Disney, Good Faith, and Structural Bias

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This Article assesses the recent Disney decision and argues that on the facts presented, the decision was probably correct. However, the court squandered an opportunity to develop and articulate an appropriate doctrinal approach for the issues the case presented. The case was an excellent opportunity for courts to provide some means to constrain executive compensation, and more generally, to address problems caused by “structural bias,” the cozy relationship directors may have with officers (and, less often, controlling shareholders). In such cases, there is no breach of the duty of loyalty as that duty has traditionally been articulated. However, the duty of care rubric doesn’t seem properly applicable either. The directors have not simply been careless; rather, they seem to have gone through some motions of decision making when their decision was a foregone conclusion given their ties to the officers. The court created space for a doctrine of good faith, but it provided little guidance as to how that doctrine might work, even in cases like Disney itself. We suggest an extension of the duty of good faith that could provide a bit more bite. Plaintiffs should be allowed to demonstrate bad faith with a two-part showing: (1) the challenged decision occurred within an environment of structural bias, and (2) influenced by that structural bias, the directors were grossly negligent in making the challenged decision. Even if a court were to follow our suggestion, most cases would turn out as they historically have, with defendant victories. But we think that if courts articulate a doctrine requiring more scrutiny of decisions made in an environment of structural bias, a Caremark-like shift in norms and practices, directed by a combination of legal and extra-legal forces, might be encouraged.

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I. INTRODUCTION

The most recent decision in the Disney litigation, *Disney V*, disappointed some corporate governance scholars and activists. The case seemed like an excellent opportunity for courts to provide some means to constrain executive compensation and, more generally to address problems caused by “structural bias,” the cozy relationship directors may have with officers (and, less often, controlling shareholders). But the decision instead vindicated the directors’ conduct, painting a picture of informed directors making considerable efforts to do right by their company.

This Article assesses *Disney V*, and comes to several conclusions. On the facts presented, the decision was probably correct. However, the court did partially squander an opportunity—to develop and articulate an appropriate doctrinal approach for the issues the case presented. The court created space for a doctrine of good faith, but it provided little guidance as to how that doctrine might work, even in cases like *Disney V* itself. We suggest an extension of the duty of good faith that could provide a bit more bite. Plaintiffs should be allowed to demonstrate bad faith with a two-part showing: (1) the decision occurred within an environment of structural bias, and (2) influenced by that structural bias, the directors were grossly negligent in making the decision.

Even if a court were to follow our suggestion, most cases would turn out as they historically have, with defendant victories. Indeed, we recognize that the issues the *Disney* cases present can’t be fully addressed by a legal prohibition enforceable in the courts. Rather, norms-shifts and other like forces are necessary. We think that judicial articulation of a doctrine contemplating more scrutiny for decisions made in an environment of structural bias may help mobilize such forces. Consider, in this regard, the extent to which the *Disney* trial and attendant publicity increased focus on the issue. What we hope for, and believe may be possible, is a *Caremark*-like shift, propelled by a combination of legal and extra-legal forces.

This Article proceeds as follows. Part II outlines the traditional analysis courts have used to determine whether directors have breached their fiduciary duties. Part III discusses the *Disney* decisions themselves, using the changing political climate as a backdrop. Part IV considers the *Disney* decisions as exemplifying a particular type of problematic case. Part V considers the general character of those problematic cases—structural bias. In such cases, there is no breach of the duty of loyalty as that duty has traditionally been articulated. However, the duty of care rubric does not seem properly

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1. *In re Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27 (Del. 2006).
2. *See In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (approving a settlement of a suit alleging breach of fiduciary duty when company had engaged in criminal conduct yielding fines and a plea agreement). The settlement gave “very modest benefits,” but there was “essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function.” *Id.* at 971.
applicable either. What the directors have done is not simply to be careless; rather, they
seem to have gone through some motions of decision making when, given their ties to the
officers, their decision was a foregone conclusion. Part VI sets forth our doctrinal
proposal, arguing that Disney-type cases ought to be dealt with as breaches of the duty of
good faith. It also discusses the relationship between the two parts of the proposed test
and typical circumstances in which we envision the test being applied. Part VII considers
how the doctrine would be applied by courts, and the legal and extra-legal influences it
might have on director conduct. Part VIII concludes.

II. TRADITIONAL FIDUCIARY DUTY ANALYSIS

A. Duties of Loyalty and Care

Classically, courts and commentators have split corporate fiduciary duty cases into
duty of loyalty and duty of care categories. Where the courts see self-dealing as being
implicated, they invoke the duty of loyalty and scrutinize the transaction carefully. Courts
recognize self-dealing in situations where a director, officer, or controlling shareholder
has clearly identifiable, specific monetary interests at stake in a decision that puts her
own self-interest at odds with the interests of the corporation.

A director is considered interested where he or she will receive a personal
financial benefit from a transaction that is not equally shared by the
stockholders. Directorial interest also exists where a corporate decision will
have a materially detrimental impact on a director, but not on the corporation
and the shareholders. 3

The paradigmatic cases include the hiring of a family member and transactions between
the director and the corporation.

Once the court has identified a transaction as involving a problematic conflict of
interest, the transaction is presumptively invalid. However, the transaction may still be
“cleansed” if the defendant can validate it using one of three methods. In Delaware, these
two methods come from section 144 of the Delaware General Corporation Law; 4 most
states have a variant of this statute. 5 One method of validating a conflicted transaction is
to get approval of the transaction by the disinterested and independent members of the
board. If the conflict is with an interested director or officer, then the disinterested and
independent board’s approval will itself get deferential care-type review with the benefit
of the business judgment rule, as described below. 6 If the conflict is with a controlling

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3. Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) (internal citation omitted). The American Law
Institute and Model Business Corporation Act have codified this definition in detail. See ALI, PRINCIPLES OF
CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.23 (1994) [hereinafter ALI PRINCIPLES];
5. See ALI PRINCIPLES, supra note 3, § 5.02 report n.1.
6. Actually, this point is not entirely clear, and there are some cases that appear to apply a different
standard of review in these circumstances. Perhaps the clearest sign of some confusion on this point comes from
Cooke v. Oolie, where, in the same case, in different decisions, the court (without discussion) at one point
applied the fairness standard with a burden shift, see Cooke v. Oolie, No. CIV. A. 11134, 1997 WL 367034
(Del. Ch. June 23, 1997), and at another time applied the business judgment rule, see Cooke v. Oolie, No. CIV.
shareholder, then approval by the disinterested directors gets less deference—the court will ask whether the transaction was fair to the corporation, but the board approval will shift the burden of proof of fairness from the defendant to the plaintiffs.7

The second method of validating conflicted transactions is to get approval of disinterested shareholders. Here too, the court handles shareholder approval differently depending upon whether the transaction is with interested directors or officers, or with a controlling shareholder. In the former situation, the transaction, once approved by disinterested shareholders, is subject only to the highly deferential waste standard of review.8 In contrast, if the transaction is with an interested controlling shareholder, then, as with board approval, the transaction is still subject to fairness review with the burden of proof shifted to plaintiffs.9

The third method for validating conflicted transactions is for the defendant to show that the transaction was entirely fair to the corporation. This involves demonstrating both that the corporation followed a fair procedure and that the transaction was on substantively fair terms.10

If the duty of loyalty is not at issue, then the court will scrutinize the transaction much less carefully, using a duty of care analysis. Under this analysis, defendants receive the benefit of the “business judgment rule.” This 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.”11

Plaintiffs have the burden of rebutting this presumption. The focus in doing so has been in showing that the directors did not act on an informed basis. The Delaware courts require plaintiffs to show that the defendant directors were grossly negligent in informing themselves prior to making the disputed decision.12 For the most part, the courts are unwilling to hold that defendants have been grossly negligent. The one time that they did, in Smith v. Van Gorkom, the decision shocked the corporate law community, and drew a very quick reaction from the Delaware legislature.13 Scholars still harshly criticize the decision; indeed, a bashing of Van Gorkom is a ritual of entry into the ranks of the respectable corporate law scholarly community.14

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7. See Kahn v. Lynch Commc’ns Sys., Inc., 669 A.2d 79 (Del. 1995) (holding that cash-out merger was entirely fair to minority shareholder even though the controlling shareholder failed to specifically describe the potential risk of a lower priced tender offer if its bid was not accepted).
9. See In re Wheelabrator Techs. Inc. S’holders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995) (noting that “the review standard applicable to [the] merger is business judgment, with the plaintiffs having the burden of proof”).
10. That being said, although “[t]he concept of fairness has two basic aspects: fair dealing and fair price . . . price may be the preponderant consideration outweighing other features of the merger.” Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983).
12. See Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (holding that the board’s approval of amendments to a cash-out merger without fully informing themselves constituted gross negligence and a violation of their fiduciary duty of care).
14. See Symposium, Van Gorkom and the Corporate Board: Problem, Solution, or Placebo, 96 N.W. U. L.
The extent to which plaintiffs may, under business judgment review, argue that a decision was so substantively bad that the defendants should lose the protection of the presumption is unclear. Occasionally, the courts suggest that their review in duty of care cases is purely procedural—no matter how substantively awful a decision may appear, it should not lead to liability absent a showing of a conflict of interest. Plaintiffs do have another doctrine available to them: they can criticize the substance of a decision, arguing that it was a waste of corporate assets. However, the waste standard is extremely hard for the plaintiffs to meet—they must show that the decision was so disadvantageous for the corporation that it amounted to giving away corporate assets and getting nothing in return.

Judicial doctrine thus makes it extremely unlikely for plaintiffs to prevail once a court has slotted a case into the care category. The legislature’s reaction to Van Gorkom, mentioned above, made it even harder. The legislature added section 102(b)(7) to the Delaware General Corporation Law, allowing corporations to add a charter provision waiving personal liability of directors for violations of fiduciary duty. Liability for certain types of violations cannot be waived. These include loyalty violations, and decisions that are in bad faith—a provision we will discuss in more detail below. However, personal liability for pure care violations may be waived, and most Delaware corporations have indeed adopted such waivers of liability in their charters. This insulates directors from personal liability unless their behavior violates the duty of loyalty or is in bad faith.

Thus, when we teach fiduciary duty analysis to our corporate law students, we tell (or rather, told—see below) them that one starts by asking whether the facts at issue involve a director, officer, or controlling shareholder who has a conflict of interest with the corporation. If the answer is no, one conducts a duty of care analysis, the business judgment presumption applies, and the defendants are guaranteed victory unless the court arbitrarily flies off into the wilds of Van Gorkom land. If the answer is yes, a conflict exists, one conducts a duty of loyalty analysis, and the plaintiffs at least have a fighting chance.

