How to Be Good: the Emphasis on Corporate Director's Good Faith in the Post-Enron Era

Thomas Rivers
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I. IN THE WAKE OF CORPORATE SCANDAL

The "irrational exuberance"\(^1\) of the late 1990s, marked by frenzied stock trading and risky investment strategies,\(^2\) fueled aggressive accounting practices that exaggerated real achievements and camouflaged setbacks.\(^3\) During that time, investors accepted business practices that measured performance by revenue, rather than earnings or cash, and by the number of "eyeballs hitting Internet sites."\(^4\) According to Federal Reserve Chairman Alan Greenspan, "when greed swept through our nation, we were not prepared to address it."\(^5\) The result was accounting scandals at Enron, WorldCom and other organizations, in which directors failed to ask "questions of management to determine whether the stock was rising solely as a result of smoke and mirrors."\(^6\) In 2002, Congress responded to these scandals with the Sarbanes-Oxley Act, which modified governance, reporting and disclosure rules for public companies.\(^7\)

Beyond the federal legislative response, these corporate scandals occasioned a new judicial and regulatory focus on directors' good faith performance of their corporate responsibilities. This trend has been evident in recent state and federal court decisions addressing directors' fiduciary duty of good faith and the business judgment rule.\(^8\) Most notably, in the 2003 decision *In re The Walt Disney Co.*

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2. *Id.*


4. *Id.* at 927.


6. E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, 38 WAKE FOREST L. REV. 839, 840 (2003). Such was the case according to the Thornburgh Report on WorldCom, which revealed that WorldCom's directors allowed the senior officers to manage to the market instead of a solid, strategic business plan that the directors developed and monitored. *Id.* The Powers Report on Enron differed, but also pointed to fundamental flaws in corporate governance. *Id.*


8. The business judgment rule is a corporate director's strongest defense against shareholder lawsuits. See John Gibeaut, *Stock Responses*, A.B.A. J., Sept. 2003, at 38 (stating that the business judgment rule is a "venerable bludgeon that has whacked countless... derivative lawsuits").
Derivative Litigation, a Delaware chancery court declined to apply the business judgment rule in a derivative action where the court found that the company's directors failed to exercise any judgment in their decision making.9 According to one commentator, the court's decision raised concerns among many corporate directors about their own personal liability when making decisions on behalf of their corporations, and "serves as a warning to corporate directors that state courts are now willing to allow plaintiffs to prove that directors who fail to exercise due care in carrying out their fiduciary duties should be liable to the shareholders of the corporation, even without the suggestion of self-dealing."10 The Disney case seems to have been well-received by the Delaware Supreme Court,11 suggesting that this approach will influence other jurisdictions.12

In the regulatory context, the Securities and Exchange Commission (SEC) has recently displayed a "willingness to pursue cases against outside directors who [are] reckless in their oversight of management and asleep at the switch . . . ."13 Specifically, in SEC v. Adley, the SEC brought its first charges ever against an outside director who allowed securities fraud to occur under his watch.14 The Adley action may signal a new regulatory emphasis on directors' good faith performance of their duties and, as a result, directors may face increased liability exposure.

Corporate directors' concern for the continued viability of the business judgment rule15 underscores the importance of understanding the current status of the law. Part II of this Note surveys the development of directors' fiduciary duties and the business judgment rule in Delaware and details the SEC's initiative

