DEVELOPMENTS IN CORPORATE GOVERNANCE: THE DUTY OF GOOD FAITH AND ITS IMPACT ON DIRECTOR CONDUCT

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INTRODUCTION

Recent corporate debacles have led to an increase in the scrutiny of corporate directors and their fiduciary duties. Academic discussion and several court decisions illustrate a reemphasis on the duty of good faith. Because the duty of good faith has not been clearly defined nor fully developed, its definition and application are being driven by numerous forces. This article will discuss some of the many factors that define what it means for a corporate director to act in good faith. These factors include the judicial application of state corporate law, federal and state legislation, shareholder activism, the publication of and reliance on corporate governance ratings, and the expectations of the public in response to the media’s treatment of current issues in corporate governance. This article will also explore the issues surrounding shareholder value in light of fiduciary duties, the business judgment rule, and the multifaceted development of the duty of good faith.

I. RESPONDING TO CORPORATE SCANDAL

A. Increased Scrutiny of Corporate Fiduciary Conduct

In an effort to restore confidence in America’s capital markets following the corporate scandals of 2001, Congress acted swiftly and boldly with its passage of the Sarbanes-Oxley Act of 2002—the “most far-reaching
reform of American business practices since the creation of the SEC during the Great Depression.”

Many suggestions have been offered as to the causes of the egregious corporate failures. The former chief justice of the Delaware Supreme Court opined that “the main corporate governance failure . . . [has been] the lassitude and indifference of some boards of directors who were not pro-active in their oversight and strategic roles.” Former Chief Justice Veasey and others foresee a new corporate culture, which is characterized by increased litigation against corporate directors for failing to exercise adequate oversight as well as a greater number of lawsuits seeking to hold directors personally accountable for corporate misdeeds.

The duty of good faith will be an increasingly prominent component of this “subtle shift” toward heightened scrutiny of director conduct.

B. Turning to the Duty of Good Faith

The traditional approach for determining director liability has focused primarily on process and on conflicts of loyalty that may exist between

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2 Some of the reasons suggested include “infectious greed,” rogue managers who somehow fooled the capital markets, negligent and inattentive boards of directors, or a general decline in business morality. John C. Coffee, Jr., What Caused Enron? A Capsule Social and Economic History of the 1990s, 89 CORNELL L. REV. 269, 269-72 (2004). Professor Coffee contends that no plausible theory suggests that corporate board performance had deteriorated during the years preceding the failures. Id. at 270. Rather, he argues that Enron and related scandals were “neither unique nor idiosyncratic” and that “a focus on the deficiencies of any individual board of directors cannot explain the sudden surge of governance failures.” Id.

3 E. Norman Veasey, Policy and Legal Overview of Best Corporate Governance Principles, 56 SMU L. REV. 2135, 2136 (2003). The federal government’s actions have been motivated by the same sentiment. Connecticut Senator Joseph Lieberman proclaimed, “Let us make sure that directors are accountable and vigilant, that they act as the shareholders’ first line of defense against corporate negligence, mismanagement or corruption, and that they give investors the confidence our economy needs to grow as robustly as we all want it to.” The Role of the Board of Directors in Enron’s Collapse: Hearing Before the Permanent Subcomm. on Investigations, S. Comm. on Governmental Affairs, 107th Cong. 10 (2002) (statement of Sen. Joseph Lieberman).

4 Veasey, supra note 3, at 2145.


6 Hern, supra note 1, at 215.

directors and investors.8 Recent corporate misdeeds, however, indicate that preventing egregious fiduciary behavior may require something more than a strictly procedural benchmark. In any attempt to prevent and punish deviant corporate conduct, an examination of circumstance and substance is increasingly important.9 Strict enforcement of the duty of good faith will lead to such a robust examination and, as one author has stated, promises to create the kind of incentives that will result in effective corporate governance and prevent the abdication of fiduciary responsibilities.10 The duty of good faith analysis allows for a more substantive investigation into director conduct.11

Recent judicial willingness to entertain greater exploration of the duty of good faith is evidence of a general recognition that the duty of good faith presents fertile ground for assessing director liability. Whether or not any of the closely followed cases addressing the duty of good faith leads to the establishment of binding legal precedent, a message is being sent to shareholders indicating the standard of behavior they can demand from their companies’ directors and officers.12

II. THE DUTY OF GOOD FAITH

A. Defining Good Faith

Although the duty of good faith has long been important in fiduciary duty analysis, courts have yet to explain its meaning concisely and consistently.13 In practice, the duty of good faith “works as part of the articulation of the business judgment rule that applies to the directors’ decision-making process and . . . is part of the directors’ oversight responsibility . . . .” [A]

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10 Id. at 462.
11 See Troy A. Paredes, A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn’t The Answer, 45 WM. & MARY L. REV. 1055, 1082 (2004) (stating that, when fleshed out, the duty of good faith will be more substantive than procedural); see also Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 150 (S.D.N.Y. 1989) ("[T]he good faith requirement further demands ’an ad hoc determination of the board’s motives’ in making the business decision.” (quoting Citron v. Fairchild Camera & Instrument Corp., 1988 Del. Ch. LEXIS 67, at *46 (Del. Ch. May 19, 1988))); Sale, supra note 9, at 488 (stating that “[g]ood faith based liability . . . raises issues related to the motives of the actors”).
12 See Paredes, supra note 11, at 1091-92.
director who flunks the ‘good faith’ test has not lived up to her currently expected standard of conduct.”

Moreover, a director’s behavior arguably implicates the duty of good faith if it is “reckless, disingenuous, irresponsible, or irrational.” Such behavior could lead to personal liability for directors even where the actions are not necessarily self-dealing in nature.

Historically, the duty of good faith did not impose upon directors a duty to operate a “corporate system of espionage” to ferret out wrongdoing, absent suspicion such wrongdoing existed. In a move toward increased director responsibility, the Delaware Supreme Court stated in 1996 that a sustained or systematic failure of the board of directors to exercise oversight—such as an utter failure to attempt to assure that a reasonable information and reporting system exits—would establish a lack of good faith.

Some legal scholars have expanded this concept by stating that a lack of oversight, even though there has been no sustained or system-wide viola-

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15 Veasey, supra note 3, at 2144.
16 See id.
17 Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963). In Allis-Chalmers, non-director employees and officers pled guilty to an indictment for antitrust violations involving price fixing. Id. at 127. Shareholders of the company brought suit against the directors alleging that they had not carried out their fiduciary responsibilities with good faith. Id. In rejecting the shareholders’ plea, the court explained that in a corporation the size of Allis-Chalmers, a director’s role was primarily limited to broad policy decisions of the corporation. Id. at 130. In this case, once the directors acquired actual knowledge of the antitrust violations, immediate action was taken. Id. at 129-30. For the court, this was sufficient evidence of good faith. Id. at 129. The court explained that “absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.” Id. at 130. Moreover, directors are not required to “assume, with no justification whatsoever, that all corporate employees are incipient law violators who, but for a tight checkrein, will give free vent to their unlawful propensities.” Id. at 131.
18 In re Caremark Int’l Inc., 698 A.2d 959, 971 (Del. Ch. 1996). Thirty-three years after Allis-Chalmers, In re Caremark International Inc. was decided. Caremark involved shareholder allegations that the board had not been aware of federal and state violations being committed by some of the corporation’s employees. Id. at 960. Acknowledging that the directors were not aware of the violations, the court considered the possibility of holding the directors liable because of inaction or negligence. Id. at 968. The court, in dicta, contended that “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exits—will establish the lack of good faith that is a necessary condition to liability.” Id. at 971. The court concluded that this “quite high” standard was not met. Id. The court saw sufficient evidence that the board was reasonably informed with regard to relevant facts, and reasoned that since the board was not aware of the facts that led to the indictments, the case against them was weak. See id. at 971-72. One writer has suggested that Caremark “updated” the duties of directors. See Sale, supra note 9, at 468-69. In Allis-Chalmers, directors could be liable only if they ignored “red flags.” Id.; see Allis-Chalmers, 188 A.2d at 130. After Caremark, directors had some semblance of a duty to “ferret out wrongdoing” through the establishment of a reasonable oversight system. Sale, supra note 9, at 469; see Caremark, 698 A.2d at 971.
tion, could result in a violation of the duty of good faith. More recently, the following have been considered potential violations of the duty of good faith: intentional or unintentional misconduct; reckless behavior given a certain duration or magnitude; conscious disregard of known risks; and behavior that cannot rationally be explained on any other grounds. According to the latest cases, directors may be liable for a good faith violation if they act as if they simply do not care about the risks inherent in the transaction at hand.

Other undefined aspects of the duty of good faith include whether bad faith in the corporate context can be inferred and whether recklessness constitutes bad faith. Such concepts are ripe for litigation and are highly factsensitive. Despite diverse holdings and opinions, courts generally agree that a finding of bad faith requires proof of an illicit motive or bad faith state of mind. Both the Delaware Supreme Court and the Delaware Court of Chancery have stated that a bad faith state of mind and even recklessness can be inferred if there are sufficiently specific and particularized allegations of fact. To be clear, Delaware courts have not expressly equated

19 See Reed & Neiderman, supra note 5, at 132.

20 See McCall v. Scott, 239 F.3d 808, 818 (6th Cir. 2001), amended by 250 F.3d 997 (refusing to conclude that only intentional conduct could implicate the duty of good faith).

21 Reed & Neiderman, supra note 5, at 123; see also id. at 137 n.104 (pointing out that no court has expressly equated recklessness with bad faith).

22 McCall, 239 F.3d at 818-19 (quoting FRANKLIN R., BALOTTI & JESSE A. FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.29, at 4-116 to 4-116.1 (3d ed. Supp. 2000), for the proposition that a conscious disregard of known risks could be considered a violation of the duty of good faith).

23 McGowan v. Ferro, 859 A.2d 1012, 1031 (Del. Ch. 2004) (citing In re J.P. Stevens & Co. S'holders Litig., 542 A.2d 770, 780 (Del. Ch. 1988)), aff'd, 873 A.2d 1099 (Del. 2005); Reed & Neiderman, supra note 5, at 140.

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


26 Parnes v. Bally Entm’t Corp., 722 A.2d 1243, 1246 (Del. 1999); Alidina v. Internet.com Corp., No. 17235-NC, 2002 Del. Ch. LEXIS 156, at *14-20 (Del. Ch. 2002); In re Btc Commc’ns, Inc. S’holder Litig., 789 A.2d 1 (Del. Ch. 2001) (stating that to overcome exculpatory provision plaintiffs must present a “basic factual showing (or reasonable basis to infer) that the directors’ conduct was the product of bad faith” (quoting In re Lukens Inc. S’holders Litig., 757 A.2d 720, 734 (Del. Ch. 1999), aff’d sub nom. Walker v. Lukens, Inc., 757 A.2d 1278 (Del. 2000))); cf. Giammalvo v. Sunshine Mining Co., No. 12842, 1994 Del. Ch. LEXIS 6, at *23 (Del. Ch. Jan. 31, 1994) (opining that questions about good faith often require the Court to look below the surface and evaluate what appears to be valid decisions, utilizing the test of whether the “decision made by an apparently well motivated board . . . is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith” (quoting In re Lukens Inc. S’holders Litig., 757 A.2d 1278 (Del. 2000))).
recklessness with bad faith. But several decisions indicate that even where there is no explicit bad faith intent or motive, Delaware courts could conclude that particular behavior, reckless or otherwise, was so inappropriate that it must have been undertaken in bad faith. Because of the uncertainty surrounding these concepts, future litigation addressing the question of whether a director acted in good faith will likely include discussions of whether or not reckless behavior amounts to a breach of the duty of good faith and whether or not bad faith can be inferred in the absence of an explicit bad faith intent or motive. As a consequence of the uncertainty, courts will likely refrain from constructing bright line rules with regard to the good faith analysis. Director liability will hinge upon judicial interpretation of these ambiguous concepts.

