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# The New Concept of Loyalty in Corporate Law

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# The New Concept of Loyalty in Corporate Law

Andrew S. Gold\*

*Traditionally, the fiduciary duty of loyalty is implicated where corporate directors have conflicts of interest. In a major new decision, *Stone v. Ritter*, the Delaware Supreme Court determined that directors may also be disloyal when they act in bad faith. As a consequence, directors may be disloyal even when they have no conflicts of interest, and even when they intend to benefit their corporation. This Article reconciles this expanded fiduciary obligation with existing concepts of loyalty. The new loyalty is not incoherent, and it is not unpredictable. Courts have adopted a recognizable understanding of loyal behavior — being “true” — that exists in other social spheres. Under this conception, loyal directors must not only act in the best interests of their corporation and its shareholders, they must also be honest with shareholders and comply with positive law.*

*This Article also offers insights into the function of these expanded fiduciary duties. Although the new loyalty duties pose risks, there are good reasons to think they will provide net benefits. Following the recent *Lyondell* decision, it appears that the *Stone* case and its progeny will not result in significant revisions to the business judgment rule. However, the recent change in a director’s loyalty obligation may substantially lower information costs, giving better guidance to directors and simplifying coordination. In addition, the new conception of loyalty can serve an important expressive function, enabling a more efficient level of trust among corporate actors, investors, and those who transact with the firm.*

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## INTRODUCTION

An important new category of director liability is emerging in corporate law. Delaware cases now suggest that an unconflicted director can be liable for disloyalty even if the director sincerely intends to benefit her corporation and its shareholders.<sup>1</sup> Under traditional notions of a director's loyalty duties, such an outcome is highly unusual. This Article explains what this new conception of loyalty means, and why it may be desirable.

A director's fiduciary duty of loyalty has long been a core feature of corporate jurisprudence. The standard features of this loyalty requirement are also straightforward: it is typically implicated when directors engage in self-dealing, or when they take personal benefits if those benefits are not shared with all the shareholders.<sup>2</sup> Yet the duty of loyalty has recently become complex. In *Stone v. Ritter*, decided in 2006, the Delaware Supreme Court explained that the fiduciary duty of good faith is a subsidiary component of the duty of loyalty.<sup>3</sup> Given the uncertain content of the fiduciary duty of good faith, this could produce dramatic changes to the content of loyalty.<sup>4</sup>

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<sup>1</sup> See, e.g., *Desimone v. Barrows*, 924 A.2d 908, 933 (Del. Ch. 2007) (indicating that directors are disloyal when they have "consciously taken action beyond their authority," even though "their motives were not necessarily selfish"). In light of Delaware's dominance as a place of incorporation, this Article will focus on Delaware's corporate law jurisprudence. This is not to say that Delaware's role is exclusive. Federal law has become a significant jurisdictional competitor. See generally Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (suggesting that Delaware competes with federal government as source of corporate law).

<sup>2</sup> See *In re Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693, 751 (Del. Ch. 2005) ("The classic example that implicates the duty of loyalty is when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all the shareholders.").

<sup>3</sup> See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

<sup>4</sup> There is now a substantial literature on recent developments to the fiduciary duty of good faith. Significant contributions include: Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 WAKE FOREST L. REV. 1131 (2006); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006) [hereinafter Eisenberg, *Duty of Good Faith*]; Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398 (2007); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005); Claire A. Hill & Brett McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833 (2007) [hereinafter Hill & McDonnell, *Disney*]; David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004) [hereinafter Sale, *Good Faith*].

*Stone* raises interesting definitional questions regarding the meaning of disloyal conduct. Can a director be disloyal to her corporation if she knowingly causes it to break the law, in the sincere belief that this will benefit the corporation? Can a director be disloyal to her shareholders if she lies to them, thinking that these lies will maximize shareholder wealth? Under the form of loyalty now recognized in recent Delaware cases, the answer to both of these questions is yes — such conduct is disloyal.<sup>5</sup>

Several commentators have questioned whether the above types of cases should be viewed in terms of loyalty duties.<sup>6</sup> Arguably, a director who has no conflicts of interest *cannot* be disloyal if he or she sincerely believes the board's decision is in the best interests of the corporation and its shareholders.<sup>7</sup> And, in light of prior case law, critiques of the new loyalty decisions are unsurprising.<sup>8</sup> If loyalty requires that a fiduciary must act to advance the corporation's or shareholders' best interests, director conduct taken with that intent does not seem to violate this duty.<sup>9</sup> How can one be disloyal to an individual as a result of actions intended to benefit that individual?

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For recent analyses of the duty of good faith and the duty of loyalty after *Stone v. Ritter*, see Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008); Claire A. Hill & Brett McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769 (2007) [hereinafter Hill & McDonnell, *Stone v. Ritter*]; Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719 (2007); Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. J. (forthcoming 2009), available at <http://ssrn.com/abstract=1349971>.

<sup>5</sup> See, e.g., *Stone*, 911 A.2d at 369-70 (determining that fiduciary duty of good faith is component of loyalty, and noting that failure to act in good faith occurs in cases of intentional violations of law); *Desimone*, 924 A.2d at 933 (indicating that conscious deception of shareholders would be disloyal even if directors' motives were not necessarily selfish); *Ryan v. Gifford*, 918 A.2d 341, 355 (Del. Ch. 2007) (suggesting it is difficult to conceive of context in which director may lie to shareholders and satisfy duty of loyalty).

<sup>6</sup> See Bainbridge et al., *supra* note 4, at 590-94 (critiquing view that intentional violations of positive law should be understood as loyalty violations); Eisenberg, *Duty of Good Faith*, *supra* note 4, at 38 (critiquing view that intentional violations of positive law should be understood as loyalty violations); *id.* at 41 (critiquing view that violations of the duty of candor could be loyalty violations).

<sup>7</sup> See Eisenberg, *supra* note 4, at 41 (suggesting that candor violations cannot be loyalty violations "because the board may violate the obligation not to mislead even if it is not self-interested").

<sup>8</sup> One potential critique is grounded in the value of consistency. Recent Delaware cases clearly described three fiduciary duties, with good faith as the third part of a "triad." See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001).

<sup>9</sup> For purposes of this Article, I will not address the question of whether a director's duties are best understood to extend to the corporation or instead to its

As these challenges suggest, we can no longer simply claim that loyalty is an overarching fiduciary duty to act in the best interests of the corporation and its shareholders.<sup>10</sup> But it is not necessary to give up on the goal of coherence altogether. Instead, loyalty has to be understood in a different way. This Article provides a means to grasp the new post-*Stone* duty of loyalty within a coherent conceptual framework.

The current judicial understanding of loyalty in corporate law dovetails with conceptions of loyalty that already exist in other social spheres. As others have noted, nonlegal settings are a rich source of content for fiduciary duties.<sup>11</sup> For example, outside of corporate law people commonly understand that one can be disloyal even without self-dealing.<sup>12</sup> Under this view, knowing indifference to a beneficiary's interests is not loyal conduct.<sup>13</sup> A requirement of affirmative devotion to one's beneficiary is a reasonable feature for corporate law to recognize as a part of loyalty.

But this affirmative devotion strand of loyalty does not account for the legal bar on deception and illegality as a means to benefit shareholders. One could be affirmatively devoted to someone and still lie to that person as a means to benefit him or her — a paternalistic act is not *per se* lacking in devotion.

This Article proposes that corporate law is drawing on an additional understanding of loyalty. Loyalty, at least under some versions of the

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shareholders. Delaware courts often fail to separate the two. *See, e.g.,* N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders."). Whether loyalty duties are owed to either or both parties, the present analysis would remain unchanged. The distinction is important, however. For a recent critique of current case law regarding the proper beneficiary of the board's fiduciary duties, see Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1316-33 (2008). If the courts were to more narrowly delimit the beneficiaries of loyalty duties — choosing the shareholders or the corporation — this could affect outcomes for future loyalty cases.

<sup>10</sup> Such claims are made with increasing frequency, however. *See, e.g.,* Hill & McDonnell, *Disney*, *supra* note 4, at 855 ("Ultimately, directors and officers owe only one fiduciary duty to a corporation — the duty to actively pursue the best interests of the corporation. The duties of loyalty, care, and good faith address differing aspects of this duty.").

<sup>11</sup> *See, e.g.,* Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27 (2003) (indicating how loyalty may involve affirmative devotion based on social understandings of loyalty).

<sup>12</sup> *See id.* at 37-42 (discussing this broader conception of disloyalty).

<sup>13</sup> *See, e.g.,* Strassburger v. Earley, 752 A.2d 557, 581 (Del. Ch. 2000) (concluding that indifference to "the duty to protect the interests of the corporation and its minority shareholders" violates duty of loyalty).

concept, bars conduct that is deceitful, manipulative, or in some sense untrue to the terms of a relationship.<sup>14</sup> In context, such conduct is a form of betrayal. Once this nonbetrayal aspect of loyalty is recognized, many of the recent loyalty cases in corporate law are easy to explain.

Properly understood, the new fiduciary duty of loyalty is neither incoherent nor counterintuitive. In order to be loyal, directors must act to benefit their corporation and its shareholders. This requires more than a limit on self-dealing; it requires an affirmative devotion to the interests of the corporation and its shareholders. Yet there is also another element. Loyalty also requires an appropriate respect for the decisions of the corporation and its shareholders in contexts where the corporation and shareholders have legitimate authority. In other words, directors must look out for the interests of their beneficiaries, but they may not use deceit, manipulation, or broken promises to shareholders to achieve their otherwise legitimate goals.

The recent fiduciary duty cases could eventually alter the standards of review by which courts assess director behavior. Arguably, these decisions will give courts more leeway in holding directors accountable for harmful business practices.<sup>15</sup> However, while the new loyalty cases do expand the potential scope of director liability — at least in theory — it does not appear that Delaware courts are inclined to make major incursions on their traditional business judgment rule jurisprudence.<sup>16</sup> Furthermore, there are cogent reasons for this judicial reluctance.<sup>17</sup>

If the new loyalty cases do not result in significant changes to directors' liability risks, what purpose do they serve? This Article suggests that these loyalty cases are actually quite noteworthy. Although standards of review are largely unchanged, the new precedents have a substantial effect on directors' standards of conduct.

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<sup>14</sup> For a discussion of this type of loyalty as a character trait, see SIMON KELLER, *THE LIMITS OF LOYALTY* 154 (2007).

<sup>15</sup> See Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1780 ("The duty of good faith thus offers a conceptual framework, under the broader rubric of the duty of loyalty, to encompass cases of culpable conduct not constituting breaches of the duty of loyalty as traditionally conceived.").

<sup>16</sup> See *infra* notes 198-205 and accompanying text. For a recent example, see *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 243-44 (Del. 2009) (providing test for bad faith in transactional context which would be very difficult to meet).

<sup>17</sup> See generally Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004) (supporting business judgment rule as abstention doctrine based upon concerns regarding director risk-taking, judicial expertise, and internal dynamics of board); Gold, *supra* note 4 (supporting business judgment rule in light of severe judicial uncertainty regarding appropriate balance between board authority and accountability).

Corporate law shows a long-established divergence between directors' standards of conduct and judicial standards of review.<sup>18</sup> Under this approach, directors' standards of conduct often benefit shareholders, even if courts rarely enforce them. Directors' fiduciary duties guide conduct through other means. And, by extension, adjustments to these standards of conduct can have value even if the applicable standards of review are left unchanged.

An important benefit to the conception of loyalty described in this Article is its potential for lowering information costs.<sup>19</sup> The recent case law limits the number of fiduciary duties, and also their potential content. Directors, shareholders, and various other constituencies benefit from the accessibility of fiduciary concepts. Morality and virtue-based conceptions of a fiduciary's obligation are salient and often intuitively easy to grasp. Following these new loyalty holdings, the content of fiduciary duties should be substantially more accessible.

In addition, the new loyalty cases — such as the recent decisions precluding lies to shareholders — are closely linked to the question of trust among corporate actors.<sup>20</sup> A readily internalized reading of a director's loyalty obligations may cause a decrease in deceptive director conduct, thus producing more efficient intra- and intercorporate relations.<sup>21</sup> And, even if these duties are not internalized by all directors, their enunciation by the courts may still serve important expressive functions, creating external incentives for desirable director conduct.<sup>22</sup>

Part I of this Article analyzes the recent developments in Delaware law regarding the duties of good faith and loyalty. Part II explains the conception of loyalty embedded in the recent Delaware case law. It develops how the Delaware courts have moved from a relatively

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<sup>18</sup> See generally Melvin Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993) [hereinafter Eisenberg, *Divergence*] (analyzing standards of conduct and standards of review in corporate law).

<sup>19</sup> For purposes of this Article, I will treat morality-based or virtue-based conceptions of loyalty as if they were one category. However, it should be noted that the requirements of loyalty as a virtue are not necessarily consistent with conventional requirements of morality. Since much of the prior discussion regarding conceptual accounts of fiduciary duty describes the loyalty concept as a moral understanding, both terms will be used together.

<sup>20</sup> See *infra* notes 245-258 and accompanying text. For a leading account of how trust matters for corporate law purposes, see Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1753-59 (2001).

<sup>21</sup> See *infra* notes 264-297 and accompanying text.

<sup>22</sup> See *infra* notes 298-311 and accompanying text.



limited conception of loyalty to a view that expands the duty of loyalty in new directions. Part III indicates how the current conception of loyalty may be a valuable response to information cost concerns, as well as a means to facilitate efficient levels of trust respecting corporate actors. The Article concludes by reviewing the implications of these developments for corporate governance policy.

## I. THE DOCTRINAL DEVELOPMENT OF THE DUTY OF LOYALTY

The past few years have witnessed a sea change in the Delaware courts' understanding of the fiduciary duty of loyalty. These legal revisions are part of a larger adjustment to the content and effect of fiduciary duties. In order to make sense of current developments in loyalty jurisprudence, it will therefore be helpful to trace the evolution of fiduciary duties in Delaware case law.

Over the last two decades, directors' fiduciary duties evolved significantly. They shifted from two traditional duties (care and loyalty) to three independent duties (care, good faith, and loyalty). Then they shifted back to two duties (care and loyalty), but with good faith as an expressly recognized component of loyalty. This created a great deal of confusion.

This Part explains how these changes transpired. The legal doctrine here has been, at best, fragmented. Recently, a viable idea of a director's fiduciary duty of good faith emerged. Yet the Delaware Supreme Court then incorporated good faith into loyalty, with the result that both good faith and loyalty became uncertain.

Effectively, directors have a duty of loyalty that addresses self-dealing. They also have a duty of loyalty that requires affirmative devotion to the corporation and its shareholders. Finally, they have a duty of loyalty that precludes lying to shareholders, intentional violations of positive law, and the breaking of certain commitments. The analysis below explains how these several loyalty duties came to be.

### A. *The Disney Case and the Duty of Good Faith*

Until recently, Delaware courts focused on two basic fiduciary duties: a duty of loyalty, and a duty of care.<sup>23</sup> The duty of loyalty was

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<sup>23</sup> See Bainbridge et al., *supra* note 4, at 564 (noting that "a director's obligation to act in good faith traditionally was 'subsumed in a court's inquiry into the director's satisfaction of her duties of care and loyalty'" (quoting ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, DIRECTORS: FIDUCIARY DUTIES IN TAKEOVERS AND MERGERS, IN FIRST ANNUAL DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE 911 (PLI Corporate Law & Practice, Course Handbook Series 2003))).

primarily implicated in cases that involved conflicting interest transactions and the taking of corporate opportunities.<sup>24</sup> The duty of care was primarily implicated in cases of process failures during the course of board decisionmaking.<sup>25</sup> Although judicial references to the requirements of “good faith” occasionally surfaced, good faith was often treated as an aspect of care or loyalty, not as an independent source of liability.<sup>26</sup>

Section 102(b)(7) of the Delaware General Corporation Law changed this pattern. In the aftermath of the *Smith v. Van Gorkom* decision, a controversial duty of care case, the Delaware legislature enacted section 102(b)(7) as a means of limiting the liability risk faced by boards of directors.<sup>27</sup> This statute provided for the potential exculpation of directors from monetary liability based on violations of their duty of care.<sup>28</sup> Pursuant to the statute, directors received these statutory protections if the corporation’s charter contained a protective provision restricting liability.

Notably, the scope of protection under section 102(b)(7) was limited to duty of care cases. Under its express terms, the statute set forth a number of exceptions. An exculpatory provision would not preclude monetary liability:

- (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law; (iii) under [section] 174 of this

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<sup>24</sup> See *Disney IV*, 907 A.2d 693, 751 (Del. Ch. 2005); see also Gold, *supra* note 4, at 407; D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1410-11 (2002).

<sup>25</sup> See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985) (describing duty of care as “a director’s duty to exercise an informed business judgment . . .”); see also *Brehm v. Eisner (Disney II)*, 746 A.2d 244, 264 (Del. 2000) (en banc) (“Due care in the decisionmaking context is *process* due care only.”).

<sup>26</sup> See Bainbridge et al., *supra* note 4, at 564; see also Griffith, *supra* note 4, at 15-16 (“The mystery of good faith . . . was unexplored for almost two decades, until the chancery court’s development of good faith jurisprudence in 2003.”). As noted, however, courts did historically refer to the duty of good faith. See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 29 (2007). For a helpful discussion of the incorporation of “good faith” into “loyalty” in pre-*Stone* corporate precedents, as well as in agency and trust law, see Strine et al., *supra* note 4, at 45-58.

<sup>27</sup> See *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) (noting that section 102(b)(7) was enacted following directors and officers insurance liability crisis and *Van Gorkom* decision).

<sup>28</sup> See DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).

title; or (iv) for any transaction from which the director received an improper personal benefit.<sup>29</sup>

Various forms of improper conduct cannot be exculpated under the statute, so long as the basis of a plaintiff's claim falls outside of a due care theory.<sup>30</sup>

Because Delaware courts could now be expected to recognize claims under these exceptions to section 102(b)(7), this new statutory structure had substantial implications for the business judgment rule. The business judgment rule is a judicial presumption that a business decision of the board of directors was well-informed, made in good faith, and decided in the honest belief that it would benefit the corporation and its shareholders.<sup>31</sup> Traditionally, the business judgment rule severely limited successful suits against directors. The primary means to avoid the reach of the business judgment rule was to allege that the board of directors had a material conflict of interest.<sup>32</sup> Claims of corporate waste could also succeed, but the legal standard for a successful waste claim is very hard to meet.<sup>33</sup>

Yet the listed exceptions to section 102(b)(7) arguably extended beyond the standard business judgment rule exceptions, given the statutory language regarding "acts or omissions not in good faith." Thus, the big question post-section 102(b)(7) was when, if ever, directors could be held liable in the absence of a material conflict of interest.

Against this backdrop, a distinct fiduciary duty of good faith emerged. In 1993, within a few years of the enactment of section 102(b)(7), the Delaware Supreme Court noted the existence of a "triad" of fiduciary duties: the duties of care, loyalty, and good faith.<sup>34</sup>

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<sup>29</sup> *Id.*

<sup>30</sup> See *Emerald Partners v. Berlin*, 787 A.2d 85, 94 (Del. 2001) (indicating that exculpatory provision "bars any claim for monetary damages against director defendants based solely on the board's alleged breach of its duty of care but does not provide protection against violations of the fiduciary duties of either loyalty or good faith").

<sup>31</sup> See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (setting forth business judgment rule).

<sup>32</sup> For an analysis of the classic business judgment rule protections, see Bainbridge, *supra* note 17, at 95-100. For a discussion of how the evolving duty of good faith implicates the business judgment rule, see generally Gold, *supra* note 4, at 426-32 (analyzing standard of review for claims of director bad faith).

<sup>33</sup> See *Disney II*, 746 A.2d 244, 264 (Del. 2000).

<sup>34</sup> See *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993) ("To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the

The Delaware chancery court proved quite resistant to the idea that good faith was a separate fiduciary duty.<sup>35</sup> However, three independent fiduciary duties had officially become a part of Delaware law. The practical effect of this third fiduciary duty in the triad — good faith — remained unclear.

Scholars offered a variety of theories to explain and develop the meaning of good faith. Some commentators suggested that an independent fiduciary duty of good faith enabled the Delaware courts to better address egregious violations of due care, to inculcate good corporate practices, or to respond to social changes.<sup>36</sup> Some found that the duty of good faith served as a rhetorical device, useful in Delaware's efforts to remain the leading jurisdiction for corporate law.<sup>37</sup> For others, the duty of good faith was less revolutionary. Under this view, the duty could be reconciled with prior legal understandings without requiring major changes to the law.<sup>38</sup>

In the end, it was a high profile executive compensation dispute at the Disney corporation which shed light on the practical import of good faith duties. The *Disney* litigation involved a shareholder derivative suit over the lucrative severance payments Michael Ovitz received when the corporation terminated his employment.<sup>39</sup> Ovitz received approximately \$130 million worth of compensation for some

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*triads* [sic] of their fiduciary duty — good faith, loyalty or due care.”).