12. The Delaware Supreme Court is frequently followed by other state courts in the area of corporate law. WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 1.17 (7th ed. 2004).
14. See SEC Sues Former Top Officers, Directors and Auditors of Chancellor Corporation for Financial Fraud, Accounting and Auditing Enforcement Release No. 1763, 80 S.E.C. Docket 130, 130-31 (Apr. 24, 2003) [hereinafter SEC Sues Former Top Officers] (charging an outside director with securities fraud for "ignoring clear warnings signs that financial improprieties were ongoing at the company" and for "failing to ensure that the company's public filings were accurate").
15. See Marsh, supra note 10, at 14 (stating that "[w]ith the increased number of derivative actions against directors for breach of fiduciary duty, corporate directors now realize that the business judgment rule no longer stands as an impenetrable shield against personal liability").
targeting directors. Part III gauges the extent to which recent case law and regulatory action signal a change in the application of the business judgment rule or signal expanded regulatory liability for directors. Part IV provides practical guidance to corporate practitioners, who may counsel outside directors, about procedural failures that may expose directors to liability and steps those directors can take to minimize their exposure. Part V considers the policy implications of stricter directorial liability and offers suggestions for courts and the SEC to proceed in this area.

II. BACKGROUND ON DIRECTORS’ LIABILITY: CASE LAW AND REGULATORY ACTION

A. Delaware’s Business Judgment Rule

In the Disney case, the central issue was whether to apply the business judgment rule to the board of directors. \(^{16}\) Under Delaware law, the business judgment rule is a presumption that in making a business decision, corporate directors “acted on an informed basis, in good faith and in the honest belief” that their action was in the best interests of the corporation. \(^{17}\) Thus, directors’ decisions are protected from judicial second-guessing “unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.” \(^{18}\)

This rule rests upon assumptions that “[managers and directors possess] skills, information and judgment not possessed by reviewing courts” and that “there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information . . . .” \(^{19}\) The business judgment rule gives directors considerable freedom to make decisions

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17. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), partially overruled by Brehm v. Eisner, 746 A.2d 244, 253-54 (Del. 2000) (noting that Aronson “suggest[s] this Court will review under a deferential abuse of discretion standard a decision of the Court of Chancery on a Rule 23.1 motion to dismiss a derivative suit” but finding that “our scope of review must be de novo”, and as a result, “[t]o the extent that Aronson and its progeny contain dicta expressing or suggesting an abuse of discretion scope of review, that language is overruled.”).

18. Brehm, 746 A.2d at 264 n.66.

without fear of personal liability, but the rule is not absolute and understanding its exceptions is crucial to applying the rule properly.\textsuperscript{20}

1. The Triad of Fiduciary Duties

The Delaware Supreme Court recognizes three distinct fiduciary duties owed by corporate directors: care, loyalty, and good faith.\textsuperscript{21} Traditionally, the duties of care and loyalty received more attention from courts and academics than the duty of good faith.\textsuperscript{22} In fact, at least one Delaware jurist doubts whether the duty of good faith exists separate and apart from the duty of loyalty.\textsuperscript{23} In \textit{Emerald Partners v. Berlin}, however, Delaware explicitly recognized good faith as a distinct and equally important part of the "triad" of directors' fiduciary duties.\textsuperscript{24} This distinction is important because a freestanding duty of good faith can apply to situations that do not implicate a director's duty of loyalty.\textsuperscript{25}

2. Breach of the Duty of Good Faith

Delaware case law gives various formulations to the good faith requirement in the business judgment rule,\textsuperscript{26} but the general effect is to allow a court to "review the substance of a business decision made by an \textit{apparently} well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."\textsuperscript{27} In \textit{Parnes v. Bally Entertainment Corp.}, the Delaware Supreme Court allowed shareholders to proceed with a class action challenging the good faith of the board of directors'
approval of a merger.\textsuperscript{28} In that case, the company’s CEO allegedly conditioned his approval of the merger upon his receipt of bribes from any would-be acquirors.\textsuperscript{29} For their part, the company’s directors allegedly breached their fiduciary duties by “acquiescing in [the CEO’s] self-interested negotiations and by approving a merger at an unfair price.”\textsuperscript{30} The court concluded that the complaint alleged facts that were “inexplicable on any ground other than bad faith.”\textsuperscript{31} If, as the shareholders claimed, the CEO negotiated the merger by demanding a bribe, then it was “inexplicable that independent directors, acting in good faith, could approve the deal.”\textsuperscript{32} \textit{Parnes} shows that, in practice as well as in theory, irrationality may support a finding of bad faith without additional evidence of self-dealing or a lack of due care.