B. Recent Developments

1. Recent Cases Illustrating a Mixed Approach to the Duty of Good Faith

Several recent cases illustrate a judicial willingness to entertain the possibility of a more expansive definition of the duty of good faith. In re Abbott Laboratories Derivative Shareholders Litigation involved a complaint by shareholders that the board of directors failed to act when the Food and Drug Administration raised concerns over a six-year period about one of the company’s manufacturing facilities. The failure to take action presented a typical due care scenario. The court found that if the allegations in the complaint were true, they evidenced a “sustained and system-

(finding that the plaintiff’s accusations of bad faith were rebutted); Litt v. Wycoff, No. 19083-NC, 2003 Del. Ch. LEXIS 23, at *23 (Del. Ch. Mar. 28, 2003) (indicating that if there are specific particularized allegations of fact the court may infer that a board of directors acted recklessly or in bad faith, but ultimately finding that such facts were not present in the case).

See Reed & Neiderman, supra note 5, at 137 n.104.

See cases cited supra note 26.

The federal government, on the other hand, is increasingly likely to establish bright line rules. See discussion infra Part III.A.1.

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

Abbott’s directors claimed they failed to act because they disagreed with the FDA’s findings. Id. at 801. The directors’ failure to take action resulted in the company being required to pay a $100 million fine, withdraw medical diagnostic kits from the United States market, destroy inventory, and change manufacturing procedures. Id. at 798.

A typical due care scenario involves a director who is entirely disinterested but whose actions have failed to meet an acceptable level of carefulness or attentiveness. DAVID A. DREXLER ET AL., 1 DELAWARE CORPORATION LAW AND PRACTICE § 15.06 (2005).
atic failure of the board to exercise oversight . . . .” Since this failure to exercise oversight was a recurring problem over the course of a significant amount of time, the court, citing Caremark, found that the behavior “indica[ted] that the directors’ decision to not act was not made in good faith and was contrary to the best interests of the company.” The court noted that the magnitude and duration of the alleged wrongdoing were important factors in determining whether there had been a violation of the duty of good faith. The board’s “conscious inaction” over a six-year period led to the imposition of the highest fine ever imposed by the FDA. The court found that the plaintiff’s allegations, if true, indicated a breach of the duty of good faith such that the directors would not be protected by the business judgment rule. The “conscious disregard” of known risks, if proven, amounted to conduct that could not have been undertaken in good faith. The court in Abbott changed its focus of analysis from breach of the duty of due care to breach of the duty of good faith.

In McCall v. Scott, shareholders brought suit against certain directors of Columbia/HCA Healthcare Corporation (“Columbia”) alleging “widespread and systematic health care fraud by Columbia’s hospitals, home health agencies, and other facilities.” The plaintiffs alleged that a violation of the duty of good faith could be inferred from the directors’ failure to act in the face of an ongoing federal investigation and a New York Times investigation into the company’s billing practices, among other things. The court agreed that, if the allegations were true, such intentional misconduct and reckless behavior could result in a violation of the duty of good faith. Because the court found that the plaintiffs’ allegations were adequate, the exculpatory provision in Columbia’s articles was not applicable. Most

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33 Abbott, 325 F.3d at 809 (quoting Caremark, 698 A.2d at 971) (internal quotation marks omitted). See Mark J. Loewenstein, The Quiet Transformation of Corporate Law, 57 SMU L. Rev. 353 (2004), for further discussion of this case.
34 Id.
35 Id.
36 Id.
37 Id.
38 Id. at 811.
39 One writer claims that the analysis in Abbott was flawed in a couple of ways and that the conclusion that the Abbott board acted in bad faith was conclusory. Nevertheless, the author reasoned that “[o]ne might conclude from Abbott . . . that [because] the court was skeptical of the combined effect of the business judgment rule and the provision in the company’s articles limiting the directors’ liability . . . [t]he avenue for review was the good faith exception.” Loewenstein, supra note 33, at 375.
40 239 F.3d 808 (6th Cir. 2001), amended by 250 F.3d 997 (6th Cir. 2001).
41 McCall, 239 F.3d at 813.
42 Id. at 819-20.
43 Id. at 817.
44 Id. at 819.
significantly, the court did not limit a finding of bad faith to instances of intentional conduct but indicated that bad faith could be inferred.\textsuperscript{45} Also noteworthy is the court’s indication that the defendants should have been more aware of the employee misconduct because the directors possessed a specialized knowledge and background.\textsuperscript{46} Consequently, some have cautioned that \textit{McCall} potentially represents a substantial source of director liability.\textsuperscript{47}

The case \textit{Stockbridge v. Gemini Air Cargo, Inc.}\textsuperscript{48} involved an action by a stockholder and former employee of a Delaware corporation to recover damages for breach of the corporation’s contract to repurchase his shares.\textsuperscript{49} Stockbridge was a former chief executive officer of Gemini Air Cargo, which was a Delaware corporation having its principal place of business in Virginia.\textsuperscript{50} In March 2002, Gemini terminated Stockbridge’s employment without cause.\textsuperscript{51} Pursuant to Stockbridge’s shareholder agreement, Stockbridge had the option to sell back to the company all restricted shares and vested options held by him.\textsuperscript{52} However, instead of repurchasing the shares as outlined by the agreement, Gemini sent Stockbridge a “Disability Notice,” stating that the corporation’s senior credit facility prohibited Gemini from repurchasing Stockbridge’s shares due to its “significant financial distress.”\textsuperscript{53} Gemini asserted that any repurchase of its stock would violate Section 160(a) of the Delaware General Corporation Law, which prohibits the repurchase of a corporation’s own stock while its capital is impaired.\textsuperscript{54}

In remanding to the trial court to determine whether Section 160(a) applied to the facts at hand, the court noted that the board of directors of a Delaware corporation has the legal responsibility to manage its business for the benefit of the corporation and its shareholders with “due care, good faith, and loyalty.”\textsuperscript{55} The court stated that Gemini may avail itself of Section 160(a) as an excuse for non-performance of its shareholder agreement with Stockbridge if it carries its burden of proving, as an affirmative defense, that its capital was impaired at all pertinent times.\textsuperscript{56} Gemini may not
avail itself of this defense, however, if its capital impairment was procured by bad faith on the part of its directors, or if they acted in bad faith with respect to Stockbridge’s rights under the agreement. Recognizing that directors have a fiduciary duty to manage a corporation with good faith in the best interests of all its shareholders and of the long-term health of the corporation, the court opined that whether directors have acted in good faith is a question of fact.

A recent case from the District of Kansas considered the definition of good faith for purposes of Delaware Code, Title 8, Section 102(b)(7), which serves to limit or eliminate a director’s personal liability for breaches of fiduciary duty in certain circumstances. One count of the plaintiff’s complaint charged the directors with corporate waste. The complaint asserted that the company could have sold an asset for a substantially higher return than it received. The directors argued that the corporation’s exculpatory provision barred the plaintiff’s claim. Indicating a willingness to infer bad faith, the court stated that to sufficiently plead a claim for corporate waste or bad faith, the “plaintiff must show that the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.” The court ruled against the board of directors, finding that if the plaintiff’s allegations were true, “the board did not have any valid business reason to choose such a transaction, particularly when an alternative transaction . . . would have yielded 90 [percent] of fair market value.” The court opened the door for an inference of bad faith on the part of the directors, placing them beyond the protection of the company’s exculpatory provision.

*In re Walt Disney Co. Derivative Litigation* involved a challenge to the decision of Disney’s board to approve a contract for Michael Ovitz, which resulted in a $140,000,000 payout after just one year of employment. The plaintiffs’ basic claim exemplified a typical duty of due care situation: they claimed that the board had not done its job in adequately
informing itself about Ovitz’s employment contract.\textsuperscript{68} The facts alleged that the defendant directors were essentially absent from the negotiation and adoption of Ovitz’s employment agreement.\textsuperscript{69} It was further alleged that the compensation committee spent less than one hour reviewing the terms in the draft agreement, and that the defendant directors failed to review the final agreement, which contained terms materially different from those in the draft agreement.\textsuperscript{70} Finally, the directors neither questioned the no-fault termination of Ovitz nor considered alternatives.\textsuperscript{71} As alleged, it appears that the directors placed the entire process of negotiation of Ovitz’s employment agreement, and later his termination, within the hands of Michael Eisner, Disney’s Chief Executive Officer at that time and Ovitz’s long-time friend.\textsuperscript{72}

When moving for a motion to dismiss, the board contended that it could not be liable for a due care violation because of an exculpatory provision in its articles exempting it from liability for due care violations.\textsuperscript{73} The Delaware Court of Chancery proceeded to find that the facts of the case “[gave] rise to a reason to doubt whether the board’s actions were taken honestly and in good faith.”\textsuperscript{74} The court reasoned that the facts suggest more than a failure to become informed about an issue of material importance, but portrayed a conscious and intentional “we don’t care about the risks” attitude.\textsuperscript{75} Thus, the plaintiffs’ allegations convinced the court to deny the motion to dismiss and recast the case as one involving a breach of the duty of good faith.\textsuperscript{76} Significantly, exculpatory provisions do not protect actions not taken in good faith.\textsuperscript{77} The court in Disney acknowledged that it generally does not second guess the business decisions of corporate directors but concluded that if the facts were true they “imply that the . . . directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.”\textsuperscript{78} Such actions, if true, place the director conduct beyond the protection of the business judgment rule.\textsuperscript{79}

\textsuperscript{68} Disney, 825 A.2d at 278.
\textsuperscript{69} Id. at 279-82.
\textsuperscript{70} Id. at 280.
\textsuperscript{71} Id. at 287.
\textsuperscript{72} Id. at 281.
\textsuperscript{73} Id. at 286.
\textsuperscript{74} Id.
\textsuperscript{75} Id. at 289 (internal quotation marks omitted).
\textsuperscript{76} Sale, supra note 9, at 48-81.
\textsuperscript{77} See discussion infra Part II.B.2.
\textsuperscript{78} Disney, 825 A.2d at 289.
\textsuperscript{79} Id.
More than two years later, the Delaware Court of Chancery ruled upon the merits of the case.\textsuperscript{80} Faced to answer the allegation by plaintiffs that the Disney board of directors breached its fiduciary duties to its shareholders in connection with the hiring and termination of Michael Ovitz, the court ruled in favor of the defendants.\textsuperscript{81} The court found that the board of directors did not act in bad faith when it hired Ovitz and approved his employment agreement, but may have been “ordinarily negligent.”\textsuperscript{82} According to the business judgment rule, ordinary negligence alone is insufficient to constitute a violation of the duty of due care.\textsuperscript{83} Although Eisner made no effort to notify the board of his agreement to hire Ovitz,\textsuperscript{84} he informed himself of all material information reasonably available when making this employment decision, thereby exercising good faith.\textsuperscript{85} Likewise, other directors also informed themselves of all material information reasonably available.\textsuperscript{86}

Although Judge Chandler ruled in favor of the defendant directors, he was clear in pointing out that the “defendants’ conduct . . . fell significantly short of the best practices of ideal corporate governance” and Eisner’s conduct in particular was not consistent with how fiduciaries of Delaware corporations are expected to act.\textsuperscript{87} Judge Chandler criticized that by making the decision regarding Ovitz’s hiring without board input, Eisner “enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom . . . .”\textsuperscript{88} The court stated that current and future directors in this case could use the defendants’ conduct as an example of how not to act.\textsuperscript{89} Judge Chandler emphasized that the Delaware Court of Chancery strongly encourages directors and officers to act according to the best practices of corporate governance.\textsuperscript{90}

These cases allow us to draw several conclusions. First, there is no consistent definition of what it means to act in good faith. Jurisdictions and individual courts have produced varying pronouncements of the doctrine.

