphasis added). The appellate court further stated: "We do not think that a showing of 'a' motive to retain control, without more, constitutes bad faith in this context unless we are to ignore the realities of corporate life." Id.

²⁸⁰ See Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

If the plaintiff could show that such interests predominated, it could place the burden of proving entire fairness on the directors.

The arrival of *Unocal* made good faith the explicit basis of a new standard in takeover jurisprudence.²⁸¹ In *Unocal*, Mesa Petroleum launched an unsolicited tender offer for the Unocal Corporation, to which the Unocal board responded with a self-tender offer that excluded Mesa.²⁸² When Mesa's suit to enjoin Unocal's exclusionary self-tender reached the Delaware Supreme Court, the court explicitly recognized the risk of an entrenchment motive in takeover defenses and designed a test of standard to counter it:

Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.²⁸³

In recognizing the self-interested entrenchment motive as a structural feature of every defensive reaction to a takeover proposal, the court refused simply to grant boards the deference that they would receive, under the business judgment rule, for other types of corporate actions. Instead, the court articulated a threshold test requiring, first, a reasonable belief on the part of the target board that the takeover bid represented a threat "to corporate policy and effectiveness," and second, that the defensive response undertaken by the board have an "element of balance" and be "reasonable in relation to the threat posed." The *Unocal* standard, because it created—for takeover defenses—a level of judicial review greater than that accorded to ordinary business decisions under the business judgment rule but less than that applied to clear instances of self dealing under the entire fairness test, was quickly labeled "intermediate scrutiny." ²⁸⁶

Rather than focus, as much of the commentary has,²⁸⁷ on the operation and effect of intermediate scrutiny, it is more important to emphasize, for purposes of this article, that *Unocal*'s invention of intermediate scrutiny was constructed on a rhetoric of "good faith" that mixed the standards and the issues developed under the duties of care and loyalty. Discussion of good faith appears throughout the opinion. The Unocal board

²⁸⁶ In subjecting takeover bids to a heightened standard of scrutiny—review of the *reasonableness* both of the board's belief and the board's response clearly suggested something more than *rationality* review—the *Unocal* standard suggested a significant departure from the deference accorded to boards under the business purpose test but less than "entire fairness" review. See supra note XX.

²⁸¹ Unocal Corporation v. Mesa Petroleum Co., 493 A.2d 946 (1985) [hereinafter *Unocal*].

²⁸² Id., at 949-51.

²⁸³ Id., at 954.

²⁸⁴ Id., at 955.

²⁸⁵ Id.

²⁸⁷ One of the best reviews of Unocal's operation and effect appears in Ronald J. Gilson & Reinier Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review, 44 Bus. Law. 247 (1989). *See also* Sean J. Griffith, *Deal Protection Provisions In The Last Period Of Play*, 71 FORDHAM L. REV. 1899 (2003); Robert A. Ragazzo, *Unifying The Law Of Hostile Takeovers: Bridging The Unocal/Revlon Gap*, 35 Ariz. L. Rev. 989 (1993).

argued that it had acted in good faith. The Chancery Court had agreed, as the Supreme Court ultimately did as well, emphasizing that "unless it is shown... that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty, such as fraud, overreaching, lack of good faith, or being uniformed, a Court will not substitute its judgment for that of the board." This sounds a lot like *Cheff* and, indeed, the *Unocal* court cited *Cheff* with approval since the ultimate question from that case—the good faith of the board in pursuit of shareholder welfare—remained unchanged. What *Unocal* did change, however, was the standard for evaluating the good faith of the board. Rather than leaving the question, as the earlier cases had, to a whiff-test of whether selfishness dominated care, the court required the target board to show that the takeover bid represented a threat to corporate policy and demonstrate that the defensive response was *proportional* to thethat threat. The test of intermediate scrutiny can thus be read as a codification of the good faith inquiry in the context of takeovers. The *Unocal* board passed the test and thus received business judgment deference for its good faith decision-making.

The *Unocal* test for good faith also involves elements of a Thaumatrope. The poles of opposition were the two standards of scrutiny previously applied to takeover defenses: entire fairness and the business judgment rule. As already noted, entire fairness review was based on significant duty of loyalty concerns while the business judgment rule applied when the only significant issues were under the duty of care. In the takeover context, the difficulty with this doctrinal dichotomy was that the principle problem—the omnipresent specter of entrenchment—mixed these issues. A board that is motivated to preserve its own seats may reject a transaction without fairly evaluating whether it is in its shareholders' best interest. The board's conflict may be milder than plain self-dealing under the duty of loyalty, but the conflict may be enough to prevent it from adequately reviewing the transaction under the duty of care. The threat of entrenchment thus spins the card in the Thaumatrope: on one side is question of conflict under the duty of loyalty, on the other is the issue of the board's care in deciding how to respond. The composite image is one of a board either acting in good faith—putting aside their personal interests

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²⁸⁸ *Unocal*, at 953 ("Unocal contends that its board of directors reasonably and in *good faith* concluded that Mesa's \$54 two-tier tender offer was coercive and inadequate.... Furthermore, Unocal argues that the board's approval of the exchange offer was made in *good faith*, on an informed basis, and in the exercise of due care.") (emphasis added).