B. Intermediate Scrutiny and Structural Bias

Since 1980, Delaware courts have developed special approaches for several specific kinds of situations where neither a loyalty nor a care analysis, as traditionally conceived and described above, seems up to the task. Traditional care analysis paradigmatically
addresses generic inattention, where directors may not have given a decision the care and
diligent effort it warranted. Traditional loyalty analysis addresses situations that the law
is comfortable presuming ought to be heavily scrutinized, if not actually discouraged,
such as directors doing personal business with their corporations or hiring their relatives.

In certain special situations, the potential for directors to favor their own interests
over those of the corporation is significant; however, the decisions at issue relate to
matters the law recognizes as within the ordinary purview of a corporation, such as
mergers and takeovers of the corporation, and decisions regarding lawsuits the
corporations will pursue. In these situations courts have developed several standards of
review that are intermediate, falling between the extreme deference of the duty of care
and the relative toughness of the duty of loyalty. We note three such intermediate
standards of review; the first two relate to mergers and takeovers, and the third relates to
decisions to conduct lawsuits.

One of the intermediate standards applies where boards adopt antitakeover
measures. Here, Delaware courts use the Unocal standard. The Unocal standard is a
two-step analysis. The court first asks whether the antitakeover measure was adopted in
response to a legitimate threat to corporate interests. If so, the court then asks if the
measure adopted was reasonable in relation to the threat posed. The Delaware Supreme
Court explicitly adopted this as an intermediate standard of review. Its reason for doing
so is interesting and relevant to our thesis. The court noted that where a board adopts
antitakeover measures, it need not have a conflicting interest as the courts narrowly
define it. Indeed, directors always have some self-interest in protecting against hostile
takeovers, since the result may be that they lose their board positions. Directors may
value the compensation they earn as directors; they may also value other benefits, such as
reputational benefits and the benefits of making valuable business connections; also,
officers are often in a position to do things that benefit directors, such as donating monies
on behalf of the corporation to a director’s favored charity. Beyond that, directors may
identify closely with the officers, especially the CEO, with whom they work on the board
and who probably selected them for service on the board. Directors are also motivated by
the “pernicious golden rule” to defer to those whose deference they would want as
officers. The outside directors may thus make decisions that favor those officers and
themselves even if doing so is not the best course for the corporation as a whole.
Nonetheless, there may be good business reasons for protecting a corporation against
takeovers, business reasons that directors are better-positioned to evaluate than judges. So
neither the rigors of loyalty analysis nor the ease of care analysis seems right. In
response, the court invented a new standard of review intermediate between the two.

Another intermediate standard of review comes into play when the board puts a
corporation up for sale or the corporation’s break up is inevitable. Here the Revlon

20. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (holding that antitakeover measures
that are enacted in furtherance of the board’s duties of care and good faith are legitimate).

21. See id. at 954-56 (holding that when a board addresses a corporate takeover, while its decisions are
entitled to respect, a threshold inquiry must be made before the protections of the business judgment rule can be
conferred).

22. The Delaware Supreme Court has narrowly defined putting the corporation up for sale. In the
Paramount/Time case, the court limited application of Revlon to two circumstances: where a corporation
initiates an active bidding process, seeking to sell itself or break up the company, or where it alters its long-term
standard applies. Court review becomes more stringent than under either a care or a Unocal review. The board must show that it has taken measures to assure that its shareholders receive the best value available in return for the sale of the corporation. The rationale is the same as in the antitakeover context, except with a bit more bite. The board’s decision to shun suitors is somewhat suspect; the board’s selection of a suitor may be even more suspect, since an obvious reason a board might prefer suitor A over suitor B is that A proposes to give better treatment—retention or more generous severance—to the board and management than does B. Furthermore, as with antitakeover mechanisms, even outside directors with a modest personal stake may identify with the interests of top corporate officers and may be motivated by the pernicious golden rule.

A third standard exists when a special litigation committee recommends dismissal of a derivative suit after demand has already been excused: the Zapata standard. The courts go beyond care analysis in this context because of their concern that even disinterested and independent board members will be reluctant to approve the continuation of a lawsuit against fellow board members. Given that demand was excused, the court has concluded that the board would not have brought the suit regardless of its merit; thus, the court further concludes, the committee’s decision not to bring the suit is suspect. If the board’s judgment could not be trusted, should a litigation committee consisting of some of the board members be trusted?

Like Unocal, the Zapata standard provides for a two-step approach. The first step looks much like business judgment review: the court asks whether the committee members were disinterested and independent and whether they reasonably informed themselves before deciding to recommend that the case be dismissed. The second discretionary step goes beyond this, though, and the court asks whether, in its own independent judgment, dismissal is in the best interests of the corporation. This step brings the court close to the fairness strand of the duty of loyalty.

These three intermediate standards were developed in situations that evoke what courts have called structural bias. As discussed in more detail in Parts IV and V, infra, structural bias results on account of (a) the shared group membership between directors and officers, (b) the bonds of collegiality, and (c) the pernicious golden rule—treating other directors and officers as one would want to be treated in one’s capacity as an officer of another corporation. These all come together to yield conditions in which directors’ motivations are not strictly fiduciary in nature, but are also not classically self-serving. Structural bias also includes one motivation that is classically self-serving: directors want to keep their jobs and know that they have to keep the favor of those who select them—the officers—to do so. A similar motivation exists for directors who have been chosen

strategy and, in response to a bidder’s offer, seeks a transaction involving a breakup. Paramount Commc’ns, Inc. v. Time, Inc., 571 A.2d 1140, 1149-50 (Del. 1989). A few years later, the court extended the circumstances somewhat, holding that Revlon duties apply where a corporation seeks to transfer control to a single person or entity. Paramount Commc’ns, Inc. v. QVC Network, 637 A.2d 34, 42 (Del. 1994).

25. The formulation looks like the business judgment rule, but there is considerably less deference. The burden is shifted to the corporation to show independence, good faith, and a reasonable investigation. See id. at 788-89.
26. See id. at 789.
and elected by a controlling shareholder, who may remove them whenever it wishes. Those directors are likely to favor the controlling shareholder’s interest over those of the shareholders as a whole.\textsuperscript{27} Also, as is the case with officers, directors may find themselves promoting the interests of controlling shareholders in part because of bonds developed from personal dealings.

The courts have at times expressed concern over structural bias.\textsuperscript{28} They have not, however, developed any specific doctrine to deal with it. The intermediate standards mentioned above, though, can be seen as ways of dealing with structural bias in particular contexts, as can the weaker deference afforded to decisions involving controlling shareholders discussed above. The conflict between controlling and minority shareholders is significantly different from the agency problem in public corporations with dispersed shareholders, which is our main concern here. The structural bias problems of these two situations are therefore also quite different, but we shall see some similarities in the problems as we turn to public corporations. In particular, there are often valid reasons justifying transactions with controlling shareholders, and where the board has put decision making power in the hands of independent directors, the decision has not been made by the person or entity with the direct interest in the transaction. That being said, there are good reasons to expect that those persons who did make the decision are not fairly looking after the interests of all shareholders equally. This causes a dilemma for courts reviewing such decisions. We shall see some similarities in how courts handle the problems in the cases of controlling shareholders and of public corporations.

C. Good Faith

The Disney cases themselves, pre-figured by several earlier cases, suggest another intermediate standard between loyalty and care: the duty of good faith. The notion of a duty of good faith has origins in both judicial decisions and statutes. The term “good faith” appears in various judicial formulations of the fiduciary duties of a director. Consider, for instance, the canonical Aronson formulation of the business judgment rule quoted above.\textsuperscript{29} One part of the presumption is that the directors acted “in good faith.”\textsuperscript{30} Presumably, then, one route to rebutting the business judgment presumption is to show that they did not, in fact, act in good faith. Before Disney II, though, there was very little guidance as to how one might go about doing that.

There has been a tussle between the Delaware Supreme Court and the Delaware Chancery Court in the doctrinal placement of the duty of good faith.\textsuperscript{31} In several cases in

\begin{itemize}
\item \textsuperscript{27} See Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997) (reversing and remanding the court of chancery’s decision approving a corporation and board of directors’ purchase of stock because the special committee that the corporation established to negotiate the purchase did not function independently, and therefore, the burden shifted to the plaintiff shareholder).
\item \textsuperscript{28} See Biondi v. Scrushy, 820 A.2d 1148, 1164 n.40 (Del. Ch. 2003) (involving stockholders that sued directors, alleging breach of duty of loyalty, breach of fiduciary duty, and improperly received compensation); Guttman v. Huang, 823 A.2d 492, 500 (Del. Ch. 2003) (granting a motion to dismiss in a case in which the plaintiff shareholders sued the corporation’s directors and officers for selling corporate stock based on material, non-public information about the company).
\item \textsuperscript{29} See supra note 11 and accompanying text.
\item \textsuperscript{30} Id.
\item \textsuperscript{31} See Christopher M. Bruner, \textit{Good Faith, State of Mind, and the Outer Boundaries of Director Liability}
the 1990s, the Delaware Supreme Court began referring to a \textit{triad} of fiduciary duties—loyalty, care, and good faith.\footnote{See Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999); Malone v. Brincat, 722 A.2d 5, 10 (Del. 1997); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1997).} These cases suggested that good faith was independent of both loyalty and care. In a variety of cases, however, the chancery court has been more prone to locate good faith as an aspect of loyalty.\footnote{See Guttmann v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003); Nagy v. Bistricer, 770 A.2d 43, 48-49 n.2 (Del. Ch. 2000).} Neither court, however, gave much indication as to what constituted good faith or what sort of behavior they might hold constituted bad faith.