\textsuperscript{80} See In re Walt Disney Co. Derivative Litig., No. CIV.A.15452, 2005 WL 2056651, at *1 (Del. Ch. Aug. 9, 2005).
\textsuperscript{81} Id.
\textsuperscript{82} Id. at *39.
\textsuperscript{83} Id.
\textsuperscript{84} Id. at *40.
\textsuperscript{85} Id. at *41. The court clarified that by acting in good faith, Eisner acted “with the subjective belief that those actions were in the best interests of the Company . . . .” Id.
\textsuperscript{86} In Re Walt Disney Co., 2005 WL 2056651, at *42-*47.
\textsuperscript{87} Id. at *1, *41 (emphasis added). Judge Chandler noted that the ideals of corporate governance have evolved because of recent corporate scandals, including the debacles involving Enron and WorldCom. Id. at *1. However, Delaware law does not hold fiduciaries liable for a failure to comply with the ideals of director conduct. Id.
\textsuperscript{88} Id. at *41.
\textsuperscript{89} Id. at *39.
\textsuperscript{90} Id. at *1.
Because of this uncertainty, courts have seemed unwilling to adopt bright-line rules and have considered the factual minutia of the case at hand. Uncertainty and inconsistency aside, fiduciary behavior that manifests a “we don’t care about the risks” attitude will increase the possibility of personal liability for directors. And because of the uncertainty and inconsistency, a director that brings a specialized knowledge to the boardroom may very well be held to a higher or completely different standard of good faith. In addition, post-Enron corporate behavior deemed reckless may give rise to an inference of bad faith.

2. When and Where to Apply the Duty of Good Faith

The duty of good faith analysis is significant primarily because of the comfort corporate directors commonly take in provisions such as Section 102(b)(7) of the Delaware General Corporation Law. Section 102(b)(7) was created “to help alleviate the consequences and concerns of directors” following the decision in the seminal case in the field of director liability, Smith v. Van Gorkom. Section 102(b)(7) allows a Delaware corporation to include a provision in its articles of incorporation limiting or eliminating director liability for breaches of fiduciary duty. But the provision expressly prohibits exculpation for, among other things, actions not taken in good faith. Therefore, a more expansive definition of what it means to act in bad faith places directors increasingly beyond the protection offered by such exculpatory provisions. A director is more likely to be found personally liable to the extent that the duty of good faith is applied broadly to director conduct.

So when and where does the duty of good faith apply? This question has been answered in at least three different ways. First, the duty of good faith may be considered a subset of the duties of loyalty and due care. Under this view, a director must carry out his or her duties of care and loyalty in good faith. This interpretation reasons that apart from being the means by which a director should fulfill his or her two fiduciary duties, there is no separate duty of good faith. Accordingly, it would be impossible to have a violation of the duty of good faith without a concurrent violation of the duty of due care or loyalty. The Delaware Court of Chancery seems to ad-

92 Reed & Neiderman, supra note 5, at 113-14.
93 488 A.2d 858 (Del. 1985) (reaffirming and solidifying the position that the business judgment rule provides no protection for directors who have made an unintelligent or unadvised judgment).
94 § 102(b)(7); see Reed & Neiderman, supra note 5, at 113-14.
95 § 102(b)(7).
here to this view. Under this approach, an investigation into whether an action involved bad faith would cease if there were no evidence of disloyal behavior.

Another interpretation is that the duty of good faith is a separate, freestanding duty. A freestanding duty of good faith demands compliance in its own right. Under this approach, director behavior could be in bad faith but at the same time comply with the demands of due care and loyalty. The Supreme Court of Delaware appears to support this interpretation. An advocate of a freestanding duty of good faith contends that a more expansive understanding of when and where the duty is to be applied can be a valuable tool of corporate governance because of its “potential for addressing those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts.” Such a duty, it has been said, can prevent fiduciary abdication by powerfully motivating corporate directors to implement effective corporate governance systems, can be implicated in situations where “fiduciaries failed to adhere to basic practices;” and can “regulate non-conflicted but deliberately indifferent behavior and transactions, creating incentives for action rather than passivity.” Courts have begun to establish a framework for a freestanding duty of good faith.

A third interpretation, one that expands the duty of good faith beyond that of a freestanding duty, is that the duty is analogous to the duty of good faith in the contractual context. Such an interpretation would require a director to act in good faith with regard to all of the obligations imposed upon him or her. This obligation includes “the fiduciary duties of loyalty and care, as well as any other duties to which the director has agreed.” This approach could greatly expand the potential for holding a director per-

97 Rosenberg, supra note 96, at 501.
98 Sale, supra note 9, at 463.
99 Id. at 464.
100 Rosenberg, supra note 96, at 495 (making reference to the Delaware Supreme Court’s decision in Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).
101 Sale, supra note 9, at 494.
102 Id. at 462.
103 Id. at 488.
104 Id. at 464.
105 Rosenberg, supra note 96, at 505-16. See id. for a discussion regarding the differences between the three approaches. Despite the similarities, one writer has commented that corporations are not “participatory democracies” but are governed by authoritative hierarchies. Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U.L. Rev. 547, 555 (2003).
106 Rosenberg, supra note 96, at 513-14.
personally liable because even non-shareholder constituencies could arguably become beneficiaries of corporate fiduciary duties.\textsuperscript{107} Under this view, liability largely depends upon expectations\textsuperscript{108} and is centered upon the idea that there is an implied duty not to take advantage of another party in a way that could not have been contemplated at contract formation.\textsuperscript{109} Also, this interpretation requires conformity to the spirit of the fiduciary relationship.\textsuperscript{110}

C. Summary

Historically, the duty of good faith has been important to corporate jurisprudence and will play an important role in the heightened scrutiny of director conduct that has resulted from recent corporate scandals. It is common practice to begin the duty of good faith analysis with a consideration of a fiduciary’s intent and motive. Less clear is whether reckless behavior will subject a director to good faith liability. Because the duty to act in good faith is a general standard and not a rule, diverse factual scenarios have led courts to declare that there are situations that justify an inference of recklessness or bad faith.

Liability, in fact and in degree, stemming from an action not undertaken in good faith, largely depends upon when and where the duty of good faith is applied. Whether the duty to act in good faith is merely a subset of the duties of care and loyalty, a duty separate and freestanding from the other two duties, or a duty similar to the duty of good faith required in the contractual context, remains to be answered. Importantly, the duty of good faith could be held to encompass compliance with the expectations of the parties involved and conformity to the spirit of the fiduciary relationship. Finally, despite inconsistency and uncertainty, under the emerging definition of the duty of good faith, directors may be held personally liable for corporate misbehavior if their conduct evidences improper motive or ill will, a reckless disregard of known risks, a sustained failure to oversee management, or is so egregious that it is unexplainable on any other grounds other than bad faith.

\textsuperscript{107} Cf. Bainbridge, supra note 105, at 575 (describing the widely-followed proposition that a director’s only obligation is to shareholders).

\textsuperscript{108} Rosenberg, supra note 96, at 508 (“We use good faith to ensure that both parties act according to the other parties’ expectations even when the contract itself does not explicitly dictate whether certain behavior is permissible.”).

\textsuperscript{109} JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 96, at 569-70 (4th ed. 2001).

\textsuperscript{110} Rosenberg, supra note 96, at 494.
III. EXTRAJUDICIAL FACTORS INFLUENCING THE DEFINITION OF WHAT IT MEANS TO ACT IN GOOD FAITH

A. Regulatory Action Influencing the Definition of the Duty of Good Faith

1. Federal Regulatory Action

The federal government’s power to regulate commercial activity stems from the Commerce Clause of the United States Constitution and has been construed very broadly. Notwithstanding this expansive power, the regulation of corporate structure and procedure has traditionally been limited to disclosure-oriented laws. Breaking tradition, and penetrating into the heart of corporate governance, Congress enacted the Sarbanes-Oxley Act of 2002, the goal of which was to remedy problems that arose because of the abdication of director oversight. Many provisions of the Sarbanes-Oxley Act have added to or redefined the norms of corporate governance. Fiduciaries acting in good faith will abide by such norms; the avoidance of the

111 U.S. CONST, art. 1, § 8, cl. 3. The Federal Constitution’s Commerce Clause allows Congress to regulate three broad areas of activity: (1) the use of the channels of interstate commerce; (2) the protection of the instrumentalities of interstate commerce, or persons or things in interstate commerce, even though the threat may come only from intrastate activities; and (3) those activities that substantially affect interstate commerce. United States v. Lopez, 514 U.S. 549, 558-59 (1995). Where economic activity substantially affects interstate commerce, congressional legislation regulating that activity will be sustained. Id. at 559.
112 For example, the federal securities laws are primarily intended to prevent fraud by requiring full disclosure. See, e.g., Katz v. Pels, 774 F. Supp. 121, 124 (S.D.N.Y. 1991).
114 Johnson & Sides, supra note 13, at 1155-56 (“One major theme of Congress and the SEC in Sarbanes-Oxley and subsequent rulemaking was a sense that public company boards of directors had abdicated their oversight responsibilities . . . . Section 301 of Sarbanes-Oxley is an attempt to remind directors of their role and responsibilities . . . .”).
115 Johnson and Sides report: [Although o]nly one title of Sarbanes-Oxley, Title III, references corporate fiduciary duty issues . . . several other titles have the effect of regulating the conduct of directors and officers of public companies in a manner that is akin to regulating the exercise of their fiduciary duties. In addition to Title III, much of Title IV and Section 906 substantively regulate the conduct of officers and directors.
116 Sale, supra note 9, at 485.
new norms of corporate governance as specified by Sarbanes-Oxley will likely result in a violation of the duty of good faith.\footnote{117}

Corporate fiduciary duties have traditionally been defined by \textit{standards} of conduct.\footnote{118} But the manner in which Congress has responded to corporate scandal illustrates that long-time accepted \textit{standards} of corporate governance may have left too much room for interpretation and discretion on the part of corporate fiduciaries.\footnote{119} Thus, in an attempt by the federal government to regulate corporate fiduciary duties,\footnote{120} Congress enacted \textit{rules} setting forth specific corporate governance measures. This rule-making is a “wholly novel . . . approach to corporate governance” and “represents a new federal presence in corporate governance.”\footnote{121} Consequently, the definition of what it means for a director to act in good faith will be impacted by the invigorated federal presence in corporate law. Existing federal responsibilities, and those to come, will influence the definition of what it means to act in good faith.\footnote{122}

2. Self-Regulatory Organizations

Regulations established by the NASDAQ and the NYSE are also establishing norms of corporate governance. As a result, the decisions made by self-regulatory organizations (“SROs”) may influence the definition of what it means to act in good faith. The regulations set forth standards with which publicly held companies must comply before they can be listed on the particular exchange. The existing listing standards’ principal focus is director independence, further illustrating the general belief by regulators that director abdication of oversight responsibilities has led to corporate malfeasance. The listing standards of both the NYSE and NASDAQ require that listed company boards have a majority of independent directors; they

\footnote{117} Johnson & Sides, supra note 13, at 1218. For example, as discussed supra Part II.A, case law has indicated that directors could be found to have not acted in good faith if there is a sustained or systematic failure to attempt to assure a reasonable information and reporting system. The Sarbanes-Oxley Act can reasonably be interpreted as setting forth necessary components of a corporation’s reporting system. Reed & Neiderman, supra note 5, at 142.