The Delaware Supreme Court has stated clearly that the good faith requirement does not allow for the substantive review of directors’ decisions short of a determination of irrationality.\textsuperscript{33} According to the court in \textit{Brehm v. Eisner}, “[c]ourts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context.”\textsuperscript{34} Yet, there is perhaps a fine line between reviewing the rationality of a director’s decision and reviewing its substance. In \textit{Gimbel v. Signal Companies}, a court of chancery considered a shareholder’s challenge to a company’s sale of assets, where the shareholder sought an injunction against the transaction based on the inadequacy of the sale price.\textsuperscript{35} The court afforded the company’s directors a presumption of good faith,\textsuperscript{36} but stated that the plaintiff might dispel the protections of the business judgment rule by proving that “price fixed for the sale of [the
company's] assets was so clearly inadequate as constructively to carry the badge of fraud."\(^{37}\)

The *Gimbel* court arguably reviewed the substance of the directors' sale price, despite the lack of evidence suggesting self-dealing\(^ {38} \) or failure to exercise due care.\(^ {39} \) According to the court, "the ultimate question is not one of method but one of value" and "a dollar result which appears perhaps to be shocking is significant."\(^ {40} \) This language illustrates that while there may be no "substantive due care" concept in the business judgment rule,\(^ {41} \) there are substantive limits to what a court will view as a good faith decision.

In evaluating good faith, the irrationality standard also contemplates some degree of procedural review of directorial decision making. In 1997's *Scattered Corporation v. Chicago Stock Exchange, Inc.*, the Delaware Supreme Court considered various procedural steps in its good faith analysis.\(^ {42} \) The case involved a derivative suit by members of the Chicago Stock Exchange alleging that officers and directors of the Exchange had approved or at least passively permitted systemic corruption.\(^ {43} \) At issue in the case was the board of directors' decision not to act on the plaintiffs' pre-suit demand.\(^ {44} \) According to the court, in assessing whether the directors wrongfully refused the plaintiff's demand, the court looks only to good faith and the reasonableness of the directors' investigation.\(^ {45} \) The court then considered the chancery court's analysis of the good faith and reasonableness of the directors' investigation, which focused on procedure.\(^ {46} \) On the basis of what it found to be adequate process, the

\(^{37} \) Id. at 609 (quoting Marks v. Wolfson, 188 A.2d 680, 685 (Del. Ch. 1963)) (internal quotations omitted).

\(^{38} \) Id. at 610 ("[T]he Court can find no indication of self-dealing on the part of the Board of Directors such as would taint the proposed transaction or neutralize the effect of the business judgment rule.").

\(^{39} \) Id. at 615 ("When considered in light of the whole case, [the facts] do not in themselves justify the conclusion that the 'directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment.'" (quoting Mitchell v. Highland-W. Glass Co., 167 A. 831, 833 (Del. Ch. 1933))).

\(^{40} \) Id.

\(^{41} \) Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

\(^{42} \) 701 A.2d 70, 76-77 (Del. 1997).

\(^{43} \) Id. at 71.

\(^{44} \) Id. at 72, 74-77.

\(^{45} \) Id. at 75.

\(^{46} \) Id. at 76. Specifically, the Court of Chancery looked at:

(a) the creation of [a] Special Committee; (b) the fact that it interviewed 25 people as well as other people the plaintiffs had suggested would corroborate their claims of wrongful conduct; (c) the findings by the Special Committee that claims made in the demand were unsubstantiated; and (d) the conclusion by the Executive Committee, after 'careful
The chancery court held that "the [directors'] decision was the product of a valid exercise of business judgment." The Delaware Supreme Court affirmed the chancery court's decision under these facts.