²⁸⁹ Id., at 949 ('The factual findings of the Vice Chancellor, fully supported by the record, establish that Unocal's board, consisting of a majority of independent directors, acted in *good faith*, and after reasonable investigation found that Mesa's tender offer was both inadequate and coercive."); 952-53 (describing the Chancery Court's finding that "the directors' decision to oppose Mesa's tender offer was made in a *good faith* belief that the Mesa proposal was inadequate"); and 958 ("the Court of Chancery specifically found that the 'directors' decision [to oppose the Mesa tender offer] was made in the *good faith* belief that the Mesa tender offer is inadequate.") (emphasis added).

²⁹⁰ *Id.*, at 958. *See also id.*, at 957 ("If the board of directors is disinterested, has acted in *good faith* and with due care, its decision in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment.") and 958 (concluding that "there was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in *good faith* and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise") (emphasis added).

²⁹¹ *Id.*, at 955 ("The standard of proof established in *Cheff v. Mathes* ... is designed to ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders....").

in retaining their seats and carefully evaluating the proposed takeover on its merits—or in bad faith—selfishly giving in to the desire to retain its seats and, as a result, giving short shrift to any takeover proposal. The Delaware Supreme Court constructed intermediate scrutiny out of the spinning image, offering the two-part threat/ proportionality test as a means of determining which image, good faith or bad, appeared in a particular case.

Unocal thus provides a useful analogy to the modes of analysis in the Disney opinion. It has the same rhetorical grounding—good faith—and applies the same analytical methodology—a blending of previously distinct doctrinal categories. Unocal, however, developed a new doctrinal standard—intermediate scrutiny—to fill the space between these categories. This is what Professor Sale suggests will happen to the Disney case, along the lines of securities law scienter. However, I have been more skeptical that good faith will become a separate doctrinal standard. Part of the reason for my skepticism can be seen by examining what became of the standard of intermediate scrutiny in the years following its birth, a story that I believe foreshadows the likely development of good faith in the context of corporate governance.

How the *Unocal* standard would be developed in subsequent decisions of the Delaware courts was an open question in the summer of 1985. It is not, however, an open question now. Heightened scrutiny under *Unocal* has, as a practical matter, collapsed back into the business judgment rule. Although *Unocal* has never been overruled and a kernel of doctrine remains from the case and is occasionally applied, the standard of intermediate scrutiny not longer exerts the constraint on boards that it initially promised.

Early indications of the subsequent evolution of the doctrine appeared within a few months of *Unocal*. In *Moran v. Household International*, the Delaware Supreme Court upheld the adoption of the poison pill, the most important structural defense in a target company's arsenal.²⁹² Although the court stated that *Unocal* scrutiny applied to pill adoption and use,²⁹³ the court applied a glib version of that scrutiny, failing to seriously review either the perceived threat or the proportionality of the response, and effectively handed target boards the winning weapon in takeover battles, undisturbed by the strictures of intermediate scrutiny.²⁹⁴ The failure to question the proportionality of

In addition, the Rights Plan is not absolute. When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard they were held to in originally approving the Rights Plan.

²⁹² 500 A.2d 1346, 1350 (Del. Supr. 1985) [hereinafter *Moran*]. Poison pills work by making hostile tender offers prohibitively expensive. However, companies with poison pill alone is not takeover proof. *See generally* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 Stan. L. Rev. 887 (2002) (describing takeover defenses as a package).

²⁹³ *Moran*, at 1354. The court stated:

Id. In addition, the court listed a variety of ways in which a tender offer could still be made notwithstanding a target's adoption of a poison pill. [PIN]

²⁹⁴ In its application of the Unocal scrutiny, the court permitted the possibility of a future threat to corporate policy to stand as the board's reasonable perception of a threat, aided perhaps by the fact that the

the poison pill—recall that the proportionality prong of *Unocal* was the most significant innovation from the previous cases that tested only motive²⁹⁵—thus represented a retreat from heightened scrutiny and a partial return to the pre-*Unocal* line of takeover jurisprudence, where the only question was whether entrenchment was the sole or primary purpose of the board's action.²⁹⁶

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Upon closer review, this retreat from proportionality may have been nascent in *Unocal* itself. The threat in *Unocal* was Mesa's two tier-tender offer, which promised shareholders who tendered a better mix of consideration (primarily cash) than shareholders who chose not to tender (junk bonds). By structuring the offer in this way, Mesa pressured Unocal shareholders to tender regardless of whether they considered the offer price to be fair. In response to this threat, the court permitted Unocal to launch its own tender offer and exclude Mesa. What the court failed to analyze, however, was the coerciveness of Unocal's tender offer, which had exactly the same structure as the Mesa offer and, if anything, was *more* coercive. Unocal offered \$72 for 49% of its shares. Those who did not tender their shares, including Mesa, and those who would be unable to sell all of their shares in the buy-back, would continue to be shareholders of Unocal. However, because Unocal shares after the buy-

Household board sat through presentations by Wachtell, Lipton and Goldman Sachs. [PIN] The court scarcely addressed proportionality, instead merely repeating that "the Directors reasonably believed Household was vulnerable to coercive acquisition techniques and adopted a reasonable defensive mechanism to protect itself." [PIN]

²⁹⁵ See supra TAN XX.