\footnote{118} Johnson & Sides, supra note 13, at 1195; Sale, supra note 9, at 491; see also Hillary A. Sale, \textit{Judging Heuristics}, 35 U.C. DAVIS L. REV. 903, 961 n.240 (2002) (offering a general discussion of the differences between rules and standards).

\footnote{119} The imprecision accompanying the \textit{standards} of fiduciary conduct can lead to too much interpretive discretion on the part of judges, as well as directors. See Johnson & Sides, supra note 13, at 1194-95.

\footnote{120} Id. at 1154.

\footnote{121} Id. at 1195.

\footnote{122} Id. at 1216.
also clarify and tighten the definition of “independence.” 123 Significantly, the exchanges went to great lengths to address non-financial forces that often curb director independence—influences such as “reputation, family ties, duty, and loyalty, as well as the psychological constraints inherent in prereform board structures and procedures.” 124 As with other areas of regulation already mentioned, it has been said that failing to comply with SRO regulatory enactments may likewise fall into the category of bad faith. 125 In line with the reasoning of the federal government, the SROs have justified “deep regulatory intrusions into the operations and composition of corporate boards” with the need to quickly restore confidence in America’s capital markets. 126 These regulations are an influential component of the evolving duty of good faith.

3. State Regulatory Action

As traditional purveyors of corporate legislation, states are uniquely positioned to influence the definition of fiduciary duties. But it has been suggested that while states are typically the “key player in the development of corporate law,” they have been “remarkably absent in enacting reforms” and have abdicated their role of defining the internal affairs of publicly held entities. 127 The same author noted, and this author is surprised to note, that the Delaware legislature has remained silent with regard to corporate gov-


\[124\] See id. at 2194-95.

\[125\] Sale, supra note 9, at 495.

\[126\] See Developments in the Law, supra note 123, at 2196-97.

\[127\] Loewenstein, supra note 33, at 385. He contends: State law could increase the incentives to monitor by requiring a higher standard of care for directors and by removing the barriers to a change of control. Doing so would incentivize independent directors to be more professional as directors, and they would, in turn, demand the resources (and compensation) to discharge their heightened duties. Potential legal liability and the market for control are powerful incentives to behavior, yet state law has disabled both.

\[Id.\] This author states that the reasoning behind the business judgment rule is unsubstantiated because qualified persons will not serve without the rule. \[Id.\] at 379. The author claims “a change in the legal rules governing director conduct could have the effect of professionalizing the boardroom.” \[Id.\] at 379-80. If the business judgment rule were scaled back, directors (based on a cost benefit analysis) would spend more time at their job and demand more pay. \[Id.\] at 379. Likewise, if state legislatures did more to expand the market for corporate control, directors would be more concerned about acting in ways consonant with shareholder expectations and positive returns. \[See id.\] at 384-85. “The market for corporate control, in theory, can act as a check against incompetent boards, but that market is hardly free and vigorous.” \[Id.\] at 379.
ernance legislation. But the American Institute of Certified Public Accountants (“AICPA”) has expressed concern that states may attempt to legislate well beyond the demands of federal regulation such as Sarbanes-Oxley. The AICPA believes such action by states could adversely impact small businesses. An example of legislation going beyond the demands of federal regulation is the California Corporate Disclosure Act of 2002. The Act requires that public companies doing business in the state make a yearly report of all stock options and loans made to their directors, as well as provide information on bankruptcies, fraud convictions, or fines for violations of securities or banking laws by the company or its officers or directors. The provisions of this Act have been called “burdensome” and “duplicative” as they require the disclosure of information already available to the public through the Securities and Exchange Commission. The AICPA recommends that state legislatures and regulators use caution when implementing new corporate governance requirements upon businesses in their state. Acting without such caution could lead to a negative business climate. As state and federal regulations diverge, it may be difficult to determine which standards govern the scope of corporate fiduciary duties. In any case, state legislation, whether dormant or affirmative, will influence the definition of what it means for a director or officer to act in good faith.

128 Id. at 385.
130 Id. “Small businesses constitute roughly half of the U.S. economy and are a primary source of economic growth and job creations.” Id.
132 Id.
133 California Corporate Disclosure Act, 2004 Cal. Adv. Legis. Serv. 819 (2004). Governor Arnold Schwarzenegger signed into law Assembly Bill 1000, effective September 27, 2004, as an urgency statute, which amends and attempts to clarify California Corporations Code sections 1502 and 2117, and adds California Corporations Code sections 1502.1 and 2117.1. Id. Governor Schwarzenegger stated that he would direct the California Department of Corporations to consider sponsoring legislation to further align the act with federal reporting requirements. Id. On December 1, 2004, the California Department of Corporations announced a request for public comment on the effectiveness of the California Corporate Disclosure Act. California Department of Corporations Announces Study on Effectiveness of California Corporate Disclosure Act, Requests Public Comment, BUSINESS WIRE (Dec. 1, 2004).
135 Id.
B. Shareholder Activism Influencing the Definition of Good Faith

Recent corporate scandals have brought about a resurgence of shareholder activism.136 The term “shareholder” encompasses varying degrees of power, sophistication, and an equally vast spectrum of interests and motivations. One type of “shareholder” who wields considerable power and influence is the institutional shareholder.137 It has been said that in the post-Enron corporate era, institutional shareholders are shifting the focus of their power to the corporate boardroom.138 There is a concern, however, that such activism will lead to trouble for the national economy.139 The reason for the concern is a foundational characteristic of corporate law that has been “carved into stone”—the idea of separation of control and ownership.140 When shareholders are allowed to determine corporate policy, a shift in control occurs—one that necessarily takes power away from the board of directors. As a consequence, directors are prevented from carrying out their quintessential function.141 However, one prominent writer has suggested that institutional shareholders can serve a valuable function in corporate governance.142

Notwithstanding the controversy over the proper place of shareholder activism, such shareholders do attempt to influence corporate governance,

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136 Michael T. Burr, Shareholders Revolt!: Shareholder Power is Here to Stay. How Companies Respond Will Determine Whether That Power Translates into Conflict or Progress, CORPORATE LEGAL TIMES, Feb. 2005. Much of the resurgence has been encouraged by legislative and regulatory changes expanding corporate disclosure obligations, and a more stringent definition of director independence. Id.

137 Whether—and if so, to what degree—corporate governance is impacted by institutional investor activism is the topic of substantial debate. Professor Bainbridge contends that there is no evidence that institutional shareholder activism has mattered. Bainbridge, supra note 105, at 571. And, he continues, most active institutional investors devote very limited time and resources to corporate governance activism. Id. at 572.


139 Id.

140 Stephen M. Bainbridge, Director v. Shareholder Primacy in the Convergence Debate, 16 TRANSNAT’L LAW. 45, 46 (2002).

141 See infra Part IV.A.1.

142 See William B. Chandler III & Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. PA. L. REV. 992-93 (2003), which states:

A natural source of talent exists within the ranks of America’s institutional investor community, which controls a large portion of this country’s equity holdings. To date, there has been a reluctance on the part of many institutional investors and many money management firms to “walk the walk” of good corporate governance. Although these firms “talk the talk,” and regularly advocate better board-room practices, and although they stress their status as “long-term stockholders,” they in fact provide few representatives to serve as directors on public company boards. Warren Buffett remains a relatively lonely example of a money manager willing to stand and be counted as a fiduciary.
and corporations, at times, respond to such pressures. For example, *The Wall Street Journal* recently reported that a group of pension funds proposed a shareholder resolution at Walt Disney Co. that would allow the pension funds to nominate two independent directors to Disney’s board in 2006. The four funds that submitted the proposal are the California Public Employees’ Retirement System (“CalPERS”), the New York State Common Retirement Fund, the American Federation of State, County and Municipal Employees Union’s pension funds, and the Illinois State Board of Investment. This move by the pension funds was “intended to turn up the heat on Disney and possibly give the funds a greater voice in board appointments.” Even though the institutional shareholders lost and Disney was lawfully able to exclude the provision from their annual proxy meeting, the scenario illustrates the kind of pressure that institutional investors are increasingly placing on public corporations. Disney’s board was successful in preventing the provision from being included in the proxy, but only after having evaluated the institutional investors’ position and subsequently contending with the SEC. A recent decision by Disney further reflects the idea that shareholders, especially big-block shareholders, are influencing boardroom decision-making.

The articles above illustrate two points: first, whether binding or non-binding, shareholder proposals exert pressure on corporate directors; and second, the media quickly indulges in such shareholder activism. Even where shareholders cannot directly impact corporate governance practices, they may have the power to rally the public and the media—which can lead to further regulation at the state or federal level. This article’s purpose is neither to condemn institutional shareholder activism nor extol its virtues. It

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144 Id.
145 Id.
146 Bruce Orwall & Deborah Solomon, *SEC Says Disney Can Exclude Shareholder Resolution After All*, *Wall St. J.*, Dec. 29, 2004, at C4. After first deciding to prevent Disney from withholding the resolution from its annual meeting proxy, the SEC reversed its position after a challenge from Disney. *Id.* The SEC recognized “some basis” for the view that Disney should be able to exclude the proposal. *Id.*
147 Id.
149 Companies such as Disney are intensely monitored by the major news outlets. Decisions regarding corporate policy are nearly instantaneously disseminated to a worldwide audience.
150 Burr, *supra* note 136 (“[C]ompanies that dismiss shareholder concerns run the risk of investor backlash and possibly legal and regulatory action.”). Mr. Burr counsels that companies digging in their heels will face greater activism from investors and the public. *Id.*
is merely to illustrate that because institutional shareholders do exert pressure on public corporations by demanding certain behaviors or rights, shareholder activism will be a factor in the interpretation of the duty of good faith.

The method by which institutional shareholders exert pressure upon corporations is usually through proxy voting guidelines or more general corporate governance guidelines. Such guidelines can signal to corporate directors the type of behavior that will more likely assist them in avoiding a breach of the duty of good faith. Three predominant areas of concern addressed by proxy and corporate governance guidelines are executive and director compensation, the board of directors, and shareholder rights and responsibilities.\footnote{These categories were taken from corporate governance and/or proxy voting guidelines at three of the largest institutional investors in the country: TIAA-CREF, CalSTERS, and CalPERS.}

These categories were taken from corporate governance and/or proxy voting guidelines at three of the largest institutional investors in the country: TIAA-CREF, CalSTERS, and CalPERS.