The Scattered Corp. decision illustrates that the good faith standard can include procedural review. This approach makes sense intuitively. If directors' bad faith may be indicated by irrationality, then one might reasonably expect a court to consider whether directors followed some type of rational decision-making process in arriving at a challenged decision. For example, one might imagine a decision-making process so inadequate (e.g., totally lacking any effort to investigate or consider the issue) that no reasonable person could conclude that the directors acted in good faith. Although Scattered Corp. did not involve such an extreme example, the subsequent Disney decision shows that such poor decision making does not exist only in the abstract. For a more comprehensive understanding of the modern interplay between the duty of good faith and procedural review, it is necessary to review the duty of care.

3. Breach of the Duty of Care

Procedural review is the central focus of the duty of care analysis. The duty requires directors to act on an informed basis. In modern jurisprudence, the duty of care is integral to the application of the business judgment rule, but that has not always been the case. At one time, courts were reluctant to hold directors liable for uninformed decisions, absent some indication of self-dealing, bad faith, or illegality. The Delaware Supreme Court's landmark 1985
decision in *Smith v. Van Gorkom*, which held directors liable for an uninformed decision even without self-dealing or bad faith, gave new significance to the duty of care.\(^{55}\) In fact, *Van Gorkom* precipitated a swift legislative response which amended the Delaware General Corporation Law "to allow for an optional charter provision to exculpate directors for violations of the duty of due care."\(^{56}\) These now-common exculpatory provisions have tempered the practical effect of the duty of care; as one commentator observed, "[t]oday, the duty of care serves as only a very weak constraint on director conduct and is spoken of in unusually shrunken terms."\(^{57}\) Yet duty of care procedural standards reemerged in post-Enron cases like *Disney* as a means of holding directors liable.

Unlike most states, Delaware has not enacted a statute to specify the degree of care required from a corporate director,\(^{58}\) but the Delaware Supreme Court stated in 1963's *Graham v. Allis-Chalmers Manufacturing Co.* that "directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."\(^{59}\) A court will not find a board of directors to have breached its duty of care unless the directors failed to inform themselves fully and in a deliberate manner before voting on a significant transaction.\(^{60}\)

The *Graham* decision also addressed a director's duty to monitor company employees for signs of wrongdoing. In that case, a shareholder derivative action to recover damages for antitrust violations,\(^{61}\) the court considered the defendant directors' failure to

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55. *Van Gorkom*, 488 A.2d at 893; BRODSKY & ADAMSKI, supra note 20, § 2:11.
56. Sale, supra note 5, at 466.
59. 188 A.2d 125, 130 (Del. 1963).
60. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 368 (Del. 1993). If the court finds that a board of directors breached its duty of care, the board "lose[s] the protection of the business judgment rule" and the court must "scrutinize the challenged transaction under an entire fairness standard of review." *Id.*
61. The indictments against the Allis-Chalmers company and its four non-director defendants alleged that the company and the defendants "conspired with other manufacturers
maintain internal control systems. The plaintiffs claimed that the directors were liable by reason of their failure to take action designed to learn of and prevent antitrust activity by any company employee. The court concluded that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." The court addressed in dicta the circumstances in which a director could be personally liable for losses incurred by a corporation due to neglect, but determined that the directors could not be liable where, as soon as the misconduct became evident, the board acted promptly to end it and prevent its recurrence.