²⁹⁶ See supra TAN XX.

²⁹⁷ If the Mesa offer succeeded, non-tendering shareholders' shares would be bought out in a back-end merger in which they would receive junk bonds with the same "value" as the cash consideration paid in the front-end of the tender offer—i.e., \$54. [PIN CITE TO CASE] It is worth noting that the court's glib assertion that \$54 in junk bonds is worth less than \$54 in cash is controversial—a \$54 junk bond can be sold for \$54 in cash provided that the bond is really worth \$54, a question the court did not seriously analyze.

²⁹⁸ Target shareholders in this situation face a prisoner's dilemma, where they have both a positive (get the best I can get) and negative (avoid the worst case scenario) to tender notwithstanding their estimate of the true value of a share. See generally William J. Carney, Two-Tier Tender Offers and Shark Repellants, 4 Midland Corp. Fin. J. 48 (1986) (describing the prisoner's dilemma faced by target shareholders in the context of a two-tier tender offer).

²⁹⁹ See [PIN].

³⁰⁰ [PIN CITE OPINION]

Mesa shares, which amounted to approximately 13% of the outstanding Unocal shares, were excluded from the buy-back offer. See supra TAN and n. XX.

³⁰² Because of the coercive effects of the Unocal offer, discussed *infra*, all eligible shareholders will have an incentive to tender, resulting in more than 49% of all eligible shares being tendered, leaving eligible shareholders to share pro-rata in the 49% offer. *See infra* note 303.

 $^{^{303}}$ Assuming that 100% of the eligible Unocal shareholders tendered into the Unocal offer, for every share tendered each shareholder could expect to be left with \$40.55 in cash and .4368 Unocal shares. These proportions are a function of the Mesa Exclusion. Because Unocal was buying only from eligible shareholders, of its offer for 49% of the total outstanding shares, Unocal effectively bought 56.32% of the outstanding (.49/.87 = 56.32%) held by eligible shareholders and none of the outstanding shares held by Mesa. For an eligible shareholder, the difference, 43.68%, is the percentage of her current shareholdings that she will continue to own after the buy-back. Mesa will continue to hold 100% of its current shares in Unocal shares after the buy-back.

back would be worth far less than \$72 offered in the buy-back, ³⁰⁴ the Unocal tender offer replicated the coercive two-tier structure of the Mesa bid. Worse still, the Unocal offer is more coercive than the Mesa offer since the second tier of the Mesa bid—a cash-out merger—would have created shareholder appraisal rights under state law. ³⁰⁵ The second tier of the Unocal offer, by contrast, created no appraisal right or remedy under state law because the recipients *remained* Unocal shareholders. ³⁰⁶ This reading of the facts in *Unocal* underscores the difference between the level of scrutiny *announced* by the court and the level of scrutiny *applied* the court. Just as *Moran* purported to apply heightened scrutiny in endorsing the poison pill, *Unocal* purported to create heightened scrutiny while, in fact, endorsing a response that was more coercive than—that is, *disproportionate* to—the perceived threat.

Later decisions further circumscribed the space of enhanced scrutiny. In *Paramount v. Time*, ³⁰⁷ the Delaware Supreme Court rejected Chancery Court interpretations of proportionality that would have required directors rejecting a proposed transaction to proffer a better one. ³⁰⁸ In reaching this decision, the stated that:

Plaintiffs' position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment of what is a 'better' deal for that of a corporation's board of directors. To the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis.³⁰⁹

If Unocal bought back 70 million shares at \$72, that left 100 million shares that would be worth a lot less, including all of the Mesa Partners holdings, which would drop to around \$30 a share after the buyback. Our stock would then be worth less than \$700 million--a loss of about \$300 million.

³⁰⁶ See William J. Carney, Mergers & Acquisitions 82 (2000).

³⁰⁴ Boone Pickens seized on this immediately,

Colan v. Mesa Petroleum Co., 951 F.2d 1512, 1521 (9th Cir. 1991) (entering Pickens' statements as evidence in a Rule 16(b) action against Mesa). *See also* Michael C. Jensen, When Unocal Won over Pickens, Shareholders and Society Lost, IX, No. 11, Financier 50, 51 (Nov., 1985) (finding that the market value of remaining Unocal shares was \$35).