<sup>35</sup> See, e.g., *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (contending that supreme court's formulation was “fresh way of referring to the ‘fundamental duties of care and loyalty’”). For further discussion of this division, see Bruner, *supra* note 4, at 1155; Gold, *supra* note 4, at 408-09; Rosenberg, *supra* note 4, at 505.

<sup>36</sup> See Eisenberg, *Duty of Good Faith*, *supra* note 4, at 75 (suggesting that duty of good faith “may give rise to the articulation of new specific fiduciary obligations that come to be seen as appropriate in response to social changes, but cannot be accommodated within the duties of care or loyalty”); Sale, *Good Faith*, *supra* note 4, at 494 (suggesting that “[t]he value of a separate good faith duty . . . is in its potential for addressing those outrageous and egregious abdications of fiduciary behavior that are not simply the results of bad process or conflicts”); *id.* (contending that real value of good faith is “in the *ex ante* role it can play in changing the behavior and incentives of corporate fiduciaries and, thereby changing corporate governance”).

<sup>37</sup> See Griffith, *supra* note 4, at 8 (suggesting that purpose of good faith rhetoric “is to loosen the doctrinal constraints on the Delaware judiciary and to enable its judges to shift the authority/accountability balance in response to a change in the set of pressures and constraints then operating upon them”). In Professor Sean Griffith's view, these pressures stem from the risk of corporate migration and federal preemption. See *id.*

<sup>38</sup> See Steele, *supra* note 26, at 28.

<sup>39</sup> For a detailed analysis of the facts and evidence surrounding this dispute, see *Disney IV*, 907 A.2d 693, 699-745 (Del. Ch. 2005).

14 months of employment at Disney.<sup>40</sup> The plaintiffs charged the Disney board of directors with breaches of loyalty and care, and with corporate waste, based on Ovitz's hiring and subsequent termination.<sup>41</sup> Although these initial claims were doctrinally unremarkable, the significance of the case soon became apparent.

During the course of the *Disney* litigation, the fiduciary duty of good faith moved to the fore. In 2000, the Delaware Supreme Court had dismissed several of the plaintiffs' claims, and the court dismissed the plaintiffs' loyalty claims with prejudice.<sup>42</sup> Given that the Disney corporation had a section 102(b)(7) charter provision, the plaintiffs' case on remand looked bleak. Yet the plaintiffs amended their complaint, and presented a stronger case for compensation in their new allegations. In a 2003 opinion ("*Disney III*"), Chancellor Chandler permitted the plaintiffs' suit to survive the defendants' motions to dismiss on the theory that the plaintiffs successfully alleged a failure to act in good faith.<sup>43</sup>

The *Disney III* opinion was a turning point: this was apparently the first time that such a good faith claim had been determinative in a fiduciary duty dispute.<sup>44</sup> Notably, the court distinguished the alleged misconduct from a mere violation of due care. The alleged wrongdoing indicated more than gross negligence in the decisionmaking process. Instead, Chancellor Chandler concluded that the directors had "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."<sup>45</sup> According to the court, the amended complaint alleged facts that provided a "reason to doubt whether the board's actions were taken honestly and in good faith."<sup>46</sup>

In a lengthy post-trial opinion ("*Disney IV*"), Chancellor Chandler developed a legal standard for the violation of good faith duties.<sup>47</sup> According to the court:

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<sup>40</sup> See Gold, *supra* note 4, at 410-12 (summarizing process that led to this result).

<sup>41</sup> See *Disney II*, 746 A.2d 244, 248-49 (Del. 2000).

<sup>42</sup> See *id.* at 248 (affirming dismissal of plaintiffs' claims). As noted, the loyalty claims were dismissed with prejudice. See *id.* at 258 n.42. However, the court permitted the non-loyalty claims to be repleaded. See *id.* at 267.

<sup>43</sup> See *In re Walt Disney Co. Derivative Litig. (Disney III)*, 825 A.2d 275, 291 (Del. Ch. 2003).

<sup>44</sup> See Griffith, *supra* note 4, at 19 ("Although the chancellor was able to invoke the good faith carve out in 102(b)(7) as the basis for his decision, this application of good faith was unprecedented in Delaware.").

<sup>45</sup> See *Disney III*, 825 A.2d at 289.

<sup>46</sup> See *id.* at 286.

<sup>47</sup> See *Disney IV*, 907 A.2d 693, 755 (Del. Ch. 2005).

A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.<sup>48</sup>

Ultimately, the court concluded that the Disney board had not violated this standard.<sup>49</sup> The court's legal analysis nevertheless provided an important step in the development of the good faith duty's content. For clarity, this Article will refer to the above test for "a failure to act in good faith" as the "*Disney* standard."

On appeal, the Delaware Supreme Court affirmed the chancery court's dismissal of the case ("*Disney V*").<sup>50</sup> The *Disney V* opinion made clear that a party could pursue a good faith claim in circumstances that fall outside the standard conflicts of interest scenarios that the duty of loyalty ordinarily implicates. The court also adopted the *Disney* standard for the determination of acts that are not taken in good faith.<sup>51</sup> This meant that in Delaware, a violation of good faith was an *intent*-based violation: it involved conscious wrongdoing, or an intentional failure to act in the face of a known duty.<sup>52</sup> Such actions can involve "subjective bad faith" — i.e., actions which are motivated by an intent to do harm.<sup>53</sup> But the *Disney* standard is broader in scope. It also covers actions that reflect a conscious disregard of a director's duties.<sup>54</sup>

Interestingly, the *Disney V* court emphasized that the *Disney* standard is not an exclusive one. Other circumstances, not described by the court, might also qualify as acts "not in good faith." According to the *Disney V* court, "There may be other examples of bad faith yet to be proven or alleged."<sup>55</sup> This language suggests that the duty of good faith is potentially open-ended.<sup>56</sup> As developed below, the

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<sup>48</sup> See *id.*

<sup>49</sup> See *id.* at 697.

<sup>50</sup> See *In re Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 75 (Del. 2006).

<sup>51</sup> See *id.* at 67.

<sup>52</sup> For a discussion of the intent requirement of the *Disney IV* and *Disney V* analyses of actions not taken in good faith, see Gold, *supra* note 4, at 422-26.

<sup>53</sup> See *Disney V*, 906 A.2d at 64.

<sup>54</sup> See *id.* at 67.

<sup>55</sup> See *id.*

<sup>56</sup> Some commentators have lamented the uncertainty engendered by the language

possibility of expansion of the categories described in *Disney V* has proven significant.

*B. The Connection Between Good Faith and Loyalty*

In late 2006, shortly after the *Disney V* opinion was issued, the Delaware Supreme Court decided *Stone v. Ritter*.<sup>57</sup> *Stone* reaffirmed the conceptual guidance set forth in *Disney V*. While the *Stone* decision confirmed the idea that intent is central to a good faith claim, however, it also reordered the roles of good faith and loyalty. Prior to *Stone*, a series of Delaware Supreme Court cases had described a “triad” of fiduciary duties, comprised of care, loyalty, and good faith. *Stone* made clear that there is no triad — good faith is a subsidiary element of loyalty.<sup>58</sup> A successful claim that directors breach their duty of good faith is simply a means to seek liability for a breach of loyalty.

In *Stone*, the Delaware Supreme Court confronted a claim that the board had violated its duty to monitor corporate activities. The defendant directors in *Stone* managed a corporation whose subsidiary, AmSouth Bank, had run afoul of various banking regulations.<sup>59</sup> In this case, the problem was not that the board itself had intentionally chosen to have the corporation take actions that involved illegal conduct. Rather, the board had allegedly failed in its oversight capacity, thus producing substantial losses to the corporation.<sup>60</sup>

An influential chancery court decision, *In re Caremark Int’l Derivative Litig.*, had indicated that a sufficiently serious failure of oversight could provide a basis for director liability.<sup>61</sup> The *Stone* court endorsed the doctrine set forth in *Caremark*.<sup>62</sup> It also concluded that a lack of oversight sufficient to meet the requirements under *Caremark*

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in the *Disney V* opinion. See Bainbridge et al., *supra* note 4, at 591 (suggesting that “the resulting uncertainty leaves room for courts to subject additional classes of decisions to substantive review”). Professor Stephen Bainbridge contends that this circumstance will encourage litigation challenging board decisions. See *id.*

<sup>57</sup> 911 A.2d 362 (Del. 2006).

<sup>58</sup> See *id.* at 370 (“[A]lthough good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”).

<sup>59</sup> See *id.* at 365-66.

<sup>60</sup> See *id.* at 370 (describing plaintiffs’ claim that directors breached their oversight duty “as a result of their ‘utter failure’ to act in good faith to put into place policies and procedures to ensure compliance with BSA and AML obligations”).

<sup>61</sup> See *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

<sup>62</sup> See *Stone*, 911 A.2d at 369.

implicated the duty of loyalty, rather than the duty of care.<sup>63</sup> *Stone* interpreted *Caremark* as describing a claim based on the duty of good faith, consistent with the *Disney* test for intentional failures to perform known duties.<sup>64</sup> In the process, the *Stone* court explained that violations of good faith may “indirectly” result in liability for loyalty violations.<sup>65</sup> The practical effect of this holding was to turn claims based on a lack of good faith into a type of loyalty claim.<sup>66</sup>

As the *Stone* Court explained: “[A] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”<sup>67</sup> Following *Stone*, Delaware corporate law shifted back from three fiduciary duties to the original two: loyalty and care.<sup>68</sup> The incorporation of the duty of good faith into loyalty, however, significantly expanded the potential circumstances in which a successful loyalty claim might be brought.<sup>69</sup> At least in theory, the variety of loyalty claims that could be viable appeared much greater than under the recent triad precedents. Notably, a claim of disloyalty based on a lack of good faith does not require a plaintiff to show that the board suffered from material

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<sup>63</sup> See *id.* at 370 (concluding that “because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty”).

<sup>64</sup> See *id.* at 369.

<sup>65</sup> See *id.* at 370 (“[T]he latter two duties [of care and loyalty], where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.”).

<sup>66</sup> As other commentators have suggested, the reference to “indirect” liability in *Stone* does not appear to have practical significance. See Bainbridge et al., *supra* note 4, at 559 (“[T]his holding may not matter much, because the *Stone* court made clear that acts taken in bad faith breach the duty of loyalty.”); Hill & McDonnell, *Disney*, *supra* note 4, at 857 n.121.

<sup>67</sup> *Stone*, 911 A.2d at 370 (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

<sup>68</sup> Some would suggest that this is what section 102(b)(7) required all along. For a pre-*Stone* suggestion that each exception under section 102(b)(7), including actions not in good faith, should be understood to involve a form of disloyalty, see William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 464 & n.49 (2002). See also Bruner, *supra* note 4, at 1177 (suggesting reform to this effect).

<sup>69</sup> This theoretical expansion — an increase in *potential* claims — need not mean that the actual liability risk for directors will materially increase. As developed later in this Article, recent post-*Stone* decisions have indicated a standard of review under which it is generally quite difficult for plaintiffs to bring successful claims. See *infra* notes 195-205 and accompanying text.



conflicts of interest. The practical effects of *Stone*, on the other hand, would depend on how courts applied the loyalty duty in future cases.

### C. The Next Wave of Good Faith Decisions

Both *Disney* and *Stone* set forth examples of bad faith conduct based on conscious wrongdoing: intentional acts taken with a purpose other than advancing the best interests of the corporation; intentional violations of positive law; and intentional failures to act in the face of a known duty to act.<sup>70</sup> Both opinions also expressly stated that “[t]here may be other examples of bad faith yet to be proven or alleged.”<sup>71</sup> The aim of this open-ended addendum to the *Disney* standard was unclear. The language used in *Disney* and *Stone* is broad enough that it should already capture the common understanding of what fiduciary good faith requires. A director must act with an honesty of purpose and in the best interests of the corporation and its shareholders.<sup>72</sup>

If the overarching fiduciary duty of a director is to act in the good faith belief that his or her actions are in the best interests of the corporation and its shareholders, it appears that the *Disney* standard should exhaust the available options for bad faith conduct. The *Disney* standard is quite far-ranging in its potential application. Thus, the potential for additional categories of bad faith (and thus disloyal) conduct raises several questions. What do the *Disney* categories mean in practice? How else could one act in bad faith toward the corporation and its shareholders? Why do the Delaware courts indicate room for additional ways to violate good faith?

Recently, the Delaware courts have begun to answer these questions, adding additional examples to the list of actions not taken in good faith.<sup>73</sup> The courts have also begun to clarify the scope and content of the existing categories. This subpart of the Article will analyze these precedents as a source of content for the fiduciary duty of good faith. Given recent Delaware holdings, the doctrinal basis for several distinct

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<sup>70</sup> See *Stone*, 911 A.2d at 369 (quoting *Disney V*, 906 A.2d 27, 67 (Del. 2006)).

<sup>71</sup> *Id.* (quoting *Disney V*, 906 A.2d 27, 67 (Del. 2006)).

<sup>72</sup> See *Disney IV*, 907 A.2d 693, 755 (Del. Ch. 2005) (“To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation.”).

<sup>73</sup> See, e.g., *Ryan v. Gifford*, 918 A.2d 341, 357 (Del. Ch. 2007) (suggesting that additional examples of bad faith conduct “include any action that demonstrates a faithlessness or lack of true devotion to the interests of the corporation and its shareholders”). In the *Ryan* case, an alleged deliberate violation of a shareholder approved stock option plan and false disclosures were found to meet this test. See *id.* at 358.

types of bad faith conduct is now evident. A common theme is that this case law bars director choices that are, at least potentially, made with the intent of benefitting the corporation or its shareholders. These cases preclude directors from dishonest conduct toward shareholders or from conduct that exceeds a director's authority — regardless of whether or not the directors honestly believe their decisions will produce desirable outcomes.

### 1. Intentional Failure to Perform Duties

Following *Disney V* and *Stone*, a director's intentional failure to perform her duties violates the requirement of good faith, and by extension, loyalty. Some intentional violations of a director's duties are more obviously linked to loyalty than others, however. Where a case involves an intentional violation of a fiduciary duty, the connection to loyalty is straightforward. For example, an intentional lack of due care suggests an intentional failure to do what is best for the corporation or its shareholders.<sup>74</sup> Other intentional failures to perform duties are less clearly connected to loyalty.

The important question here involves the role of intent in the courts' analysis. For example, a director might honestly believe she was benefiting her corporation, and even in good faith believe she was acting with due care, yet her actions could unintentionally fail to meet an objective standard of careful conduct. This unintentional failure to meet the legal standard for due care would not be disloyal, even though the actions at issue were performed intentionally.<sup>75</sup> The Delaware courts have addressed this concern for nonculpable directors by making clear that it is an intentional violation of a *known* duty that triggers liability.<sup>76</sup>

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<sup>74</sup> See Hill & McDonnell, *Disney*, *supra* note 4, at 855 ("However, on some profound level, [a breach of care], too, is a breach of the fiduciary duty of loyalty, although the courts do not consider it such — directors and officers are taking leisure that they are not entitled to.").

<sup>75</sup> Indeed, much comes down to where the court focuses in making such assessments. It may always be possible to recast a negligent act as an intentional failure. See Griffith, *supra* note 4, at 31 ("Because intent and recklessness can be characterized as negligence and negligence similarly can be recast as intent, either analysis will ultimately ask whether the board was careful or prudent according to some standard of conduct."). As I have suggested elsewhere, the Delaware courts' focus on *known* duties should resolve this concern. See Gold, *supra* note 4, at 425.

<sup>76</sup> See, e.g., *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243 (Del. 2009) (noting "a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties").

On the other hand, if a director intentionally acted without due care *from her own perspective*, it is hard to see how this behavior could be loyal. A director could not believe she was making a decision in a procedurally inadequate manner while simultaneously believing she was acting in the best interests of the corporation. Due care is an extension of loyalty to the extent that courts seek the degree of care that a loyal individual would exercise.<sup>77</sup> A failure of care, if the director herself believes she has shown a lack of due care, is implicitly a failure of loyalty.

This analysis leaves open a third category of conduct. What if a director honestly believes she is benefiting the corporation while intentionally violating an objective standard of care? In other words, could a director violate an objective standard of care in the sincere belief that the corporation would then be better off? This raises a more difficult conceptual question. If the standard of care mandated by the courts required inefficient decisionmaking procedures, one might argue that true loyalty requires a violation of the applicable duty.<sup>78</sup> Delaware precedent, in contrast, appears to treat intentional violations of a judicially recognized duty as a form of disloyalty, whether or not the director believes the breach of duty will benefit the corporation.<sup>79</sup> Intentional violations of duties can sometimes be consistent with a sincere belief that the directors' actions will benefit the corporation or its shareholders; therefore, this category of disloyalty raises interesting conceptual questions about the nature of loyalty duties. Moreover, there are several specific types of good faith violations which are explained, or at least explicable, in terms of intentional violations of known duties.

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<sup>77</sup> See Griffith, *supra* note 4, at 40-41 (explaining that question of prudence is "framed with a tacit element of loyalty").

<sup>78</sup> Bainbridge has noted the potential that *Stone* creates for such scenarios. Ordinarily, if a board decides against a particular business plan based on a weighing of costs and benefits, it is protected by the business judgment rule. Yet *Caremark* apparently creates a general duty to develop an information reporting system. Arguably, *Stone* would preclude a board from consciously rejecting the use of such a system. See Bainbridge et al., *supra* note 4, at 603 ("Under *Stone*, however, it seems possible that a conscious decision by a board of directors that the costs of a law compliance program outweigh the benefits no longer will be protected by the business judgment rule.").

<sup>79</sup> Cf. *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) ("For reasons *Caremark* well explained, to hold directors liable for a failure in monitoring, the directors have to have acted with a state of mind consistent with a conscious decision to breach their duty of care.").

## 2. Intentional Violations of Law

A noteworthy example arises in cases of legal violations. In *Guttman v. Huang*, a 2003 decision, Vice Chancellor Strine argued that the duty not to intentionally violate positive law is a subset of the duty of loyalty.<sup>80</sup> This has also become the Delaware Supreme Court's view. The court incorporated a bar against such conduct into the *Disney* standard for failures to act in good faith.<sup>81</sup> Post-*Stone*, this means that intentional violations of positive law are now, by extension, violations of the fiduciary duty of loyalty.

Although a bar against intentional violations of positive law is well-established, the justification for understanding this rule in terms of loyalty is less well-developed. Public policy is a leading basis for limiting the board's discretion to break the law. But viewing intentional violations of positive law as socially undesirable does not provide a clear conceptual basis for treating such violations as a form of *disloyalty* to the corporation or its shareholders.<sup>82</sup>

Professor Stephen Bainbridge has recently questioned the link between legal violations and loyalty duties. Although courts have long recognized intentional violations of positive law as an exception under the business judgment rule, it does not follow that the availability of liability under these circumstances implicates loyalty rather than care.<sup>83</sup> Bainbridge expresses concern that loyalty is the wrong concept for this type of board action.<sup>84</sup> As he argues:

Individuals routinely make cost-benefit analyses before deciding to comply with some *malum prohibitum* law, such as when deciding to violate the speed limit. Is it self-evident that directors of a corporation should be barred from engaging in similar cost-benefit analyses?<sup>85</sup>

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<sup>80</sup> See *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

<sup>81</sup> See *Disney V*, 906 A.2d 27, 67 (Del. 2005).

<sup>82</sup> Except, perhaps, to the extent that harm to society is understood as an indirect harm to shareholders, who are members of society. See Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1784-85 (noting this potential argument).

<sup>83</sup> See Bainbridge et al., *supra* note 4, at 591-92. For a leading example of judicial recognition that the business judgment rule does not apply to such cases, see *Miller v. Amer. Tel. & Tel. Co.*, 507 F.2d 759, 762 (3d Cir. 1974).

<sup>84</sup> Bainbridge also suggests that intentional violations of positive law should be understood as a distinct category, in light of their separate treatment in section 102(b)(7). See Bainbridge et al., *supra* note 4, at 591. But see Strine et al., *supra* note 4, at 39-45 (suggesting reasons to reject such statutory reading).

<sup>85</sup> See Bainbridge et al., *supra* note 4, at 592. For a similar critique, see also Eisenberg, *Duty of Good Faith*, *supra* note 4, at 38.

Bainbridge's point is not that courts should permit corporations to break the law.<sup>86</sup> Instead, his challenge is to the treatment of law-breaking in terms of liability for breaching loyalty obligations.<sup>87</sup> If the corporation is better off overall due to the violation of positive law — any fines or penalties outweighed by the benefits — Bainbridge's argument suggests precluding shareholders from suing the board for disloyalty.<sup>88</sup>

Yet, for present purposes, the challenge is conceptual rather than policy-based. Does an intentional violation of law fit with the other conduct described in the *Disney* standard? In fact, it is possible to explain the existing doctrine as an extension of the rule against intentional violations of duties. Intentional violations of law implicate more than just social policy. They may also implicate the authority of the board, and by extension, the duties of the board. For example, in *Desimone v. Barrows*, Vice Chancellor Strine argued as follows:

[B]y consciously causing the corporation to violate the law, a director would be disloyal to the corporation and could be forced to answer for the harm he has caused. Although directors have wide authority to take lawful action on behalf of the corporation, they *have no authority* knowingly to cause the corporation to become a rogue, exposing the corporation to penalties from criminal and civil regulators.<sup>89</sup>

Arguably, directors intentionally breach a known duty that they owe *as directors* when they intentionally cause the corporation to violate positive law.<sup>90</sup> Corporate charters only allow the corporation to act consistently with positive law, and directors are bound to comply with the terms of their corporate charter.<sup>91</sup> The duty to act consistently with

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<sup>86</sup> See Bainbridge et al., *supra* note 4, at 593.