The Graham decision's "reasonable director" standard gave guidance to directors about Delaware courts' expectations for them, but uncertainties remained as to the degree of negligence that would result in a breach of the duty of care. In 1984's Aronson v. Lewis, the Delaware Supreme Court considered the standard of care for corporate directors in informing themselves of reasonably available material information prior to decision making. Although Delaware case law was imprecise in "articulating the standard by which the exercise of business judgment is governed," the court concluded that director liability requires gross negligence. In addition, the court noted that "the business judgment rule operates only in the context of


62. Id. at 130-31.
63. Id. at 127.
64. Id. at 130.
65. See id. ("If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.").
66. Id. In this case, the directors had reason to suspect antitrust violations in November 1959, when some of the company's employees were subpoenaed before a grand jury. Id. at 128. In February 1960, the directors commenced a series of meetings with employees, "[t]he purpose and effect of [which] was to eliminate any possibility of further and future violations of the anti-trust laws." Id. at 129.
68. See Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984) ("[T]he Delaware cases have not been precise in articulating the standard by which the exercise of business judgment is governed . . .."), overruled in part by Brehm v. Eisner, 746 A.2d 244 (Del. 2000); see infra Part II.A.4.
69. Id. at 812.
70. Id.; see supra note 69.
GOOD FAITH IN THE POST-ENRON ERA

Where directors have either abdicated their functions or failed to act without making a conscious decision, the business judgment rule is inapplicable. In 1985’s Smith v. Van Gorkom, the Delaware Supreme Court refused to apply the business judgment rule where the defendant directors failed to reach an informed business judgment in voting to sell their company in a cash-out merger. After just a two-hour meeting, the directors approved the merger agreement based solely upon a twenty-minute presentation by the CEO, supporting representations by the company’s officers and an attorney, and their own knowledge of “the market history of the company’s stock.” The directors did not discover the methodology used by the CEO to value the company, and it was unclear whether they were given an opportunity to study the merger agreement before voting on it. Under these circumstances, the court found that the directors did not reach an informed business judgment in voting to sell the company’s shares. According to the court, the business judgment rule offers no protection to directors who make “unintelligent or unadvised judgment[s].”

The court also distinguished the duty of care and duty of loyalty components of the business judgment rule, stating that the “duty to exercise an informed business judgment is in the nature of a duty care, as distinguished from a duty of loyalty.” This language gave notice that the court was prepared to enforce directors’ duty of care as a distinct element of the business judgment rule and that liability was not predicated upon an accompanying finding of self-dealing or bad faith. As the court stated, “fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud.”

As mentioned previously, the legislature amended the Delaware General Corporation Law immediately after Van Gorkom to

71. Id. at 813.
72. Id. “[A] conscious decision to refrain from acting” may be protected by the business judgment rule. Id.
73. 488 A.2d 858, 893 (Del. 1985).
74. Id. at 869.
75. Id. at 868 n.7.
76. Id. at 874. Specifically, “the directors (1) did not adequately inform themselves as to [the CEO’s] role in forcing the ‘sale’ of the [c]ompany and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the [c]ompany”; and therefore (3) were, “at a minimum,... grossly negligent in approving the ‘sale’ of the [c]ompany [after cursory consideration] without prior notice, and without the exigency of a crisis or emergency.” Id.
77. Id. at 872 (quoting Mitchell v. Highland-Western Glass, 167 A. 831, 833 (1933)).
78. Id. at 872-73.
79. Id. at 872.
allow exculpatory charter provisions for violations of the duty of care. The amendment allowed directors to propose that such a charter provision be added or removed. Shareholders have the final say on the proposal, but once an exculpatory provision is in place, it cannot be removed unless the board of directors chooses to put the issue back on the ballot. The Delaware judiciary has limited the reach of these exculpatory provisions by holding that the provisions apply as affirmative defenses only to due care allegations that are not intertwined with other alleged fiduciary breaches, such as those involving good faith. This limitation was particularly important in Disney and other later cases that explored the relationship between good faith and procedure.

More than thirty years after the Graham decision, Delaware jurisprudence revisited the question of whether directors could be liable for failing to monitor company employees for signs of wrongdoing. In the 1996 case In re Caremark International Inc. Derivative Litigation, Delaware’s Chancellor Allen considered a derivative suit claiming that the defendant directors breached their “duty of care ... in connection with alleged violations by [company] employees of federal and state laws and regulations applicable to health care providers.” The company’s employees had a practice of entering into contracts for services with physicians, at least some of whom prescribed or recommended services or products that the company provided. These contracts raised the possibility of unlawful “kickbacks,” and two officers subsequently faced federal indictments for violations of the Anti-Referral Payments Law. In their complaint against the directors, the shareholders alleged that they “allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance.”