The Teachers Insurance and Annuity Association—College Retirement Equities Fund (“TIAA-CREF”) is uniquely positioned to influence corporate governance at companies nationwide. First, it is very large and has an excellent reputation. TIAA-CREF, About TIAA-CREF, http://www.tiaa-cref.org/newsroom/facts.html (last visited Apr. 3, 2006). It has more than $350 billion dollars in assets under management. Id. In Fortune’s 2005 listing of America’s Most Admired Companies, TIAA-CREF is rated fourth most admired among mutual insurers. Fortune also ranks TIAA-CREF among the 50 Best Companies for Minorities. Id. Moreover, Working Mother magazine rated TIAA-CREF one of the 100 Best Companies for Working Mothers. Id. TIAA-CREF has over 3.2 million retirement system participants and is one of a handful of companies offering insurance which have received the highest rating possible from all four ratings agencies. Id. Second, it communicates with portfolio companies and other institutional shareholders. TIAA-CREF, POLICY STATEMENT ON CORPORATE GOVERNANCE 25 (2004), http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf [hereinafter TIAA-CREF, POLICY]. It is TIAA-CREF’s practice to distribute its corporate governance guidelines to its portfolio companies with a suggestion that managers and officers review them—clearly setting forth what is expected of the management of the companies whose stock they own. Id. It also distributes its corporate governance policies to other institutional shareholders. Id. Third, it vigilantly monitors current events. The most current edition of its corporate governance guidelines reflects recent regulations, changes in the law, and evolving investor expectations. See id. at 1-2. Because of these reasons, TIAA-CREF will likely influence the way America’s corporations are governed and what it means to act in good faith as a director.

The California State Teachers’ Retirement System (“CalSTRS”) is the largest teachers’ retirement system in the United States. CalSTRS, CalSTRS at a Glance, http://www.calstrs.com/About%20CalSTRS/ataglance.aspx (last visited Apr. 3, 2006). CalSTRS had a total membership of approximately 755,000 and assets of $128.9 billion as of June 2005. Id. CalSTRS’s “primary responsibility is to provide retirement related benefits and services to teachers in public schools from kindergarten through community college.” Id. Like TIAA-CREF, CalSTRS has developed extensive proxy voting guidelines. These main topics of focus for the guidelines are executive compensation, board of directors, and shareholders’ rights.

The California Public Employees’ Retirement System (“CalPERS”) “provides retirement and health benefits to more than 1.4 million public employees, retirees, and their families and more than 2,500 employers.” CalPERS, About CalPERS, http://www.calpers.ca.gov/index.jsp?bc=about/home.xml (last visited Apr. 3, 2006). As of June 30, 2005, CalPERS “provided benefits for 1,016,982
1. Executive and Director Compensation

Whether a company and its directors are viewed as being unlike the corporate miscreants of late may largely depend on the type of compensation practices they employ. Warren Buffett has commented that “[t]he acid test for reform will be CEO compensation.” 152 There is great sensitivity surrounding executive compensation because, as some sources estimate, over the past ten years, the average factory worker’s pay has increased 36% while the average CEO’s pay has increased 340%. 153 As one source stated, “CEO pay reached 301 times the average worker’s pay” in 2003 primarily because of stock options. 154 The disproportionate compensation practices have given rise to intense public scrutiny of corporate governance policies relating to executive and director compensation. Attracting and retaining executive talent is of prime importance to corporations. Lucrative compensation packages are the essential means for accomplishing this goal. But excessive pay practices carried out in unyielding secrecy places public corporations at risk of catastrophic public scrutiny and pressure. Consequently, how a company decides to handle the delicate issue of executive and director compensation could assist in the determination of executive and director liability.

A critical assessment required of all companies involves determining how they will properly reward executives without encouraging decision-making that is near-sighted. Recognizing this dilemma, the major institutional shareholders have declared that those policies that align the rewards of employees with those of shareholders are favored because doing so will “enhance the long-term performance of the corporation.” 155 TIAA-CREF specifically denounces compensation policies motivated by accounting treatment or the attainment of short-term price targets. 156 Similarly, CalPERS’s corporate governance guidelines are founded on the idea that “[p]oorly designed compensation packages may have disastrous impacts on the company and its shareholders by incentivising short-term oriented and


154 AFL-CIO, BEHIND THE CURTAIN, supra note 152, at 5.

155 TIAA-CREF, POLICY, supra note 151, at 16.

self-interested behavior.” Thus, its policies attempt to foster an atmosphere where compensation packages are designed to align management with owners, as well as motivate long-term superior performance.\footnote{Id.} According to TIAA-CREF, only “the creation of genuine and sustainable value” should be rewarded.\footnote{TIAA-CREF, POLICY, supra note 151, at 10.} Furthermore, compensation policies should be able to withstand the critical scrutiny of investors, employees, and the public at large.\footnote{Id. at 16.} Acknowledging the same concern, CalPERS’s general guidelines specify that a company should disclose its philosophies regarding how it sets base pay, any “pay at risk” components of the compensation package, and how it determined compensation—whether according to peer review analysis or other criteria.\footnote{CalPERS, supra note 156.} Disclosures of executive compensation policy should “articulate how the company ensures optimal alignment of interests with shareowners through the design and implementation of its executive compensation program”\footnote{Id. at 17.} and be complete, and understandable.\footnote{Id. at 18.}

TIAA-CREF has specific recommendations with regard to how a corporation utilizes equity-based compensation.\footnote{TIAA-CREF recommends the use of restricted stock and counsels the judicious use of stock options because of the fear that stock options fail to create genuine performance incentives and can lead to decisions geared to immediate term stock price movements.\footnote{See TIAA-CREF, POLICY, supra note 151, at 5, 18.} Stock options should be “performance-based” and include “performance hurdles to achieve vesting.”\footnote{Id. at 18.} CalPERS suggests using return on invested capital, return on assets, and

\begin{footnotesize}
\begin{enumerate}
\item Id.
\item TIAA-CREF, POLICY, supra note 151, at 10.
\item Id. at 16.
\item CalPERS, supra note 156.
\item Id.
\item Id. at 17-18.
\item Id. at 17.
\item See TIAA-CREF, POLICY, supra note 151, at 5, 18.
\item Id. at 18.
\end{enumerate}
\end{footnotesize}
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return on equity as the metrics of performance-based plans. It believes that utilizing multiple performance metrics in a way that ties “small portions of vesting to individual metrics or larger portions of vesting to multiple metrics” optimizes the functionality of performance-based plans. CalSTRS has stated that the design of such plans should focus on establishing objective performance-based measures that must be reached before compensation is received. Specific performance metrics should include growth in earnings per share, return on equity, and total return. All agree that companies should set threshold levels of performance for executive pay and should disclose the threshold levels it chooses in its proxy statement. According to CalSTRS, “there must be some level of performance for which employees will receive no reward . . . . Executives . . . receive salaries and they ought to deliver some threshold level of performance before they receive any additional compensation, no matter its form.”

Because of their prevalence in the dot-com era, stock option plans are now subject to greater scrutiny. TIAA-CREF, CalSTRS, and CalPERS support premium options with vesting dependent on attainment of a predetermined appreciation of stock and/or indexed options with a strike price tied to an index. “Mega Grants” of stock options should be severely restricted, if not prohibited, and compensation plans should make clear that stock or stock options issued in order to take advantage of non-public information are prohibited. CalSTRS recommends a vote against any Mega Grant where there is no clear link with performance or where performance requirements seem too generous “given past history and no defined peer group by which to judge performance of the subject corporation.” CalSTRS recommends a vote against an ISO plan of selling shares to executives at a price of less than eighty-five percent of market value at time of grant, tandem stock options, stock appreciation rights, purchased options, cashless exercise, restricted stock options plans, and ISO plans granting loans to executives for the purpose of exercising stock options. Furthermore, CalPERS’s general proxy voting guidelines with regard to executive

168 CalPERS, supra note 156.
169 Id.
170 See CalSTRS, supra note 165.
171 Id.
172 Id.
173 CalSTRS, supra note 165; CalPERS, supra note 156; TIAA-CREF, POLICY, supra note 151, at 18.
174 TIAA-CREF, POLICY, supra note 151, at 18 (clarifying that Mega Grants are grants of stock options that have a value at the time of grant that is greater than a reasonable and explainable multiple of the recipient’s total cash compensation).
175 CalSTRS, supra note 165.
176 Id.
compensation recommend a vote against “any plan that does not include a significant portion of performance-based components” (e.g., “premium priced options,” “index-based options,” and “performance-based metrics that are required to achieve vesting”); “any plan that does not include vesting periods of at least four years for a significant portion of overall grants;” “any plan that provides reload options;” and, in the case of companies using broad based equity compensation plans, any plan “where grant patterns indicate that greater than [five percent] of the equity compensation is granted to the top [five] officers.”

The exercise of stock options results in a diminution of the value of the stock held by existing shareholders. Consequently, issues of dilution are another area of concern for institutional shareholders. In general, “CalSTRS will not support any equity compensation plans where shareholders will suffer greater than [twenty] percent in net dilution, or where greater than five percent of the total equity compensation granted is to the top five executive officers.”

CalPERS states that a company should disclose to shareholders how they intend to address the issue of dilution.

Finally, if any of the following are present or occur, major institutional shareholders are likely to raise a red flag indicating a possible withdrawal of their support through a negative vote or a withholding of their vote: the total potential dilution from compensation plans exceeds 2% in one year or 15% over the duration of the plan; the potential dilution from stock and stock option grants averaged over 2% per year in the most recent three years; a plan proposal provides for granting reload options; the plan contains an evergreen feature; the option grants are disproportionate to the compensation of other employees of the corporation, and/or are excessive compared to the scale and/or success of the corporation; on the date of a proposed grant the exercise price is either unspecified or below one hundred percent of fair market value; a plan limited to restricted stock exceeds

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178 The exercise of stock options increases the number of shares outstanding and reduces the value of holdings of existing shareholders. The earnings of the corporation must then be spread over a larger number of shareholders thereby effectively reducing the earnings per share.
179 CalSTRS, supra note 165.
180 CalPERS, supra note 156.
181 A reload option is an employee stock option granted upon the exercise of an option using shares already in the holder’s possession. The reload option expires on the same date as the original option and its exercise price is equal to the price of the stock upon exercise of the original option. Reload Option, http://www.investorwords.com/5762/reload_option.html (last visited Apr. 3, 2006).
three percent dilution; a plan is limited to a small number of senior employees; an option plan gives the company the ability to lower the exercise price of underwater options; the material terms of other awards are not specified in the proposal; or a vote on an executive compensation plan is coupled with a vote on an unrelated proposal. These do not trigger an automatic negative vote but immediately call into question the portfolio or potential portfolio company’s compensation practices.