<sup>87</sup> See *id.*

<sup>88</sup> This doctrine is known as the net loss rule. For a discussion of its applications, see *id.* at 592-93. See also Norwood P. Beveridge, *Does the Corporate Director Have a Duty Always to Obey the Law?*, 45 DEPAUL L. REV. 729, 732-33 (1996) (defining rule). There is also opposition to a cost-benefit approach toward compliance with positive law, however. See generally Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76 N.C. L. REV. 1265 (1998) (critiquing law-as-price theory of corporate law compliance).

<sup>89</sup> *Desimone v. Barrows*, 924 A.2d 908, 934 (Del. Ch. 2007).

<sup>90</sup> One might also put the argument in terms of fidelity to one's office. This concept is developed in Eisenberg, *Duty of Good Faith*, *supra* note 4, at 38. This appears to be a different way of stating the same basic argument regarding director actions that exceed their authority. Professor Melvin Eisenberg, however, sees fidelity to one's office as a subset of good faith and not a part of the loyalty obligation. *Id.*

<sup>91</sup> Cf. DEL. CODE ANN. tit. 8, § 102(a)(3) (2009) (indicating that it is sufficient for

positive law is thus not only a duty imposed directly by that positive law, it is also a duty incorporated into the charter itself.<sup>92</sup>

An intentional violation of positive law is an intentional violation of a corporation's charter, given the present requirements for the content of charters. Directors have committed themselves to following their corporations' charter. Consequently, the loyalty implications of a director's duty to comply with positive law are closely tied to the loyalty implications of a director's intentional failure to perform known duties.

### 3. Dishonesty Towards Shareholders

Director dishonesty towards shareholders raises a distinct set of issues. In *Disney IV*, the court suggested that "[t]o act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation."<sup>93</sup> This language is ambiguous. "Honesty of purpose" plausibly refers to the honest intention to benefit the corporation or its shareholders. If so, a director could sincerely believe that a lie to shareholders would benefit the corporation, and in that sense act with an honesty of purpose *vis à vis* the goal of benefiting shareholders, while simultaneously misleading those same shareholders.<sup>94</sup>

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articles of incorporation to state that corporation's purpose "is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware"). For a suggestion that limitations regarding violations of positive law implicate the ultra vires doctrine, see FRANKLIN A. GEVURTZ, CORPORATION LAW 315 (2000). See also Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on How Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1314-22 (2001) (examining evidence for understanding illegal corporate acts as ultra vires).

<sup>92</sup> For a helpful analysis of this point, see Thomas A. Uebler, *Shareholder Police Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 DEL. J. CORP. L. 199, 210-11 (2008) (noting that violations of law involve both "external" and "internal" constraints on director action). It should be noted that this view of intentional violations of law is coherent even if the positive law at issue was adopted in order to benefit non-shareholder groups, and even if the shareholders might have desired a different charter term if such terms were not mandated by state law.

<sup>93</sup> *Disney IV*, 907 A.2d 693, 755 (Del. Ch. 2005).

<sup>94</sup> The efficiency of such conduct has been discussed at some length in the securities litigation context. See, e.g., Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 947-64 (1991) (contending that corporations should have option of lying, but should then be required to disclose that they do not warrant truth of their statements); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1272-73 (1999) [hereinafter Eisenberg, *Corporate Law*] (disputing support for corporate lying based on expressive function of law); Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An*

On the other hand, if “honesty of purpose” refers to honesty more broadly, then a director’s intentional falsehood toward the corporation and its shareholders could readily violate the duty of good faith.<sup>95</sup> Recent Delaware cases suggest that the requirement of “honesty of purpose” covers both senses of honesty. Several cases addressing backdating of employee stock option grants make clear that an intentional director deception of shareholders constitutes a form of disloyalty due to bad faith.<sup>96</sup>

In this setting, alleged misrepresentations to shareholders are a central issue. Undisclosed option backdating raises issues of illegality and accounting fraud. In addition, such backdating effectively misstates information that will be received by the corporation’s shareholders.

The Delaware courts took a strong stance against such conduct. In *Ryan v. Gifford*, a case involving option backdating claims, Chancellor Chandler noted that “it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder approved plan, no less), and yet satisfy his duty of loyalty.”<sup>97</sup> In *Desimone*, Vice Chancellor Strine agreed, contending that the alleged deception discussed in *Ryan* “is itself a disloyal act.”<sup>98</sup>

These cases clarify the view of the Delaware courts on director dishonesty. As always, intent matters. When directors unintentionally make false statements, they may actually have complied with their duties, or possibly violated the duty of care.<sup>99</sup> However, in cases where a director intentionally deceives shareholders, this is an act in bad faith that constitutes a disloyal act.<sup>100</sup> Such conscious deception is apparently disloyal regardless of whether the underlying motivations

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*Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1069-70 (1990) (supporting use of falsehoods if management and directors have good faith belief that this will further interests of investors).

<sup>95</sup> Note that intent is relevant here, as elsewhere in loyalty/bad faith contexts. An inadvertent falsehood may at most violate the duty of care. See *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061-62 (Del. 1996) (discussing relevance of motive to proxy disclosures).

<sup>96</sup> For a helpful analysis of option backdating, see generally Jesse Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853 (2008).

<sup>97</sup> *Ryan v. Gifford*, 918 A.2d 341, 355 (Del. Ch. 2007).

<sup>98</sup> *Desimone v. Barrows*, 924 A.2d 908, 933 (Del. Ch. 2007).

<sup>99</sup> See *Zirn*, 681 A.2d at 1062 (indicating that good faith erroneous judgment regarding disclosures implicates duty of care, not loyalty).

<sup>100</sup> There are other ways in which a disclosure case might be brought. A bad faith failure to be informed that results in misleading disclosures could also support a claim of disloyalty. See *In re Citigroup, Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 134 (Del. Ch. 2009) (indicating this possibility).

are selfish or grounded in perceived benefits to the corporation and its shareholders.<sup>101</sup>

#### 4. Violations of Commitments to Shareholders

When a board intentionally violates restrictions that the board has committed itself to recognize, this provides another basis for a loyalty claim. For example, in *In re Tyson Foods, Inc.*, the court indicated that a board's intentional avoidance of shareholder approved restrictions on the exercise price of stock options would support a claim that the board acted disloyally and in bad faith.<sup>102</sup> One may view this type of case as involving deception, but the conduct is distinct from the type of shareholder deception that occurs when directors directly lie to their shareholders. A commitment may be honestly entered into, and then subsequently breached, without recourse to lies.<sup>103</sup>

In *Tyson*, the court addressed an alleged "spring-loading" of stock options.<sup>104</sup> In such a case, a corporation issues stock options prior to nonpublic good news that the corporation will subsequently release. Spring-loading need not require lying. However, the plaintiffs' allegations suggested that the spring-loading of options in that case was intentionally designed to avoid valid restrictions on board action which the shareholders had approved.<sup>105</sup>

Chancellor Chandler indicated in *Tyson* that the "honesty of purpose" language in *Disney IV* precluded directors from deception of shareholders.<sup>106</sup> According to the court, "A director's duty of loyalty

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<sup>101</sup> This conclusion is implicit in Vice Chancellor Strine's analysis of a hypothetical scenario discussed in the *Desimone* case. There, he finds that the deception at issue would be disloyal despite the directors having a "reasonable business basis" for their actions. See *Desimone*, 924 A.2d at 933. This conclusion also follows from Chancellor Chandler's statement in *Ryan* that "it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders . . . and yet satisfy his duty of loyalty." *Ryan*, 918 A.2d at 355.

<sup>102</sup> *In re Tyson Foods*, 919 A.2d 563, 593 (Del. Ch. 2007).

<sup>103</sup> For example, scholars who see contracts in terms of trust draw a distinction here. See, e.g., CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 16 (1981) ("To renege [on a promise] is to abuse a confidence [the promisor] was free to invite or not, and which he intentionally did invite. To abuse that confidence now is like (but only like) lying: the abuse of a shared social institution that is intended to invoke the bonds of trust.").

<sup>104</sup> *In re Tyson*, 919 A.2d at 576.

<sup>105</sup> See *id.* at 592-93.

<sup>106</sup> The court concluded that "a director's duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary," and then cited to the *Disney IV* language referring to an "honesty of purpose" for support. See *id.* at 592 & n.76.



includes the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary."<sup>107</sup> The *Tyson* court concluded that board conduct intended to circumvent valid shareholder-approved restrictions would be disloyal because it is a failure to deal fairly and honestly with the shareholders.<sup>108</sup>

The Delaware courts have since elaborated on why this conduct is disloyal. In the *Desimone* case, Vice Chancellor Strine explained that the type of conduct at issue in *Tyson* is disloyal because it exceeds the board's authority.<sup>109</sup> Moreover, according to Strine, this type of conduct would be disloyal whether or not the board's motives are selfish.<sup>110</sup> This fits the pattern of the cases previously discussed. Cases involving broken commitments to shareholders, like cases involving an intentional violation of positive law, implicate the rule against intentional violations of a director's duties. Such violations are problematic even where the intent underlying the violation might be to benefit the corporation or its shareholders.

### 5. Encroachments on Shareholder Authority

In some cases, courts find corporate directors to have acted disloyally, despite a devotion to their corporation's best interests, and despite an apparent absence of dishonest or otherwise deceptive conduct. An excellent example is Chancellor Allen's 1988 decision in *Blasius Industries, Inc. v. Atlas Corp.*<sup>111</sup> Although *Blasius* predates the recent good faith/loyalty decisions, it is worth noting here as a related precedent.<sup>112</sup>

In the *Blasius* case, the directors of Atlas Corporation added two new seats to their board and then appointed nominees to fill those seats. This was done in an effort to block a recapitalization plan supported by Blasius, an insurgent shareholder.<sup>113</sup> The Atlas board had no material conflicts of interest, and its decision to alter Atlas's board structure was not motivated by self-interest.<sup>114</sup> The board sincerely

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<sup>107</sup> See *id.* at 592.

<sup>108</sup> See *id.* at 593 (describing elements of claim brought against disinterested board that issued spring-loaded options).

<sup>109</sup> See *Desimone v. Barrows*, 924 A.2d 908, 924 (Del. Ch. 2007).

<sup>110</sup> See *id.*

<sup>111</sup> 564 A.2d 651, 651 (Del. Ch. 1988).

<sup>112</sup> Cf. Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1793-94 (discussing *Blasius* as part of continuum from loyalty to care).

<sup>113</sup> See *Blasius*, 564 A.2d at 658.

<sup>114</sup> See *id.* (concluding board was not acting out of self-interested motive).

intended to benefit the corporation through its actions.<sup>115</sup> Despite these facts, the court found the board's conduct to be disloyal.<sup>116</sup>

The court concluded that the board's actions were intended to foreclose effective shareholder action as to who would be elected to the board.<sup>117</sup> Chancellor Allen eschewed a per se rule against this type of conduct, but he also found that strict scrutiny should be applied when directors take such actions.<sup>118</sup> The court specifically noted that there might be circumstances when a board, in good faith, would "paternalistically seek to thwart a shareholder vote" and be justified in its decision.<sup>119</sup> The court nonetheless added that, in this case, "[E]ven finding the action taken was taken in good faith, it constituted an unintended violation of the duty of loyalty that the board owed to the shareholders."<sup>120</sup>

*Blasius* suggests that loyalty violations can exist where the board believes its actions are in the best interests of the corporation or its shareholders. The case involved the question of whether a board acting in "subjective good faith" may act for the principal purpose of preventing shareholders from electing a majority of new directors.<sup>121</sup> Accordingly, it is worth asking whether *Blasius* represents an extension of the same principles discussed above, or some other theory of loyalty. As with the recent post-*Stone* loyalty cases, *Blasius* has the interesting feature of finding that a loyalty violation can exist when the board is unconflicted and intends to benefit the corporation or its shareholders.<sup>122</sup>

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<sup>115</sup> See *id.* (concluding that board acted "in order to thwart implementation of the recapitalization that it feared, reasonably, would cause great injury to the Company").

<sup>116</sup> See *id.* at 663 (concluding that board's actions "constituted an unintended violation of the duty of loyalty that the board owed to the shareholders").

<sup>117</sup> See *id.* at 658 (finding that "board was chiefly motivated . . . to forestall or preclude the possibility that a majority of shareholders might place on the Atlas board eight new members sympathetic to the *Blasius* proposal").

<sup>118</sup> See *id.* at 662 (rejecting per se rule). For a helpful discussion of why a per se rule should be avoided in such cases, see generally Leo Strine, *If Corporate Action is Lawful, Presumably There are Circumstances in Which It Is Equitable to Take that Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft*, 60 BUS. LAW. 877 (2005).

<sup>119</sup> *Blasius*, 564 A.2d at 662.

<sup>120</sup> *Id.* at 663.

<sup>121</sup> See *id.* at 658.

<sup>122</sup> As Professor Ethan Stone indicates, *Blasius* is a case which "seems contradictory" in its suggestion that a board could be liable on the basis of an improper purpose, even if the board was acting in good faith. See Ethan Stone, *Business Strategists and Election Commissioners: How the Meaning of Loyalty Varies with the Board's Distinct Fiduciary Duties*, 31 J. CORP. L. 893, 928 (2006). While Stone's argument is that there are distinct fiduciary duties at issue (depending on the board's

*Blasius* could be seen as an outlier — the decision is rarely found applicable in practice.<sup>123</sup> Although the rule in *Blasius* is only rarely applied, however, it is an important precedent. As a statement of Delaware's views about board and shareholder relations, the case has become a leading precedent regarding the boundaries between appropriate and inappropriate director actions. Accordingly, a coherent explanation of the fiduciary aspects of *Blasius* is valuable. A closer look at the court's theory, and the available conceptions of loyalty, suggests that the recent bad faith decisions and the *Blasius* policy against undue board interference with shareholder voting are part of the same underlying phenomenon.

When the balance of corporate power is analyzed, the *Blasius* rule follows a pattern that resembles the other loyalty cases described in this section. As with the more obvious deceit and broken commitment cases, the issues here involve the question of what it means for directors to act consistently with their fiduciary relationship. *Blasius* involves an overstepping of bounds, such that the board occupies a role reserved to shareholders. No discrete agreement between directors and shareholders is violated when the board intentionally impedes a shareholder vote. However, a version of the concern seen in *Tyson* — an overstepping of agreed upon commitments of the board — exists if the corporate structure is contemplated from a contractual perspective.<sup>124</sup>

Some degree of voting authority is reserved to shareholders as part of their corporate contract.<sup>125</sup> As Professors Gordon Smith and Robert Thompson suggest, there is a form of "sacred space" reserved to shareholders as a part of the structure of corporate law.<sup>126</sup> Most board decisions do not implicate this shareholder authority, but certain board decisions threaten this shareholder role. Notably, the *Blasius*

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operating or coordinating role), the present Article offers an alternative explanation based on the type of loyalty recognized in Delaware.

<sup>123</sup> See *Chesapeake Corp. v. Shore*, 771 A.2d 293, 319-20 (Del. Ch. 2000); *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. Ch. 1996).

<sup>124</sup> In both cases, moreover, it is at least possible that the board could intend to benefit the corporation or its shareholders, yet still be disloyal. See *supra* notes 109-110 and accompanying text (discussing this possibility with respect to *Tyson* case).

<sup>125</sup> For example, there is the right to vote on amendments to the articles of incorporation, or the right to vote in director elections. See DEL. CODE ANN. tit. 8, § 211(b) (2009) (election of directors); *id.* § 242(b) (2009) (amending articles of incorporation). Certain fundamental business transactions, such as mergers, may also require a shareholder vote. See *id.* § 251(c) (2009).

<sup>126</sup> See Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 263 (2001).

case describes the issues before the court in that case as involving “authority as between the fiduciary and the beneficiary.”<sup>127</sup>

In those cases where it appears that a board is intentionally taking on authority that properly belongs to the shareholders instead, a fiduciary breach will be found.<sup>128</sup> Control rights that belong to the shareholders have been taken over by the board. In *Desimone*, the court views the intentional violation of a shareholder approved option plan as a case of directors who have “consciously taken action beyond their authority.”<sup>129</sup> *Blasius* is arguably a variation on this problem. In effect, the board has breached a contractual commitment to the shareholders where *Blasius* applies — the commitment is to comply with the relationship each party accepted when they joined the firm and adopted the standard form rules provided by the Delaware corporate code.<sup>130</sup>

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<sup>127</sup> *Blasius Indus., Inc., v. Atlas Corp.*, 564 A.2d 564, 658 (Del. Ch. 1988).

<sup>128</sup> In effect, the *Blasius* rule is outcome determinative, despite the official rejection of a per se rule. See *Chesapeake*, 771 A.2d at 319-20 (noting that determining whether *Blasius* test applies “comes close to being outcome-determinative in and of itself”). Cases in which *Blasius* should apply may be hard to discern in practice, however. See *id.* at 320 (noting difficulty in determining when board’s primary purpose is to preclude effective shareholder action). There are also rare exceptions in which a court indicates that a *Blasius* analysis would not result in liability. See, e.g., *Mercier v. Inter-Tel, Inc.*, 929 A.2d 786, 819 (Del. Ch. 2007) (concluding that, if compelling justification standard applied to Special Committee’s actions, such justification was demonstrated in this case).

<sup>129</sup> *Desimone v. Barrows*, 924 A.2d 908, 933 (Del. Ch. 2007).

<sup>130</sup> Another line of cases that implicates control rights in the absence of discrete contractual arrangements is the series of cases involving a fiduciary’s efforts to dislodge a controlling individual through means of deceitful or surreptitious acts. See, e.g., *Adlerstein v. Wertheimer*, No. 19101, 2002 WL 205684 (Del. Ch. Jan. 25, 2002) (involving undisclosed plan to remove controlling shareholder from board after diluting his share holdings); *VGS, Inc. v. Castiel*, No. 17995, 2000 WL 1277372 (Del. Ch. Aug. 31, 2000) (involving undisclosed plan to use merger to remove controlling member of LLC from control); see also *Koch v. Stearn*, No. 12515, 1992 WL 181717 (Del. Ch. July 28, 1992) (involving removal of individual from office by tricking him into attending board meeting). In these cases, the board or managers of the business are found to have acted in bad faith contrary to their fiduciary duties, irrespective of their aim to benefit the business. The duty to disclose is triggered by the existence of the dislodged party’s opportunity to prevent the scheme, but for its nondisclosure. Cases like *Adlerstein* may be grouped with *Blasius* as decisions in which a fiduciary party improperly encroaches upon the authority of another party while acting with subjective good faith respecting the firm’s interests. For insightful analyses of *Adlerstein* and similar decisions, see Eisenberg, *Duty of Good Faith*, *supra* note 4, at 51-57; Charles R.T. O’Kelley, *The Entrepreneur and the Theory of the Modern Corporation*, 31 J. CORP. L. 753, 772-74 (2006).

#### D. Summary

The recent loyalty cases offer a disparate mix. This is an unsurprising outcome of the decision in *Stone* to incorporate good faith into loyalty. In some cases, the link to traditional fiduciary obligations is relatively straightforward, as with intentional violations of the duty of care. But in other cases the link is more tenuous, as with intentional violations of positive law. Broken commitments to shareholders and manipulation of the corporate voting process can violate directors' fiduciary mandate. And, an intentional falsehood to shareholders is also a violation of loyalty obligations.

A striking feature of the above cases is that they each (at least potentially) implicate the idea of disloyalty in cases where a director is intending to benefit the corporation or its shareholders.<sup>131</sup> Each of these decisions suggests that an unconflicted board can act with this end yet still be liable for violating the duty of loyalty.<sup>132</sup> Thus, each presents a puzzle. If loyalty is confined to conflicting interest contexts, none of these cases make sense. Under the *Disney* standard, many of these cases are at least explicable as breaches of a duty of good faith. Yet, following *Stone*, these decisions must be understood to implicate more than bad faith — they must be understood in terms of loyalty breaches.

Under some of the leading theories of loyalty duties in corporate law, it is hard to coherently explain this cluster of legal precedents. The next Part analyzes how the above precedents can be understood to implicate the duty of loyalty, even in cases where a board may in fact sincerely intend to benefit the corporation and its shareholders. Loyalty turns out to have a much richer meaning than an anti-self-dealing rule, and it is sufficiently comprehensive to support a claim of fiduciary breach in each of these settings.

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<sup>131</sup> For these purposes, I do not mean to imply that directors who have engaged in intentional lawbreaking or deceit of shareholders — e.g., by backdating options — actually meant to help their shareholders or corporation. These are often disputed factual questions. Rather, the point is that, even if directors did in this sense mean well, the conduct would still count as disloyal.