³⁰⁵ See DGCL §262.

³⁰⁷ Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (1990) [hereinafter, *Tim*].

³⁰⁸ See AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 112 (Del. Ch. 1986) (two-tier self tender found to be a disproportionate response to a "concededly fair" and "non coercive" takeover bid); City Capital Associates Limited Partnership v. Interco, Inc., 551 A.2d 787, 799 (Del. Ch. 1988) ("The \$74 cash offer did not represent a threat to shareholder interests sufficient in the circumstances to justify, in effect, foreclosing shareholders from electing to accept that offer."); Grand Met. PLC v. Pillsbury Co., 558 A.2d 1049, 1057 (Del. Ch. 1988) (stating that "a Pillsbury shareholder [might prefer the takeover offer, but] a stockholder in Pillsbury cannot make that choice unless the Rights are redeemed"). In addition, other Chancery Court opinions in the late 1980s suggested that *Unocal* scrutiny might have teeth. *See*, *e.g.*, Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227 (Del. Ch. 1988); Tate & Lyle PLC v. Staley Cont'l, Inc., 1988 WL 46064 (Del. Ch. May 9, 1988); Phillips v. Insituform of N. Am., Inc., 1987 WL 16285 (Del. Ch. Aug. 27, 1987).

³⁰⁹ Time 571 A.2d 1140, at 1152 (citation, to Interco "and its progeny," omitted).

Proper *Unocal* analysis, it became clear after *Time*, not only permitted structurally coercive self-tender offers as proportional responses, but also validated the "just say no" defense in which a target board could simply leave its takeover defenses in place and pursue its preconceived business strategy rather than seeking an alternative transaction to a takeover bid. Other decisions recognizing as threats bids at an "inadequate price," even when they were not structurally coercive, further suggested that target boards would be free to leave their takeover defenses in place and refuse to respond to unsolicited bids. The express judicial blessing of this approach came finally in 1995 when a federal court applying Delaware law permitted a target board to refuse to redeem its rights plan in the face of an offer that was not structurally coercive, but merely "inadequate," without seeking an alternative transaction. The result of this line of cases, as prominent practitioners have noted, is that "just say no' is alive and well."

Unocal scrutiny, by contrast, is not doing so well. This doctrinal evolution described above represents a steady decline in the stringency of intermediate scrutiny. No case has yet over-ruled *Unocal*, but given the fact-specific nature of Delaware law, none has had to.³¹⁷ Instead, the courts have steadily eroded the constraint of intermediate

³¹⁰ *Id.*, at [PIN]. *See also* Jeffrey N. Gordon, "*Just Say Never?*" *Poison Pills, Deadhand Pills, and Shareholder Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 551 (1997) (arguing that ability of boards to resist takeovers *ad infinitum* "would have a devastating impact on the control market and, ultimately, would have large scale economic effects").

Takeover Law: The Uncertain Search For Hidden Value, 96 Nw. U.L. REV. 521, 523 (2002) ("substantive coercion," [is] a term which one of us now regrets having introduced ... to describe how a court might (by squinting) conclude that shareholders who wished to accept a tender offer were coerced into doing so, merely because the target's bad at an inadequate price could amount to "substantive coercion," which the authors had defined as "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value." Ronald J. Gilson & Renier Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?, 44 BUS. LAW. 247, 267 (1989), quoted in Time Warner, at 1153, n.17. One of the authors has subsequently expressed regret for having introduced the concept. See Bernard Black & Reinier Kraakman, Delaware's Takeover Law: The Uncertain Search For Hidden Value, 96 Nw. U.L. REV. 521, 523 (2002) ("substantive coercion," [is] a term which one of us now regrets having introduced ... to describe how a court might (by squinting) conclude that shareholders who wished to accept a tender offer were coerced into doing so, merely because the target's board considered the offer price to be too low").

³¹² See supra TAN/n. [DESCRIBING/DISCUSSING "STRUCTURAL COERCION"]

³¹³ See, e.g., Unitrin, Inc. v. American Gen. Corp. (In re Unitrin, Inc.), 651 A.2d 1361, 1384 (endorsing the concept of "substantive coercion" and recognizing the threat that shareholders would mistakenly sell for an apparent premium when "the board considered Unitrin stock to be a good long-term investment"). ³¹⁴ Moore Corp. v. Wallace Computer Servs., 907 F. Supp. 1545 (Dist. Del. 1995) [hereinafter Moore]. The

threat recognized by the Wallace board and approved by the *Moore* court was that shareholders "tempted by the suitor's premium, might tender their shares in ignorance or mistaken belief as to management's representations of intrinsic value and future expectations." *Id.*, at 1557.

 $^{^{315}}$ *Id.*, at 1561-62.

³¹⁶ See Adam O. Emmerich, et al., "Just Say No" is Alive and Well, Wachtell Lipton Rosen & Katz client memorandum, Dec. 4, 2003 (describing ArvinMentor's attempted takeover of the Dana Corporation and Dana's use of the just say no defense to remain independent).

