Caroline Bradley
Business Associations
Additional Material for October 29-November 2 2007

Note that in the decision in the **Disney case** referred to in the Casebook on pages 354-5, Chancellor Chandler also addressed the issue of how to think about good faith (and lack of good faith) in the context of DGCL §102(b)(7). He said:

...an action taken with the intent to harm the corporation is a disloyal act in bad faith... It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation. Bad faith can be the result of "any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation," including greed, "hatred, lust, envy, revenge, …shame or pride." Sloth could certainly be an appropriate addition to that incomplete list if it constitutes a systematic or sustained shirking of duty. Ignorance, in and of itself, probably does not belong on the list, but ignorance attributable to any of the moral failings previously listed could constitute bad faith.

It is unclear, based upon existing jurisprudence, whether motive is a necessary element for a successful claim that a director has acted in bad faith, and, if so, whether that motive must be shown explicitly or whether it can be inferred from the directors' conduct. Shrouded in the fog of this hazy jurisprudence, the defendants' motion to dismiss this action was denied because I concluded that the complaint, together with all reasonable inferences drawn from the well-plead allegations contained therein, could be held to state a non-exculpated breach of fiduciary duty claim, insofar as it alleged that Disney's directors "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision." Upon long and careful consideration, I am of the opinion that the concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.

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. The presumption of the business judgment rule creates a presumption that a director acted in good faith. In order to overcome that presumption, a plaintiff must prove an act of bad faith by a preponderance of the evidence. To create a definitive and categorical definition of the universe of acts that would constitute bad faith would be difficult, if not impossible. And it would misconceive how, in my judgment, the concept of good faith operates in our common law of corporations. Fundamentally, the duties traditionally analyzed as belonging to corporate fiduciaries, loyalty and care, are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary. The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the

corporation and its shareholders. 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 applicable 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. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient…

The Delaware Supreme Court upheld the Chancery Court's decision. On the issue of bad faith, the Delaware Supreme Court said:

...as a matter of simple logic, at least three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label.
The first category involves so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm. That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic....
The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent... we address the issue of whether gross negligence (including a failure to inform one's self of available material facts), without more, can also constitute bad faith. The answer is clearly no.
...in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.
...To adopt a definition of bad faith that would cause a violation of the duty of care automatically to become an act or omission "not in good faith," would eviscerate the protections accorded to directors by the General Assembly's adoption of Section 102(b)(7)....
That leaves the third category of fiduciary conduct, which falls in between the first two categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from gross negligence. This third category is what the Chancellor's definition of bad faith—intentional dereliction of duty, a conscious disregard for one's responsibilities—is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, nonindemnifiable violation of the fiduciary duty to act in good faith. In our view it must be, for at least two reasons.
First, the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is

more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.
Second, the legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence. Section 102(b)(7)(ii) of the DGCL expressly denies money damage exculpation for “acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.” By its very terms that provision distinguishes between “intentional misconduct” and a “knowing violation of law” (both examples of subjective bad faith) on the one hand, and “acts…not in good faith,” on the other. Because the statute exculpates directors only for conduct amounting to gross negligence, the statutory denial of exculpation for “acts…not in good faith” must encompass the intermediate category of misconduct captured by the Chancellor’s definition of bad faith.
For these reasons, we uphold the Court of Chancery’s definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith.

Another recent decision you should be aware of is the judgment of the Delaware Supreme Court in **Stone v Ritter**. The Plaintiff shareholders had sought to bring a derivative suit after the company, a Delaware corporation which owned a bank, was subjected (together with the bank) to $50 million of fines and civil penalties for failures to file suspicious activity reports (required to control money laundering). The Chancery Court had held that demand was required: although it was “beyond question that AmSouth’s internal controls with respect to the Bank Secrecy Act and antimoney laundering regulations compliance were inadequate” there was no basis to excuse demand.

The Delaware Supreme Court took the opportunity to make some statements clarifying directors’ duties under Caremark:

...The phraseology used in Caremark and that we employ here— describing the lack of good faith as a “necessary condition to liability”—is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith “is a subsidiary element[,]” i.e., a condition, “of the fundamental duty of loyalty.” It follows 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.
This view of a failure to act in good faith results in two additional doctrinal consequences. First, although 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. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in Guttman, "[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."
We hold that Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith...