<sup>132</sup> There is one other important context which implicates this possibility. This is the case of a well-meaning director subject to conflicts of interest. Liability may attach here based on a failure to show entire fairness, even where subjective good faith is present. Vice Chancellor Strine and his co-authors rightly describe this as an "exceptional" circumstance. See Strine et al., *supra* note 4, at 17-18.

## II. THE DIFFERENT CONCEPTIONS OF LOYALTY

The latest judicial decisions are not readily squared with several leading academic understandings about what loyalty means in corporate law.<sup>133</sup> For instance, just before *Stone* was decided, Professor Melvin Eisenberg contended that the fiduciary duty of good faith should be understood as an independent fiduciary duty, distinct from care or loyalty.<sup>134</sup> If Eisenberg is right, many violations of the fiduciary duty of good faith are simply not plausible violations of the fiduciary duty of loyalty.

In order to see the depth of this disagreement, an example may be helpful. In *Guttman v. Huang*, Vice Chancellor Strine states that “one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.”<sup>135</sup> This is an instance of the broad view of loyalty recently elaborated by the Delaware courts. In a 2006 article, however, Eisenberg concludes that Vice Chancellor Strine’s view of loyalty in *Guttman* is in error. According to Eisenberg:

This argument . . . conflicts with both conventional legal usage and clear analysis. Why, and to whom, is a director or officer being disloyal if he causes the corporation to take an action that violates the law, when he is not self-interested in the action and the action is rationally calculated to increase corporate profit and shareholder gain?<sup>136</sup>

As Eisenberg puts it, “Trying to squeeze such conduct into the duty of loyalty is like trying to squeeze the foot of Cinderella’s stepsister into Cinderella’s glass slipper — an enterprise equally painful and fruitless.”<sup>137</sup> For similar reasons, Eisenberg concludes that the duty of candor may be seen in terms of good faith duties, but not loyalty duties.<sup>138</sup>

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<sup>133</sup> See, e.g., Eisenberg, *Duty of Good Faith*, *supra* note 4 (contending that fiduciary duty of good faith should be seen as independent fiduciary duty, distinct from loyalty and care). As Vice Chancellor Strine and his co-authors demonstrate, the treatment of good faith as a component of loyalty can be squared with certain pre-*Cede* Delaware cases, however. See Strine et al., *supra* note 4, at 53-58.

<sup>134</sup> See Eisenberg, *Duty of Good Faith*, *supra* note 4, at 6-21.

<sup>135</sup> *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

<sup>136</sup> See Eisenberg, *Duty of Good Faith*, *supra* note 4, at 38.

<sup>137</sup> *Id.*

<sup>138</sup> See *id.* at 49 (“An officer’s obligation of candor is not based on the duty of loyalty, because an officer typically will have no pecuniary self-interest in providing or withholding information. The duty of care also does not provide a basis for this obligation, because an officer who violates this obligation typically does so because he reasonably believes that doing so is in the corporation’s best interest.”).

Eisenberg's argument could simply mean that the recent cases incorporating good faith into loyalty depart from traditional understandings of loyalty in corporate law. Conventional legal usage has often limited loyalty claims to cases involving financial conflicts and self-dealing.<sup>139</sup> At least in comparison to the recent triad case law, the latest good faith cases reshape the approach in this area. And, although this is a matter of continuing debate, some contend that the pre-triad cases also distinguished between good faith and loyalty.<sup>140</sup>

But Eisenberg seems to be saying something more, as indicated by his Cinderella analogy, and his reference to "clear analysis." He appears to be arguing that there is a conceptual reason — a reason other than *stare decisis* — why bringing the bad faith cases under a loyalty rubric will not work. Is this latter view correct?

Assuming that the only available understanding of loyalty in existing social practices were limited to self-dealing or conflicting interest cases, there would be good reason to question whether "loyalty" is really what the Delaware courts are describing in cases like *Guttman*, *Tyson*, or *Ryan*. Yet the question whether these cases can be understood as loyalty cases calls for further analysis before reaching this conclusion. Many legal concepts, loyalty among them, get some of their content from other, social practices.<sup>141</sup> If we want to assess whether the new loyalty is a misnomer, it will be helpful to think about our understandings of loyalty in the various contexts in which a loyalty concept is used.

This Part of the Article assesses the new understanding of loyalty in Delaware law, by means of a comparison to existing social practices that make use of the concept of loyalty. It will become clear that existing social understandings of loyalty readily include cases where the party accused of disloyal conduct has no conflicts of interest. In addition, it will become clear that, even if an individual director

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<sup>139</sup> This view that loyalty cases involve conflicting interests is common in corporate legal scholarship. See, e.g., Sale, *Good Faith*, *supra* note 4, at 484 (suggesting that one can act in bad faith "without being disloyal, at least as traditionally viewed"); Smith, *supra* note 24, at 1410-11 (noting that "courts typically reserve the label 'loyalty' for self-interested actions"); see also Bruner, *supra* note 4, at 1159 n.136 (discussing scholars' views on this question).

<sup>140</sup> For a detailed analysis supporting the view that pre-triad cases had adopted an understanding of loyalty that included good faith duties, see Strine et al., *supra* note 4, at 45-58. For a recent response critiquing that view, see Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?*, (Notre Dame Legal Studies, Working Paper No. 09-35, 2009), available at <http://ssrn.com/abstract=1457804>. The claims in the present Article do not require resolution of this question.

<sup>141</sup> Cf. Johnson, *supra* note 11, at 29 (describing "a portrait of loyalty as it has been, and is now, both in corporate law and in our larger social milieu").

sincerely believes he or she is acting in the best interests of another, courts may still reasonably describe this director as disloyal in cases where the director acts dishonestly or manipulatively toward the beneficiary of his or her actions. A coherent, intuitively plausible conception of loyalty covers each of the recent Delaware cases, without departing from common social understandings of what loyalty means.

#### A. *Minimum and Maximum Conditions of Loyalty*

In an influential article, Professor Lyman Johnson argues that loyalty in corporate law has two different aspects.<sup>142</sup> Drawing on the work of Professor George Fletcher, he suggests there is a minimum condition, under which loyal behavior requires an individual to reject temptation and not “betray the object of one’s loyalty.”<sup>143</sup> In addition, there is a maximum condition, which involves “affirmative duties of devotion.”<sup>144</sup> The classic fiduciary duty of loyalty case in corporate law invokes the minimum condition — directors should not self-deal or take corporate opportunities for themselves. Yet, as Johnson suggests, this idea of loyalty does not exhaust the possibilities for the concept.<sup>145</sup>

In Johnson’s view, the affirmative devotion aspect of loyalty brings the duty of loyalty and the duty of care under one overarching fiduciary concept.<sup>146</sup> An affirmative dimension of loyalty would suggest that the directors should “care for” the interests of the corporation and its shareholders.<sup>147</sup> Loyalty can thus incorporate due care as a feature of a broader duty to act in the interests of another.

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<sup>142</sup> See *id.* at 27 (describing “non-betrayal” aspect and “more affirmative, ‘devotion’ dimension”).

<sup>143</sup> See *id.* at 38 (quoting GEORGE P. FLETCHER, *LOYALTY: AN ESSAY ON THE MORALITY OF RELATIONSHIPS* 40 (1993)).

<sup>144</sup> See *id.* (quoting GEORGE P. FLETCHER, *LOYALTY: AN ESSAY ON THE MORALITY OF RELATIONSHIPS* 24 (1993)).

<sup>145</sup> As Johnson suggests, some corporate law decisions capture both the minimal and maximum dimensions of loyalty. See *id.* at 40 (indicating that famous corporate opportunity case of *Guth v. Loft*, 5 A.2d 503 (Del. Ch. 1939), is example of decision which includes both features).

<sup>146</sup> See *id.* at 42 (“[T]he more full-bodied the concept of loyalty is, the more likely that the philosophical boundaries between loyalty and care is ‘fuzzy’ rather than sharp.”); see also Griffith, *supra* note 4, at 43 (“To put it another way, the fundamental question underlying both duties [care and loyalty] really is good faith. Are the directors doing their best in acting for someone else?”); Hill & McDonnell, *Disney*, *supra* note 4, at 855 (suggesting that directors owe “only one fiduciary duty to a corporation — the duty to actively pursue the best interests of the corporation”).

<sup>147</sup> See Johnson, *supra* note 11, at 45-47.



While Delaware cases recognize both types of loyalty, an emphasis on affirmative devotion opens up a much more extensive and demanding view of loyalty than corporate law has sometimes recognized. Johnson argues that these broader moral ideas of loyalty should play a greater role in corporate law, at least if courts continue to use the language of loyalty in support of their decisions.

In *Disney IV*, Chancellor Chandler cited Johnson's article for support, and its tenets are readily visible in the idea of good faith described in *Disney V* and in *Stone*. In fact, Chancellor Chandler expressly draws upon Johnson's reasoning in defining good faith in *Disney IV*. According to the court: "Professor Johnson's description of a more expansive duty of loyalty to encompass affirmative attention and devotion may, in my opinion, fit comfortably within the concept of good faith (or vice versa) as a constituent element of the overarching concept of faithfulness."<sup>148</sup>

The legal test for bad faith that the court adopted in *Disney V* supports this view. When the *Disney V* court states that it violates a fiduciary duty of good faith when a director "intentionally acts with a purpose other than that of advancing the best interests of the corporation," this suggests an affirmative duty of devotion.<sup>149</sup> Bringing the good faith duty described in *Disney V* within the rubric of loyalty — the result in *Stone* — means that the fiduciary duty of loyalty now reflects this maximum condition of loyalty.

As Johnson's work demonstrates, it is not the case that loyalty is conceptually limited to cases involving conflicts of interest and self-dealing. Eisenberg's complaint may fit well with certain earlier Delaware decisions, but the broader, maximum condition of loyalty is also an intuitive, commonly understood view of what loyalty means in other, nonlegal settings. Nothing in the concept of loyalty precludes Delaware courts from finding that an affirmative devotion-based conception is what loyalty calls for in the corporate context.

### B. Loyalty as Being True

While Johnson offers important insights in his assessment of the "minimum" and "maximum" conditions of loyalty, the nonbetrayal dimension of loyalty merits further analysis. As Johnson describes the minimum condition of loyalty, it is apparently coterminous with loyalty's nonbetrayal mandate.<sup>150</sup> If so understood, the nonbetrayal

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<sup>148</sup> *Disney IV*, 907 A.2d 693, 760 n.487 (Del. Ch. 2005).

<sup>149</sup> See *Disney V*, 906 A.2d 27, 67 (Del. 2006).

<sup>150</sup> In Johnson's description of the minimal demand of loyalty, which he associates

aspect of loyalty would apparently be restricted to situations where the fiduciary party is acting out of self-interested motives. This is unduly limiting. As the discussion below suggests, such a reading would offer an overly constrained understanding of this dimension of loyal behavior. The rule against self-dealing is one of many rules that can follow from a nonbetrayal mandate.

Johnson's writing emphasizes the continuum between a rule against self-dealing and a requirement of affirmative devotion. One may also recognize another, distinct continuum along which to measure conceptions of loyalty. This is a continuum of nonbetrayal norms. The key feature of this nonbetrayal continuum is the manner in which a loyal party is required to show *respect* toward the judgment and dignity of the person to whom he or she is loyal.

Based on distinct, socially recognized conceptions of loyalty, we can discern broad and narrow versions of a nonbetrayal requirement. The narrow version of the nonbetrayal principle requires avoidance of self-dealing, but does not speak to questions of how the loyal actor should behave, so long as the loyal actor does not self-deal. At the other end of this nonbetrayal continuum, dishonest and manipulative behavior is seen as a betrayal of the beneficiary — even if the individual did not self-deal, and even if the conduct at issue was thought to be in the best interests of the beneficiary. This latter conception of disloyalty corresponds to the requirements of being “true.”

As this subpart will develop, the importance of this nonbetrayal dimension of loyalty merits closer inquiry. The broad conception of loyalty on which this Article focuses is not unique to corporate law. Instead, it is a commonly held understanding of a specific type of loyalty, recognizable in nonlegal, social settings. Loyalty can encompass an obligation to be honest toward one's beneficiary, to be reliable, to keep one's word. Loyalty, in other words, can involve a type of *respect* toward another.<sup>151</sup> This is evidenced by the kind of

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with corporate law, he suggests that “[t]he duty of loyalty is a shorthand expression for the duty of fair dealing by . . . [directors] when they are financially interested in a matter.” See Johnson, *supra* note 11, at 39 (quoting Eisenberg, *Corporate Law*, *supra* note 94, at 1271). Similarly, Johnson's description of the “minimum condition” of loyalty focuses on a nonbetrayal requirement that operates with respect to a loyal actor's restraint against temptation. See *id.* at 38.

<sup>151</sup> This view of loyalty could also be extended to suggest an antipaternalist reading of director loyalty. Given a suitably broad view of paternalism, many of the recent cases extending the duty of loyalty can be understood to bar director conduct which paternalistically substitutes the judgment of the directors for the judgment of the shareholders in contexts where the authority of the shareholders to decide deserves recognition. Cf. Seana Valentine Shiffrin, *Paternalism, Unconscionability Doctrine, and Accommodation*, 29 PHIL. & PUB. AFF. 205, 218 (2000) (defining paternalism such that

behavior the loyal party shows toward the beneficiary — the *means*, and not just the ends, of the loyal actor are at issue.<sup>152</sup>

The outlines of the emerging corporate law idea of loyalty are clearly visible in philosophic discussions of being true. In a recent book, the philosopher Simon Keller offers a helpful analysis of the idea.<sup>153</sup> As Keller notes, people sometimes see loyalty as a character trait:

There is a sense of “loyal” that is associated with being dependable, or reliable, or dutiful, or true — as in, “straight and true.” In telling you that somebody is loyal in this sense, I am telling you that you can trust him; he is not scheming or deceitful or manipulative; he will not sell you out; he takes his promises and commitments seriously; he knows his job and he gets it done.<sup>154</sup>

This way of being loyal shows a pattern of honesty, respect, and dutifulness.<sup>155</sup>

Notice that this conception is not the same as the affirmative devotion idea of loyalty, although the two can overlap. There is a potential divide between being true and being loyal in the affirmative devotion sense. As Keller indicates, an individual who is true in the above fashion “might be reliable, and so on, not out of a particularized regard for any entity with which he takes himself to have a special relationship, but simply because he values the keeping of

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it would cover conduct in many loyalty cases described in this Article). In such cases, the board shows inadequate respect for the agency of the shareholders. *See id.* at 220 (suggesting that “[t]he essential motive behind a paternalist act evinces a failure to respect either the capacity of the agent to judge, the capacity of the agent to act, or the propriety of the agent’s exerting control over a sphere that is legitimately her domain”). However, this view would be in tension with certain Delaware cases that do allow for paternalist conduct on the part of boards. *See, e.g.,* *Unitrin, Inc. v. Amer. Gen. Corp.*, 651 A.2d 1361, 1384-85 (Del. 1995) (recognizing board’s ability to respond to risk of substantive coercion — i.e., risk that shareholders would accept offer out of ignorance or mistaken beliefs).

<sup>152</sup> *But cf.* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 *BUFF. L. REV.* 99 (2008) (suggesting that fiduciary duties are relationships in which fiduciary adopts ends of another).

<sup>153</sup> *See* KELLER, *supra* note 14, at 153-55.

<sup>154</sup> *See id.* at 154.

<sup>155</sup> Notably, this idea also fits an extra-legal understanding of what it means to act in “good faith.” *See* Lyman P.Q. Johnson, *The Social Responsibility of Corporate Law Professors*, 76 *TUL. L. REV.* 1483, 1498 (2002) (discussing philosopher André Comte-Sponville’s essay on “good faith”).

commitments, or because that is the way of dealing with the world which he finds easiest.”<sup>156</sup>

Another insightful analysis of what it means to be true is found in Professor Joseph Raz’s discussion of loyalty duties in *The Morality of Freedom*.<sup>157</sup> Raz analyzes how some types of conduct (and attitudes respecting that conduct) are incompatible with the existence of certain relationships.<sup>158</sup> In the course of this analysis, Raz discusses the role of loyalty. According to Raz, “All social forms involve ways of being true to the project or to the relationship which they define.”<sup>159</sup> Loyalty could thus mean that an individual will be true to a pursuit or relationship, according to its terms.<sup>160</sup>

Being true in this sense is distinct from doing what will best further the aim of the relationship. Some conduct is inconsistent with the successful pursuit of the relationship as such, regardless of the benign motives underlying the conduct. One might do a terrible job in attempting to pursue a project or participate in a relationship, while still being true to that project or relationship.<sup>161</sup> On the other hand, as Raz suggests, one could “do a lot of good as a parent, spouse, employee, music lover, etc., while being false to one’s pursuit or relationship.”<sup>162</sup>

In Raz’s view, it is possible to be false toward another, while still having good intentions:

Indeed people have been known to betray their friends or their employers in the interests of those friends. Many a soap opera

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<sup>156</sup> See KELLER, *supra* note 14, at 154-55. For Keller, the more interesting type of loyalty does involve the importance of a special relationship. See *id.* However, for purposes of this Article, both types of loyalty (being “true,” and showing affirmative devotion) are significant.

<sup>157</sup> JOSEPH RAZ, *THE MORALITY OF FREEDOM* 354-55 (Clarendon 1986).

<sup>158</sup> See *id.* at 321-66.

<sup>159</sup> See *id.* at 354.

<sup>160</sup> See *id.* at 355 (“Being true to pursuits and relations is being engaged in them according to their terms.”). Arguably, this type of loyalty could represent a shift from a focus on the beneficiary as an individual to a focus on the relationship itself. There is a hint of such an idea in a recent Delaware case. In the *Desimone* case, Vice Chancellor Strine speaks of the importance of being loyal to one’s obligations. See *Desimone v. Barrows*, 924 A.2d 908, 933 (Del. Ch. 2007) (indicating that, because of exculpation clause, “the directors can only be held liable if they act with a state of mind that is disloyal to their obligations to the corporation”). Being untrue to a relationship’s terms, however, can be understood as being untrue to a beneficiary as well.

<sup>161</sup> See RAZ, *supra* note 157, at 354 (“One may be clumsy, neglectful, thoughtless, of bad judgment, misconceiving one’s role or duty, and so on. And with all that one may be true to one’s pursuits or relationships.”).

<sup>162</sup> *Id.*

has capitalized on the idea of the lover who is *disloyal* in order to break the relationship because he realizes, correctly, that that is in the best interest of the loved one. Such cases may show that being false to one's pursuit or relationship is, sometimes, justified. But even a justified betrayal is a betrayal.<sup>163</sup>

The understanding of a "betrayal" in the above analysis is distinct from the idea that loyalty simply involves showing an affirmative devotion to the interests of the individual toward whom one is loyal.<sup>164</sup>

As Raz's discussion illustrates, being true means not engaging in a particular type of betrayal, potentially independent from the betrayal implicated by self-dealing. The betrayal that occurs when an individual is not true involves dishonesty, manipulation, or some other form of broken trust on the part of the supposedly loyal party. Such a betrayal can occur in cases where the person doing the betraying sincerely believes his or her actions are consistent with an affirmative devotion to another individual.

Many of the recent corporate precedents suggest that being true is a component of the Delaware conception of loyalty. This is apparent when we compare the recent Delaware holdings to Keller's above description of the character trait.<sup>165</sup> When the Delaware chancery court states that a director cannot lie to shareholders and also act consistently with loyalty, this holding follows the idea that a loyal individual would not be "deceitful or manipulative." The view that a broken agreement between the board and the corporation's shareholders is an act of disloyalty tracks the view that a loyal individual "takes his promises and commitments seriously." The

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<sup>163</sup> *Id.*

<sup>164</sup> Note that, under a different conception of loyalty, such conduct is by definition *not* a betrayal. One might argue that, so long as the fiduciary intends to benefit the beneficiary, a failure to respect the wishes of the beneficiary is still faithful conduct. A good example of how this distinction can be meaningful in legal settings is the debate between textualists and some non-textualists over what it means for a court to be a "faithful agent" of the legislature. Professor William Eskridge, for example, suggests that an honest agent may deviate from a principal's directives in certain circumstances. See William N. Eskridge, Jr., *Spinning Legislative Supremacy*, 78 GEO. L.J. 319, 329-30 (1989). Textualists, in contrast, are likely to view this type of conduct as unfaithful. See, e.g., John F. Manning, *Textualism and the Equity of the Statute*, 101 COLUM. L. REV. 1, 15-21 (2001) (contending that faithful agent would follow legislative text where social and linguistic conventions render its meaning clear). Of course, courts may not be agents of the legislature in the first place. See Andrew S. Gold, *Absurd Results, Scrivener's Errors, and Statutory Interpretation*, 75 U. CIN. L. REV. 25, 49-52 (2006).

<sup>165</sup> See KELLER, *supra* note 14, at 154.

requirement that a loyal director not act contrary to his corporation's charter suggests that the director "takes his . . . commitments seriously," and also that the director "knows his job and gets it done."