³¹⁷ See Fisch, supra note 34, stating:

the [Delaware] supreme court ... appears ready to distinguish or overrule a precedent without regard to considerations of stare decisis. The absence of attention to stare decisis is partially a consequence of the fact-intensive nature of the court's decisions; the court can easily deny that it is overruling a precedent by using case specific facts to distinguish its prior holding. Similarly the court can narrow the precedential effect of its decisions by framing its holdings narrowly and tying those holdings to specific facts.

scrutiny, with Delaware Supreme Court decisions narrowing *Unocal* scrutiny to apply only to situations involving unilateral board action³¹⁸ and broadening the permissible "range of reasonable responses."³¹⁹ Professors Thompson and Smith have tested and empirically confirmed this steady erosion of the *Unocal* doctrine.³²⁰ After gathering all Delaware decisions citing to Unocal between 1985 and the end of 2000 and rejecting incidental citations, the authors found thirty-four Chancery Court opinions and eight Supreme Court opinions that worked through the analysis to a conclusion.³²¹ Of these decisions, almost all found a legally cognizable threat, and although the Chancery Court occasionally found a disproportionate response under the proportionality prong,³²² every case that reached the Supreme Court outside of the change of control context was also found to satisfy the proportionality prong.³²³ This confirms the suspicion that little of substance remains of *Unocal* and that intermediate scrutiny of takeover defenses has slid most of the way back to the business judgment rule.³²⁴

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Id., at 1079 (footnote omitted).

A Unocal analysis should be used only when a board unilaterally (i.e., without stockholder approval) adopts defensive measures in reaction to a perceived threat. Unocal is a landmark innovation of the dynamic takeover era of the 1980s. It has stood the test of time, and was recently explicated by this Court in Unitrin. Yet it is inapplicable here because there was no unilateral board action.

Id., at 1377.

319 See Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995). There the court stated: The *ratio decidendi* for the "range of reasonableness" standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a "range of reasonableness," a court must not substitute its judgment for the board's.

Id., at 1388. (citation omitted).

³¹⁸ See Williams v. Geier, 671 A.2d 1368 (Del. 1996) (applying the business judgment rule to a shareholder approved charter amendment). In *Williams*, the court further suggested that *Unocal* belonged to a specific time and place and that it may not be of permanent relevance:

³²⁰ See Robert B. Thompson and D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 Tex. L. Rev. 261 (2002).

³²¹ *Id.*, at 284 ("Between the issuance of Unocal in 1985 and the end of 2000, a Westlaw search shows that the Delaware Court of Chancery issued 141 opinions citing Unocal and that the Delaware Supreme Court issued 33 opinions citing Unocal.")

According to the authors nine Chancery Court cases found disproportionate responses. See id., at n. 113. Among these were *AC Acquisitions Corp.*, discussed at supra TAN and n. XX; Grand Met., discussed at supra note XX; Interco, discussed at supra note XX; and cases cited in note XX.

When necessary, the Supreme Court "reversed or pushed to the side" inconsistent Chancery Court findings on the proportionality prong. *See* Thompson & Smith, *supra* note 320, at 284.

³²⁴ See generally Eric A. Chiappinelli, The Life And Adventures Of Unocal - Part I: Moore The Marrier, 23 DEL. J. CORP. L. 85, 143 (1998) (stating that "Unocal was created, debated, and turned into the equivalent of the business judgment rule"); Ronald J. Gilson, Unocal Fifteen Years Later (and What We Can Do about It), 26 DEL J CORP L 492, 512 (2001) ("Unocal was to provide the theory that Household International lacked, but the lesson of Unocal's first fifteen years is that the Delaware Supreme Court's march toward an unarticulated and unjustified preference for elections over markets, however understandable in its original motivation, has proven to be a failure."); Paul L. Regan, What's Left of Unocal?, 26 DEL. J. CORP. L. 947, 969 ("Moran's Unocal promise—of fiduciary accountability for the board's use of a pill in the face of an actual offer—has vanished."); Roe, supra note 250, at 625 (noting that Delaware "consciously sought to be

So, what happened? Why did Delaware create intermediate scrutiny only to retreat from it, interpreting proportionality to mean, essentially, board deference?