In the Delaware Chancery Court’s \textit{Caremark}\footnote{In re Caremark Int’l., Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).} opinion, the court gave some guidance on this issue, appearing to require boards to attempt to monitor the corporation’s internal affairs to protect against corporate violations of the law, and characterizing the requirement as falling within the duty of good faith. Contrary to prior characterizations of good faith as coming within the duty of loyalty, good faith itself was seemingly characterized as falling within the duty of care.\footnote{See id. at 969-70 (discussing the board’s “supervisory and monitoring role”). In any event, the monitoring requirement is sufficiently weak and hedged that liability for its violation is extraordinarily unlikely.}

Another interesting pre-\textit{Disney} use of good faith was in \textit{Scattered Corp.},\footnote{See id. at 970 (analyzing the concept of director’s duty of care). That is how most commentators understand \textit{Caremark}, including Chancellor Allen, \textit{Caremark}’s author, who in his casebook includes \textit{Caremark} in the chapter on the duty of care. See William Allen, Reiner Kraakman & Guhan Subramanian, \textsc{Commentaries and Cases on the Law of Business Organization} 282-88 (2d ed. 2007). However, in a recent case, the Delaware Supreme Court has placed \textit{Caremark}, and good faith generally, within the duty of loyalty. See Stone v. Ritter, 911 A.2d 362 (Del. 2006). The Supreme Court thereby sided with the Chancery Court’s placement of good faith. See supra notes 32 & 33 and accompanying text.} which helped pull back a bit on the anti-plaintiff turn of \textit{Levine v. Smith}.ootnote{Scattered Corp., 701 A.2d at 73.} In \textit{Levine}, the court seemed to indicate that by making demand upon the board in a derivative case, the plaintiff admitted that the board was disinterested and independent, and thereby forfeited the ability to claim otherwise if demand was refused and the plaintiff brought suit.\footnote{Levine v. Smith, 591 A.2d 194 (Del. 1991).} In \textit{Scattered Corp.}, the court backtracked a bit, allowing that after demand was refused the plaintiff might still argue that the board’s process of refusing demand evidenced that it was not independent and disinterested.\footnote{Id. at 209 (stating that “stockholders who . . . make a demand which is refused . . . subject the board’s decision to judicial review according to the traditional business judgment rule” (citing Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984))).} The court’s characterization was that the plaintiff might be able to demonstrate that in refusing demand, the board did not act in good faith.\footnote{Scattered Corp., 701 A.2d at 71 (“A demand does not preclude a plaintiff from alleging with particularity facts creating a reason to doubt that a special committee in investigating the demand or the executive committee of the board in acting on the demand acted independently and in good faith or conducted a reasonable investigation.”).}

In recent years courts have mentioned good faith at an accelerating pace. They have

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\item \textit{Caremark}’s author, who in his casebook includes \textit{Caremark} in the chapter on the duty of care. See William Allen, Reiner Kraakman & Guhan Subramanian, \textsc{Commentaries and Cases on the Law of Business Organization} 282-88 (2d ed. 2007). However, in a recent case, the Delaware Supreme Court has placed \textit{Caremark}, and good faith generally, within the duty of loyalty. See Stone v. Ritter, 911 A.2d 362 (Del. 2006). The Supreme Court thereby sided with the Chancery Court’s placement of good faith. See supra notes 32 & 33 and accompanying text.
\item Scattered Corp., 701 A.2d at 73.
\item Levine v. Smith, 591 A.2d 194 (Del. 1991).
\item Id. at 209 (stating that “stockholders who . . . make a demand which is refused . . . subject the board’s decision to judicial review according to the traditional business judgment rule” (citing Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984))).
\item Scattered Corp., 701 A.2d at 71 (“A demand does not preclude a plaintiff from alleging with particularity facts creating a reason to doubt that a special committee in investigating the demand or the executive committee of the board in acting on the demand acted independently and in good faith or conducted a reasonable investigation.”).
\end{itemize}
been pushed by plaintiffs trying to bring suits notwithstanding the exculpatory language of section 102(b)(7) of the Delaware General Corporation Law, which brings us to one of the main statutory bases for the duty of good faith. As noted above, section 102(b)(7) allows corporate charters to exempt directors from personal liability for violations of their fiduciary duty. However, the section lists several specific types of duty violations which may not be so exempted. One of these is acts that are not in good faith. Thus, plaintiffs who seek damages are motivated to argue that behavior was not in good faith in order to get around the inevitable 102(b)(7) charter provision.

A second statutory provision of note is section 145.42 Section 145 allows corporations to indemnify directors and officers for debts incurred due to their actions on behalf of the corporation, including the costs of legal liability.43 However, the section does not allow the corporation to indemnify for certain types of legal liability, including liability incurred as a result of actions not in good faith.44

A third relevant statutory provision is section 144.45 Section 144 provides that conflicted transactions are not void or voidable on account of the conflict if they have been cleansed in one of the three ways discussed above, namely disinterested board approval, shareholder approval, or fairness.46 Section 144(a) provides that the transaction will be cleansed only if the board or shareholder approval is in good faith.47

A fourth relevant statutory provision is section 141(e).48 This section provides that directors are protected if they rely in good faith on the records of the corporation and opinions presented by officers, employees, and experts.49 In the rare instances when courts do not allow directors to be protected by this section, the statute’s good faith language has proved important.50

Thus, as both a matter of statute and case law, it appears that either in addition to or as a part of determining whether directors and officers have performed their duties loyally and with adequate care, it matters whether they have acted in good faith. Exactly why and how it matters has not been entirely clear—good faith has occupied something of a nether realm between loyalty and care. Moreover, what it means to act in good faith, or in bad faith, has not been spelled out. Commentators hoped that Disney IV and Disney V would shed some more light on these questions.

42. DEL. CODE ANN. tit. 8, § 145(a)-(b) (2007).
43. Id.
44. Id. Interestingly, though, the Second Circuit held that good faith wasn’t required under section 145(c), the section addressing mandatory indemnification where an officer or director is “successful on the merits or otherwise.” See Waltuch v. Conticommodity Servs., Inc., 88 F.3d 87, 96 (2d Cir. 1996) (stating that when examining a section 145(c) indemnification claim, “the only question a court may ask is what the result was, not why it was.”).
45. DEL. CODE ANN. tit. 8, § 144 (2007).
46. Id.
47. DEL. CODE ANN. tit. 8, § 144(a)(1)-(2) (2007).
48. Id. § 141(e).
49. Id.
III. The Disney Decisions

In the mid-1990s, Disney’s CEO Michael Eisner was looking for a second-in-command who could serve as his presumptive heir. He thought that Michael Ovitz would be a good choice. Ovitz was the founder and head of Hollywood’s largest talent agency. He was a leading player in the industry and a longtime friend of Eisner. As a proven industry executive with close ties to much of the leading movie talent in the world, Ovitz was, Eisner thought, a good fit for Disney. Eisner began negotiations to bring him on as President of the company.

Ovitz was interested, but he demanded a very high price. He wanted a significant reward if things went well, and protection if they did not. As controlling shareholder of a highly successful private company, Ovitz already earned tens of millions of dollars each year, and he didn’t have to worry about getting fired, so it took a lot to convince him to move. The price was extraordinarily high for a non-CEO executive of a public company—extraordinarily high even by the high standards of modern U.S. corporations.51 Eisner took the lead on Disney’s side of the negotiation, helped out by a few other Disney executives and by Graef Crystal, a leading executive compensation consultant. How hard they bargained and to what extent they considered the costs to Disney were among the key debated points in the case. Disney eventually reached an agreement with Ovitz.52

Ovitz started to work for Disney. Well, sort of. By most accounts he did an appallingly bad job, and totally failed to fit into the Disney culture. Before long, Eisner began to negotiate the terms of Ovitz’s departure. Ovitz’s contract called for an extremely generous payout—it turns out that he received around $140 million for leaving the company after a year of pathetic job performance.53 Ovitz would have received much less had Disney been able to fire him for cause under the terms of his contract, but Disney’s counsel did not believe that the company had a plausible argument for a for-cause firing given the contract’s terms.

Given the sizeable amount of money that Ovitz received for doing a horrible job, it was virtually inevitable that some Disney shareholders would sue. They did. The suit claimed that Eisner, Ovitz, and the Disney board violated their fiduciary duties both in negotiating the terms of the contract and in allowing Ovitz to depart without claiming that his firing was for good cause. Initially, in the first Disney case, the Delaware Chancery Court did what Delaware courts generally do where they do not see a loyalty claim—it dismissed on the pleadings.54 The opinion contained a director-by-director analysis of the

51. Ovitz was to receive an annual cash salary of $1 million, cash bonuses up to $10 million a year, and two series of options—the first options were to purchase three million shares of Disney stock at the October 16, 1995 price and the second series to purchase two million shares if he entered into a new contract with Disney. Brehm v. Eisner, 746 A.2d 244, 250 (Del. 2000). Most controversially, the agreement provided that upon a non-fault termination, Ovitz was to receive his salary for the remainder of the contract period, $7.5 million bonus money for each remaining year, a $10 million termination payment, and the three million share options would vest immediately. See id. The original complaint valued the amount Ovitz actually received upon termination at $140 million. Id. at 253.
52. For an overview of the facts in the case, see Disney V, 906 A.2d 27, 36-46 (Del. 2006).
53. See supra note 51 (explaining Ovitz’s contract).
54. In re Walt Disney Derivative Litig. (Disney I), 731 A.2d 342, 380 (Del. Ch. 1998) (dismissing the plaintiffs’ claims against Eisner).
board’s potential domination by Eisner; the court concluded that the bulk of the directors were not so dominated. Among the directors deemed not dominated were the President of Georgetown University; Georgetown had received over $1 million in donations from Eisner. Also deemed not dominated was the principal of the elementary school that Eisner’s children had once attended, whose salary as a teacher was quite low relative to her director compensation. The plaintiffs appealed to the Delaware Supreme Court. In 2000, in Brehm v. Eisner, the supreme court mostly affirmed the chancery court in an opinion that on the whole displayed the usual deference to board authority that the courts show absent a case involving conflicts of interest. However, it did find the board’s behavior potentially disturbing, and allowed the plaintiffs to re-plead their care and waste claims.

The plaintiffs did re-plead their case, this time obtaining more evidence through Delaware’s section 220 procedure and drafting a more careful complaint. This time they also focused more on good faith. Defendants again moved to dismiss, and the chancery court issued a new opinion in 2003, in Disney II. The court denied the motion to dismiss. It held that if the plaintiffs succeeded in establishing the facts they had pled, they might be able to demonstrate that the board had acted in bad faith both in negotiating the contract and in not trying to terminate Ovitz for good cause. The case thus proceeded to a well-publicized trial. After the trial, Chancellor Chandler issued a new opinion in 2005, in Disney IV. He found for the defendants on all claims. Although Chancellor Chandler thought that Disney’s process was far from ideal, the chancery court held that the board had not behaved badly enough to give rise to legal liability.