The classic fiduciary duty case of *Meinhard v. Salmon* confirms that there is longstanding legal precedent for this broad, nonbetrayal conception of loyalty.<sup>166</sup> In *Meinhard*, Judge Cardozo famously explained that the duties between joint venturers were duties of "the finest loyalty."<sup>167</sup> This strict version of loyalty meant that the fiduciary had to act *honorably* towards the party to whom he was loyal:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.<sup>168</sup>

Although commentators often see Cardozo's language about a "punctilio of an honor the most sensitive" as mere moral rhetoric,<sup>169</sup> read in context this language sets forth the content of the "finest loyalty" mandate. Acting honorably towards another is a particular way in which the nonbetrayal aspect of loyalty is expressed.

As the above examples indicate, the most recent Delaware decisions have not invented a form of loyalty out of whole cloth.<sup>170</sup> A perfectly recognizable view of loyalty — present in both nonlegal and legal settings — readily fits the Delaware courts' current statements of what

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<sup>166</sup> *Meinhard v. Salmon*, 249 N.Y. 458, 463-64 (Ct. App. 1928). Although the *Meinhard* case arose in the joint venture setting, it is frequently cited in corporate jurisprudence, and suggests the salience of this view of loyalty within the legal community.

<sup>167</sup> *See id.*

<sup>168</sup> *Id.* at 464.

<sup>169</sup> Cf. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 440 (1993) (describing cases like *Meinhard* as "laden with moralizing language").

<sup>170</sup> Note that a recent draft article co-authored by Vice Chancellor Strine and several other experts in Delaware corporate law makes reference to being true in discussing the duty of good faith and its link to loyalty. In analyzing the meaning of "good faith," they state: "A classic way to describe a disloyal director is as a 'faithless fiduciary,' which is not surprising as the term faithless means that one has been 'disloyal,' in the sense of having been 'untrue to what should command one's fidelity or allegiance.'" *See Strine et al., supra* note 4, at 20 (emphasis added) (citations omitted); *see also id.* at 28 (suggesting that where directors knowingly cause corporation to violate law "they make the corporation untrue to itself") (emphasis added). These statements provide further evidence that being true is a feature of loyalty as understood by Delaware courts and lawyers.

loyalty requires. Moreover, if courts are applying this conception of loyalty to corporate boards, then the judiciary is not just substituting its ideas of interpersonal morality (e.g., the view that lying is wrong) in place of loyalty duties. This conception of loyalty encompasses obligations that happen to overlap with commonly held moral views, but these duties nonetheless have their source in a specific fiduciary relationship.

### C. Limitations to the New Loyalty

The above analysis does more than provide a conceptual grounding for the new loyalty cases; it also offers insights into the boundaries of the new loyalty. Under Delaware's recent loyalty precedents, courts do not consider it bad faith for the board to select corporate goals that conflict with shareholder wishes. This result may seem odd. Agents are not expected to act in this fashion toward their principals. However, this limitation on loyalty claims against directors is consistent with the idea that loyalty means being true according to the terms of a relationship. Indeed, the relationship that directors occupy in corporate firms justifies the limits of their loyalty obligation.

Contrary to some commentators, the fiduciary relation that directors occupy is not an agency relation.<sup>171</sup> The loyalty that directors must show to shareholders does not stem from agency law, but rather from the unique structure of the corporate organization. Directors hold a *sui generis* position in which they are given very broad discretion over how to manage the corporation.<sup>172</sup> They must act loyally toward

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<sup>171</sup> For convincing analyses of how directors are not agents, see Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 726-28 (2006); Robert Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 56-59 (John W. Pratt & Richard J. Zeckhauser eds., 1985). There are dissents, however. Although the distinctions between these legal categories are substantial, some commentators do take the view that a fiduciary relationship is an agency relationship. See, e.g., Laby, *supra* note 152, at 135 ("[F]iduciary relationships, like other agency relationships, entail consent by the principal that the fiduciary will act on the principal's behalf and subject to the principal's control."). Occasionally, agency language and reasoning also surfaces in Delaware opinions. See, e.g., *Unisuper Ltd. v. News Corp.*, No. 1699-N, 2005 WL 3529317, at \*6 (Del. Ch. Dec. 20, 2005) ("[T]he board's power — which is that of an agent's with regard to its principal — derives from the shareholders, who are the ultimate holders of power under Delaware law.").

<sup>172</sup> For a helpful analysis of the scope of directors' authority, see Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559-74 (2003). But see Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1399-1400 (2008) (critiquing Bainbridge's view).

shareholders and the corporation, but they have the power (and responsibility) to make their own decisions within the sphere of their proper authority.

This concern with authority accounts for cases in which the Delaware chancery court has refused to find disloyal behavior even if the board is consciously acting contrary to shareholder preferences. For example, consider the recent decision in *In re Lear Corp. Shareholder Litigation*.<sup>173</sup> In that case, the shareholder plaintiffs argued that the Lear board had acted disloyally, based on the board's decision to enter into a merger agreement when the board allegedly knew that shareholder approval of this merger was unlikely.<sup>174</sup>

The *Lear* plaintiffs suggested that it is disloyal for the board to act contrary to the perceived wishes of their corporation's shareholders. As Vice Chancellor Strine explained, such a claim misunderstands the role of a director: "During their term of office, directors may take good faith actions that they believe will benefit stockholders, even if they realize that the stockholders do not agree with them."<sup>175</sup> In other words, the good faith element of loyalty does not mean that the board must follow the desires of shareholders, at least not in areas that are committed to the board's judgment.

Under the broad sense of nonbetrayal described in this Article, there are still important limits to the scope of loyalty duties. Were directors agents, then a case could be made that failure to follow their principal's preferences raises a loyalty concern. Since the relationship at issue for directors is not an agency relationship, but rather a relationship in which the board is *expected* to exercise independent judgment on behalf of the corporation and its shareholders, being true within this relationship does not mandate that directors act as they believe the shareholders would want them to act with respect to business decisions.

#### D. Summary

If it is clear that the general concept of loyalty offers more than one idea of what counts as a betrayal, it is also increasingly apparent that the Delaware Courts have accepted a particular conception. This is a conception that looks to whether the fiduciary party is doing what was authorized. Delaware has endorsed a conception that rejects lying,

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<sup>173</sup> 967 A.2d 640 (Del. Ch. 2008).

<sup>174</sup> See *id.* at 655.

<sup>175</sup> *Id.* Or, as Vice Chancellor Strine also puts it: "Directors are not thermometers, existing to register the ever-changing sentiments of stockholders." *Id.*



breaking commitments, or lawbreaking, even when these actions are designed to benefit the corporation and its shareholders.

The key loyalty component here is the requirement of being true. In light of the view that charters incorporate legal requirements, one can understand illegal acts as disloyal because they violate a commitment incorporated into the charter. The violation of that commitment is not honorable behavior toward the corporation or its shareholders. Lies to shareholders are also disloyal, ultimately for related reasons. In both cases, loyalty is not present even if the fiduciary sincerely believes the law-breaking or lying will benefit the corporation or its shareholders.<sup>176</sup>

This is admittedly not the only conception of loyalty available. One might adopt an intelligible conception of loyalty under which an individual director acts loyally if she simply acts in a sincere belief that her choices will benefit the corporation or its shareholders. Yet this alternative is clearly not the view expressed in cases like *Tyson*, *Ryan*, or *Desimone*. Given what the courts presently indicate, the connection between being true and the concept of loyalty provides a much needed explanation of how the various forms of bad faith conduct — from lying to shareholders, to breaching commitments, to intentional violations of positive law — are all understandable as loyalty violations.

### III. POTENTIAL JUSTIFICATIONS FOR THE NEW CONCEPTION OF LOYALTY

In light of how recent *Stone* and its progeny are, it is worth asking whether the emerging conception of loyalty is a desirable one. Although it has defenders, Delaware's evolving loyalty jurisprudence has already drawn critics.<sup>177</sup> Among other concerns, the new loyalty cases have created a substantial amount of uncertainty regarding the content of a director's fiduciary duties, and equally important, regarding the standard of review that courts will apply in enforcing these duties. It is still an open question whether the transition will be worthwhile.

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<sup>176</sup> These actions, regardless of good intent, are insufficiently respectful of the beneficiary's judgment in an area where the beneficiary's judgment is dispositive. Note that not all cases have these features, however. Cf. *In re Lear*, 967 A.2d at 655 (noting that directors are expected to exercise their own business judgment to advance interests of corporation and its stockholders).

<sup>177</sup> See, e.g., Bainbridge et al., *supra* note 4, at 581-604 (critiquing decision in *Stone* to subsume good faith into loyalty in light of potential effects).

The Delaware courts are adopting a major change in their loyalty jurisprudence, at least in terms of the formal division of fiduciary duties.<sup>178</sup> The actual costs and benefits of this change are still unknown. Moreover, although the expanded version of loyalty described in this Article is confined within predictable boundaries, there is enough flexibility in the current precedents on good faith to permit further expansions. Delaware's corporate law is well-known for indeterminacy, and the courts' application of *stare decisis* is less than rigorous.<sup>179</sup> Expanding the duty of loyalty to cover cases outside of self-dealing contexts could be a first step toward more dramatic shifts in corporate litigation.

In light of these concerns, the long-term implications of an expanded loyalty duty deserve close scrutiny. Even if the recent changes to loyalty appear harmless as presently applied, it does not follow that they are worth adopting. New variations on loyalty can be hard to predict, and future cases may demonstrate that a good faith element to loyalty is not easily confined. Accordingly, the conceptual analysis above invites a further question. Are there reasons why Delaware corporate law *should* include a conception of loyalty like the one described in this Article?<sup>180</sup>

This Part explores several potential justifications for the expanded duty of loyalty. Depending upon how the new loyalty is applied, there are potential advantages to Delaware's recent fiduciary case law. The new loyalty duties should significantly limit information costs. Furthermore, the new version of loyalty may serve an important function in engendering optimal levels of trust among corporate constituents. Although the analysis that follows is necessarily tentative — the case law is new, and empirical data is lacking — these benefits could be substantial.

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<sup>178</sup> Whether or not this change is a return to an earlier vision of loyalty contained in prior Delaware case law will be bracketed for purposes of this Article. *But cf.* Strine et al., *supra* note 4, at 53-58 (suggesting that idea of good faith as component of loyalty has long pedigree in Delaware corporate law).

<sup>179</sup> See Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1078 (2000) (suggesting Delaware Supreme Court "appears ready to distinguish or overrule a precedent without regard to considerations of *stare decisis*").

<sup>180</sup> For purposes of answering this question, this Article will assume that the purpose of fiduciary duties is to benefit the corporation and/or its shareholders. It is always possible, of course, that a particular fiduciary doctrine is actually designed to benefit society at large, rather than the corporation or its shareholders. *Cf.* Einer Elhauge, *Sacrificing Corporate Profits*, 80 N.Y.U. L. REV. 733 (2005) (contending that directors legally have profit-sacrificing discretion to act in public interest).

A. *The Duty of Loyalty and Standards of Review*

One proposed justification for the recent good faith and loyalty cases is their potential to alter the judicial role in fiduciary litigation. Professors Claire Hill and Brett McDonnell suggest that the recent bad faith cases are a means for the Delaware courts to police self-interested board actions in contexts where traditional conflicts of interest are absent.<sup>181</sup> As they note, cases involving a lack of candor will often implicate structural bias or improper motives.<sup>182</sup> Similarly, a board's willingness to engage in illegal conduct "may be a proxy for their willingness to engage in conduct that more directly diverges with the shareholders' interests."<sup>183</sup> Shifting the underlying standard of conduct could then be a way of shifting the standard of review.<sup>184</sup> An expansion of loyalty to cover good faith permits courts to address cases where conventional conflicts of interest are lacking, yet complete judicial deference to the board's decisions would nevertheless be undesirable.<sup>185</sup>

Hill and McDonnell argue that the Delaware courts should adopt a sliding scale standard of review to address the various fact patterns in which disloyalty can occur. Depending on the extent to which structural bias is present, and on the amount of director negligence, courts could assess board decisions with varying degrees of scrutiny.<sup>186</sup> In other words, an expanded duty of loyalty offers new categories by which courts could limit the application of the business judgment rule.

Lying or law-breaking often correspond to self-interest. In addition, directors may have an increased likelihood of acting against the best

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<sup>181</sup> See Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1789 ("The general backdrop of good faith gives courts flexibility to deal with new circumstances that do not fit within better defined standards of review, and to develop new standards for other sorts of cases where appropriate.").

<sup>182</sup> *Id.* at 1783.

<sup>183</sup> *Id.* at 1784.

<sup>184</sup> On the distinction between standards of conduct and standards of review in Delaware law, see generally Eisenberg, *Divergence*, *supra* note 18 (analyzing this distinction).

<sup>185</sup> In Hill and McDonnell's view, these cases occupy a middle ground between standard loyalty and care cases. In such cases, there is a potential for greater judicial scrutiny than the business judgment rule standard. See Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1789-95. Although I believe the expansion of loyalty duties to include good faith duties is reasonable, I have suggested elsewhere why the developing duty of good faith does not support such changes to the business judgment rule standard of review. See Gold, *supra* note 4, at 467-70 (discussing Hill and McDonnell's suggestion).

<sup>186</sup> See Hill & McDonnell, *Disney*, *supra* note 4, at 855-61; Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1791-95.

interests of the corporation and its shareholders in cases of dishonesty or lawbreaking, even if they believe that their conduct will have a positive effect. The directors' assessments of their beneficiary's best interests may be less accurate in such cases.<sup>187</sup> As Professors Louis Kaplow and Steven Shavell have suggested:

If an individual would like to be able to lie, because it promotes his narrow self-interest, he would like to convince himself that it would be moral to do so . . . [and] if moral rules are complex, admitting myriad context-specific exceptions, the capacity to rationalize and misperceive pertinent information makes it likely that individuals would frequently err in favor of their own self-interest.<sup>188</sup>

A more searching standard of review could thus respond to the likelihood that the directors' judgments are less reliable when they lie to shareholders or break the law.

Granting these premises, however, it is still questionable whether such an adjustment to the standard of review would provide a net benefit. Stephen Bainbridge and his co-authors rightly note that the conventional remedial features of the duty of loyalty are ill-suited for cases that do not involve self-dealing.<sup>189</sup> Bainbridge also emphasizes the litigation risk associated with the potentially open-ended content of the duty of good faith.<sup>190</sup> Both of these concerns are legitimate reasons to question whether the duty of good faith is a desirable basis for revising the business judgment rule.

In addition, as I have suggested in prior work, Delaware has good reason to retain the traditional scope of the business judgment rule due to the severe uncertainty involved in assessing how much oversight should be allocated to judicial actors.<sup>191</sup> The decision costs

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<sup>187</sup> In addition, evidence that the directors were acting in subjective good faith might also be less reliable in such contexts. I wish to thank Matt Sag for raising this point.

<sup>188</sup> Louis Kaplow & Steven Shavell, *Human Nature and the Best Consequentialist Moral System* 12 (Nat'l Bureau of Econ. Research, Working Paper No. 349, 2002), available at <http://ssrn.com/abstract=304384>.

<sup>189</sup> See Bainbridge et al., *supra* note 4, at 585-88 (noting difficulty of crafting loyalty-type remedies in cases where defendant did not receive improper benefit). But see Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1788 (noting that courts have discretion as to remedies in this context).

<sup>190</sup> See Bainbridge et al., *supra* note 4, at 591 (suggesting that "the definition of good faith is potentially open-ended"). Bainbridge and his co-authors also suggest that the resulting uncertainty "will invite shareholder-plaintiffs to test the boundaries of the concept." See *id.*

<sup>191</sup> See generally Gold, *supra* note 4, at 447-72 (suggesting robust version of

and transition costs associated with a more limited business judgment rule are substantial, and it is doubtful that courts are equipped to accurately locate an ideal balance between director accountability and director authority if they alter existing standards of review.<sup>192</sup> Without a better means to assess this balance, a strict business judgment rule is an appropriate default.

Hill and McDonnell respond that the courts' ability to create "fine-tuned and precise standards of review for a variety of specific situations" limits the uncertainty associated with good faith liability.<sup>193</sup> This is a fair point. Courts can be expected to fine-tune their legal doctrines over time. The Delaware courts often make use of context-specific categories, and this type of refinement could readily occur in the good faith setting. But it is a matter of dispute whether Delaware courts' practice of creating standards of review for specific fact patterns is an adequate response to uncertainty concerns.

In a recent article, Professors William Carney and George Shepherd provide a lengthy critique of the Delaware courts' tendency to create new categories of fiduciary case law.<sup>194</sup> The difficulty with developing case-specific categories as a response to uncertain doctrine is the increasing proliferation of such categories in Delaware law, and the absence of notice as to when new categories are on the horizon. So long as it is unclear when a new category will arise, the indeterminacy problem is substantial.

Moreover, the Delaware courts have yet to adopt a sliding-scale standard of review, at least to the degree endorsed by Hill and McDonnell.<sup>195</sup> And, at present, it is doubtful that the courts will do so. Courts have shown a marked reluctance to enforce the good faith loyalty duty in a way that would create inroads on existing protections against director liability. For example, in the *Desimone* case, Vice Chancellor Strine expressly noted that the duty of good faith is not a

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business judgment rule in light of severe judicial uncertainty regarding proper balance between board authority and accountability).

<sup>192</sup> See *id.* at 467-70.

<sup>193</sup> Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1787.

<sup>194</sup> See William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 16-17 ("The important observation here is not that the rules are difficult to discern once announced, but that new rules have been announced with remarkable regularity.").

<sup>195</sup> Although they consider the doctrinal fit to be a good one, Hill and McDonnell concede that Delaware law is not, presently, a perfect fit with their proposal. See Hill & McDonnell, *Disney*, *supra* note 4, at 859 (noting that their proposal "goes beyond what the Delaware courts have said or done so far"). In particular, the courts' emphasis on conscious wrongdoing is in tension with their suggested approach. See *id.* at 860.

means to avoid the strong protections of section 102(b)(7).<sup>196</sup> As Strine emphasized, *Stone* requires scienter for violations of the fiduciary duty of good faith where there are failures of monitoring.<sup>197</sup>

In addition, the Delaware Supreme Court has recently adopted a challenging standard for claims of bad faith-based disloyalty in transactional contexts. In *Lyondell Chemical Co. v. Ryan*, the court addressed a purported breach of good faith by disinterested directors whose company was being sold.<sup>198</sup> These directors had a duty to seek the best price for their shareholders, which the plaintiff claimed they had disregarded.

The *Lyondell* court confirmed the importance of showing a conscious breach for a violation of fiduciary good faith duties, and provided a very high hurdle for demonstrating this level of intent. As the court explained:

[I]f the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they *knowingly and completely* failed to undertake their responsibilities would they breach their duty of loyalty . . . . Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the [trial court's] inquiry should have been whether those directors *utterly failed to attempt* to obtain the best sale price.<sup>199</sup>

*Lyondell* suggests a standard of review for demonstrating a conscious disregard of known duties that will be quite difficult for plaintiffs to meet — in many cases, impossible.<sup>200</sup> The Delaware courts could still

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<sup>196</sup> See *Desimone v. Barrows*, 924 A.2d 908, 936 n.97 (Del. Ch. 2007).

<sup>197</sup> See *id.* It should be noted that, in this context, scienter appears to involve subjective intent, rather than an objective standard.

<sup>198</sup> *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 237 (Del. 2009). Successful claims for lack of oversight are also hard to demonstrate, and the Delaware courts have recently reaffirmed the importance of the business judgment rule in this setting. See *In re Citigroup, Inc. S'holder Derivative Litig.*, 964 A.2d 106, 124-26 (Del. Ch. 2009).

<sup>199</sup> See *Lyondell*, 970 A.2d at 243-44 (emphasis added). For a recent indication that the standard of review for bad faith claims will be quite difficult for plaintiffs where disclosure is at stake, see *In re Citigroup, Inc. S'holder Derivative Litig.*, 964 A.2d at 131-34. Recent decisions also suggest how difficult successful claims of bad faith will be in risk management cases. See generally Stephen Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 972-90 (2009) (analyzing risk management claims under recent precedent and suggesting cautionary approach to director liability).

<sup>200</sup> See Posting of Stephen Bainbridge to ProfessorBainbridge.com,

adjust their standards of review to ease plaintiffs' burdens, but they have not yet chosen this path.<sup>201</sup>

For the moment, the new understanding of loyalty does not promise major revisions to existing standards of review under the business judgment rule.<sup>202</sup> What this suggests is that the *Stone* case will have a limited effect on the board's risk of paying damages. Prior to *Stone* and its progeny, it was already the case that the business judgment rule did not protect intentional violations of positive law.<sup>203</sup> Similarly, it was already the case that the business judgment rule did not protect fraud.<sup>204</sup> While *Stone* does have implications for the selection of remedies, even here the change in actual liability risk may be minimal.<sup>205</sup>

If the regime of legal sanctions is left largely untouched, however, there is still reason to think that an expanded conception of loyalty in corporate law will offer benefits. Indeed, as Hill and McDonnell note, the new loyalty cases could provide important benefits in terms of extralegal forces, such as norms and reputation.<sup>206</sup> The import of

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<http://www.professorbainbridge.com> (Apr. 26, 2009, 15:38 PST) (suggesting that after *Lyondell*, "bad faith may be in the process of becoming the functional equivalent of the so-cal[l]ed egregious or irrational decision exception to the business judgment rule; i.e., a theoretical claim that in practice is an empty set").