2. The Board of Directors

The composition and function of the board of directors is another critical determinant of the overall effectiveness of a company’s corporate governance. TIAA-CREF has stated that it will “focus on how company boards interpret and implement the new exchange listing requirements as reflected by their actions and corporate governance positions.” It affirms that “the primary responsibility of the board of directors is to foster the long-term success of the corporation.” In doing so, the board must be independent and accountable to shareholders. An independent board, according to TIAA-CREF, is one where there is a supermajority of independent directors. Importantly, TIAA-CREF states that “the definition of independence should extend beyond that incorporated in amended listing standards of the exchanges” and directors should be accountable to shareholders for an explanation as to how director independence is determined. Directors should be able to demonstrate objectivity and loyalty to shareholders, “in fact” and “in appearance.” Likewise, based on its policy guidelines,

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183 Stock options in which the strike price (the price at which the employee is contracted to buy the shares) is higher than the current stock price. Underwater, http://www.investorwords.com/5131/ underwater.html (last visited Apr. 3, 2006).
184 TIAA-CREF, POLICY, supra note 151, at 26-28.
185 See id.
186 See id. at 3.
187 See TIAA-CREF, POLICY, supra note 151; see also Developments in the Law, supra note 123, at 2195-204, which states:

If directors are to exercise consistently effective oversight, rather than merely step in when the situation becomes dire, they must be free not only of personal conflicts of interest, but also, to the maximum extent possible, of psychological pressure to avoid debate and dissent. For this reason, new federal regulations and the listing standards of the NYSE and NASDAQ reflect “vaguer motivations such as reputation, family ties, duty, and loyalty, as well as the psychological constraints inherent in prereform board structures and procedures.” Developments in the Law, supra note 123, at 2195-204. Thus, for example, violating listing standards because you are not psychologically independent could subject you to a good faith violation. See id.
188 TIAA-CREF, POLICY, supra note 151, at 4.
189 See id.; see also In re Oracle Corp. Derivative Litig., 824 A.2d 917, 920-21, 942-48 (Del. Ch. 2003).
CalPERS maintains that “[i]ndependence is the cornerstone of accountability.”\footnote{CALPERS, GLOBAL PROXY VOTING PRINCIPLES (June 9, 2005), http://www.calpers-governance.org/principles/global/globalvoting.pdf.} It recommends that independent directors should meet periodically and do so without the CEO.\footnote{Id.} CalPERS further suggests that, in order to “instill independent leadership,” the Audit, Director Nomination, Board Evaluation and Governance, CEO Evaluation and Management Compensation, and Compliance and Ethics committees should be comprised of independent directors.\footnote{Id.}

Furthermore, TIAA-CREF maintains that companies should disclose to shareholders whether directors are participating in programs designed to “improve their competence and understanding of their roles and responsibilities and to deepen their exposure to the company’s businesses, operations and management.”\footnote{TIAA-CREF, Policy Statement on Corporate Governance, http://www.tiaa-cref.org/pubs/html/governance_policy/board_directors.html (last visited Apr. 3, 2006) [hereinafter TIAA-CREF, Corporate Governance]. As discussed in Part II.B.1, the court in 

\textit{McCall v. Scott} found that specialized knowledge increased the standard by which the directors should be judged. Directors are in the difficult spot of being charged with gaining technical and specialized knowledge all the while becoming subject to greater liability by doing so.\footnote{TIAA-CREF, POLICY, supra note 151, at 6.} 

\footnote{Id. at 6-7.}

\footnote{TIAA-CREF, Corporate Governance, supra note 194.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}

\footnote{Id.}
across-the-board basis." But it may support proposals to limit due care liability as long as the director meets the good faith standard.

Other guidelines include the following: CalSTRS recommends voting in favor of proposals calling for a simple majority of shares outstanding to approve a merger, voting against proposals for staggered terms; and voting in favor of an independent non-executive chairman who has not had a substantive employment relationship with the company in the past five years. Sitting directors who have not attended seventy-five percent of the meetings will receive a negative vote. CalSTRS states that “votes may be withheld when it appears that the existing board has been remiss in the performance of oversight responsibilities” in light of the surrounding circumstances. Proposals granting directors stock instead of cash for fees will receive a positive vote. Votes for directors may be withheld where there is an inherent conflict because of consulting fees for legal counsel and investment bankers who underwrite the corporation’s securities.

3. Shareholder Rights

Because common stockholders cannot enforce a contractual right against the corporation, their only relief is to enforce conduct of the board of directors through “thoughtful and informed proxy votes.” TIAA-CREF mandates that shareholders have the right to approve matters with a simple majority. Supermajority requirements should be used only where minority shareholders need protection from a dominant shareholder. Shareholders should have the right to ensure that increases in the authorized number of common shares are not to be used in a manner inconsistent with shareholder interests, such as for “excessively generous equity compensation plan[s].” Shareholders “should have the ability to communicate effectively with the board of directors.” Confidential voting should be im-

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203 Id. ("Board of Directors" section).
204 Id.
205 Id.
206 Id.
207 Id.
208 CalSTRS, supra note 165.
209 Id.
210 Id.
211 TIAA-CREF, POLICY, supra note 151, at 12.
212 Id. at 14.
213 Id.
214 Id.
215 Id. at 15.
plemented where possible in an effort to protect shareholders from undue influence in the voting process. And, shareholders should be able to vote on “separate and distinct” issues as opposed to voting on issues bundled by management. Any proposal recommending the opposite of any of the above will likely be opposed by TIAA-CREF fund managers.

In general, CalSTRS disfavors cumulative voting and supports eliminating preemptive rights. Currently, CalPERS is urging the U.S. Securities and Exchange Commission (“SEC”) to consider key enhancements for a proposed rule that would give shareholders more say in who sits on corporate boards. CalPERS told the SEC by letter that it strongly champions the proposal to liberalize companies’ director nomination process. CalPERS suggested several changes to the proposal, including allowing investors to place board director nominees on the proxy when there is a twenty percent vote to “withhold” on one or more directors. The SEC’s proposed rule sets that trigger at thirty-five percent. CalPERS recommends several measures in an attempt to grant shareholders greater power to check the board of directors’ power. Shareowners should “be able to amend the company’s bylaws by . . . proposal,” “call special meetings” with a majority, and “be able to act by written consent.” Also, no company should allow greenmail, nor should a board approve a poison pill without shareowner approval, and every director should be elected annually.

The above recommendations and guidelines present the types of issues and concerns that could characterize future litigation with regard to the duty of good faith. Whether such activism is proper or effective is always in debate. Nonetheless, institutional shareholders are voicing their opinion. These opinions, whether adhering to sound corporate law principles or not, may lead to outcome-determinative proxy votes or potentially damaging scrutiny by the media. Consequently, the policies used by the nation’s largest institutional shareholders should be considered a factor in the development of the definition of what it means for a director to act in good faith.

216 Id. at 13.
217 TIAA-CREF, POLICY, supra note 151, at 15.
218 CalSTRS, supra note 165.
220 Id.
221 Id.
222 Id.
223 Id.
C. Ratings Agencies Influencing the Definition of Good Faith

Proxy voting guidelines established at increasingly popular governance ratings agencies also participate in the establishment of the norms of corporate governance and, by doing so, can influence the definition of good faith. They measure corporate entities against factors they have determined in order to create an environment where the best interests of the corporation and shareholders are most likely served. Whether such rankings and ratings adequately and accurately measure the health of a company may be debated. Nevertheless, companies and investors are increasingly relying on the rankings and ratings. This fact exerts pressure on public companies to implement the agencies’ policies. Ratings agencies impact corporate governance to the extent shareholders rely on their metrics for guidance.

One prominent ratings agency is Institutional Shareholder Services (“ISS”). For over twenty years, ISS has promoted the idea that good governance leads to positive shareholder returns. It seeks to bridge the gap that exists between the institutional investors proposing corporate governance measures and the companies implementing the measures. ISS attempts to influence corporate governance in two ways. First, it provides proxy voting services to institutional shareholders. It offers proxy analyses and objective vote recommendations to more than one thousand institutional and corporate clients for over thirty-three thousand companies in 102 markets across the globe. Because of increased public scrutiny, institutional shareholders have become progressively more concerned with voting shares in a manner that reflects well upon their institution. ISS arrives at its recommendation by following a set of “Proxy Voting Guidelines.”

Second, ISS impacts how corporations are governed through their use of the Corporate Governance Quotient (“CGQ”). The CGQ ranks companies on how well they perform with regards to corporate governance. The

225 Paredes, supra note 11, at 1111 n.191.
226 See Sale, supra note 9, at 485.
227 See id.
228 See generally supra note 150 and accompanying text.
230 Id.
231 Id.
234 Id.
CGQ was designed to “assist analysts, portfolio managers, research directors and others in evaluating the impact that a company’s corporate governance structure and practices might have on a portfolio’s performance.” Therefore, even where a company does not agree with the CGQ, its business may be impacted by the issuance of the CGQ depending on how much weight it is given by organizations and/or constituencies that are critical to the company’s survival. As has been recently reported,

[M]any of the world's largest and most respected financial institutions have incorporated ISS’ CGQ data and ratings into various aspects of their operations, leveraging the objective and independent nature of the ratings to enhance their research discipline. Analysts, portfolio managers and bankers are using CGQ worldwide as a tool in equity and credit research, to perform risk analysis, manage portfolios, conduct due diligence and support buy/sell decisions.

In many cases, ISS’s CGQ influences such fundamental aspects of business as the ability to attract investors. Consequently, in order to achieve a positive CGQ, many corporations are beginning to conform to the principles set forth by ISS. Furthermore, ISS’s criteria for the CGQ are influenced by and reflect regulations such as the Sarbanes-Oxley Act and the new listing standards of the NYSE and NASDAQ. ISS arrives at the CGQ by using a set of sixty-one metrics in eight general categories designed to gauge the effectiveness of the company’s corporate governance measures.

235 Id.
238 The eight general categories are: (1) Board; (2) Audit; (3) Charter/Bylaws; (4) Anti-Takeover Practices; (5) Executive and Director Compensation; (6) Progressive Practices; (7) Ownership; and (8) Director Education. First, the Board category addresses the structure and function of the company’s board of directors. Special attention is paid to whether or not CEO/Chairman are separate positions, the board is disclosing information to shareholders and responding to their inquiries, whether board members attend the meetings, and whether the directors have been involved in any related party transactions. Second, the Audit category analyzes how the audit committee fares with regard to auditor rotation, ratification and compensation. Third, the Charter/Bylaws section considers vote requirements, whether special meetings are allowed, how board amendments are made, the company’s capital structure and features of any poison pills. Fourth, with regard to Anti-Takeover practices, ISS looks to whether the company has opted out of any applicable state takeover provisions. Fifth, the Executive and Director Compensation looks at the costs of option plans to shareholders, whether the company has or intends to reprice options, whether shareholders are given the right to approve option plans, whether there are any interlocks on the compensation committee, whether options are expensed, and other aspects of executive compensation. Sixth, the Progressive Practices section looks at whether the company has put in place a
Governance Metrics International ("GMI") is another corporate governance rating service. GMI’s primary customers are institutional investors and money management firms.\footnote{Governance Metrics International, Products and Services, http://www.gmiratings.com/ (3gcdzp550n5cnj45y4tu1g55)/Products.aspx#methodology (last visited Apr. 3, 2006).} GMI arrives at a ranking of corporate governance proficiency based on six areas of analysis.\footnote{A questionnaire is completed by each company, answering yes or no to several questions in the areas of Board Accountability, Financial Disclosure and Internal Controls, Shareholder Rights, Remuneration, Market for Control, and Corporate Behavior. Sample questions from the GMI analysis include the following: Does the company disclose the criteria used by the board or a board committee to formally evaluate CEO performance? Does each board committee undertake an evaluation of its own performance on a regular basis? What is the regulatory environment like within which the corporation is operating? Are there indications that executive compensation is closely aligned with shareholder interests? Does the board disclose its efforts to align executive compensation policies with shareholder interests? Is the board independent? Do restricted stock grants include performance hurdles? Are the company’s takeover mechanisms appropriate given their influence on the market for corporate control and accountability? See, e.g., Governance Metrics International—Sample Report, http://www.gmiratings.com/(dzwimv45dwfkjc552awgkh55)/Images/SampleReport.pdf (last visited Apr. 23, 2006).}

Undoubtedly there are going to be issues of credibility and reliability surrounding the issuance of ratings such as those issued by ISS and GMI. But, as mentioned above, institutional shareholders are not the only ones using the metrics. To the extent that creditors and other parties representing choke points in the financing process give credence to the metrics, companies may have to adapt to the rating methodology in order to maintain their competitive position in the marketplace.