In this case there was a compliance system which was not effective. On one hand the case does not suggest that the Caremark duties are especially demanding. But on the other hand, if those duties are aspects of the duty of loyalty rather than care, DGCL s 102(b)(7) would not exclude liability in damages.

We will come back to the relationship between the duty of care and duty of loyalty issues after we have discussed the duty of loyalty. But meanwhile, consider this case, **Roberts v. Financial Technology Ventures, L.P**, decided last week in the Middle District of Tennessee, where the court dealt with an attempt by Roberts, a CEO of a corporation (Verus) to enforce a contract with a prospective acquiror of his corporation (FTV) which would give him a financial payment for supporting the acquisition. The court refused to enforce the contract as an illegal contract because it breached the CEO's fiduciary duties. The court said:

...Under his own admissions, the plaintiff extracted a payment from another shareholder in exchange for supporting, as CEO, an action that he otherwise did not think was in the best interest of the shareholders. If the court were to find that the action was, in fact, in the best interest of the shareholders, that would mean that the plaintiff extracted a payment from another shareholder by threatening not to support an advantageous corporate action. In either event, the plaintiff breached his duty of loyalty by entering into this agreement....

Violation of Caremark duties can justify demand excusal. Consider, e.g., **In re SFBC International**, where the District Court in New Jersey (SFBC moved from Miami to New Jersey in 2006) said:

...The Court finds that Plaintiffs have adequately pled a disabling personal interest of a majority of the directors who sat on the board on the date this suit was filed. The Complaint contains particularized factual allegations showing that the Demand Directors faced a substantial risk of personal liability for their inattention to PDG's allegedly improper business and clinical testing practices. The wrongdoing detailed in the Complaint paints a picture of the kind of sustained and systematic failure of the board to exercise oversight over the company's operations that state a claim for breach of fiduciary duty involving bad faith. The primary business of PDG - drug trials involving human beings as test subjects - were routinely conducted in an egregiously unethical manner, compromising the data on products that could eventually reach the public and, more immediately, putting the safety of the participants at risk. The Complaint also describes a practice of preying on groups particularly vulnerable to PDG's financial inducements to participate in drug trials without protest regarding the conditions of treatment. As alleged, the violations are not isolated or rare occurrences. The Complaint avers that this was PDG's operating procedure, indeed, that it was the approach that enabled the company to secure and perform contracts for large drug trials...

The Complaint, however, alleges endemic mismanagement of the company, raising plenty of red flags concerning the improper and even possibly illegal practices in which the company was engaged. Plaintiffs allege with particularity the multiple test procedure violations detected by the FDA and the citations issued by the FDA against PDG. They detail abuses of the tests' human participants and deliberate falsification of test data, including a compensation structure for test subjects that discouraged the reporting of adverse effects. The Complaint also describes overcrowded and unsanitary conditions at PDG's principal Miami testing facility, located at the company's headquarters, with over 80 citations issued! Indeed, the Miami facility was ultimately condemned by the building department. IRBs with conflicts of interest were selected to monitor the trials. Moreover, the alleged misconduct related to the core of PDG's business. PDG primarily engaged in the business of conducting clinical trials. The wrongful conduct alleged involved many critical aspects of the way in which PDG conducted clinical trials, including the treatment of people participating in the trials, overcrowded and unsanitary conditions at the testing facility located at the corporate headquarters, falsification and manipulation of the reporting of test results, and hiring conflicted IRBs to oversee the trials. This was not merely decentralized activity by employees of a far-flung enterprise of the company, as was the case in Caremark. The PDG directors certainly should have known about the company's performance of its core business, and assuming the truth of Plaintiffs' allegations, about the particularly reprehensible manner in which it was done. Under these circumstances, the Court finds that the Complaint avers sufficient obvious signs of wrongdoing to support the allegation that the Demand Directors knew or should have known that they were not fulfilling their obligations by failing to take action in response to the company's widespread problems. In short, the Complaint contains "the kind of fact pleading that is critical to a Caremark claim," meaning that it shows the directors were conscious of the fact that they were not doing their jobs....