<sup>201</sup> For further analysis of how the intent element is important under Delaware's conception of fiduciary good faith, see Strine et al., *supra* note 4, at 84-92.

<sup>202</sup> In fact, it is possible that tying claims of bad faith to claims of disloyalty will limit the scope of future expansions of the good faith doctrine, should courts feel a need to address how a particular type of bad faith is also a form of disloyal conduct. Furthermore, even proponents of closer judicial scrutiny under the latest loyalty precedents do not anticipate that such an adjustment would result in substantial increases in director liability. See Hill & McDonnell, *Disney*, *supra* note 4, at 862.

<sup>203</sup> See Bainbridge, *supra* note 4, at 591-92 (noting that, pre-*Disney*, "the business judgment rule did not insulate illegal conduct from judicial review"); see also Strine et al., *supra* note 4, at 30 n.69 (suggesting that "unless the corporation has itself suffered a major detriment as a consequence of law-breaking, the liability threat to directors is minuscule").

<sup>204</sup> A classic business judgment rule case, *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968), is quite explicit on this point. See *id.* at 780 (indicating that plaintiffs could not succeed in their case unless defendants' conduct at least borders on "fraud, illegality or conflict of interest" in making their decision). In Delaware, the importance of fraud as an exception to the business judgment rule was made clear well before *Stone* was decided. See, e.g., *Malone v. Brincat*, 722 A.2d 5, 14 (Del. 1998) (indicating cause of action may be available where directors deliberately misinform shareholders about business of corporation).

<sup>205</sup> See Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1788 (discussing remedial implications of *Stone*).

<sup>206</sup> See *id.* at 1794-95.

fiduciary duties extends beyond the specific fact patterns in which courts enforce those duties with legal sanctions.

### B. *Moral Concepts and Information Costs*

Another potential justification involves the use of moral concepts as a source of content for loyalty duties. The new loyalty cases may be intended to make directors' loyalty duties better reflect nonlegal understandings of appropriate director behavior. The moral rhetoric in these recent judicial opinions suggests that this is a plausible interpretation. Moreover, the view that dishonesty to shareholders and intentional lawbreaking necessarily conflict with the requirements of loyalty sounds like a morality or virtue-based understanding.

The Delaware courts have admittedly been wary about using fiduciary duties to enforce the norms of morality.<sup>207</sup> This is cause to question whether the courts are truly concerned with what morality or virtue *as such* require of corporate directors.<sup>208</sup> Yet there may be instrumental reasons for seeking convergence with widely held nonlegal understandings of a fiduciary's responsibility, reasons which coincide with well-established aims in corporate jurisprudence. For example, a view of loyalty that converges with conventional moral intuitions could be a means to attain greater efficiency in corporate law. The resulting correspondence to existing values could increase compliance in comparison to the available alternatives.<sup>209</sup>

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<sup>207</sup> See, e.g., *Desimone v. Barrows*, 924 A.2d 908, 932 (Del. Ch. 2007) (noting "the justified concern that concepts of fiduciary duty not be used in an unprincipled and wholly-elastic way to reach any and all behavior that, upon first blush, strikes judges as inappropriate").

<sup>208</sup> A key question is whether it is appropriate for courts to enforce interpersonal morality. For an insightful analysis of different ways in which this concern can be assessed, see Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 713-19 (2007). The benefits of Delaware's law could be analyzed in non-economic terms — e.g., in light of whether corporate law accommodates moral rules governing directors or judges. This possibility will be bracketed for purposes of the present Article.

<sup>209</sup> For example, the norms enforced by corporate law opinions may be more readily internalized if these judicial opinions express that the conduct at issue is actually *wrong*. See Eisenberg, *Corporate Law*, *supra* note 94, at 1272-73. As others have noted in the tort law context, if the understanding of a legal duty is consistent with the structure of relational duties embedded in the private law, this suggests the duty will have greater moral credibility. See John C.P. Goldberg & Benjamin C. Zipursky, *The Moral of MacPherson*, 146 U. PA. L. REV. 1733, 1840-41 (1998). A lack of moral credibility, in contrast, may discourage compliance. For this reason, it has been suggested that a purely consequentialist basis for such legal duties may receive less compliance due to a disconnect from commonly held moral intuitions. See *id.*; cf.



The difficulty with such a theory is that increased compliance on the basis of convergence with existing norms is speculative. Several different conceptions of loyalty could plausibly correspond to directors' pre-existing values — the variations among trust law, partnership law, and agency law suggest there are multiple templates for loyalty.<sup>210</sup> Ongoing disagreements among corporate scholars regarding these doctrines suggest multiple views that reasonable people could hold about what loyalty means. The new loyalty cases also tend to use categorical reasoning (e.g., dishonesty to shareholders is per se disloyal). It may well be that directors would consider a case-by-case analysis of loyalty duties to be a better fit with their moral intuitions. In addition, for compliance purposes, a morality or virtue-based concept may be unnecessary. Directors may be quite capable of complying with ideas of loyalty that do not at all resemble conventional understandings of what loyalty is.

However, even if the recent loyalty cases do not bring about a beneficial convergence with existing norms, information costs offer a powerful reason for courts to adopt an accessible, morality or virtue-based conception of loyalty. Directors, shareholders, and creditors have a strong interest in knowing what the general contours of the duty of loyalty are.<sup>211</sup> Directors who desire to comply with the law and do not intend fiduciary breaches will share in this interest.<sup>212</sup> The ability to grasp legal content cheaply assists with the guidance function of law.<sup>213</sup> Furthermore, transactional planning is much

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Paul Robinson & John Darley, *The Utility of Desert*, 91 NW. U. L. REV. 453 (1997) (supporting similar point in criminal law context).

<sup>210</sup> Notably, corporate law has drawn on analogies to each of these spheres. Reasonable minds may differ on which analogy is most suitable and under what circumstances. The difficult problems in moral philosophy regarding paternalistic lies also suggest room for debate as to whether a per se rule against dishonest conduct is mandated as a moral matter. See *infra* note 270.

<sup>211</sup> For example, in some cases third parties are unable to enforce a contract with a corporation, due to a conflict between the contract terms and the board's fiduciary duties. See *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 50-51 (Del. 1994). Such third parties would wish to know ex ante what the board's duties are, or at least be able to readily ascertain such duties.

<sup>212</sup> Cf. Curtis Bridgeman, *Contracts as Plans*, 2009 U. ILL. L. REV. 341, 378 ("The threat of legal enforcement of contracts can create trust in someone where it may not have existed, or been strong enough, before. But trusting in someone is not enough unless one has confidence that the person understands his legal responsibilities.").

<sup>213</sup> For a discussion of this function, see generally Dale A. Nance, *Guidance Rules and Enforcement Rules: A Better View of the Cathedral*, 83 VA. L. REV. 837, 857-69 (1997) (describing guidance rules designed for law-abiding citizens).

simpler when the expectations of fiduciary conduct are capable of being easily understood *ex ante*.<sup>214</sup>

In the case of the fiduciary duty of good faith, the courts' use of a third, independent fiduciary category engendered a great deal of confusion.<sup>215</sup> It was never entirely clear under this three duty approach when conduct that failed to violate the duty of care or the duty of loyalty was nevertheless "not in good faith." Folding good faith into loyalty shows promise for limiting that confusion. In particular, adopting a simple, morally resonant content for loyalty duties should make the meaning of good faith duties significantly more accessible.

Good faith itself is a truly vague concept, dependent on context.<sup>216</sup> In practice, loyalty concepts may help in elaborating on the meaning of good faith. Of course, fiduciary duties will always require a case by case analysis. But fiduciary duties can be more accessible if good faith is tethered to a well-known morality or virtue-based concept — such as loyalty — than if courts engage in a more *ad hoc* approach whenever new good faith cases arise.<sup>217</sup> For these purposes, the emerging conception of loyalty is a means of filling in good faith that has relatively predictable applications. Because the new loyalty is also categorical in its approach (e.g., there is no exception for paternalistic lies), it is much easier to grasp.

Recent analyses of information costs offer insights into why this use of moral concepts matters. One can view laws as communicating information to an audience.<sup>218</sup> The costs of interpreting these laws — information costs — may be daunting. Accordingly, legal doctrine can be assessed in terms of how much information the law requires its

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<sup>214</sup> See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 85 (1991) (discussing importance of clarifying rules around which parties can transact).

<sup>215</sup> See Bruner, *supra* note 4, at 1176-77 (critiquing independent duty of good faith in light of its incoherence).

<sup>216</sup> For an analysis of good faith as it has been applied in both fiduciary and contractual contexts, see Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 133-40 (2006).

<sup>217</sup> In fact, fiduciary law already reflects this insight to a degree. For a suggestion that fiduciary duties have a rule-like quality when applied, rather than a hypothetical bargain analysis for individual parties, see Mariana Pargendler, *Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered*, 82 TUL. L. REV. 1315, 1325 (2008) (noting that "policymakers conceive the hypothetical bargain as a gap-filling method at a high level of generality — at the category level").

<sup>218</sup> See Henry E. Smith, *The Language of Property: Form, Context, and Audience*, 55 STAN. L. REV. 1105, 1108 (2003) (suggesting that structure of property and related law can be understood in terms of audience design).

audience to process, and in terms of who comprises the law's audience.<sup>219</sup> Different legal doctrines and methods of legal reasoning will implicate different concerns about information costs. As Professor Henry Smith has noted: "Relatively context sensitive realism and relatively acontextual formalism can be seen as points along a spectrum of methods of striking a tradeoff between communicating a lot to a few or a little to many."<sup>220</sup>

The law of business organizations is sensitive to such information cost concerns. In this respect, corporate law shows similarities to property law.<sup>221</sup> Both rely on standardization of legal options to cut down information costs. Property law divides the available types of property into certain fixed, relatively rigid forms of ownership.<sup>222</sup> This fixed set of options permits a variety of regulated parties to rapidly assess the risks related to ownership of different property types. The law of business entities has a parallel fixed structure. A fixed legal treatment for distinct types of business entities allows large numbers of potential legal participants — e.g., shareholders and creditors — to assess the rules that will govern a particular business.<sup>223</sup>

This standardization approach is a well-known and useful method for addressing information costs in contexts of *in rem* rights or duties. Standardized legal forms (for property or for corporations) limit

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<sup>219</sup> See *id.* at 1110-11 (describing issues of information intensiveness — understood in terms of amount of information per unit of delineation cost — and information extensiveness — understood in terms of size and other features of intended audience).

<sup>220</sup> See *id.* at 1107.

<sup>221</sup> For an analysis of potential parallels between corporations and property, see Thomas W. Joo, *Contract, Property, and the Role of Metaphor in Corporations Law*, 35 UC DAVIS L. REV. 779, 805-18 (2002).

<sup>222</sup> On this standardization of property forms, see generally Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000) (analyzing how forms of property interest are standardized and assessing functions of this standardization). Notably, where *in rem* relations are implicated, similar patterns can be located outside the sphere of conventional property interests. See Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773, 809-51 (2001).

<sup>223</sup> For example, the information cost concern arguably lies at the heart of Delaware close corporations cases, which strictly avoid developing a distinct set of fiduciary duties for corporations with fewer shareholders. See, e.g., *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993) (rejecting special rules for closely held corporations when not qualified as statutory close corporation). Likewise, publicly held LLCs are subject to the same rules regarding exculpation from liability for breach of fiduciary duties as closely held LLCs. See, e.g., *Wood v. Baum*, 953 A.2d 136 (Del. 2008) (applying exculpatory provision that limited director liability to cases of fraudulent or illegal conduct in case involving publicly held LLC). The selection of business form is decisive as far as the type of fiduciary treatment available.

variation in legal content. Yet standardization is not the only method of lowering information costs. Theorists have recently focused on the use of moral concepts as a way to bring information costs to a manageable level.

Granted, the use of moral concepts may seem out of place when assessing the efficiency of property or corporate law. Property law, like corporate law, involves legal rights that are dependent on a set of state-provided rules.<sup>224</sup> While there may be a natural law aspect to property,<sup>225</sup> it is not generally thought that natural law principles specify the precise forms of property that ought to be recognized by positive law.<sup>226</sup> Likewise, many consider corporations to be an artificial creation, with no single correct moral answer as to appropriate legal doctrine.<sup>227</sup> In both spheres, commentators frequently downplay morality as a contribution to legal content.

Still, overlooking the role of moral concepts in these spheres is a mistake. Professors Thomas Merrill and Henry Smith have recently argued that the role of morality in property law deserves more attention from a law and economics standpoint. Merrill and Smith contend that judicial decisionmaking in the context of core property rights is suffused with moral values.<sup>228</sup> As they demonstrate, these moral concepts can be a useful means of limiting information costs. Their arguments are helpful in assessing corporate law, including the merits of a morally grounded concept of loyalty.

In the case of property, Merrill and Smith suggest that the use of morality is necessary to solve coordination problems.<sup>229</sup> Very large numbers of people are affected by property rights, often relating to items of property to which the public has had little or no prior exposure.<sup>230</sup> The information costs associated with these *in rem*

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<sup>224</sup> It is possible that “corporateness” can evolve without a state-provided concession, however. See Paul Mahoney, *Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873, 878-86 (2000).

<sup>225</sup> For a helpful analysis of natural rights theories of property as they historically existed in the United States, see generally Eric R. Claeys, *Takings, Regulations, and Natural Property Rights*, 88 CORNELL L. REV. 1549 (2003).

<sup>226</sup> Property rights stemming from self-ownership offer an arguable exception. See Andrew S. Gold, *A Property Theory of Contract*, 103 NW. U. L. REV. 1, 16 n.72 (2009).

<sup>227</sup> The classic case suggesting this view is *Trustees of Dartmouth College v. Woodward*, 17 U.S. (1 Wheat.) 518, 636 (1819) (suggesting that corporation is “artificial” being, with those properties “which the charter of its creation confers upon it”).

<sup>228</sup> See Thomas W. Merrill & Henry E. Smith, *The Morality of Property*, 48 WM. & MARY L. REV. 1849, 1858-66, 1870-90 (2007).

<sup>229</sup> See *id.* at 1850 (noting that “[p]roperty is a device for coordinating both personal and impersonal interactions over things”).

<sup>230</sup> See *id.* (“[P]roperty rights must be communicated to a wide and disparate group

relations can be staggering. In turn, information costs implicate the types of property rights that can be realistically enforced: "Because property rights need to coordinate the behavior of large numbers of unconnected people, they must be easily comprehended and must resist possible misinterpretation."<sup>231</sup> For this functional reason, a publicly shared, moral understanding of property ownership is essential.

Corporate law implicates similar coordination problems. There are large numbers of potential right holders and relatively large numbers of potential duty holders. Multiple directors and officers hold fiduciary duties. Even if arms-length interactions were possible, the identities of shareholders and directors change over time. Moreover, the interests of bondholders and other creditors are often greatly affected by the content of the board's fiduciary duties.

In response, courts may seek to limit the available content of fiduciary duties. As Professors Claire Hill and Erin O'Hara note:

[T]he [fiduciary] rules are not just onerous and absolutely stated: in many areas of the law, the applicable fiduciary rules constitute a standardized, law created package. There is less for a principal to inquire about. The selection of a fiduciary is therefore made easier — fewer (potentially trust eroding) inquiries need be made.<sup>232</sup>

Yet courts may need to offer more than standardization of fiduciary duties in order to avoid imposing substantial information costs. A legal doctrine could be standardized yet comparatively opaque or costly to figure out.<sup>233</sup> Indeed, fiduciary duties are notoriously case-specific.

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of potential violators; these rights are in rem."'). As an example of how morality plays a role here, consider how the morality of property ownership makes it unnecessary for members of the public to research the ownership of property with which they interact. As Merrill and Smith note, it is frequently important to know that property is owned by someone else, but not necessary to know who owns the property. *See id.* at 1853-54.

<sup>231</sup> *See id.* at 1850.

<sup>232</sup> Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1760 (2006). Whether there should be an ability to alter this standardized package is a matter of debate. Some would argue that the importance of standardizing fiduciary content supports limitations on opt-outs from directors' fiduciary duties. *See* Blair & Stout, *supra* note 20, at 1786-87 (discussing "informational externality" where fiduciary duties are subject to opt-outs). *See also* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1567-69, 1593 (1989) (discussing "public good" hypothesis regarding standard form fiduciary duties). This issue will be bracketed for purposes of the present Article.

<sup>233</sup> It should also be noted that not all commentators see uncertainty in this area as

Although judicial opinions may assist in clarifying doctrine over time,<sup>234</sup> the duty of good faith has proven unusually opaque. The need to make the rules of fiduciary duty accessible to a multitude of interested parties provides justification for using a well-known morality or virtue-based concept — loyalty — to fill in and delimit the content of corporate fiduciary obligations.

In order to serve as an *in rem* coordination device, the morality which property law adopts “must be simple and accessible to all members of the community.”<sup>235</sup> As with property law, a morality or virtue-based understanding of loyalty duties can thus serve a utilitarian function. The new conception of loyalty is both simple and accessible. It enables private parties to understand case-specific legal requirements with substantially lower information costs than the prior set of three independent fiduciary standards.<sup>236</sup> Moreover, it is not only private parties who can benefit. Decision costs should also be lower from a judicial perspective, assuming that courts share similar moral intuitions to those of their legal audiences.

### C. *Trust and the Internalization of Loyalty Duties*

The law of fiduciary duties could also affect behavior such that there is a more optimal level of trust in the corporate setting. If directors comply with the recent conception of loyalty, this can increase trust among corporate directors, their shareholders, and other interested parties. In turn, this increase in trust could benefit the firm. It might seem that the desired level of compliance with the new loyalty duties would require a greater risk of legal liability for violations of those duties — contrary to cases like *Lyondell*. Still, as developed below, we may see substantial director compliance even if the business judgment rule is left untouched.

The crucial question is whether directors will actually follow the recent understanding of loyalty duties. Consciously or not, directors and officers sometimes favor their own interests over the interests of

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a flaw. See, e.g., Fisch, *supra* note 179, at 1081-85.

<sup>234</sup> See Romano, *supra* note 214, at 85 (“All firms benefit from a judicial decision clarifying the scope of permissible conduct. The benefit of clarification is not simply deterrence of future managerial misconduct, but rather, given the contractual setting of the corporation, identification of a rule around which the parties (managers and shareholders) can transact.”).

<sup>235</sup> See Merrill & Smith, *supra* note 228, at 1850.

<sup>236</sup> For a suggestion that the narrative structure of Delaware corporate law opinions is designed to guide corporate actors, see Deborah A. DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 25 WAKE FOREST L. REV. 15, 34-36 (1990).

the corporation or its shareholders.<sup>237</sup> It is well recognized that the broad authority granted to corporate directors raises agency cost and team production concerns which create a need for enforceable fiduciary duties.<sup>238</sup> Yet legal sanctions may not adequately (or efficiently) prevent opportunistic director conduct.<sup>239</sup> And in some cases, nonlegal sanctions may be quite successful in bringing about director compliance.

Professors Margaret Blair and Lynn Stout argue that external sanctions — market forces and legal remedies — are inadequate to address agency costs and team production problems due to the opaque nature of corporate decisionmaking.<sup>240</sup> When board decisions are viewed from outside the boardroom, it is not a simple matter to know what truly motivates director decisions.<sup>241</sup> Legal sanctions may be infeasible, and the potential “shaming” effect of strongly worded judicial opinions may not work, because the existence of improper behavior can often be hidden.<sup>242</sup>

Blair and Stout’s suggested solution is to focus on internal sanctions. In circumstances where board decisionmaking lacks transparency, internal sanctions can still function well. Internal sanctions (e.g., feelings of guilt) can motivate directors to act in the best interests of shareholders and the corporation in settings when opportunism would otherwise be difficult to prevent. In addition, positive motivations can also cause directors to meet the requirements of their duties. As Professor Peter Huang suggests, a fiduciary’s sense of pride in doing his or her duty might also motivate desired conduct.<sup>243</sup>

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<sup>237</sup> See Blair & Stout, *supra* note 20, at 1754-57.

<sup>238</sup> For an agency cost analysis of fiduciary duties grounded in contractual principles, see Easterbrook & Fischel, *supra* note 169, at 425-28. For a helpful analysis of team production concerns, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 265-76 (1999). Additional efficiency-based accounts also indicate the desirability of fiduciary duties. See, e.g., Smith, *supra* note 24 (offering theory of fiduciary duties based on property rights theory of firm).

<sup>239</sup> This Article focuses on directors, but obviously similar concerns apply to corporate officers. The Delaware Supreme Court has recently clarified that officers have identical fiduciary duties to directors. See *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009).

<sup>240</sup> See Blair & Stout, *supra* note 20, at 1747-50, 1789-95 (discussing limitations on both legal sanctions and market sanctions).

<sup>241</sup> *Id.* at 1795.

<sup>242</sup> *Id.* at 1795-96.