The chancellor considered the two contexts in which directors may be personally liable for a breach of the duty to exercise appropriate attention: (1) where a board decision results in a loss because that decision was ill-advised or negligent; and (2) where a loss

80. Sale, supra note 5, at 466.
81. Id.
82. Id.
83. Id. at 467.
84. See discussion infra Parts II.A.4, II.B.
85. 698 A.2d 959, 960 (Del. Ch. 1996).
86. Id. at 962.
87. Id. at 962, 964.
88. Id. at 967.
arises from an unconsidered failure of the board to act in circumstances in which due attention arguably would have prevented the loss. Under the latter context, the chancellor addressed the significance of the *Graham* decision, interpreting it to mean that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf." The chancellor eschewed a broader rule that corporate directors might satisfy their obligation of being reasonably informed without ensuring that information and reporting systems existed in the corporation. Chancellor Allen held instead that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists" and that a failure to do so could render a director liable for non-compliance.

With regard to the type of oversight failure that might trigger a fiduciary breach, the chancellor clarified that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." This language suggested that if directors' duties had been broadened since *Graham* to include some type of monitoring requirement, directors at least could take comfort in knowing that their monitoring efforts would not be subjected to strict judicial scrutiny. As Chancellor Allen noted, "the level of detail that is appropriate for such an information system is a question of business judgment." The chancellor conceded that "no rationally designed information and reporting system will remove the possibility that . . . directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law." The chancellor then concluded that the defendant directors were not guilty of a sustained failure to exercise their oversight

89. *Id.* (emphasis omitted). In the second situation, director liability for inattention results not from a decision but from unconsidered inaction. *Id.* at 968. Most decisions made by a corporation, however, are "not the subject of director attention." *Id.* Only "the most significant corporate acts or transactions, [such as] mergers, changes in capital structure, fundamental changes in business, and appointment and compensation of the CEO" require board authorization. *Id.* 89

90. *Id.* at 969.
91. *Id.* at 970.
92. *Id.*
93. *Id.* at 971.
94. *Id.* at 970.
95. *Id.*
function and that the corporation’s information systems appeared to represent a good faith attempt to be informed of the relevant facts.  

In Caremark, Chancellor Allen presented an analytical framework that would reappear in Disney and other cases: he addressed the directors’ procedural violations in terms of their good faith. Although the plaintiff shareholders alleged a breach of the duty of care, the chancellor’s analysis focused on whether the directors’ actions established “the lack of good faith that is a necessary condition to liability.” This approach foretold developments in Delaware and other states following Enron.

4. Post-Enron: Disney’s “We Don’t Care About the Risks” Attitude

From 1963’s Graham to 1996’s Caremark, Delaware case law reflects an evolving judicial perception of a director’s fiduciary duties. Examples include the Van Gorkom court’s recognition of the duty of care as a standalone, functional element of the business judgment rule and Chancellor Allen’s interpretation in Caremark that directors’ duty of care requires a good faith effort to maintain some type of employee monitoring system. In the post-Enron era, Delaware’s most recent jurisprudential evolution in this area has been an increased emphasis on the duty of good faith. This approach is manifest in the recent Disney litigation.