The answer, once again, lies in the interpretative context. When a text goes from being backgrounded and relatively uncontested, as takeover jurisprudence had been prior to the hostile takeover wave of the 1980s, to being foregrounded and contested, as it was by the mid-1980s, old doctrines are drawn into doubt and may appear unresponsive and, worse, political. In the takeover context, the Delaware courts would have been seen to be taking management's side in the intense political controversy surrounding takeovers. To avoid making a seemingly unprincipled political choice, Delaware chose a moderate path, crafting the flexible standard of proportionality out of the middle space between entire fairness review and business judgment deference. By the end of the decade, however, when the public controversy had died down—that is, the takeover discourse returned to the background and was less contested—the court could return to its initial position of deference.³²⁵

I believe this story of good faith in takeovers, and the short-lived standard of intermediate scrutiny from *Unocal*, can be read as an allegory for the development of the doctrine of good faith from *Disney*. The Thaumatrope will only become a staple of adjudication as long as the contestability of the balance between authority and accountability is foregrounded. Because good faith operates as an interpretive principle rather than a doctrinal standard, the court can discontinue this line of jurisprudence when the issues that have brought it to the fore recede. Moreover, because corporate law is highly fact specific, the court can distance itself from such analyses without overruling itself.

B. Evaluating the Good Faith Thaumatrope

My account portrays good faith as an extremely flexible doctrine that enhances the ability of the judiciary to intervene in matters of corporate governance. It frees judges from the constraint of the business judgment rule and enables the judiciary to intervene in corporate governance matters that traditional doctrine would allocate to the board alone. Although I have argued, drawing upon the extra-judicial context of the dispute, that this increase in judicial discretion will not necessarily lead to unprincipled or unpredictable results, 326 it is true under my account that not every element necessary to determine whether the Thaumatrope will apply is endogenous to the litigation itself, opening the theory to the objection that judges will have discretion not only with respect to their reading of doctrine but also with respect to their views about the world generally, about

'proportional' for most of the 1980s" but that "at the end of the decade, with the 1989 Time-Warner decision, ... Delaware turn[ed] anti-takeover").

³²⁵ [DISCUSS ADAPTIVE RESPONSES, REDUCED NEED FOR JUDICIAL CONSTRAINT.] Marcel Kahan & Edward B. Rock, How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law, 69 U. Chi. L. Rev. 871 (2002).

³²⁶ See supra Part XX. On the tendency of increased judicial discretion to lead to decreased predictability of result, see Kaplow supra note XX, at PIN (quote).

which discourses are foregrounded and contested or backgrounded and uncontested,³²⁷ and that this level of discretion can only harm corporate law by diminishing the predictability of outcomes.

How one views the criticism linking the good faith Thaumatrope to judicial discretion and diminished predictability should correspond to one's views concerning the merits of flexibility in corporate law generally. On the one hand, Delaware law is criticized as indeterminate. Indeterminacy imposes costs on the corporation through increased litigation and counseling costs and also may also increase risk-aversion in corporate decision-making. This indeterminacy, the argument goes, is no surprise since it serves the interests of both the corporate bar³³⁰ and the state fisc. On the other hand, Delaware law is celebrated as subtle, nuanced, facilitative. Flexibility increases the space of private ordering and encourages innovation in business transactions.

The non-trivial default rules of corporate law will often be muddy gap-fillers that ask courts to balance the costs and benefits of contractual obligations under particular contingencies. Muddy defaults make contractual obligations contingent on circumstances ("states of the world") that are verifiable by courts ex post, but prohibitively costly to

³²⁷ See, e.g., Lessig (where he is commenting on someone else's paper on the basis that they have differing views re: what is "up for grabs").

³²⁸ See, e.g., Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908 (1998); Kahan & Kamar; Skeel, *Cycling. But see* Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. REV. 1461, 1508 (1989) (arguing that the volume of Delaware case law increases predictability in structuring transactions). ³²⁹ See Bebchuk, 112 Yale L.J. 553, 601-602 (summarizing these arguments). See also Lucian Arye Bebchuk & Louis Kaplow, *Optimal Sanctions When Individuals Are Imperfectly Informed About the Probability of Apprehension*, 21 J. LEGAL STUD. 365, 367 (1992) (addressing the question of welfare loss from sanctions when actors' information regarding the probability of apprehension is imperfect and providing examples of over-deterrence); A. Mitchell Polinsky & Steven Shavell, *On the Disutility and Discounting of Imprisonment and the Theory of Deterrence*, 28 J. Legal Stud. 1 (1999) (discussing the problem of over-deterrence in the context of uncertainty).

problem of over-deterrence in the context of uncertainty).

330 Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987)

³³¹ kahan & kamar (indeterminacy enables Delaware to engage in price discrimination); Kamar (indeterminacy makes it difficult for other states to copy Delaware).

³³² See, e.g., Fisch, Peculiar Role, supra note XX, at 1081 (arguing that "Delaware's indeterminate corporate law... induces negotiation and removes some incentives for strategic behavior. ... Delaware's lawmaking is uniquely structured to maximize responsiveness to changing business developments. [And] Delaware reduces the potential for rent-seeking in connection with the lawmaking process."); Rock, Saints and Sinners, supra note XX, at XX (arguing that the fact-specific nature of corporate law provides the judiciary with the opportunity to guide the social norms governing corporate governance).