<sup>243</sup> See Peter H. Huang, *Trust, Guilt, and Securities Regulation*, 151 U. PA. L. REV. 1059, 1089 (2003) (noting, in broker-dealer context, that “[p]ride from not breaching a duty of loyalty clearly is a positive utility or a benefit in assessing social welfare”).

Given appropriate incentives, directors may comply with fiduciary duties in the absence of significant liability risk. Of course, the trick is finding a way to encourage such outcomes. Internal sanctions might be sporadic, or weak. Norms of director conduct may be hard to modify. There is cause, however, to think that the new loyalty duties will produce more efficient director conduct through a process of internalization. The expressive aspects of corporate law can plausibly facilitate fiduciary behavior in this setting.<sup>244</sup>

Dishonesty toward shareholders, violations of law, and broken commitments can all have harmful effects on desirable forms of trust. The first section below explains why trust is significant in the corporate governance domain. The second section indicates why the new loyalty duties may bring about a level of trust that benefits the firm and its shareholders. This analysis focuses on social norms and internal sanctions as a means to attain compliance with the new understanding of loyalty. Finally, the third section will discuss the role for external sanctions as an additional basis for director compliance.

### 1. The Importance of Trust for Corporate Governance

An important function of loyal behavior is that it enables the various participants in a corporate endeavor to trust one another, thus limiting transaction costs. This result can be quite significant. Indeed, trust is often considered vital to the functioning of a successful corporation. It is useful to review why this is so.

Trust itself has a variety of definitions. Blair and Stout have provided a helpful definition of trust, with three basic features:

First, trust involves at least two actors — the actor who trusts and the actor who is trusted. Second, the trusting actor must deliberately make herself vulnerable to the trusted actor in circumstances in which the trusted actor could benefit from taking advantage of the trusting actor's vulnerability. Third, the trusting actor must make herself vulnerable in the belief or expectation that the trusted actor will in fact behave "trustworthily" — that is, refrain from exploiting the trusting actor's vulnerability.<sup>245</sup>

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<sup>244</sup> For a recent analysis of directors' duties in terms of their expressive function, see Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 *STAN. J.L. BUS. & FIN.* 224, 261-79 (2007).

<sup>245</sup> Blair & Stout, *supra* note 20, at 1746. For purposes of discussion, this Article uses the above definition.



In Blair and Stout's view, this type of trust is crucial to the efficient functioning of the corporate firm.<sup>246</sup>

Trust among corporate actors enables transactions to occur more cheaply, lowers monitoring costs and limits the need to resort to litigation. As Blair and Stout suggest:

Trust permits transactions to go forward on the basis of a handshake rather than a complex formal contract; it reduces the need to expend resources on constant monitoring of employees and business partners; and it avoids the uncertainty and expense associated with trying to enforce formal and informal agreements in the courts. Trust behavior also reduces losses from others' undetectable or unpunishable opportunistic behavior, losses that could discourage the formation of valuable agency and team production relationships in the first place.<sup>247</sup>

These benefits are clearly valuable, assuming they can be attained.

Moreover, trust is particularly important for public corporations. Informal social norms can provide a valuable form of social capital.<sup>248</sup> In appropriate circumstances, these norms are capable of generating trust between investors and corporate managers. As Professor Jonathan Macey has recently emphasized, this outcome is especially significant for corporate governance of public corporations "because of the vague, almost wholly unspecified nature of the relationship between shareholders and the companies in which they invest."<sup>249</sup> Due to limitations on law and contracts as enforcement mechanisms in this setting, shareholders' "relationships with the firms in which they invest [are] necessarily characterized by high levels of trust."<sup>250</sup>

Social norms that include a large "radius of trust" — i.e., trust of others beyond one's immediate family and close friends — may enable the development of successful public corporations in a way that contracts and law alone cannot. According to Macey:

Unless the shareholders of a corporation are thought by managers to be within this radius of trust, the managers will

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<sup>246</sup> See *id.* at 1757 (listing various benefits of trust within corporate context).

<sup>247</sup> *Id.*

<sup>248</sup> See JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 40 (2008) (citing Francis Fukuyama, *Social Capital and Civil Society*, paper presented at the International Monetary Fund Conference on Second Generation Reforms (Oct. 1, 1999)).

<sup>249</sup> *Id.*

<sup>250</sup> *Id.*

feel no obligation to maximize the value of the firm on the shareholders' behalf. Worse, such managers will steal from shareholders to the extent that they think that they can get away with it. Recognizing that they are outside this "radius of trust," rational investors inevitably respond by declining to invest in companies run by such managers.<sup>251</sup>

Thus, a degree of trust can be a vital component to financing a large publicly held corporation.

The problem of trust in corporate law is admittedly quite complex. A lack of trust is not the only difficulty a corporation might face. Too much trust can be undesirable. In some cases, for example, directors might overtrust officers, or shareholders might overtrust directors.<sup>252</sup> Overly confident investors may deeply regret their willingness to believe a corporation's assurances that it is performing well.

In addition, there are multiple aspects to trusting behavior. Trust can take an affective form (based on one person's feeling of faith in another), and it can also take a cognitive form (based on calculated strategy).<sup>253</sup> A decrease in affective trust does not necessarily mean a decrease in cognitive trust.<sup>254</sup> Some trust is a conscious choice, while other trust stems from subconscious mechanisms.<sup>255</sup> Empirical data also suggests that individuals can trust others selectively — trusting them with respect to one set of choices while distrusting them with respect to another set of choices.<sup>256</sup>

These complexities suggest a need for caution before seeking to increase trust as a general matter. Ultimately, the policy concern is not whether trust of some sort is desirable, but how to optimize trusting behavior in the context of corporate relationships.<sup>257</sup> Given the size of that problem, this Article will not seek to determine exactly how much trust, and of what kind, is optimal for corporate actors and investors to have. Solving that intricate problem exceeds the scope of the

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<sup>251</sup> *Id.* at 41-42.

<sup>252</sup> See Hill & O'Hara, *supra* note 232, at 1785-86 (suggesting director overtrust of officers accounted for recent corporate scandals).

<sup>253</sup> See Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457, 1464-68 (2005) (distinguishing between affective and cognitive trust).

<sup>254</sup> Cf. *id.* at 1500 (suggesting that law could crowd out *affective* trust, although questioning likelihood of that outcome).

<sup>255</sup> See Hill & O'Hara, *supra* note 232, at 1740-44.

<sup>256</sup> See *id.* at 1733 (citing Roy J. Lewicki et al., *Trust and Distrust: New Relationships and Realities*, 23 ACAD. MGMT. REV. 438 (1998)).

<sup>257</sup> See *id.* at 1720 ("[A]lthough there are situations where legal policy should work to either maximize or minimize interpersonal trust, in general, the law should seek to optimize interpersonal trust.").

present endeavor. Instead, the focus will be on incremental improvements in corporate law.

At the least, basic restrictions on self-dealing transactions seem necessary if trust is to provide the efficiency benefits that Macey, and Blair and Stout, describe.<sup>258</sup> The new loyalty duties can offer similar benefits by further defining acceptable types of board conduct. As will be developed below, it is reasonable to predict that a mandate of honest and law-abiding board behavior will contribute desirably to efficient levels of trust even if the business judgment rule is left unchanged.

## 2. The Expressive Function of the New Loyalty

Why would the *specific* conception of loyalty analyzed in this Article offer benefits? The import of trust suggests an answer. If Macey, and Blair and Stout, are correct, then the role of trust within the corporate relationship is vital to the success of individual corporations.<sup>259</sup> The specific conception of loyalty adopted in Delaware's recent cases may assist in the development of desirable forms of trust between corporate directors and shareholders.

A conception of loyalty that requires that the fiduciary refrain from lying to shareholders, lawbreaking, or related forms of misconduct (even if undertaken in a subjective belief these acts will benefit the corporation or its shareholders) plausibly increases the likelihood that trust will be a part of the fiduciary relationship.<sup>260</sup> It is certainly possible to trust someone who lies to you under limited circumstances, but lying or breaking of commitments often damage

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<sup>258</sup> It should be noted that the importance of loyal behavior does not inherently support a claim for greater regulation of loyalty. Regulation might "crowd out" certain forms of trust. See Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 580-82 (2001). On the other hand, there is debate as to the likelihood that law will have this effect. See generally Cross, *supra* note 253 (suggesting that law is not necessarily antagonistic to trust).

<sup>259</sup> See Blair & Stout, *supra* note 20.

<sup>260</sup> It should be noted that one of the primary targets of Blair and Stout's article is the contractarian view of fiduciary duties. See *id.* at 1786 (endorsing anticontractarian view). I have doubts that Blair and Stout are correct in their view that the importance of trust supports rejection of a contractarian approach. Cf. Cross, *supra* note 253, at 1502 (suggesting that contracts may clarify each party's responsibilities in fiduciary relationship, thus increasing trust); Ribstein, *supra* note 258, at 566-67 (suggesting that mandatory fiduciary duties might decrease trust). This question is left open for present purposes, however. Whether or not fiduciary duties are best understood as contractual gap-fillers, a particular choice of legal content for the duty of loyalty could ultimately improve the degree of trust subsisting among corporate actors.

trust. This damage can occur even if the lies or broken commitments were intended to benefit the party whom they affected.

Common intuitions suggest that the conduct regulated by the new concept of loyalty (such as lying to shareholders) poses risks to trust. Recent experimental evidence suggests that some of the conduct prohibited by Delaware's new conception of loyalty could be especially harmful to a trusting relationship.<sup>261</sup> Research has found that trust can be gradually restored after untrustworthy behavior, when the untrustworthy behavior is followed by trustworthy acts, an apology, and a promise not to repeat the untrustworthy behavior.<sup>262</sup> However, when deception accompanies the untrustworthy behavior, trust can be more difficult to restore.<sup>263</sup>

The expressive content of Delaware's fiduciary duties may play a role in limiting the risk of hard-to-restore, damaged trust by limiting deceptive behavior. For example, the legal framing of fiduciary duties can affect the way fiduciary parties perceive their own actions.<sup>264</sup> As Blair and Stout note:

Judicial opinions unambiguously communicate that directors are fiduciaries and that fiduciary relationships call for trustworthy (loyal and careful) behavior. Corporate directors internalize this norm when they respond to the social signal by adopting the other-regarding preference function that is the hallmark of trust-based relationships.<sup>265</sup>

Even if directors do not take legal pronouncements as direct guidance regarding appropriate conduct, the law may change moral perceptions indirectly, by changing publicly exhibited behavior in a way that causes individuals to perceive a normative consensus among

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<sup>261</sup> Arguable exceptions would be cases involving intentional acts which exceed the board's authority — such as *Blasius* — which might be said to implicate deception, but not as obviously as, for example, undisclosed option backdating. Several of the leading post-*Stone* cases, however, involve a concern with deception of one form or another.

<sup>262</sup> See Maurice E. Schweitzer et al., *Promises and Lies: Restoring Violated Trust*, 101 ORG. BEHAV. & HUM. DECISION PROCESSES 1, 17 (2006); cf. Peter H. Huang, *How Do Securities Laws Influence Affect, Happiness, & Trust?*, 3 J. BUS. & TECH. L. 257, 273 (2008) (noting this study, and contending that future research should focus on how emotions such as anxiety or frustration influence trust and its recovery).

<sup>263</sup> See Schweitzer et al., *supra* note 262.

<sup>264</sup> See Blair & Stout, *supra* note 20, at 1796 (suggesting that “[c]orporate case law . . . can encourage corporate participants to internalize norms of cooperation through social framing”).

<sup>265</sup> *Id.*

their colleagues.<sup>266</sup> Director behavior in compliance with the courts' understanding of fiduciary duties (even seeming compliance) suggests a group consensus. In turn, a perception that honesty towards shareholders is an understood feature of good corporate conduct — among one's colleagues and among directors at other firms — may encourage individual directors to act honestly and internalize the norm of doing so.<sup>267</sup>

Legal sanctions will not always succeed in convincing directors or officers to meet the terms of their fiduciary duties, especially given the opacity of corporate decisionmaking.<sup>268</sup> Internal sanctions, however, may work quite well even where external sanctions are hard to enforce reliably.<sup>269</sup> The questions are: what will cause fiduciary duties to be internalized in general, and what will cause the new understanding of loyalty to be internalized in particular? If judicial efforts in this sphere are successful, the expressive features of the law may assist in producing voluntary compliance with the new refinements to fiduciary duty.

As noted above, there are culturally established conceptions of loyalty that read the nonbetrayal aspect of loyalty expansively. Some directors may already consider it disloyal to lie to or manipulate shareholders, even for the shareholders' own financial good. The fact that many individuals also feel morally constrained to follow the law, to avoid lying, and to keep their commitments provides added reason to think that a loyalty obligation that dovetails with these moral intuitions is capable of being internalized.<sup>270</sup> While directors

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<sup>266</sup> See Kenworthy Bilz & Janice Nadler, *Law, Psychology & Morality*, in *MORAL COGNITION AND DECISION MAKING* 21-22 (D. Medin et al. eds., 2009), available at <http://ssrn.com/abstract=1155104> (explaining how "[r]ather than (just) working directly to change behaviors and attitudes, the law is able to work via more subtle psychological processes, to shape perceptions of morality — even for those citizens who would not take the state of the law alone as authoritative guidance for their moral beliefs").

<sup>267</sup> Cf. Blair & Stout, *supra* note 20, at 1796 (noting that "individuals' decisions to adopt either a competitive or a cooperative mode of behavior are often determined by their perceptions of others' expectations, likely behaviors, and relationships with themselves").

<sup>268</sup> See *id.* at 1740 ("[M]arkets and law work best when the situation is transparent and opportunistic behavior can be detected and punished. *Trust can work even when the situation is opaque.*").

<sup>269</sup> See *id.* at 1757 (suggesting that "[w]here trust can be harnessed, it can substantially reduce the inefficiencies associated with both agency and team production relationships," and providing supporting examples).

<sup>270</sup> This is not to say that the moral answer regarding a topic like lying is a matter of consensus. Prominent moral philosophers disagree as to when, if ever, lying is an acceptable act. See, e.g., Christine M. Korsgaard, *Two Arguments Against Lying*, in *CREATING THE KINGDOM OF ENDS* 335 (1996) (comparing Immanuel Kant's views and

conceivably might flout the new version of loyalty, this is not an obvious instance of a legal doctrine that would produce a backlash or otherwise encourage legal noncompliance.<sup>271</sup>

On the other hand, there is still room to question whether the Delaware courts are giving expression to a loyalty norm that will be internalized by corporate directors.<sup>272</sup> The answer is not clear. Judicial efforts to encourage adoption of a norm will not necessarily succeed. Existing social norms are often quite difficult to change.<sup>273</sup> If corporate directors perceive loyalty as a duty that sometimes requires them to lie to shareholders, or sometimes requires them to break the law, they may be resistant to judicial language that seeks to impose a different understanding.<sup>274</sup> Even if a large number of directors agree with the Delaware courts, the courts' language might be unpersuasive to the remainder. Indeed, one might doubt that a director who is willing to break the law as a means of advancing his or her corporation's interests would be susceptible to the moral rhetoric of a legal opinion.<sup>275</sup>

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Henry Sidgwick's views on morality of lying).

<sup>271</sup> On the subject of legal doctrine which results in less compliance, see Janice Nadler, *Flouting the Law*, 83 TEX. L. REV. 1399, 1407-26 (2005) (providing evidence indicating that, in some cases, specific instances of perceived injustice in legal system can lead to diminished deference to unrelated laws).

<sup>272</sup> One concern, expressed by Professor Larry Ribstein, is that a sufficiently expansive understanding of fiduciary duty could be counterproductive. As he suggests:

[L]awmakers must carefully choose the conduct they stigmatize. The law may be ineffective if it tries to develop a norm that is too far removed from existing perceptions of good behavior. Courts squander their moral authority by condemning conduct that people widely regard as being in the ordinary course of business. Thus, applying the fiduciary characterization to ordinary contract breaches may cause parties to act according to contract, rather than fiduciary, norms.

Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 237.

<sup>273</sup> See Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943, 997 (1995) ("The very same influences that induce an action according to a social norm also induce resistance to efforts to change a social norm." (italics omitted)).

<sup>274</sup> It would be unsurprising if a significant number of directors did feel this way. Given that several leading scholars take this view of what loyalty should require, it is plausible that some directors would feel similarly. A group norm in this regard might be more powerful than a general societal norm. See Richard H. McAdams, *The Origin, Regulation, and Development of Norms*, 96 MICH. L. REV. 338, 389 (1997) [hereinafter McAdams, *The Origin*] (noting that "group norms are frequently much stronger than societal norms").

<sup>275</sup> Cf. Alex Geisinger, *A Group Identity Theory of Social Norms and Its Implications*, 78 TUL. L. REV. 605, 649-50 (2004) ("Shaming sanctions are . . . by their nature, aimed

Notwithstanding these caveats, there are several reasons to think that the Delaware courts could have a positive effect on the social norm of loyalty as applied to corporate boards, and, indirectly, on directors' internalization of the new loyalty duties. For one, the Delaware courts may create a new focal point, or shift an existing focal point, through their judicial opinions. This outcome may alter director conduct even where individual directors would otherwise be disinclined to adopt the courts' preferred understanding of loyalty.

A focal point is a salient solution to a coordination problem.<sup>276</sup> When it is not feasible to agree on a specific solution around which to coordinate, individuals will often select the solution that stands out from other options.<sup>277</sup> As Professor Richard McAdams has suggested, "When individuals have a common interest in coordinating, as frequently occurs, a legal rule may guide behavior merely by influencing expectations about how others will behave."<sup>278</sup>

Judicial opinions are well-suited for the creation of focal points. Judicial opinions are public, and they offer a unique answer to disputes — private litigants do not generally receive multiple answers regarding the same dispute.<sup>279</sup> People often view courts as legitimate authorities,<sup>280</sup> and in many cases courts have a reputation for providing well-reasoned answers.<sup>281</sup> In addition, recent empirical research suggests that judicial production of focal points is capable of affecting the behavior of regulated parties.<sup>282</sup> Even individuals who

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at the wrong people. They will have the least deterrent effect on the greatest norm violators and the greatest effect on the individuals who least contribute to a loss of social welfare."); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1103 (1997) (noting how some individuals may not be constrained by possibility of going "down in history as a villain of Delaware corporate law").

<sup>276</sup> See Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1659-60 (2000) (describing focal point concept).

<sup>277</sup> As a classic example, when people are unsure where and when they are to meet someone in New York City without a prior arrangement, large numbers select noon at Grand Central Station. See *id.* at 1660.

<sup>278</sup> *Id.* at 1651.

<sup>279</sup> See *id.* at 1668-72.

<sup>280</sup> See *id.* at 1671.

<sup>281</sup> See *id.* at 1671-72.

<sup>282</sup> See Richard H. McAdams & Janice Nadler, *Coordinating in the Shadow of the Law: Two Contextualized Tests of the Focal Point Theory of Legal Compliance*, 42 LAW & SOC'Y REV. 865, 868 (2008), available at <http://ssrn.com/abstract=1016488> (finding based on experimental evidence that people are "more likely to indicate a willingness to obey law in those precise circumstances where the [focal point] theory predicts a focal effect than in circumstances where the theory predicts no focal effect").

disagree over how best to resolve a dispute may find it in their interests to comply with a salient solution.<sup>283</sup>

Given a general concept like the concept of loyalty, directors must reach a decision as to what specific meaning loyalty should have. There are several salient understandings of loyalty available.<sup>284</sup> In this setting, the expressive function of judicial opinions can be significant. Directors may be influenced by judicial opinions to choose the meaning of loyalty that those opinions express, given the presumed expectations of shareholders and other parties that this is the type of loyalty that directors will provide.

Once such a norm has developed, it may then be adopted by individuals belonging to a group that follows that norm. For example, people may conform their own judgments to the judgments they perceive among others with whom they identify.<sup>285</sup> A social norm adopted because it is a useful focal point for director conduct may subsequently result in an internalized understanding that there is an obligation to comply.

Norms may also be internalized for additional reasons. Often, people internalize an abstract norm prior to the acceptance of a specific conception of that norm.<sup>286</sup> Directors may have internalized a general loyalty norm long ago (a reasonable assumption) without yet internalizing the version of loyalty the Delaware courts have developed in *Disney V* and *Stone*.<sup>287</sup> Recent decisions that develop the meaning of loyalty post-*Stone* could then facilitate internalization of a particular kind of loyalty. As McAdams indicates, “Narrow, concrete norms based solely on esteem — which are not internalized — often define the meaning of a specific behavior by defining that behavior as

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<sup>283</sup> See Bilz & Nadler, *supra* note 266, at 23 (citing McAdams & Nadler, *supra* note 282).

<sup>284</sup> For example, there are the minimal, anti-self-dealing conception; the affirmative devotion conception; and also the more recent nonbetrayal conception adopted by the Delaware courts.

<sup>285</sup> See Bilz & Nadler, *supra* note 266, at 19-20 (describing this possibility).

<sup>286</sup> See McAdams, *The Origin*, *supra* note 274, at 383 (“The point here is one of timing: If internalization occurs at all, it is likely to occur first at the abstract level and only later at a concrete level.”).