55. Id. at 356-61.
56. Id. at 359-60. As to the school principal, the court reasoned that to deem her dominated would be to discourage the membership on corporate boards of people of less-than extraordinary means. Such “regular folks” would face allegations of being dominated by other board members, merely because of the relatively substantial compensation provided by the board membership compared to their outside salaries. I am especially unwilling to facilitate such a result.
57. Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) (giving plaintiffs “another opportunity” to plead particularized facts alleging doubt that the Disney board made a business judgment).
58. Id.
59. Id.
60. In re Walt Disney Co. Derivative Litig. (Disney II), 825 A.2d 275 (Del. Ch. 2003).
61. Id.
62. Id.
63. Id.; see, e.g., Posting of Peter Lattman, We’re going to Wilmington!, Wall St. J. Online (Jan. 25, 2006, 10:54 EST), http://blogs.wsj.com/law/2006/01/25/were-going-to-wilmington/ (characterizing Disney V as “closely watched”).
64. In re Walt Disney Co. Derivative Litig. (Disney IV), 907 A.2d 693, 779 (Del. Ch. 2005). In a less consequential decision, the chancery court granted Ovitz summary judgment on the claim that he violated his fiduciary duty in negotiating his contract, holding that Ovitz was at that point not yet a Disney fiduciary. In re Walt Disney Co., No. Civ. A. 15452, 2004 WL 2050138 (Disney III) (Del. Ch. Sept. 10, 2004). That issue is tangential to those raised in this Article. The court held that there were issues of material fact as to the waste claim and the claim concerning Ovitz’s duties in receiving a non-fault termination, with only brief discussion.
65. Disney IV, 907 A.2d at 778-79.
66. Id. at 776 (“Because the board was under no duty to act, they did not violate their fiduciary duty of care, and they also individually acted in good faith.”).
board did have reason for paying Ovitz so much—and he was in a good bargaining position given how well he was doing with his own business. The board also had done some calculations in examining the terms of the proposed contract, making some use of work done by compensation consultant Crystal. As for Ovitz’s firing, the court accepted the argument that Disney did not have any valid contractual grounds for dismissing him with good cause. 67 The Delaware Supreme Court affirmed in 2006, in Disney V. 68

We comment on three elements of the opinions: doctrine, politics, and procedure. Doctrinally, the courts seemed to make clear that they recognize a triad of fiduciary duties: loyalty, care, and good faith. 69 The court also gave some guidance as to what bad faith means. The Delaware Supreme Court approvingly cited and commented upon the following chancery court language: “[T]he concept of intentional dereliction of duty, a conscious disregard for one’s responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith.” 70

However, neither the chancery court nor the supreme court provided much guidance as to what plaintiffs could do to demonstrate that decisions have been made in bad faith (or lack of good faith) so defined. In an enlightening early account of Disney II, Sean Griffith showed that the court’s analysis of the board’s decision making went back and forth between loyalty and care types of analysis, looking at both motivation and decision making procedure, but not clearly relating the two. 71 In Disney II, the court repeatedly noted that Ovitz and Eisner were good friends, and suggested that Eisner strongly dominated the Disney board. These circumstances suggest that the disinterestedness and independence of the board were questionable. And yet, they clearly do not give rise to a conflict cognizable under traditional loyalty analysis. Mere friendship with Ovitz did not give Eisner a problematic interest in his compensation; moreover, even if it did, the independence of the board legitimized its approval of Ovitz’s hiring and compensation. Elsewhere in the opinion the court repeatedly questioned the board’s decision making process. 72 Most board members spent very little time examining and discussing the Ovitz contract. According to the plaintiffs’ allegations, neither Disney officers nor Crystal did enough to calculate the cost to Disney should Ovitz be fired early (this is one point where, after trial, the court did not accept the plaintiffs’ allegations—it found that Disney

67. Id. at 720-21.
68. Disney V, 906 A.2d 27, 75 (Del. 2006).
69. See id. at 66-67. A later case places good faith within the duty of loyalty. See Stone v. Ritter, 911 A.2d 362 (Del. 2006). In retrospect, Disney V distinguishes bad faith from disloyalty “in the classic sense” or “as traditionally defined.” Disney V, 906 A.2d at 66. Stone expands loyalty to include good faith. Stone, 911 A.2d at 369.
70. Disney V, 906 A.2d at 62. Most of the language discussing good faith in both the chancery and supreme court opinions speaks as though a lack of good faith, in some common sense use of the term, would not suffice for bad faith. It uses the phrase “lack of good faith” to mean either intentional action or inaction or something quite close to it. Part V, infra, briefly considers whether it might make sense for a “lack of good faith” that does not rise to the level of “bad faith” as presently defined to trigger or play a role in triggering liability. The court’s language resembles some formulations of recklessness used in defining scienter for purposes of Rule 10b-5 liability. For a helpful analysis of good faith from that perspective, see generally Hillary A. Sale, Delaware’s Good Faith, 89 CORNELL L. REV. 456 (2004) (discussing scienter as an element of good faith).
72. Id. at 22.
and Crystal had done more than the plaintiffs alleged). This emphasis on lax procedure in the way the board informed itself is at the core of care analysis. And yet, given how loose the care standard is, it was hard for the court to find that the standard had not been met. Moreover, since bad faith is supposed to be worse than lack of care, the court struggled to articulate a standard whereby this board’s process might have been bad enough to allow the case to continue. Thus, it was very hard for the plaintiffs to succeed under either a loyalty or care claim, and yet there was enough concern about both to trouble the court. The court let the case proceed without dismissal, and suggested the above-quoted language as the standard for good faith. It never, however, really pulled together the loyalty and care aspects of its concern for what happened. 

Both the loyalty and care concerns are real and disturbing. The board was very far from a model board; the process was very far from a model process. As to the board composition concern: Eisner clearly dominated this board. Recall the presence among the directors of the principal of Eisner’s children’s school and Leo O’Donovan, the President of Georgetown University, to which Eisner had given significant contributions. Other directors included Eisner’s personal lawyer and the architect who designed a home for Eisner. In short, the bulk of the Disney board was not independent in any common sense use of the term. Indeed, the court’s director-by-director analysis is almost astounding in demonstrating the opposite of what it concludes. We seriously doubt whether this board would have carefully scrutinized a contract with Eisner himself. The problem is attenuated, though, for Ovitz, with whom most of the directors did not have a significant relationship before they hired him. It is attenuated but still real, given the close friendship between Ovitz and Eisner. One can easily interpret the hiring of Ovitz as a ploy for Eisner to use Disney shareholder money to lavish riches upon a good friend. As to the process concern: the process was also very far from what we would like boards to do, as the courts repeatedly acknowledge. Hiring Ovitz was important—it was a very visible move, and he was to be the presumptive next CEO. The board paid him a vast sum of money, and yet did not look closely into the details of the contract. As an article in the December 8, 1997 issue of Business Week noted:

Disney’s directors have won the dubious distinction of being named the worst board in America in Business Week’s second annual analysis of the state of corporate governance. Institutional investors and boardroom watchers scorn

73. Disney V, 906 A.2d at 56-58.
74. See Griffith, supra note 71, at 34-36.
75. As reported by John A. Byrne:

Among Disney’s 16 directors are Eisner’s personal attorney—who for several years was chairman of the company’s compensation committee—and an architect who designed Eisner’s Aspen home and his parents’ apartment. Joining them are the principal of an elementary school once attended by his children and the president of a university to which Eisner has donated $1 million. The board also includes the actor Sidney Poitier, seven current and former Disney executives, and an attorney who does business with Disney. Moreover, most of the outside directors own little or no Disney stock. “It is an egregiously bad board—a train wreck waiting to happen,” warns Michael L. Useem, a management professor at the University of Pennsylvania’s Wharton School.

what they see as a meek, handpicked group, many of whom have long ties to Eisner or the company.\textsuperscript{76} We would be hard pressed to better depict structural bias.

But there were some mitigating factors which pull the case back from the most extreme scenarios. As just noted, this contract was with a friend of the authoritarian CEO, not with the CEO himself. In important ways, Ovitz did seem like an attractive hire, and his position as controlling shareholder of a fabulously successful private company did give him major bargaining leverage—a genuine arms-length bargain would still have led to a highly attractive package.\textsuperscript{77} The company used one of the best compensation consultants around, Graef Crystal. Moreover, several Disney officers did seem to act as a brake in the process, questioning the benefits the company would get from hiring Ovitz. Their motivations in doing so do not appear pristine—Ovitz was a rival for the heir-to-Eisner role that they coveted—\textsuperscript{78}—but that makes us even more inclined to believe that this was not a completely cozy set-up and done deal. All of these factors seem to affect the courts in the final 2005 and 2006 opinions exonerating the defendants, and properly so. Still, it seems highly unlikely that Eisner would not have gotten his way. Of course, he did get his way after what all acknowledge was a less-than-exhaustive consideration of a major decision.

Courts’ concern about structural bias has seemed to ebb and flow. In the Disney set of cases, it started off quite low, with the formalistic director-by-director analysis leading to a finding that plaintiffs could not bring their suit. Concern seemed to reach a peak in 2003 in Disney II, when the chancery court permitted the case to go forward. In the period from the 2005 chancery court opinion in Disney IV to the 2006 supreme court opinion in Disney V, concern for structural bias seemed to be on the decline: Disney IV criticized the directors’ conduct fairly harshly notwithstanding ruling in their favor. By contrast, Disney V used a softer tone, describing the directors’ conduct far more solicitously.

What inferences can be drawn from this ebb and flow? One inference is, of course, that the issues involved are quite difficult, with the courts’ sensitivity to them being counterbalanced by their reluctance to adopt something closer to loyalty-level scrutiny. We shall return to this point later. Another inference one can draw is that the political climate is an important determinant of corporate law. Consider in this regard the relevant events of the period during which the Disney cases took place.\textsuperscript{79} In 2000, the internet boom market had just peaked, and the mood in the corporate world was relatively deregulatory. Reflecting this, the 2000 supreme court opinion in Brehm leans strongly towards deference to board authority. However, by the time of the chancery court opinion in 2003 (Disney II), the internet market bust and, various corporate scandals such as Enron and WorldCom had occurred, Congress had passed Sarbanes-Oxley, and the U.S....

\textsuperscript{76} Id. (emphasis omitted). The article goes on to note, “Yet Eisner shows no signs of backing down. ‘We have a fantastic board,’ he insists, ‘and I hope I’m not intimidated into changing the direction of the board.’” Id.

\textsuperscript{77} That being said, we do not mean to suggest that companies routinely make cronyistic hires on above market rate terms of people who do not have the required qualifications.

\textsuperscript{78} See Disney V, 906 A.2d at 44-45.

\textsuperscript{79} See Griffith, supra note 71, at 54-68 (describing the facts surrounding the Disney cases); see also Sean J. Griffith & Myron T. Steele, On Corporate Law Federalism: Threatening the Thaumatrope, Bus. LAW., Nov. 2005, at 1, 17-21 (same) .
Securities and Exchange Commission (SEC) was in activist mode. The pressures thus created may help explain the chancery court’s opinion and its relative lack of deference to the board. By the time of the 2005 chancery court opinion in Disney IV, events had moved on. The scandals were two years further in the past, and an anti-Sarbanes-Oxley backlash made further federal intervention less likely, leaving more room for the Delaware court to return to its usual pro-management position.