³³³ See Leo E. Strine, 86 Cornell L. Rev. 1257, 1259 (stating that "much of Delaware corporate law's indeterminacy and litigation intensiveness is an unavoidable consequence of the flexibility of the Delaware Model, which leaves room for economically useful innovation and creativity. [R]educing the indeterminacy of Delaware corporate law ... might also impair its central emphasis on corporate empowerment and private ordering, to the detriment of social welfare."). Delaware encourages private ordering by supplying only "muddy" default rules. See Carol M. Rose, Crystals and Mud in Property Law, 40 Stan. L. Rev. 577 (1988) (describing muddy rules as "fuzzy, ambiguous rules of decision"). See also Ian Ayres, Making a Difference: The Contractual Contributions of Easterbrook and Fischel, 59 U. CHI. L. REV. 1391, 1403-1408 (1992) (analyzing the role of "muddy defaults" in corporate law); Ian Ayres and Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L. J. 87 (1986) (providing theory of default rules). According to Ayres:

Moreover, just as predictable rules are a mixed blessing for their tendency to be either over-inclusive (and therefore to discourage efficient transactions) or under-inclusive (and therefore avoidable), ³³⁴ certainty itself may be only a qualified good since it enhances the potential of well-counseled corporations to evade the rationale behind the rule. ³³⁵

I do not intend, in this Article at least, to settle that debate. I merely wish to identify the good faith Thaumatrope as a further manifestation of the flexibility of Delaware corporate law. In this regard, good faith differs from the traditional fiduciary duties of care and loyalty only insofar as they have ossified into rule-like analyses. Under the principle of the Thaumatrope, good faith analyses remain open and relatively unconstrained. The question, then, of whether the good faith Thaumatrope ought to be celebrated or decried thus turns on the question of how the analytical tool is ultimately used. 336

The Thaumatrope is a terrible device in the wrong hands. A politicized court could use it to launch an incursion on settled legal principles. In the corporate law context, it could be used to wrest control of corporate governance decisions from boards of directors and to vest the judiciary with such powers of review that the ability to hold the board to account ultimately became the authority to decide. Applied aggressively, the good faith Thaumatrope rewrite, even erase the business judgment rule.

But is such a use of the good faith Thaumatrope likely to obtain in Delaware? In spite of being the most powerful and influential corporate law judges in the United States,

identify ex ante. Because corporations cannot practicably contract for these muddy rules in advance, courts have the possibility of filling gaps with terms that are not "trivial." Ayres, *Making a Difference*, at 1404-1405. *See also* Ian Ayres and Eric Talley, Solomonic Bargaining Dividing a Legal Entitlement to Facilitate Coasean Trade, 104 Yale L. J. 1027 (1995) (arguing that where each party has a probable claim in the entitlement, muddy defaults facilitate bargaining when parties cannot predict ex ante which of them will win in litigation).

[C]ertainty... also creates the risk that agents – such as corporate management – might deploy such well-defined rules cleverly (and technically correctly), but with the purpose in mind not to advance long-term interests of investors, but to pursue some different purpose. ... Thus, at least in that corner of contract law occupied by corporation law, clarity itself may be thought to be a qualified good, not an unqualified good.

William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 898 (1997). *Accord* Tom Baker, Alon Harel, & Tamar Kugler, *The Virtues of Uncertainty in Law: An Experimental Approach*, 89 IOWA L. REV. 443, 446 (2004) (showing, through behavioral experimentation, that deterrence goals can be achieved by increasing uncertainty—i.e., volatility—without increasing expected sanctions).

³³⁴ See, e.g., Isaac Ehrlich & Richard A. Posner, An Economic Analysis of Legal Rulemaking, 3 J. LEGAL STUD. 257, 268-70 (1974).

³³⁵ In the words of then-Chancellor Allen:

³³⁶ Accord Allen, supra note 335, at 898 ("The fiduciary concept adds ambiguity. That ambiguity is capable of causing either a net cost... or a net benefit. Whether corporate law is at one end of this spectrum of economic effects or the other depends on the way the fiduciary duty is enforced.").

³³⁷ See supra note 33 and accompanying text.

³³⁸ At least some academic commentators do not agree that the elimination of the business judgment rule would be a terrible thing. See, e.g., [LARRY MITCHEL? KENT GREENFIELD? OTHERS?]. That these views are rarely aired in serious policy discussions, however, suggests that, although mildly contested, the central role of the business judgment rule to corporate law is deeply backgrounded.

the Delaware judiciary still exists within a nexus of constraint. ³³⁹ If, as a result of their decisions, Delaware law becomes immoderate, ³⁴⁰ the state may begin to loose ground to its competitors in other states or the federal government—firms may reincorporate elsewhere ³⁴¹ or bureaucrats may receive a greater role in the regulation of corporate governance. ³⁴² Individual judges may feel these pressures as they think about reappointment and promotion, ³⁴³ or perhaps more likely for well established professionals, as they seek to protect and preserve their individual reputations for evenhandedness and expertise. ³⁴⁴ Judges exist within a professional culture that, in the words of then-Chancellor Allen, controls the judge in a number of ways:

First, he or she is part of a product of a professional culture that has shaped the judge professionally. This professional commitment to law and to our legal system will... inevitably limit the range of choices deemed acceptably judicial by the judge. Secondly, he or she is embedded within a structure of authority within which judicial judgments are reviewed by other courts or set aside by legislation. These constraints... do sharply reduce the prospect of an eccentric result surviving.³⁴⁵

In other words, even in Delaware, corporate law judges are not truly free agents, and their ability to employ an interpretive device—even one as open-ended as the Thaumatrope—is subject to significant constraints.