<sup>287</sup> The Delaware courts, in other words, may be seen as clarifying a more general, pre-existing duty of loyalty. This parallels the manner in which legislative changes to Delaware corporate law are often made. See Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1776 (2006) (noting that “when amendments are made, the legislative synopses accompanying those amendments often describe them as clarifications rather than as changes in the law”).



complying with or violating an internalized abstract norm.”<sup>288</sup> Over time, directors may internalize the more precise loyalty norm now expressed by the Delaware courts as well.

Notably, judicial decisions can shape norms in light of what they signal about an existing social consensus.<sup>289</sup> Legislatures commonly adopt laws after the moral understanding of society already contains the principles that are to be incorporated into legal doctrine.<sup>290</sup> Judicial opinions frequently follow the same pattern. To the extent the Delaware case law is recognized as representative of norms within corporate culture, it may signal a group consensus.<sup>291</sup> The opinions of Delaware judges plausibly reflect the shared norms of corporate directors and officers, influential shareholders, and Delaware corporate lawyers.<sup>292</sup>

Moreover, the recent expansion of loyalty may change the social meaning of a dissenting director's conduct in a way that alters director

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<sup>288</sup> McAdams, *The Origin*, *supra* note 274, at 383.

<sup>289</sup> See *id.* at 388; see also Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339, 340 (2000) [hereinafter McAdams, *An Attitudinal Theory*] (suggesting that “law changes behavior by signaling the underlying attitudes of a community or society”); *id.* at 378 (“The point is not that judges seek to satisfy popular attitudes in every opinion — the contrary seems obvious — but that on average their opinions may reflect the attitudes of the society from which the judge is drawn, and in which the judicial rules must operate.”).

<sup>290</sup> See McAdams, *An Attitudinal Theory*, *supra* note 289, at 358-69 (describing how legislation can signal public opinion).

<sup>291</sup> See Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1696 (2001) (noting that “with judges typically drawn from the Delaware corporate bar, or, when not, rather quickly socialized by those who were, they occupy an odd sort of insider/outsider position”); see also Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 15 (2003) (assessing claim that “judicial opinions influence the behavior of directors as ‘moral beings’ by ‘express[ing] community ideals’ about their proper deportment and role” (quoting William T. Allen, *The Corporate Directors' Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in *COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH* 307, 328 (Klaus J. Hopt et al. eds., 1998))); cf. Rock, *supra* note 275, at 1102 (noting that “a substantial number of the judges [in Delaware] are drawn from the very world at issue, that is, they are experienced and respected practitioners of Delaware corporate law”).

<sup>292</sup> Along similar lines, Professors Edward Rock and Michael Wachter contend that the Delaware judges are “in the position of having at least some credibility to influence [nonlegally enforceable rules and standards], especially in publicly held corporations, through criticism unaccompanied by legal sanction.” See Rock & Wachter, *supra* note 291, at 1696. For additional support, see Hill & McDonnell, *Stone v. Ritter*, *supra* note 4, at 1795 (describing “rush to abide by ‘Caremark duties’ after the case was decided”).

behavior.<sup>293</sup> The behavior alterations enabled by such a change in social meaning could, in turn, affect the expectations and understandings of directors and shareholders regarding the type of conduct that a loyal director will provide. Gradually, the alterations in behavior that a change in social meaning permits may then produce changes in the social norms that govern director conduct.

For example, for some boards a shareholder wealth-maximizing violation of a positive law might be understood as loyal conduct, with loyalty counting as a more important end than legal compliance within the social group to which the directors belong.<sup>294</sup> A director who did not like the idea of violating this positive law might be reluctant to voice opposition. A change in social meaning could make this dissent acceptable.<sup>295</sup>

Among such directors, the social meaning of a director's opposition to such wealth-maximizing violations of positive law would become ambiguous if public expectations regarding loyal behavior were to shift, or at least become uncertain.<sup>296</sup> A director's apparent motives for a dissenting vote would change. Voting "no" could be couched in loyalty terms. A dissenting director might then feel free to vote against violating the positive law as an expression of fidelity to her corporation's shareholders.<sup>297</sup>

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<sup>293</sup> For a seminal article on the power of law to change social meanings, see generally Lessig, *supra* note 273.

<sup>294</sup> That this is plausible is evidenced by the scholarly literature supporting a theory of an "efficient breach" of a statute. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1157 (1982) ("Some antitrust violations are efficient, just as some breaches of contract are efficient.").

<sup>295</sup> For example, laws rendering the act of dueling illegal were largely ineffective, but adding a sanction that linked dueling to forfeiture of the right to hold public office was potentially effective. See Lessig, *supra* note 273, at 970-72. The public office sanction had the potential effect of changing the social meaning of an individual's refusal to duel in such a way that it encouraged legal compliance.

<sup>296</sup> This would be an example of "ambiguation" of the social meaning at issue. See Lessig, *supra* note 273, at 1010-12 (describing manner in which law can ambiguate social meaning of behavior). Note that a similar process could unfold in cases involving lies to shareholders, or other types of broken commitments. A director might be reluctant to vote against a shareholder wealth maximizing lie to shareholders on the grounds that such lies are immoral, but willing to dissent if the vote could also be couched in loyalty terms.

<sup>297</sup> In turn, this potential change in director behavior might reinforce the social norms encouraged by Delaware courts. See Bilz & Nadler, *supra* note 266, at 25-26 (discussing examples of laws that produce changes in social meaning with effect of initially altering behavior, and which can then result in subsequent changes in moral beliefs).

Each of the above possibilities, separately or in combination, may alter director choices. Even if many directors' pre-existing understandings of loyalty are distinct from the conception presented in *Stone* and related cases, there are reasons to anticipate that Delaware's adjustments to the fiduciary duty of loyalty will affect the social norms that govern director conduct. A shift in these social norms, moreover, could plausibly result in internalization of the new loyalty duties, with resulting internal sanctions when there is noncompliance. And, to the extent increased numbers of directors do comply with the current judicial conception of loyalty, this is likely to produce a more efficient level of trust among corporate directors, officers, shareholders, and creditors.

### 3. The Effects of Liability Risk and Reputation Costs

In addition, the role of external sanctions is still important. Liability risk may be small given the business judgment rule, but, at least as to severe cases, it may deter director misconduct.<sup>298</sup> In addition to this liability risk, there is also the risk of legal embarrassment. Directors are reputation-conscious individuals, and operate in a world where the costs of harm to reputation can be substantial.<sup>299</sup> In some instances, such as the *Disney* cases, litigation has not resulted in liability for defendant directors, but has resulted in severe reprimands from the courts.<sup>300</sup> Delaware judicial opinions may thus produce trust-enhancing board behavior due to the perception that sufficiently egregious conduct will result in directors being publicly disparaged in court decisions.

Corporate law opinions have a tendency to resemble morality tales, with clearly denoted good and bad actors. In part, this narrative structure may be designed to guide future conduct.<sup>301</sup> However,

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<sup>298</sup> Were there no liability risk, it is an interesting question whether desirable social norms would develop (or be preserved). Cf. Lisa Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 443-49 (2005) (suggesting interdependence between legal and extra-legal forces in corporate law).

<sup>299</sup> See David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1832-35 (2001) (analyzing individual corporate managers' susceptibility to shaming sanctions).

<sup>300</sup> See *Disney IV*, 907 A.2d 693, 762-63 (Del. Ch. 2005) (critiquing conduct of Michael Eisner as it related to issues in the Disney litigation).

<sup>301</sup> Indeed, Delaware judges have explicitly noted this possible effect of their decisions. See, e.g., *id.* at 698 (noting possibility that "the Opinion may serve as guidance for future officers and directors — not only of The Walt Disney Company, but of other Delaware corporations").

scholars have also observed the potentially powerful shaming effects of corporate opinions,<sup>302</sup> and Delaware judges have publicly taken note of this scholarship.<sup>303</sup> The recent adjustments to the duty of loyalty serve to guide law abiding directors; in the process, they may also enable a more forceful use of the courts' rhetorical arsenal.<sup>304</sup>

The requirement that directors be true in their dealings with shareholders and the corporation — i.e., that they avoid dishonesty, manipulation, and broken commitments — fits in well with the instrumental use of moral narratives in Delaware judicial opinions. As Professor Edward Rock has elaborated, the narrative features of corporate law opinions play a prominent part in regulating corporate activities. These opinions, with their heavy emphasis on the good and bad behavior of corporate managers, serve an important guidance function that supplements the enforcement of corporate standards of conduct.<sup>305</sup>

The “sermonizing” qualities of fiduciary duty cases assist well-meaning directors, but they also serve to shame malfeasant

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<sup>302</sup> See, e.g., Skeel, *supra* note 299, at 1854-55 (noting that Delaware courts can shame directors even where they do not impose liability). For a recent example, see Sandeep Gopalan, *Shame Sanctions and Excessive CEO Pay*, 32 DEL. J. CORP. L. 757, 767 (2007).

<sup>303</sup> *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 948 (Del. 2003) (Steele, J., dissenting) (citing Professor David Skeel's scholarship on shaming in corporate law).

<sup>304</sup> Arguably, the selection of a form of loyalty that looks askance at lying, manipulation, and intentional violation of positive law is also helpful in Delaware's efforts to retain its dominant position as a provider of corporate law. As Rock notes, the moral rhetoric in Delaware judicial opinions may have more than one motivation. See Rock, *supra* note 275, at 1105 (noting role of political considerations). Sean Griffith, likewise, has argued that the duty of good faith serves a rhetorical function that helps preserve Delaware's regulatory role. See Griffith, *supra* note 4, at 8. These suggestions are plausible. Indeed, even in fields not known for political overtones, such as intellectual property, there is evidence to suggest that what courts decide may be influenced by a judge's political leanings. See, e.g., Matthew Sag et al., *Ideology and Exceptionalism in Intellectual Property: An Empirical Study*, 97 CAL. L. REV. 801 (2009) (finding that outcomes of Supreme Court intellectual property cases are influenced by ideology of justices). It would not be surprising if political considerations affected corporate jurisprudence.

<sup>305</sup> See generally Rock, *supra* note 275 (analyzing how narrative structure of Delaware corporate law opinions serves guidance function). Note that Rock's theory differs in an important respect from Blair and Stout's theory. Rock emphasizes the shaming aspect of judicial opinions — i.e., external sanctions. Blair and Stout emphasize the internal sanctions which can result when an individual is committed to his or her fiduciary obligations. See Blair & Stout, *supra* note 20, at 1795-97 (discussing this distinction).

directors.<sup>306</sup> Even if one questions whether shaming is desirable as a general punitive practice,<sup>307</sup> the nature of Delaware legal opinions in their current form is such that a judicial finding of a fiduciary breach (or a strongly-worded critique in cases of nonliability) can have a substantial reputational effect. Whether intended as shaming or as guidance, the condemnatory language in these legal opinions may be valuable for the impact it has on intra-firm relations. The deterrent of a loss to reputation may significantly increase the likelihood of trustworthy director conduct.<sup>308</sup>

The behavior involved in breaking an agreement with shareholders, or in intentionally violating positive law, is already covered by existing legal guidelines. Nonetheless, a mere finding of technical legal violations may not carry sufficient weight, especially in a world which recognizes the ideas of efficient breach (and, perhaps, efficient noncompliance with the law).<sup>309</sup> A legal opinion that chastises a director for failing to keep a commitment, or for leading the

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<sup>306</sup> See also Eisenberg, *Corporate Law*, *supra* note 94, at 1276 (noting that social norm of loyalty “adds the sanction of loss of reputation to legal sanctions”). See generally Skeel, *supra* note 299 (discussing shaming in corporate law).

<sup>307</sup> Much of the literature on shaming has focused on the criminal law setting. For a helpful discussion of the policy implications of shaming sanctions in that context, see generally Dan M. Kahan, *What do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591 (1996). Such sanctions have become the subject of a lengthy scholarly literature, with both proponents and detractors. See, e.g., Dan M. Kahan, *What's Really Wrong with Shaming Sanctions*, 84 TEX. L. REV. 2075 (2006) (suggesting shaming sanctions have social meaning handicap); Dan Markel, *Are Shaming Punishments Beautifully Retributive? Retributivism and the Implications for the Alternative Sanctions Debate*, 54 VAND. L. REV. 2157 (2001) (suggesting shaming sanctions run afoul of certain liberal virtues); Toni M. Massaro, *Shame, Culture, and American Criminal Law*, 89 MICH. L. REV. 1880 (1991) (suggesting various difficulties with shaming sanctions). For extended analysis in the corporate law context, see generally Skeel, *supra* note 299.

<sup>308</sup> Some have expressed concerns that shaming is normatively undesirable, or unequal in its application. There is also a risk that shaming sanctions will overdeter. See Skeel, *supra* note 299, at 1832-35 (discussing risk of chilling effect on director conduct due to shaming sanctions). This concern is linked to the business judgment rule concerns assessed above. See *supra* notes 189-192 and accompanying text. Assuming that liability is limited to the egregious case (and in predictable fashion), the concern is less likely to be significant with respect to the types of claims at issue in this Article.

<sup>309</sup> It also may be that, absent Delaware's recent refinements to fiduciary duty, the shareholder wealth maximizing norm creates pressure on directors to act contrary to social welfare in contexts where individual investors would not have made that choice if they controlled the firm. Cf. Elhauge, *supra* note 180, at 761 (suggesting that fiduciary duty not to violate law “counters the incentive to engage in excessive illegality otherwise created by accountability to shareholders who lack incentives to fully consider social and moral sanctions”).

corporation astray from positive law, is different in kind from a legal opinion that characterizes that director's behavior as disloyal. The loss to reputation in the latter case could be substantially more severe.

If legal opinions are more costly to directors when the duty of loyalty is implicated, then reputation-based sanctions post-*Stone* could be an important additional component in judicial efforts to support an efficient level (or type) of trust among constituents of the corporate firm. Directors who are not inclined to internalize Delaware's new understanding of loyalty might pause before risking the reputational consequences of violating that standard of conduct. And, if behavior is sufficiently constrained by reputation costs, the internalization of Delaware's new loyalty conception might eventually follow.

Finally, it is possible that the judicial language in cases which do not involve the new loyalty — e.g., traditional self-dealing cases — would be more effective at inducing compliance if Delaware courts have signaled their intolerance of intentional law-breaking and dishonesty toward shareholders. This concern goes to the law's moral credibility, in terms of public perceptions.

By more closely aligning Delaware statements on loyalty with socially established moral understandings, Delaware statements regarding loyalty in general may have a greater impact. This outcome is uncertain, in part because loyalty and morality can have distinct content.<sup>310</sup> Yet an increased impact from judicial opinions is also plausible. Cases that condemn law-breaking or dishonesty while precluding liability for breach of fiduciary duties may be publicly perceived as showing inadequate concern regarding conduct commonly viewed as unacceptable.<sup>311</sup> That perception, in turn, could undercut compliance.

#### D. Summary

A shift from three independent fiduciary duties down to two can greatly simplify the content of fiduciary doctrine. The key is how to

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<sup>310</sup> See, e.g., FLETCHER, *supra* note 143, at 13-16 (drawing distinction between duties of loyalty and those of "impartial morality").

<sup>311</sup> Cf. Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 131 (2006) (suggesting that "[w]hen courts assert that conduct is morally questionable, yet legally permissible, they convey a mixed message that enables directors to conclude reasonably that the conduct in question was not that bad"). Delaware's recent loyalty cases may also better align the apparent aims of Delaware law and federal securities law. For a recent analysis of how Delaware's law on disclosure dovetails with federal securities regulation, see Robert B. Thompson, *Delaware's Disclosure: Moving the Line of Federal-State Corporate Regulation*, 2009 U. ILL. L. REV. 167, 180-89 (2009).

interpret the duty of good faith once it is seen as a part of loyalty. An easily recognized morality or virtue-based understanding of loyalty duties may cut down on information costs for directors who seek to comply with their fiduciary obligations, and for parties who seek to coordinate their actions in light of these legal standards. The accessibility of the new loyalty conception — the idea of being true within the fiduciary relationship — makes it easier for interested parties to determine what an otherwise vague legal standard will require in specific cases.

It is also reasonable to anticipate that the recent Delaware decisions will facilitate the creation and continued existence of an efficient level of trust for corporate firms. Delaware judicial opinions that express a particular conception of loyalty may provide a focal point for coordination, signal social consensus (or consensus within corporate culture), and cause a shift in social norms that govern corporate conduct. Internalization may plausibly follow. In addition, a convergence of loyalty mandates with existing moral mandates respecting honesty and compliance with positive law may reinforce the credibility of Delaware judicial opinions. In turn, this may facilitate the use of judicial opinions as an external sanction on director misconduct.

Ultimately, it is too soon to state with confidence how the new loyalty will impact board conduct. The potential for deterring desirable risk-taking by corporate boards, and also for judicial error, should not be ignored. For these reasons, it is a strength of Delaware law that the recent evolution of good faith duties has not significantly altered the courts' longstanding deference for substantive business decisions. Should the courts continue to maintain a cautious stance on enforcement — without undue incursion on the business judgment rule — there is a real possibility that Delaware's new conception of loyalty will offer benefits that outweigh its costs.

#### CONCLUSION

In light of its novelty, the problem of disloyal directors who ostensibly intend to benefit their shareholders and corporation has received little attention in corporate law scholarship. However, it is a feature of Delaware law that is increasingly salient. Corporate scandals have drawn significant public attention over the past few years. It matters whether corporate law views lying to shareholders, or intentional violations of positive law, as a form of disloyalty.

Delaware law has shifted from a jurisprudence that primarily recognized loyalty claims in cases where there were financial conflicts

of interest to one that expressly permits good faith claims where directors show a lack of affirmative devotion to their beneficiaries. In the last three years, the legal landscape changed more dramatically. Following *Stone v. Ritter*, the fiduciary duty of good faith was absorbed by the duty of loyalty. Recent precedents now suggest that unconflicted directors may be charged with disloyalty in cases where they are sincerely motivated to benefit shareholders and the corporation.

As a result of these developments, the content of fiduciary duties is in need of a viable explanation. Fortunately, the new loyalty cases show a discernible pattern. Directors are disloyal when they lie to shareholders. They are disloyal when they violate a corporate charter, as occurs when they intentionally break the law. They are disloyal when they breach an agreement with their shareholders. Each of these cases involves a type of dishonesty or broken commitment. The difficulty is that none of these cases fit the common view that an unconflicted director is loyal if she intends her actions to benefit the shareholders or the corporation.

This Article explains what these new fiduciary cases signify. Whether the director conduct involves lying, intentional violations of positive law, or broken commitments to shareholders, each of these recent decisions involves a new strand of loyalty violation. Loyalty can mean more than avoiding self-dealing, and it can mean more than affirmative devotion by the loyal actor. Drawing on extralegal understandings of loyalty, it is clear that the nonbetrayal aspect of loyalty may require a type of respect towards a beneficiary. From this perspective, lying, violating law, and breaking commitments are each a form of betrayal. Once we adopt this broad nonbetrayal norm, the recent loyalty cases make sense.

A major benefit of this conception of loyalty is the doctrinal simplicity it allows. Three independent fiduciary duties — care, loyalty, and good faith — made for a confusing mix. A truly independent good faith duty was frustratingly unclear in scope. By bringing the fiduciary duty of good faith within the duty of loyalty, the available meanings for good faith are constrained by the idea of loyalty. It might appear that loyalty would then become uncertain in meaning, as the various bad faith cases are transformed into disloyalty cases. However, the concept of loyalty is capacious enough to withstand this expansion. If one sees the loyalty duty in terms of nonbetrayal values, the new fiduciary duty of loyalty is both coherent and confined.

If this Article correctly captures the conception of loyalty now immanent in Delaware law, then the concern that Delaware has



adopted an open-ended, overly indeterminate fiduciary duty can hopefully be laid to rest. The duty might evolve further in less efficient directions, but under the present approach, it need not do so. The existing conception of loyalty is reasonably determinate for a case-specific legal standard. It is also accessible, given that it borrows an easily recognizable nonlegal idea of loyalty obligations: the idea of being true.

The recent case law may also offer real improvements over prior doctrine. Limiting information costs is a substantial benefit. Increased compliance with fiduciary and other legal duties is a major potential gain. Delaware judicial opinions are known for their story-like narrative approach, and the new duty of loyalty fits well with this approach. Assuming that actual liability is rare, the possibility of sanctions may serve a valuable expressive function. Moreover, a greater convergence between fiduciary duties and commonly held moral understandings is likely to increase the impact of external sanctions when they do apply.

Until the courts settle into a stable pattern in applying the expanded loyalty duty, the long term effects of the recent case law will remain uncertain. The duty of loyalty might continue to evolve, or cycle between broad and narrow versions.<sup>312</sup> Much rests on the preservation of a rigorous business judgment rule. Yet the current formulation is coherent and reasonably predictable. It is a notable adjustment to director standards of conduct — it may also be a positive development for corporate law.

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<sup>312</sup> On the tendency of Delaware law to cycle between different interpretations of legal doctrine, see David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 137-54 (1997).