This outline of the politics of the Disney cases reflects several important broad patterns. Our mixed federal system of regulating corporate governance creates a variety of political pressures on Delaware, the leading state corporate law jurisdiction. On the one hand, other states stand ready to take corporations away from Delaware should Delaware’s rules become too unattractive. On the other hand, federal actors (Congress, the SEC, and the securities exchanges) may preempt many areas of corporate lawmaking if they are unhappy with what Delaware is doing, with Sarbanes-Oxley standing as a leading example of national action. Different affected interest groups have differing abilities to affect rulemaking at the state and federal levels. Managers and corporate lawyers tend to have more influence at the state level, whereas shareholders and perhaps other constituencies such as creditors and employees do better politically at the national level. The specialization of Delaware courts and the experimentation that occurs among the states also tends to lead to higher-quality rulemaking in Delaware. The mixed federal system thus allows much corporate lawmaking to be done by highly expert bodies, the Delaware courts, while the threat of preemption by the SEC and Congress helps keep in check the tendency towards managerial bias to which Delaware is prone.80

The differing interest groups push the law in different directions; managers and corporate lawyers tend to push towards limited and enabling regulation on most matters, while shareholders and other constituencies tend to push for more expansive and mandatory regulation. The relative strength of these groups varies over time, in part in response to how well things are going in the area of corporate governance. Thus, in the late-1990s stock prices were booming and the dot-coms seemed to be leading a vigorous and innovative economy. In the early years of this decade, in contrast, the corporate scandals and capital market downturn made things look bleaker. Shareholder activists became a more powerful political force as they looked for ways to reform the system. One can see this as a useful learning process—problems arise, they generate pressure for change, and the regulators generate new solutions. A more cynical view sees a cycle driven by the availability bias81—constituents and politicians panic when scandals dominate the press, then they become overly complacent in times when few corporate scandals have received recent attention.82 Both of these views strike us as partly right—


81. For a discussion of the availability bias or heuristic, see Russell Korobkin & Tom Ulen, Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics, 88 CAL. L. REV. 1051, 1087 (2000).

82. See Larry E. Ribstein, Bubble Laws, 40 HOUS. L. REV. 77 (2003) (discussing the effect of post-crash regulation on the market’s ability to recover from the crash).
they are not mutually exclusive.

The Delaware courts thus need to respond to different interests expressed at different political levels, and they need to modify their responses over time as both corporate governance and political strength vary over time. Sean Griffith argues persuasively that the doctrinal flexibility of fiduciary duty cases, in part, works to give the courts room to maneuver politically. They in part explains the evolution of good faith. In good times the language of good faith was present in the opinions, but had no actual effect. When times got more troubled and the courts felt a need to apply more pressure to boards, the good faith language proved useful in letting plaintiffs get further than they would have in the past. However, the courts did not commit themselves to forever remaining more activist—when the troubles reeled, the flexibility of their language allowed them once again to return to the practice of giving strong deference to boards. And this is precisely what happened in Disney.

This sketch of the politics of the Disney cases provides at least two lessons. First, it suggests that the legal rules resulting from this process make a certain degree of sense. The main interest groups with a stake in the law are represented in the process, at either the state or the federal level, creating roughly appropriate pressures on the Delaware courts. Second, for any suggested proposal to have a chance of adoption in Delaware, it must give the courts a wide degree of flexibility to meet differing political pressures over time; however, it also should not move too radically from the balance that the law has achieved today. The proposal in Part VI reflects those constraints.

The procedural posture of the different decisions also helps explain their outcomes. The 2000 case, Brehm, was a motion to dismiss, but one in which the plaintiffs had done a poor job in gathering information under section 220. The court allowed the plaintiffs to re-plead, but chided them for doing such a poor job in gathering information. The 2003 case, Disney II, also involved a motion to dismiss, but that time the plaintiffs provided considerably more information. This allowed them to go to trial. In many cases over the last decade or two, the Delaware courts have pushed plaintiffs to refine their complaints and plead with greater factual particularity. They have strongly encouraged plaintiffs’ counsel to use section 220 to gain access to corporate documents that will help them obtain the facts they need to create such improved complaints. The Disney cases fit nicely within this pattern.

The 2005 ruling in Disney IV followed a trial rather than pleadings. The plaintiffs had to meet a higher standard to prevail at trial, and they failed to do so. Note the pattern that may emerge. As lawyers learn more about what they need to do to create particularized complaints that are better able to survive motions to dismiss, and are thereby aided by an augmented duty of good faith that gives a doctrinal hook for those

83. Griffith, supra note 71, at 57.
84. See Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000).
85. In re Walt Disney Co. Derivative Litig. (Disney II), 825 A.2d 275, 279 n.5 (Del. Ch. 2003).
86. See Veasey & Di Guglielmo, supra note 50, at 1497 (noting that "some plaintiffs have recently—finally—heeded the Delaware Supreme Court's and Court of Chancery's repeated admonitions to pursue a section 220 action to obtain facts that will allow them to plead their claims with sufficient particularity").
facts, more cases will be able to survive past the early stages. Still, very few cases are likely to lead to damages being assessed against disinterested outside directors. Ex-Chief Justice Veasey put the matter well:

Procedure matters: many opinions turn on the procedural posture of the case. To the extent that the Supreme Court has reversed Chancery dismissals of cases with prejudice at the pleading stage, the Supreme Court establishes a precedent based on well-pleaded but sometimes extreme allegations. This may facilitate the development of an important genre of Delaware decision making. That is, an opinion that raises questions or teaches without imposing liability may provide guidance to the corporate world to conform to best practices without the downside of actually imposing personal liability.88

In cases like these, the company, its directors, and its officers do suffer. Consider the Disney corporation—it has been subjected to a case that dragged on for almost a decade, with legal costs, time demands upon its directors and officers, and plenty of bad publicity. Surely directors will want to do what they can to avoid these hassles, even if they face little if any risk of being assessed significant sums payable from their personal assets. The hope is that to avoid these hassles, directors will be motivated to do a better job. The fear is that a resulting increase in meritless suits will drain corporate resources and chill risk-taking without improving corporate decisions.

IV. DISNEY AS EXEMPLAR

The Disney cases are exemplars of problematic cases in which the traditional doctrinal solutions don’t work. There was no cognizable duty of loyalty breach. No director or officer was on both sides of the table,89 no relative of a director or officer was being hired, and no other classic category of self-dealing, such as competing with the corporation, was at issue.90 Thus, the other obvious choice was duty of care—a claim that the decisions at issue were made without due deliberation and consideration. But such a claim wouldn’t have succeeded, given how high the threshold is for the gross negligence required to establish a care claim.91 Even if such a claim had succeeded, it wouldn’t have yielded any monetary recovery, since Disney has in its corporate charter the exculpatory language permitted under section 102(b)(7).92 Thus, the plaintiffs had to do more in order to bring their case to court. Part III discussed how they couched their claim, and what the court’s response was.

89. Except, of course, Ovitz, and the courts held that he did not become an officer until after his agreement was essentially complete, and that he played no part in the decision to terminate his employment.
90. The plaintiffs argued that Eisner benefited from high pay levels for executives at Disney generally. Disney I, 731 A.2d 342 (Del. Ch. 1998). However, the loyalty doctrine wouldn’t render a decision by the board a breach of the duty of loyalty because of one person’s attenuated benefit. Id. In any event, the court noted that because Eisner owned significant stock options in Disney, an excessive payment to Ovitz would dilute the value of Eisner’s options, hence reducing the extent to which it was in Eisner’s interest to pay Ovitz excessive compensation. The court didn’t mention, though, that if Eisner were successful in increasing his pay by establishing a higher baseline via Ovitz’s compensation, Eisner might do better in his compensation than he would lose in dilution of value of his stock options.
91. See supra notes 11-19 and accompanying text.
Putting aside the doctrinal overlay, the shareholders’ real concern was that Michael Ovitz had been picked for his position because he was a friend and crony of Eisner’s, that the negotiations for Ovitz’s compensation had scarcely been at arms length, and that the rest of the board (or enough to assure approval) had simply rubber stamped what Eisner wanted. Shareholders also worried that when Ovitz was being terminated after 14 months, having clearly done a bad job, the determination to call his termination “not for cause” and therefore trigger high severance was also a product of a cronyistic board—that is, structural bias.93

How can courts get at these types of decisions? One way would be to show that but for structural bias, a particular decision would never have been made. But these types of board decisions always come with available procedural and substantive justifications. Certainly, the “waste” standard will never be met, and there will always be some evidence that the decision was considered, and with the help of experienced advisors. Indeed, while it’s difficult not to see the structural bias as a necessary feature of the decision, it’s also difficult to see the structural bias as sufficient.

What about a smoking gun? In an interesting contracts case, Sondra Locke sued Warner Bros. Studio for reneging on a promise to consider in good faith projects she proposed to develop for the studio.94 The studio made the promise to placate one of its big stars, Clint Eastwood, who was involved in an acrimonious break-up.95 Locke presented evidence of overhead conversations in which studio executives said to one another “[W]e’re not going to work with her,” and then, ‘That’s Clint’s deal.”96 Without that evidence, Ms. Locke would have been hard pressed to show any kind of breach. Similarly, since the corporate decisions at issue are defensible as a matter of procedure and substance, without catching the directors saying to one another “we’re going to do what Eisner wants no matter what we think” or some such thing, it’s hard to imagine how courts could make a determination that the decision was in fact the product of structural bias.

We pause at this point to anticipate an objection to the obvious trajectory of our argument. If the decisions at issue are in fact defensible, where is the harm to shareholders? We have two responses. First, shareholders are entitled to decision making that doesn’t just justify a foregone conclusion, just as Locke was entitled to due consideration of her projects. Second, what makes the decisions at issue substantively justified is that boards generally are making decisions that are comparable. If boards began approaching decision making much more critically, the overall norm might shift. If, for instance, there was enough critical and independent consideration of compensation packages, perhaps the prevailing rates might fall so that packages that are now readily justifiable and justified given prevailing wage rates would need more justification.97 In the next Part, we lay the groundwork for our proposed solution.