D. Summary

Along with the apparent judicial willingness to consider a more expansive interpretation of the duty of good faith, other factors influence the definition of what it means to act in good faith. Responding to previous corporate misdeeds, federal regulators have injected themselves into an arena—commonly dominated by state corporate law—by enacting rules, in contrast to the traditional state-determined standards of conduct.\footnote{See supra Part III.A.1.} Many commentators reason that a failure to adopt and abide by the norms estab...
lished by the Sarbanes-Oxley Act could result in a breach of a corporate fiduciary’s duty of good faith. State regulation may also impact the definition of what it means to act in good faith. A concern of such regulation is that it may go beyond the requirements of federal regulation making it difficult to determine which regulatory scheme applies and leading to excessively burdensome regulation. Like the federal government, self-regulatory organizations are similarly concerned with reversing the downward spiral of confidence in our capital markets. Therefore, they have enacted standards by which companies within their jurisdiction must abide. Failure to do so, among other things, may result in a violation of a corporate fiduciary’s duty of good faith. Finally, shareholder activism must be considered in defining what it means to act in good faith. Shareholders exert pressure on boards of directors. Even where they are not able to influence corporate governance policies directly, they may be able to rally the support of the public and media—which could lead to further federal regulation. Institutional shareholders actively voice their opinion regarding corporate governance policy. Prominent institutional shareholders are currently promoting specific recommendations with regard to the intricacies of corporate policy in the areas of director and executive compensation, the board of directors, and shareholders’ rights. Companies and the creditors of those companies are relying upon ratings and recommendations issued by corporate governance ratings agencies. The policies advanced by the ratings agencies profess to offer a form of corporate governance that is best for all interested parties. Federal legislation, state legislation, and SRO regulation are shaping the norms of corporate governance. Therefore, directors will likely be required to comply with such norms to avoid liability for breaching the duty of good faith. It is unclear to what extent activism by institutional shareholders and ratings agencies is shaping corporate governance norms. But, to the extent they are, directors may also be bound by these norms in order to uphold their duty of good faith.

IV. MULTIFACETED DEVELOPMENT OF CORPORATE FIDUCIARY DUTIES—HOW FAR IS TOO FAR?

As this paper attempts to point out, a variety of factors are determining post-Enron corporate fiduciary duties. The multi-faceted approach indicates a unique paradigm shift in corporate law. Whether the apparent intrusion into what has traditionally been the purview of state common law is justi-
fied and whether the approach generates shareholder value are topics for substantial debate and academic discussion. One product of the new shift in corporate law has been fear in the boardroom. A recent settlement agreement made by ten former outside directors of WorldCom Inc. poignantly illustrates post-Enron directors’ exposure to personal liability. 245 None of the ten settling directors directly participated in the $11 billion fraud, yet all suffered significant losses in their equity portfolios as a result of the fraud. 246 Alarmingly, despite their not having participated in the fraud, the settlement will tap an estimated twenty percent of their aggregate net worth. 247 For this reason, directors are afraid, and the pool of willing and able candidates for such positions is shrinking.

A. Preoccupation with Liability Detracting Directors from Performing Their Essential Function in the Marketplace

1. Function of a Corporate Director

To understand why the preoccupation with liability is so undesirable, it is important to first appreciate the position of the corporate director. A corporate director assumes multiple roles248 consisting of monitoring management and performing relational249 and strategic functions. 250 Directors must carry out these roles in a way that advances the financial interests of the corporation and its shareholders. 251 Importantly, a central aspect of their

246 Weil & Young, supra note 245.
247 Id.; see also Scannell & Solomon, supra note 245.
249 Id. at 794 (“Relational monitoring addresses the corporation’s substantial environmental uncertainties. The corporation obtains access to information, advice, support, and legitimacy by furthering relationships with stakeholders through board memberships.”).
250 Id. at 807 (stating that the general strategic functions of a board of directors includes some involvement in setting corporate goals and missions, assisting in the development of corporate strategy, pointing out possible strategic opportunities and warning of threats, and evaluating the strategic choices and implementations of senior management).
position is undertaking venturesome business activities. Indeed, courts should encourage and the market should allow entrepreneurial risk-taking by directors that is careful, independent, and in good faith. In theory, doing so will lead to greater returns for shareholders. However, because of the magnitude of the costs of compliance associated with recent regulatory reforms, a director’s ability to achieve the end of his or her fiduciary obligation may become frustrated. If it becomes too expensive and/or time-consuming to comply with regulations, a director will not be able to maximize shareholder return.

2. Costliness of Complying with Regulations

The costs of complying with recent reforms include increases in D&O Insurance premiums, accounting fees, legal fees, board compensation commensurate with increased scrutiny and risk of liability, productivity losses, and other set-up costs. As a result of costly compliance, it is becoming “increasingly expensive for companies of all sizes to attract and retain qualified directors” in the wake of Sarbanes-Oxley Act requirements. A justification for many of the recent reforms has been that they will simply be one-time charges. But some have complained that associated increases have not been one-time charges and are increasingly unpredictable. One study reveals that fees paid to outside auditors have continued to increase by double digits every year since the inception of Sarbanes-Oxley in 2002.

Some contend that the principal benefit of the costly wave of regulations and heightened scrutiny is message it sends to directors that a higher
standard of behavior is expected. Although commentators are split on the issue, it has been said that the dynamic created by Sarbanes-Oxley and other regulatory reforms “is creating appealing changes in American corporate governance.”

Perhaps the most significant change is that the new rules may provide cover for conscientious directors who feel social pressure not to “rock the boat.”

Uncomfortable questions and even investigation can now be justified as being required by regulation.

It remains to be seen to what extent the costs of compliance will impact shareholder return. There is likely a point at which additional regulations and scrutiny will stifle the very capitalistic risk-taking by directors that is essential to our free market economy. Notably, SEC Commissioner Paul S. Atkins commented that because “Sarbanes-Oxley strengthens the role of directors as representatives of the stockholders and reinforces the role of management as the stewards of stockholders’ interest” it recognizes the importance of shareholder value.

In light of the numerous factors influencing the evolution of corporate fiduciary duties, including Sarbanes-Oxley and the listing standards of the NYSE and NASDAQ, there are numerous ways in which directors can be found personally liable for a breach of one of their fiduciary duties. The traditional mechanism protecting directors from liability is the application of the evidentiary presumption of the business judgment rule.

B. The Business Judgment Rule in Light of Intense Director Scrutiny and Evolving Standards of Director Conduct

1. Despite the Apparent Tension Between Director Accountability and Authority, the Business Judgment Rule Is Alive and Well

Some have argued that reforms such as the Sarbanes-Oxley Act have weakened the business judgment rule. However, one prominent jurist asserts that the business judgment rule remains foundational to corporate law and is “alive and well today” notwithstanding the increase in scrutiny.

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258 Id. at 539.
259 Id at 530.
260 Id.
The business judgment rule is an evidentiary presumption that the board of directors acts with due care, in good faith, and in honest belief that its actions are in the best interest of the company’s shareholders. The primary purpose of the presumption is to protect and promote the full exercise of managerial power. Thus, corporate decision making begins with the board of directors. The rule recognizes that the directors, not the shareholders, control the affairs of the corporation.

Directors must be given such control, or authority, because of the information asymmetry that exists between directors and shareholders and also because of the difficulty of achieving a consensus among shareholders on account of their broadly divergent interests. As one writer suggests, the reason the business judgment rule protects director decisions from judicial review is because the law and the marketplace find value in the board’s authority. Also, the business judgment rule protects shareholders from

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264 Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (citing with approval Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981)).
266 Professor Bainbridge states that “the chief distinguishing characteristic of the modern public corporation is the separation of ownership and control.” Id. at 105 (citing ADOLPH A. BERLE & GARDNER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84-89 (1932)). A hallmark of this idea is that the alleged owners of the corporation “have virtually no power to control either its day-to-day operation or its long-term policies.” Id. at 105.
267 Id. at 106 (citing KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 70 (1974)).
268 Professor Bainbridge states that the fact that “we do not expose [some] director decisions to judicial scrutiny . . . suggests that the law finds value in the board’s authority that might be lost if director decisions were routinely subject to review.” Id. at 108. This value, he claims, comes from several sources. First, there is value in encouraging risk. Shareholders are better rewarded with risky projects.
269 Ibid. Furthermore, risk taking is justified because shareholders can externalize much of the risk by diversification. Id. at 111-12. Quoting Judge Ralph Winter, Professor Bainbridge points out that [b]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions . . . . Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may be the best choice since great losses in some stocks will over time be offset by even greater gains in others . . . . A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interests of shareholders generally.

Bainbridge, supra note 265, at 115 (quoting Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982)).

The second source of value stems from the fact that judges are not business experts. See id. at 117 (discussing Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919)). In most cases, it is not efficient for judges to consider the appropriateness of business decisions which are complex and made under conditions of uncertainty. Id. at 118-19. The third rationale, asserts Professor Bainbridge, is that there is value in not disrupting a Board of Directors’ internal dynamics. He states that boards of directors are relational teams and such teams are best monitored by a combination of mutual motivation, peer
other shareholders; it prevents stockholders from asserting their interests and forcing them upon directors, which may not be in the interests of the larger body of shareholders. Other justifications include the following beliefs: just because in hindsight decisions look bad does not mean directors should be liable; shareholders voluntarily undertake the risk of a business judgment; and shareholders can always vote directors out of office.

To maximize the efficiency of corporate decision-making, a proper mix of accountability and authority must be achieved.\(^{269}\) This is a delicate process because any increase in director accountability necessarily “shifts decision-making authority to shareholders or judges.”\(^{270}\) On the other hand, an increase in authority creates the possibility of “opportunism.” With additional authority, the board of directors, as an empowered central decision maker, “may divert organizational resources to its own benefit rather than the good of the organization and its constituents.”\(^{271}\) Conceptually, the grant of authority to corporate directors is held in check by an implicit charge to maximize shareholder wealth.\(^{272}\) There is a constant tension between director accountability and authority; recognition of such tension should be central to any analysis of the business judgment rule as it applies to a particular situation.\(^{273}\)

The recent barrage of legislation and regulatory action illustrates the difficult struggle between granting directors authority and holding them accountable. It could be argued that such prophylactic action is evidence that the authority of corporate directors had grown too large or that that directors had abdicated their authority by failing to monitor senior management. Whether regulatory, judicial, or legislative, such action represents an attempt to reestablish equilibrium in the boardroom, whether by increasing the accountability of directors or reminding them of their abdicated authority. Signals that the board room was in disequilibrium include academic discussion of and apparent judicial willingness to consider or warn of a more expansive duty of good faith; the extensive demands of the Sarbanes Oxley Act; increased activism by institutional shareholders; increased focus on and trust in corporate governance metrics; and the new listing standards of the NYSE and the NASDAQ. This external pressure on the boardroom is intended to make it more likely that directors will not be granted too much authority and that they will use their statutorily-granted pressure, and internal monitoring. Id. at 126. He argues that “judicial review might well destroy the interpersonal relationships that foster these forms of internal board governance.” Id.

\(^{269}\) Id. at 109.
\(^{270}\) Id. at 108.
\(^{271}\) Id. at 107.
\(^{272}\) See Bainbridge, supra note 105, at 575.
\(^{273}\) Bainbridge, supra note 265, at 109.
authority to prevent senior management from pursuing a course contrary to the best interests of the corporation and its shareholders. So, to the extent that the governance reforms rebalance the scale between authority and accountability, they conform to and can be justified by fundamental corporate law principles.