So far the Delaware courts have used the good faith Thaumatrope in situations of pressure to find in favor of plaintiffs when traditional doctrines would have denied relief and thereby imposed rhetorical costs on the court. The good faith Thaumatrope thus provides the judiciary with a tool to intervene in corporate governance on an as-needed basis, which, because of its resolute fact-specificity and irreducibility into a simple substantive standard, does not threaten the long-term balance between authority and accountability. As long as the good faith Thaumatrope is applied moderately and sporadically, the business judgment rule will remain intact. This may, in fact, be the best means of regulating corporate governance, essentially leaving matters up to the board except in moments of scandal and crisis when deference to the board would threaten the entire system of corporate law with pervasive regulation, which judging from the recent efforts of federal regulators, often proves wasteful and inefficient. 346

³³⁹ See Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 379 (1990) (describing the "nexus of constraints" in the intracorporate relationship). ³⁴⁰ See Roe, supra note 250, at 604-607 (describing Delaware's moderate takeover jurisprudence as a result

³⁴⁰ See Roe, supra note 250, at 604-607 (describing Delaware's moderate takeover jurisprudence as a result of federal preemption concerns).

³⁴¹ In theory, at least, the "race" can be in either direction—to please managers or shareholders. *Compare* Dodd & Leftwich, *The Market for Corporate Charters*, in ECONOMICS OF CORPORATION LAW 100 (1980) (shareholders) *and* Winter, *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (shareholders) *with* Bebchuk and Ferrell, The Race to Protect Managers From Takeovers (managers); *and* Cary, *supra* note XX (managers).

³⁴² See commentary cited at supra note XX.

³⁴³ CITE DESCRIBING DEL. APPOINTMENT PROCESS.

³⁴⁴ Rock, Saints and Sinners, supra note XX, at PIN (quote).

³⁴⁵ Allen, *supra* note 335, at 902.

³⁴⁶ Romano. Ribstein.

The good faith Thaumatrope ought therefore to be celebrated as a triumph of common law adjudication. In the right hands—and there is every reason to believe that the Delaware judiciary has the right hands or, at least, that others' hands are too heavy³⁴⁷—it constrains little when little constraint is needed yet permits a greater constraining force to be exerted when, in the opinion of an expert judiciary, greater attention to corporate governance is in order.

VI. Summary and Conclusion

This Article has explored shifts in state law corporate governance since the period of corporate scandal that began in autumn 2001, identifying the emerging jurisprudence of good faith as the most significant state law corporate governance innovation. The Article has followed the development of good faith and sought to trace its meaning, finding it to be no accident that good faith emerged from a period of scandal and crisis when the American system of corporate governance, in which the Delaware courts play a significant role, was under fierce debate. The jurisprudence of good faith represents a targeted response by the Delaware courts to correct the worst excesses of corporate governance without fundamentally rebalancing authority and accountability. As recently used in the Delaware courts, good faith is an interpretive tool rather than a substantive standard.

Good faith analyses operate like a Thaumatrope. If enough concerns are raised on the duty of care side and enough concerns are raised on the duty of loyalty side, the composite picture that emerges is of director actions that are sufficiently blameworthy to raise concerns under the underlying principle of good faith. As an interpretive principle, good faith avoids doctrinal rigidity, breaking down the barriers between the duties of care and loyalty to reveal a network of interconnections between these formally distinct doctrinal categories. Moreover, as an interpretive principle rather than a substantive standard, good faith is consistent with the resolute fact-specificity of Delaware law and enables courts to reconsider the balance between authority and accountability on an asneeded basis. These open-ended attributes of the Thaumatrope, flexibly administered by the Delaware judiciary, may offer more long-term promise for corporate governance improvement than the blunt one-size-fits-all initiatives of other regulators.

The current storm in corporate governance will, one hopes, eventually recede. Indeed, there is evidence that it has begun to do so already, with a robust stock market in 2003 and a gradual return of investors to corporate securities. As a result the hitherto foregrounded debate over authority and accountability is also likely to recede. If so, we may be waiting for a long time for Delaware courts to solidify good faith as a separate fiduciary standard. They may well be better off not doing so, instead leaving good faith and its Thaumatrope analytics, co-constitutive categories, and two-fer arguments to be invoked in the next period of scandal and reform.

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³⁴⁷ See supra TAN/n. XX.