93. See id.
95. Id.
96. Id.
V. ON STRUCTURAL BIAS

As discussed above, in the small set of cases where directors have a direct monetary stake in corporate decisions, courts will scrutinize the decisions very closely. But shareholders’ concerns go beyond such decisions; there are many decisions they may find problematic that do not breach the narrowly-constructed duty of loyalty. As discussed, the other principal handle for shareholders is to claim a breach of the duty of care. Shareholders can always try to make such claims whenever there is a decision that has bad results, but courts are understandably reluctant to micromanage corporate affairs and potentially chill director decision making. Hence they give significant deference to directors and their decision making process, intervening only where strong evidence of woefully deficient process is provided. The courts have no such fear with duty of loyalty breaches. The set of transactions that can be scrutinized is significantly circumscribed, and there’s not much, if any, cost to chilling the behavior at issue. How bad would it be if corporations never hired their directors or officers’ relatives or entered into transactions with their directors or officers as principals on the other side? Or at least made sure such transactions were approved by disinterested parties as well as being on terms at least as favorable to the corporation as third-parties would offer?

However, the vast bulk of cases outside the duty of loyalty rubric, while typically brought as duty of care cases, are, in some profound sense, not about lack of care where care means grievous inattention.98 Instead, a sense of directed and probably pre-destined decision making is what is at issue: the directors’ decision was significantly, and perhaps dispositively, influenced by their relationship with the officers (or in some cases, the controlling shareholders who elected them). The decision making process isn’t such as to allow thorough, critical consideration. A cynic might even argue that the decision making process was engaged in as much or more to protect the directors from liability as to actually make the decision. Still, the decisions can’t be successfully attacked on account of the lack of independence, or the “interest,” of the directors. Most directors are not beholden to the officers in a way that the law finds cognizable; consider the characteristics of the Disney board itself.99 Indeed, we have discussed just how circumscribed the loyalty category is: a director is involved in a decision in which he has a personal monetary stake, such as the corporation’s acquisition of a business or property in which he has an interest. Certainly, self-interest is implicated in the cases we discussed in Part II.B, where a board is deciding to ward off suitors or deciding among suitors. But many decisions might be distorted by self-interest. What acquisitions will the corporation pursue? The board may favor acquisitions as a means of empire-building, wanting to become part of a larger and more important entity with all the personal benefits that entails. What charities will the company donate to? Perhaps the


ones whose charity functions the directors or officers would like to attend. Where will the corporate headquarters be located? The decision may turn on where the officers want to live. And of course, potentially touching every director’s decision is her desire to keep her director position. Doing so depends on whether she stays in management’s good graces. Where the officers themselves do not have any sort of personal stake, this dependence of directors upon management yields only a lack of careful board oversight; the decision itself is not inherently biased. Where the officers do have some sort of personal stake, however, the objectivity of the resulting corporate decision becomes questionable.

These are cases where direct benefit to self is at issue. There are also the more attenuated cases, where directors defer to officers, or award officers generous compensation, because that’s how the directors would want to be treated if they were the officers—a pernicious golden rule. Compounding these effects, most boards are comprised of people selected by management; if they weren’t management’s friends before their board service, they may become so in the course of their board service. Furthermore, most directors are from the same social group as officers: they are often themselves officers or former officers of other corporations, lawyers, or bankers prominent in the business community. As members of the same social group, directors might naturally see issues from an officer’s perspective, rather than from the perspective of an employee, customer, or shareholder.

For all these reasons, the board’s critical faculties may not be fully engaged because the directors are biased against corporate interests and in favor of the not-infrequently-differing interests of officers, controlling stockholders, fellow directors, or themselves. The specter of structural bias looms large.

No definitive or consensus definition of structural bias exists. In our view, the strongest case is where a director makes a decision that she knows or ought to know may favor her own interests or those of another director, officer, or controlling stockholder to whom she is beholden over those of the corporation. Of course, these determinations are very fact-sensitive. Indeed, courts have had enormous difficulty judging when someone is improperly beholden. The most direct cases are subsumed within the classic doctrinal duty of loyalty. However, as we have argued, these are scarcely the only cases that cause concern. Consider, in this regard, the relationships of some of the Disney directors and Eisner. More attenuated, but still potentially problematic, connections are the sorts discussed in the literature defining director independence: interlocking directorates, common membership in professional and social associations, and so on.

The types of decisions at issue will typically fit into one of several stylized

100. See generally Board Analyst, Features & Services: Networking & Director Interlocks Tools, http://www.boardanalyst.com/index.asp?p=prodser&ks=psndit (providing “a suite of tools to help subscribers better understand the linkages of inter- and intra-board relationships as well as searchable information on key corporate leaders and their expertise”). Board Analyst notes that, “[i]nterlock data goes beyond corporate board appointments to include: Involvement with industry associations[,] key political alignments[, and] other non-corporate affiliations.” Id. The interlocks tool and software help those with the concerns we discuss ferret out potentially problematic interlocks.

101. See id.; see also BEBCHUK & FRIED, supra note 97, at 23-36 (2005) (discussing the standards of directors independence and their limits as well as interlocks and friendship as problematic connections).
categories. The most notable is executive compensation. In executive compensation decisions, the officer being compensated clearly has a strong personal stake. The board has ties to that officer (with the problem being most severe in the case of CEO compensation, given the usual role of the CEO in deciding who is on the board). In addition, board members are usually officers elsewhere, so the pernicious golden rule comes into play, and class bias may make them believe that high compensation is a natural birthright. Mergers, acquisitions, and takeovers not covered by Unocal or Revlon are another important category of cases where structural bias is potentially problematic. In this regard, we note that Smith v. Van Gorkom, a seminal duty of care case involving a takeover, implicates structural bias concerns. The board in Van Gorkom was very hasty in approving a takeover; it seems exceedingly likely that they deferred to the CEO’s promotion of the takeover because of their ties to him. Board refusal of shareholder demands is another classic case raising concerns of structural bias—the directors voting to refuse demand are either implicated in the underlying case themselves or are voting on whether or not their fellow directors should be sued. It is highly unrealistic to expect much objectivity in this decision.

While economic theory might suggest that markets (for corporate control, executive labor, and products) will discipline companies that pay their executives too much money, or have rubber-stamp boards that approve what the officers want no matter how ill-considered, the reality is quite different. There is simply too much noise in corporate results, and in economic conditions, for the market to work as well as theory would require. Collective action problems also impede market discipline: it is often not worthwhile for particular shareholders to bear the costs of changing problematic management when they won’t receive the entire benefits. Certainly, there is considerable anecdotal evidence of officers getting massive payouts while presiding over companies whose stock prices and financial results have plummeted. There is a good case to be made that officers, with the help of directors, often get what they can rather than what they are worth. Obfuscatory disclosure, gaming of performance measures, and “creative” structuring of compensation formulas ex ante and ex post also complicate the operation of market discipline.

Of course, this Article has only briefly touched on what is perhaps the central debate in corporate law circles: the extent to which markets constrain corporate decision makers.

102. See generally BEBCHUK & FRIED, supra note 97.
103. On the link between poor corporate governance and executive compensation, see id. at 30.
104. See infra note 127 and accompanying text.
106. Id. at 880.
107. See supra notes 40-41 and accompanying text.
108. See BEBCHUK & FRIED, supra note 97, at 53-58.
109. See generally id. at 53-58 (discussing the market for corporate control and a board’s defenses to takeovers); see also MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 5-7 (1994) (discussing the powerlessness of shareholders within the corporate control framework).
110. See, e.g., Michael Brush, The 5 Most Outrageously Overpaid CEOs, MSN MONEY CENT., Aug. 24, 2005, http://moneycentral.msn.com/content/P125120.asp (describing the large payouts to executive officers despite their ineffective performance).
111. See generally BEBCHUK & FRIED, supra note 97.
112. See id. at 121-200.
We do not purport to have resolved this issue. Readers who agree with us that markets have serious limits may nevertheless believe that our proposed approach, discussed in the next Part, is likely to help address those problems. For those with more faith in markets (or less faith in governmental solutions), note that we take the counter-arguments quite seriously and do not propose a huge shift from the current relatively light regulatory regime. Rather, we suggest using the law to nudge market and social forces in a better direction.

VI. WHAT SHOULD THE COURTS HAVE DONE?

We have argued that there is an important category of cases where neither loyalty nor care analyses fit well. In these cases, directors do not have traditional conflicts of interest, but structural factors may blunt their motivation to focus upon the corporation’s interests in the way we would like.\footnote{113} The duty of good faith provides an intermediate fiduciary duty that could be fashioned to address this category of cases. The Delaware courts have taken a first step. However, they have left the duty of good faith too vague to provide any real guidance.

We suggest the following way forward. Ultimately, directors and officers owe only one fiduciary duty to a corporation—the duty to actively pursue the best interests of the corporation.\footnote{114} The duties of loyalty, care, and good faith address differing aspects of this duty. Courts have adopted various more specific formulations of fiduciary duties in order to deal with problems and fact patterns that regularly arise.\footnote{115} The traditional duty of loyalty addresses situations where directors or officers have material conflicts of interest that are likely to tempt them to favor their own interests over those of the corporation. The duty of care addresses the natural human tendency of directors and officers to not actively exert themselves in pursuing the interests of others. However, on some profound level, it, too, is a breach of the fiduciary duty of loyalty, although the courts do not consider it such—directors and officers are taking leisure that they are not entitled to. The Unocal, Revlon, and Zapata standards apply to circumstances where specific problems arise. As discussed above, Unocal and Revlon fall within the more traditional duty of loyalty ambit insofar as they involve business decisions where the potential for self-dealing is significant. By contrast, Zapata implicates structural bias concerns. The duty of good faith has the potential to address recurring and diverse situations of structural bias of the sort analyzed in Parts IV and V.

How can courts adapt the duty of good faith for this purpose? One non-exclusive way for plaintiffs to make a prima facie showing of the absence of good faith, thereby rebutting the business judgment presumption, should be to establish two elements. First, structural factors are present that would likely cause the directors making the relevant decision to be biased against the interests of the corporation, where the decision itself concerns a matter where a director, officer, or controlling shareholder has an interest adverse to the corporation’s interests.\footnote{116} Second, influenced by those structural factors,
the directors were grossly negligent in making the decision. These two elements should be related on a sliding scale. The stronger the structural bias, the weaker the showing of gross negligence would need to be.

The gross negligence standard in the second element obviously borrows its language from traditional care analysis. For now, there is no need to try to calibrate that language more precisely—each case will inevitably turn upon applying this general standard to the specific facts. This will involve comparing what the board did in a given case with aspirational standards of good corporate governance and asking if the actual behavior was just too far removed from the aspirational level, as the courts did in Disney II, IV and V, with the understanding that the actual behavior must be very far indeed from the aspirational level in order to give rise to a finding of lack of good faith.