However, as mentioned above, pressure on the boardroom comes with a cost. Excessive time and money spent fretting over liability and complying with new standards effectively punishes shareholders—the intended beneficiaries of the responsive regulations. So, in light of the business judgment rule’s recognition of authority and control, how much regulation and scrutiny is too much? If the federal government intends to displace state corporate law with a federal version, this question remains largely unanswerable. But if, as is likely the case, state corporate law remains the fundamental guide for corporate activity, then legislative and regulatory action will have gone too far when the nation’s boardrooms cannot maintain equilibrium—when they are forced to abdicate control to shareholders or other constituencies, including judges and legislatures. In order for directors to perform their critical function as the corporate nervous center, they must be allowed both exclusive decision-making control and the protections of the business judgment rule. Vigorous legislative and regulatory action in response to corporate scandal should consider the potential impact of such action on the marketplace as it collides with fundamental concepts of state corporate law. In light of the multitude of factors determining corporate norms, including what it means to act in good faith, courts should “be explicit both about the fact that they are balancing competing concerns and about why they believe the balance struck in a particular case is the appropriate one.”

2. Director Accountability: Overcoming the Evidentiary Pre-...

Generally, to supersede a director’s authority and hold him or her accountable, the plaintiff must provide evidence that the board has breached one of the triad of fiduciary duties: good faith, due care, or loyalty. Of
concern to directors and important to this analysis is that the business judgment rule does not protect actions not taken in good faith. In theory, as the duty of good faith is given greater prominence in the courts, it will likely be easier to overcome the presumption and will increase the probability that a judge will not abstain from reviewing director action.

C. The Relationship Between Good Corporate Governance and Higher Shareholder Return

The duty to maximize shareholder return remains central to any evaluation of whether or not a director acted in the best interests of the corporation. Determining whether a project or a certain corporate governance measure is in the best interests of the corporation is increasingly difficult. Whether something is in a corporation’s best interest depends on the identity of shareholders, the diverse goals they may have, and even the interests of non-shareholders.\(^{276}\)

Nowadays, directors are being charged with the responsibility of ensuring that a myriad of corporate governance measures are implemented at the companies they govern. At the same time, shareholders continue to demand a positive return on their investment. An important question to be answered asks whether, and if so to what extent, corporate governance measures assist corporate directors in furtherance of their duty to maximize shareholder return.

Recently, a study commissioned by ISS revealed that firms with stronger corporate governance, as determined by a group of metrics chosen by ISS, have higher stock returns than firms with weaker corporate governance.\(^{277}\) The difference in return on equity between firms with strong corporate governance and firms with weak corporate governance is 16.05%.\(^{278}\) Firms with weaker corporate governance were found to have “lower returns on equity, lower profit margins, are less valuable, pay out less cash dividends, and repurchase fewer shares.”\(^{279}\) In contrast, the study revealed that


\(^{277}\) Brown & Caylor, supra note 238, at 3.

\(^{278}\) Id. at tbl.3. While firms with the highest corporate governance rating enjoyed a return on equity of 9.244%, firms with the lowest corporate governance rating had a return on equity of -6.806%. Id.

\(^{279}\) Id. at 15.
firms with stronger corporate governance have “higher returns on equity, higher profit margins, are more valuable, pay out more cash dividends, and repurchase more shares from their shareholders.”\textsuperscript{280} The inputs of the study fell into eight main categories: board composition, compensation, takeover defenses, audit, director education, stock ownership, state of incorporation, and practices regarding mandatory director retirement.\textsuperscript{281} Similarly, a study by GMI suggested that shareholder returns have been higher at companies with independent board members, equal-voice shareholder voting, and meaningful ownership positions by senior executives and directors.\textsuperscript{282} GMI maintains that such findings indicate that sound governance policies lead to better shareholder returns over the long term and protect against significant underperformance.\textsuperscript{283} GMI Chief Operating Officer Howard Sherman contends that the benefits of good governance go beyond a higher stock price.\textsuperscript{284} Further, a study published in The Quarterly Journal of Economics in February 2003 finds that “corporate governance is strongly correlated with stock returns during the 1990s.”\textsuperscript{285} Although the data “do[es] not allow strong conclusions about causality,” there is evidence indicating that metrics such as weak shareholder rights led to poor performance in the 1990s.\textsuperscript{286}

On the other hand, some contend that corporate governance fails to increase shareholder return. A recent analysis revealed that either the indicators of corporate governance used by academics and ratings agencies do not adequately represent actual corporate decision-making, or corporate governance has a very modest impact on shareholder return.\textsuperscript{287} The analysis involved a consideration of 2,126 firms encompassing seventy percent of the Russell 3000\textsuperscript{288} as of the end of 2003.\textsuperscript{289} The corporate governance indi-

\textsuperscript{280} Id.
\textsuperscript{281} Id. at 11-12. These categories encompassed fifty-one variables that the authors implemented at the suggestion of ISS. See id. at tbl.1.
\textsuperscript{283} Id. at 5.
\textsuperscript{284} He contends that: the benefits of good governance practice are many: lower borrowing costs, reduced or more moderate increases in directors and officers insurance, lower litigation costs, a lower chance of being targeted for shareholder action and negative proxy votes, a higher chance of recruiting and retaining good directors, higher employee morale and higher stock price.
\textsuperscript{285} Paul Gompers et al., Corporate Governance and Equity Prices, 118 Q. J. OF ECON. 144 (Feb. 2003).
\textsuperscript{286} Id. at 145.
cators measured included seven general categories: characteristics of the board of directors, stock ownership by executives and board members, stock ownership by institutions, stock ownership by activist holders, debt and preferred stock holdings, anti-takeover devices, and unionization. The authors admit that the study encompasses only one year of statistics but counter that concern by stating that it was conducted after the implementation of Sarbanes-Oxley and therefore represents the current state of corporate governance. The authors of the study reported no significant link between corporate governance based on their chosen metrics.

The full impact of reforms could take years to unfold. But to the extent that empirical studies linking corporate governance measures to positive shareholder return are validated and as updated regulations are implemented (e.g., as companies actually implement control systems required by Sarbanes-Oxley, etc.), legislation and scrutiny requiring strict compliance with rapidly changing corporate norms will find greater public support.

D. A Balanced Approach

Public and congressional outrage does not necessarily mean that the pre-Enron corporate governance norms were fatally inadequate. Moreover, regulation attempting to ensure that such outrage will never happen again runs the risk of stifling the experimentation and entrepreneurialism that is critically needed by our free market system. For these reasons, it

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The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. As of the latest reconstitution, the average market capitalization was approximately $4.8 billion; the median market capitalization was approximately $944.7 million. (As of June 14, 2005, the index had a total market capitalization range of approximately $386.9 billion to $182.6 million.


The following institutions were deemed activists by the Larker analysis: California Public Employees Retirement System; California State Teachers Retirement; Colorado Public Employees Retirement Association; Florida State Board of Administration; Illinois State Universities Retirement System; Kentucky Teachers Retirement System; Maryland State Retirement and Pension System; Michigan State Treasury; Montana Board of Investment; Education Retirement Board New Mexico; New York State Common Retirement Fund; New York State Teachers Retirement System; Ohio School Employees Retirement System; Ohio State Teachers Retirement System; Texas Teachers Retirement System; Virginia Retirement System; State of Wisconsin Investment Board. Id. at 8 n.8.


Id.
has been stated that a balanced approach is preferred over extremity. Regulations and adjudication should punish fraud but should be careful not to criminalize mistakes. With a multiplicity of factors influencing the definition of corporate fiduciary duties, it is imperative that regulators and the judiciary consider the long-term economic consequences associated with corporate governance issues. Such an approach will better serve the public and effectively balance corporate fiduciary accountability and authority.

CONCLUSION

Notwithstanding other possible causes for the recent corporate debacles, there is a general belief that corporate directors, in some measure, contributed to such failures by abdicating their oversight responsibilities. Consequently, regulators and the public have increasingly examined corporate fiduciaries. As a result of this scrutiny, many predict an increase in the number of lawsuits seeking to hold directors accountable for errant decision-making. Because traditional procedural safeguards failed to prevent corporate disaster, a more subjective analysis with regard to corporate fiduciary duties may more effectively measure culpability. Thus, the duty of good faith has emerged as a topic of substantial debate and analysis—not to mention director preoccupation.

Historically, the duty of good faith has been an important component of corporate law. But the duty remains largely undefined. It is unclear whether recklessness amounts to bad faith, or whether director action that is so egregious that it cannot be explained on any other grounds may very well be seen as a breach of that director’s duty of good faith. Likewise, fiduciary action portraying a “we don’t care about the risks” attitude will likely be deemed a violation of the duty of good faith.

Another important aspect of the duty of good faith is to determine when and where the duty applies. At least three possible approaches have been proffered. It has been said that the duty of good faith is actually a subset of the duties of loyalty and care. Another view is that the duty of good faith is emerging as a duty independent of the duties of care and loyalty. A third interpretation is that the duty of good faith is analogous to the duty of

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295 See id.
good faith in the contractual context. Such a view would place upon directors the duty to undertake all of their obligations in good faith—not just those obligations requiring loyalty and care. Regardless of the answers to when and where the duty is applied, the duty of good faith will be a significant aspect of future fiduciary duty analysis.

Beyond the judicial application and interpretation of the duty of good faith there are many factors influencing the definition of what it means to act in good faith. Federal regulation, primarily the Sarbanes-Oxley Act, has become a prominent player in what has traditionally been regarded as state corporate law territory. In addition, self-regulatory organizations have issued standards by which listing companies must abide. Furthermore, state legislatures are contemplating measures that go beyond those of Sarbanes-Oxley. Such regulation—federal, state, or by the SROs—is adding new dimensions to the definition of good faith. Failure to comply with any of the new standards and regulations could be considered a violation of the duty of good faith.

Another factor influencing the duty of good faith is shareholder activism. The degree to which shareholders impact corporate governance is debatable. But it is apparent that at times shareholders, especially big-block shareholders, do exert pressure on companies; occasionally, companies respond to that pressure. Institutional shareholders are uniquely positioned to exert an influence over public companies. They are increasingly voicing their opinions with regard to executive and director compensation, the board of directors, and shareholders’ rights. Even where institutional shareholders cannot directly influence corporate governance, their activism may give rise to public or media awareness which could lead to further federal regulation. Finally, companies and creditors of companies are increasingly giving attention to corporate governance ratings agencies and/or the policies issued by proxy service providers. Each of these factors is assisting with the development of the duty of good faith.

A significant result of the heightened scrutiny of fiduciary conduct has been fiduciary preoccupation with fear of litigation. Corporate directors have the primary responsibility to control the affairs of the corporations they govern. However, new regulation and increased exposure to liability, whether actual or perceived, has been costly for directors. Valuable time and resources that could be used to enhance shareholder value is being spent complying with the new regulatory demands in an effort to avoid liability. The business judgment rule has traditionally protected directors from liability. Regulatory reforms are likely evidence that director authority outweighed pre-Enron director accountability. If a more expansive definition of the duty of good faith is developed, the evidentiary presumption of the business judgment rule may be considerably easier to overcome.

This article recommends that the best application of the duty of good faith is an evenhanded approach to future regulation and enforcement of
corporate fiduciary duties, which will strike an appropriate balance between accountability and authority. Overly burdensome regulation could lead to a negative business climate, where corporate vision is stifled and effectively punished. Our free market economy requires that directors be able to take risks and follow entrepreneurial vision. A balanced approach can restore confidence in our capital markets and allow for the robust growth and entrepreneurialism that is the hallmark of American business.