If plaintiffs succeed in demonstrating these two elements to the court’s satisfaction, they will have presented sufficient evidence to rebut the presumption that the defendants acted in good faith, thereby removing the protection of the business judgment rule presumption. However, defendants should be allowed to present any relevant counter-evidence tending to rebut the inference of bad faith created by the plaintiffs’ evidence as to the two elements. If the defendants do so, then the court would need to weigh the evidence presented by both sides and decide whether or not the plaintiffs have made an adequate showing of lack of good faith.

At this point bad faith and good faith need a bit more elaboration. In the Disney line of cases, the opinions of both the Delaware Chancery Court and Delaware Supreme Court refer to both “bad faith” and the “absence of good faith.” The duty is sometimes articulated as a duty to act in good faith. But is the absence of good faith the same as bad faith? Does bad faith require some affirmative and problematic intention, such as an “intentional dereliction of duty”? The opinions are not completely clear or consistent on this point.

The chancery court’s opinion in Disney IV includes the following language:

Good faith has been said to require an “honesty of purpose” and a genuine care for the fiduciary’s constituents, but, at least in the corporate fiduciary context, it

117. We note that as we understand the structure of current doctrine, even if the court concludes that the plaintiffs have succeeded in establishing that defendants acted in bad faith, the defendants would still have the opportunity to argue that their decision was nonetheless fair to the corporation under the entire fairness standard. That, at any rate, is how the Delaware courts treat cases where plaintiffs succeed in showing that defendants lacked due care in informing themselves in traditional care analysis, and the same analysis would seem to apply to good faith. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 373 (Del. 1993) (finding that the lower court erred when it imposed a higher burden of proof on the plaintiff than was necessary to rebut the “business judgment presumption of care”). We are not sure that this doctrinal structure makes sense, and indeed even some sitting Delaware judges have criticized it. See William T. Allen, Jack B. Jacob & Leo E. Strine, Jr., Function over Form: A Reassessment of Standards of Review in Delaware Corporate Law, 56 BUS. LAW. 1287, 1292 (2001) (advocating judicial standards of review that more closely match the policies underlying Delaware corporate law). However, whether or not the courts choose to retain that particular doctrinal structure is a decision that is orthogonal to our proposal.

118. See supra note 70 and accompanying text. In Disney IV, the Delaware Chancery Court expressly stated that “intentional dereliction of duty” and “conscious disregard for one’s responsibilities” are non-exclusive standards for demonstrating that defendants had (not) acted in good faith. Disney IV, 907 A.2d 693, 755 (Del. Ch. 2005).
is probably easier to define bad faith rather than good faith . . . . Bad faith has been defined as authorizing a transaction “for some purpose other than a genuine attempt to advance corporate welfare or [when the transaction] is known to constitute a violation of applicable positive law.” In other words, an action taken with the intent to harm the corporation is a disloyal act in bad faith. A similar definition was used seven years earlier, when Chancellor Allen wrote that bad faith (or lack of good faith) is when a director acts in a manner “unrelated to a pursuit of the corporation’s best interest.” It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation.119

While the quote at points expressly makes equivalent bad faith and lack of good faith, it at other points articulates the two concepts quite differently. And the difference is critical: lack of good faith, articulated as lacking the “genuine care” for the fiduciary’s constituents, is precisely what seems lacking in the paradigmatic structural bias situations. But “intentional dereliction”—the affirmative definition of bad faith—is far harder to demonstrate. In our view, the concept of “absence of good faith” is the one courts should use.120 Recalling our discussion from the previous Part as to the strongest case for structural bias, the stronger the case is that the director knew, or should have known, that the decision at issue might favor an officer’s or director’s (or controlling shareholder’s) interests in a manner adverse to those of the corporation, and the more beholden the director is to the person with the adverse interest, the less of a showing of defective procedure would be needed.

In our view, good faith ought to—and in our best reading of the present doctrine, does—operate both as a third prong to Aronson, and as a substantive ground for liability.121 That is, if plaintiffs succeed in their pleading in presenting evidence that establishes a lack of good faith, either via our proposal or otherwise, then demand in that case is futile. If the facts as developed by the time of final judgment continue to show a lack of good faith, then the defendants can be held personally liable on that basis. On the Disney facts, the plaintiffs would have gotten a trial, precisely as they did, although they might have received it on the basis of the pleadings presented to the chancery court in the 1998 decision in Disney I. On the facts elicited at trial, they would have lost, just as occurred.

Our proposed test for demonstrating a lack of good faith has both evidentiary and prudential justifications. As for the evidentiary justification, bad faith is in part (though not always) getting at bad motivation, but it is often hard to provide objective evidence of subjective intent. Our standard singles out instances where an inference (and perhaps even, a presumption) of dubious motivation seems valid. If one starts with a situation where directors are likely to not be motivated to pursue the corporation’s interests, and

119. Id. at 753.
120. Note that the Delaware Supreme Court expressly considers three potential categories of bad faith: (1) subjective bad intention (nobody argued this was present in the Disney IV case), which the court agrees constitutes bad faith; (2) gross negligence, which the court says clearly does not constitute bad faith; and (3) “intentional dereliction,” which the court says would constitute bad faith. Disney IV, 907 A.2d at 753-56.
121. The Delaware Supreme Court in Stone seems to deny good faith as a substantive ground for liability. See Stone v. Ritter, 911 A.2d 362, 369-70 (Del. 2006). However, by incorporating good faith into loyalty, the substantive ground becomes a loyalty claim, understood more broadly. See id.
then further observes that they have in fact done a very poor job in making their decision, one can plausibly infer that the directors have in fact acted in disregard of their fiduciary duty to look out for the interests of the corporation.

As for the prudential justification, the analysis above suggests that in situations potentially infected with structural bias, directors are unlikely to do the job they have been entrusted with doing. Our proposed rule will increase the pressure on them in such circumstances to take more care in making their decisions, knowing that should things go poorly courts will be scrutinizing them more closely than in more innocent situations. It will also provide more clarity than Disney has managed to create, while still leaving the courts plenty of the flexibility that they crave.

An important question is the following: What sorts of circumstances will trigger a finding of structural bias? This is an area where courts will retain flexibility, allowing them to adapt the doctrine to new and unforeseen sorts of circumstances. The policy concerns raised in Parts IV and V should help drive this adaptation to specific circumstances. Although the doctrine is thus somewhat open-ended, there are several important categories of cases to which we think this approach usefully applies. We focus on several common contexts: executive compensation, the approval by disinterested directors of interested transactions more generally, business combinations, demands upon the board in derivative suits, and giving to pet charities.

The Disney cases themselves, of course, involve executive compensation, which has been the principal focus of our analysis above in considering the problem of structural bias. Another of the significant recent good faith cases in Delaware, Elkins, also concerned executive compensation. Executive compensation is one of the most delicate and debated areas in corporate governance today. It is the core area in which we see our proposal operating.

But it is not the only area. Executive compensation itself is largely a sub-class of the broader category of interested transactions that have been approved by nominally and legally disinterested directors. As described above, the standard approach in Delaware gives business judgment review to transactions that have received such approval, at least where the transaction is not with a controlling shareholder. However, the problems of structural bias are present whenever directors approve a transaction with a fellow director or top officer. They thus deserve the increased scrutiny that our proposal would provide. For the same reasons that motivate our proposal, the ALI Principles of Corporate Governance applies a form of review intermediate between business judgment and fairness for interested transactions approved by disinterested directors—in such cases, the directors must be able to have reasonably concluded that the transaction was fair to the corporation.

123. “Interested” and “disinterested” are used here in the way that courts traditionally do, so that “interested” refers only to directors with a direct material interest in the transaction. We say “largely” a sub-class because in some executive compensation cases, including the Disney cases, the executive being compensated does not yet have a relationship with the corporation, and so the case does not technically involve a transaction with an interested director or officer.
124. See DEL. CODE ANN. tit. 8, § 144(a) (2007); see also supra text accompanying notes 45-47.
125. See ALI PRINCIPLES, supra note 3, § 5.02(a)(2)(B) (1994).
As discussed above, business combinations are another area where structural bias is ubiquitous. Directors and officers in a corporation that is being sold, that is buying another corporation, or that is involved in a merger of equals all face incentives that may keep them from focusing on the interests of the corporation. For cases that fall outside the contexts in which courts have already provided for increased scrutiny—that is, *Unocal* or *Revlon*—our proposal would potentially apply.  

Another general area where our approach could help is board consideration of shareholder demands prior to derivative suits. As discussed in the *Zapata* context, board objectivity is clearly suspect where directors are deliberating whether or not to approve a suit against themselves or fellow directors. This concern underlies the *Zapata* standard of review. Even where demand is not excused, or where it may be excused but the plaintiffs nonetheless first make a demand before suing, a similar concern arises. As courts review a decision of a board to reject a demand when made, they should ask whether the board rejected the demand in good faith. The courts could apply our approach and ask how serious the structural bias problem appears on the facts in the given case, and then scrutinize the care of the board in making its decision more or less closely depending upon the answer to that question.

Another area that deserves mention is charitable giving. Usually, decisions to give to charity rightly get near-total deference under the business judgment rule. However, in a few cases corporate giving has troubled the courts, even where they have found no liability. These cases typically involve both large amounts of giving and giving to "pet charities" of particular directors, especially CEOs, where the director is closely identified with the charity and has much to gain personally from gifts to that charity. Such charitable giving does not fit within the traditional conflicting interest of loyalty analysis, and yet it does call directorial objectivity into question. In our view, it's not feasible for courts to micromanage charitable giving; indeed, we also think that the harm to shareholders wouldn't warrant much judicial scrutiny, with one notable exception: where the amounts are excessive. That being said, nobody, including us, has a straightforward way to determine whether contributions are "excessive," and we would expect very few cases claiming that contributions were excessive to survive motions at the early pleadings stages. But our approach should be used to scrutinize and potentially ground liability on the basis of charitable giving that can be demonstrated to be both "excessive" and favor some officer or director to whom the directors are beholden.

Although our proposal goes beyond what the Delaware courts have said or done so far, we believe it is essentially consistent with the *Disney* opinions and with Delaware good faith jurisprudence generally. We accept most of the current language in the cases.
as to what constitutes good and bad faith.\(^{131}\) That being said, the weak end of the structural bias continuum is at some tension with language requiring a “conscious disregard for one’s responsibilities.”\(^{132}\) Still, much of what this Article has described as structural bias is conscious; even less deliberate forms of bias do show a disregard of one’s responsibilities, consistent with language that bad faith is acting for “some purpose other than a genuine attempt to advance corporate welfare.”\(^{133}\)

We suggest a more clearly defined way that plaintiffs should be able to prove lack of good faith. Our proposal would give the same result on the facts of the Disney cases. Although the facts represent a situation where structural bias exists, thus meeting the first prong of our test, the structural bias is not as severe as it is in many executive compensation cases: Ovitz did not have a strong pre-existing relationship with most Disney board members and some board members had interests in opposing Ovitz that trumped their fealty to Eisner. On the second prong, the court found that there was no gross negligence, and we agree with that finding.

Will our proposal swamp traditional care analysis? With or without our proposal, good faith is likely to increasingly crowd out traditional care analysis because of the effects of section 102(b)(7) on litigation strategy.\(^{134}\) Our proposal might help that development proceed. The effect would be to allow court investigation of board procedure to have some bite in situations where structural bias is present; by contrast, where there is no structural bias present boards would be almost perfectly safe. That result makes sense because it captures explicitly what courts have been doing implicitly.

Indeed, we think that duty of care and structural bias can be viewed as part of a continuum, with duty of loyalty at the other end. At one end are the truly generic inattention cases, of which there are very few.\(^{135}\) In most cases, directors are giving less care than they should be because they are being deferential—and, almost certainly, they feel reasonable in doing so because they have some level of identification or shared perspective with the officers. Contrast how people comport themselves at a gathering of

\(^{131}\) See generally supra Part II.C. (summarizing how the Delaware courts have defined good and bad faith).

\(^{132}\) In re Walt Disney Co. Derivative Litig. (Disney V), 906 A.2d 27, 62 (Del. 2006) (emphasis added).

\(^{133}\) In re Walt Disney Co. Derivative Litig. (Disney IV), 907 A.2d 693, 753 (Del. Ch. 2005).

\(^{134}\) See Dunn, supra note 87, at 547-49.

\(^{135}\) A leading casebook, WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS AND CORPORATIONS (6th ed. 2006), has under the duty of care heading the following cases: Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Brehm v. Eisner, 746 A.2d 244 (Del. Ch. 2005); In Re Caremark Int’l, Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996); Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981); and Kamin v. Am. Express, 383 N.Y.S.2d 807 (N.Y. Spec. Term 1976). As we discuss in this Article, Brehm and Van Gorkom are not really “pure” care cases, and we have seen that the Delaware Supreme Court now categorizes Caremark as involving the duty of loyalty, not care. See supra note 36 It’s possible that Kamin isn’t a care case either: there is some intimation in the case that the practice complained of, which prevented a $25 million accounting loss, at a cost of foregoing $8 million of tax savings, might have benefited four (of twenty) directors insofar as their compensation was tied to the company’s earnings. Kamin, 383 N.Y.S.2d 807. In Francis, a widow succeeds her husband as a director of a corporation of which they owned 48%, and, despondent over his death, begins to drink heavily while completely ignoring the corporation, knowing “virtually nothing of its corporate affairs” and never reading or obtaining the annual financial statements. Francis, 432 A.2d at 819. The widow’s behavior was not simple inattentiveness—it was, rather, far more culpable. She had been warned by her husband that one of the other shareholders and directors, their son, was completely untrustworthy. Francis, 432 A.2d 814.
strangers in a public place with how they do so at a gathering of friends or people otherwise known to them through community or reputation. When we are surrounded by people we have reason to trust, we are less vigilant; when we are surrounded by people we don’t particularly have reason to trust, we are more vigilant.136 There are various cognitive stories one can tell about the less-vigilant directors: some stories reflect more conscious awareness than others. But all these stories are closer to the care end of the continuum. At that end of the continuum, the officers too do not have any particular interest in the outcome that differs from the corporation’s interest, aside from the time and effort involved in diligent deliberation.

From generic inattention, we move to the cases where structural bias becomes a problem along two dimensions. First, one or more decision makers (a director or officer), or a controlling shareholder, has an interest in the decision that is adverse to the corporate interest. This adverse interest can vary from indirect and small to direct and quite large. Second, the rest of the board may be more or less beholden to the decision maker with the adverse interest. This, too, can vary from being beholden only in the sense of identification or a shared perspective to the pernicious golden rule case of mutual back scratching to the point of having a very close personal tie, e.g., a spouse.

At the far end of this spectrum are cases that fall under the traditional duty of loyalty. We note that there will be many cases nearer to the care end, where there are significant ties between directors and officers, a sense that the board accorded not-insignificant deference to the officers on that account, and some argument that personal benefit to the officers was a factor in the subject matter of the decision. But many of these cases won’t make it to trial, much less a showing of legal liability, absent egregiously bad or non-existent procedure. To the extent corporate governance needs to address these types of cases, another solution, such as more shareholder representation on boards, is necessary. However, courts need not restrict themselves only to the other extreme, cases that fall under the duty of loyalty as traditionally conceived.

Our proposal would impose a heightened standard for director conduct where structural bias exists and can be shown to have affected the directors’ behavior. We think our proposal captures what is really at issue; it is superior to, and should supplant, the post-Enron focus on defining independence increasingly restrictively.137 One of us has argued that those definitions are far more restrictive than is needed to guard against Enron-type situations.138 But the definitions are, in a sense, not restrictive enough to address structural bias. Indeed, definitions of independence don’t properly get at structural bias: they don’t capture the more attenuated relationships and the mindsets from which structural bias can arise. Given the present composition of boards of directors, there will necessarily be significant potential for structural bias even if directors with the types of relationships contemplated by the definitions of independence are


137. Following Enron, rules, regulations, and proposals are requiring or encouraging more “independent” directors, where independence is defined by reference to particular relationships between directors and the officers or the company (such as family relationships, consulting relationships, interlocking arrangements, etc.). See, e.g., NYSE, INC., LISTED COMPANY MANUAL § 303.02 (1999).

excluded. Thus, it makes sense to focus on the subset of cases in which the boards are considering potentially problematic decisions and their decision making process is influenced by their structural bias.  

VII. LIMITS OF OUR PROPOSAL

As a practical matter, though, what can our proposal achieve? It can make cases withstand dismissal for failure to make demand. But will it make a difference in substantive outcome? Here, we are a bit more agnostic. We do not envision our proposal as leading to liability in many more cases. In this regard, we note again that we think the results in Disney IV and V are justified—the courts plausibly argue that the decision-making was not grossly negligent. Two factors will make actual findings of liability difficult in most cases. One is that directors’ decisions typically are substantively defensible given today’s norms and standards of corporate decision making. The second is related; that it will therefore be possible to document the directors’ deliberations in a manner that will be hard to assail without the type of second-guessing and micromanaging that courts appropriately avoid.

Nevertheless, our proposal should serve an important function. Consider the effect of Caremark, in which the court’s articulation of what became known as “Caremark duties” became highly influential notwithstanding the court’s pronouncement that the directors were almost certainly not liable for breach of duty. And certainly, more cases moving beyond the stage where they are dismissed for failure to make demand will have an effect as well. But might that effect only be as a full employment act for lawyers—corporate money being used to achieve insulation from liability for directors without commensurate benefit for shareholders and other principals?

We think not, for two reasons. First, we think the law would have a significant expressive effect. Second, and related to the first, we think the expressive effect would be enabled and amplified by the present-day concerns over the issue of structural bias. There is much talk of “outrage” as a possible constraint, and of norms-shifts. There is also talk of increasing shareholder ability to directly control election of directors as well as other matters. A signal by the Delaware courts that they found structural bias legally cognizable as a basis for imposing increased scrutiny on directors’ decisions might supply the needed momentum—to focus directors on the need for them to look critically at what is presented to them, not just to detect possible fraud, but also to try to view the corporation and its interests through their principals’ eyes.

How much will our proposal ultimately do to make directors true stewards of shareholders’ interests? Even with incentives and tools, such as educational resources

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139. Our objection is to attempts at defining independence in a generally applicable rule. We do not object at all to courts applying a broader use of the term within fiduciary duty analysis, as the chancery court did in Oracle. See generally In re Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003) (holding that the test for independence ultimately focuses on impartiality and objectivity). Indeed, cases such as Oracle complement our suggested approach to good faith quite well.

140. See BECHUK & FRIED, supra note 97, at 64-66.

141. See, e.g., SEC, Spotlight on: Security Holder Director Nominations, http://www.sec.gov/spotlight/dir-nominations.htm (last visited April 7, 2007) (discussing the SEC’s proposal to have directors nominated by shareholders).

142. We leave out here any consideration of the role of gatekeepers. Gatekeepers may be well-situated to
increasingly available through specialized programs, directors selected by management who are and view themselves as peers of management may not be as effective at monitoring as shareholders would ideally like them to be. Our proposal could have considerable success in getting directors to ferret out fraud, since it can increase both their will and way to detect it. It can also push directors towards viewing vigilance as being their job, and giving them more of a reputational stake in being perceived as vigilant. Indeed, both these things are happening. But a perspective shift, from peer to critic, will be much harder; it may well require more than playing with the rules of fiduciary duty law. Major reforms may also be needed to give more power to shareholders in choosing boards, and perhaps more shareholder power over other areas as well. As to this concern, at this point we remain agnostic.

It is also debatable whether such a perspective shift would all-in-all be a good thing. Boards have important functions besides monitoring officers. They also help guide strategic planning and network to provide strategic resources. Moreover, boards work as a team, and an overly critical perspective backed by the threat of legal intervention could upset their proper functioning. It may not be possible to obtain the benefits of management selected boards—considerable knowledge about the company, and collegiality among themselves and in their dealings with the officers—consistent with the caliber and level of vigilance fiduciary duties require.

VIII. CONCLUSION

The last few years have pointed out grievous problems in corporate governance. Some problems involved large scale and, we hope, unprecedented and uncommon, fraud. But other problems have been more hum-drum, arising out of what many view as too cozy a relationship between boards of directors and officers of the companies the directors are supposed to be monitoring. The corporate community is seriously rethinking who should be on boards, and how they should be chosen. The questions involved are profound, and beyond the scope of this article. But so long as board composition stays substantially as it is, the cozy relationship between directors and officers will be a problem—a problem well exemplified by Disney V. In our view, Disney V was correctly decided. But the courts deciding the Disney cases could, and should, have sent a message to the corporate community that they wanted directors to act more beholden to their true constituency, and be more wary and critical of their colleagues in management. As is well known, corporate actors are influenced not only by the traditional sources of law, decisions and statutes, but also by a plethora of extra-legal forces, including norms and

detect fraud; it is far harder to see how they address the types of matters at issue in the Disney cases and comparable cases. See generally John C. Coffee, Jr, Gatekeepers: The Professions and Corporate Governance (2006).

143. See Hill & O’Hara, supra note 136, at n.280, and accompanying text (discussing director education programs).


reputation. In Disney IV and V, the courts squandered the opportunity to send a message that could have had a real impact, fueling and propelling other forces pushing for better-run corporations.