In 2000’s Brehm v. Eisner, the Delaware Supreme Court addressed Disney shareholders’ allegation that their board of directors’ approval of an overly-generous employment contract for the company’s president, Michael Ovitz, was not protected by the business judgment rule. The complaint against Disney set out various claims that the directors breached their fiduciary duties to the company, including a waste claim based on calculations that Ovitz’ severance

96. Id. at 971.
97. See id. at 971-72 (noting that the plaintiff's claims were weak because there was no evidence “that the defendants either lacked good faith in the exercise of their monitoring responsibilities or conscientiously permitted a known violation of law by the corporation to occur”).
98. Id. at 960.
99. Id. at 971.
100. 746 A.2d 244, 248 (Del. 2000).
101. Specifically, the plaintiffs alleged that (1) the Disney board of directors “breached its fiduciary duty in approving an extravagant and wasteful [e]mployment [a]greement [for] Michael S. Ovitz as president of Disney;” (2) the board of directors “breached its fiduciary duty in agreeing to a ‘non-fault’ termination of the Ovitz’ [e]mployment [a]greement, a decision that was extravagant and wasteful;” and (3) “the directors were not disinterested and independent.” Id. at 248-49.
package was worth over $140 million.\textsuperscript{102} But despite the strikingly lucrative terms of Ovitz’s severance package, the court rejected the waste claim.\textsuperscript{103} According to the court, “the size and structure of executive compensation are inherently matters of judgment.”\textsuperscript{104} The court noted that there were outer limits to executive compensation, but they are confined to “unconscionable cases where directors irrationally squander or give away corporate assets.”\textsuperscript{105}

Moreover, the shareholders’ complaint was a “pastiche of prolix invective” and was “permeated with conclusory allegations of the pleader and quotations from the media, mostly of an editorial nature (even including a cartoon).”\textsuperscript{106} The Supreme Court dismissed the plaintiffs’ complaint for failing to create a reasonable doubt that the board’s decision to approve the employment contract was protected by the business judgment rule.\textsuperscript{107} In dismissing the complaint, however, the court gave the plaintiffs an opportunity to re-plead their case.\textsuperscript{108} As Chief Justice Norman E. Vasey later stated:

\begin{quote}
[T]he complaint was presented in an awful manner. . . . But we felt there could have been something in it. In particular, did Disney’s board act in good faith in agreeing to Mr. Ovitz’s compensation? Although the company had retained an outside expert, that expert later admitted that the board had never looked at what it would cost to buy Mr. Ovitz out. In the end, we said that the shareholder group’s arguments were not good enough to justify setting entirely aside the ruling of the Court of Chancery in favor of the Disney board. We did say, though, that we would be willing to allow the stockholders to file a new pleading.\textsuperscript{109}
\end{quote}

The court expressed concerns that the Disney directors’ processes in approving Ovitz’s employment agreement were “casual, if not sloppy and perfunctory”\textsuperscript{110} and suggested without subtlety several ways that the plaintiffs might plead a valid case.\textsuperscript{111} According to the court, in a due care case where an expert has advised the board in its decision-making process,\textsuperscript{112} the complaint must allege particularized facts (not conclusions) that would show, for example, that (1) the

\begin{thebibliography}{99}
\item \textsuperscript{102} Id. at 253.
\item \textsuperscript{103} Id. at 263-64.
\item \textsuperscript{104} Id. at 263.
\item \textsuperscript{105} Id.
\item \textsuperscript{106} Id. at 249.
\item \textsuperscript{107} Id. at 262.
\item \textsuperscript{108} Id.
\item \textsuperscript{109} What’s Wrong with Executive Compensation?: A Roundtable Moderated by Charles Elson, HARV. BUS. REV., Jan. 2003, at 76 [hereinafter What’s Wrong with Executive Compensation].
\item \textsuperscript{110} Brehm, 746 A.2d at 249.
\item \textsuperscript{111} Id. at 262.
\item \textsuperscript{112} In this case, the directors were advised by an expert and relied upon his expertise in approving the employment contract. Id. at 261.
\end{thebibliography}
directors did not in fact rely on the expert; (2) their reliance was not in good faith; (3) they did not reasonably believe that the expert's advice was within the expert's professional competence; (4) the expert was not selected with reasonable care, and this faulty selection was attributable to the directors; (5) the subject matter that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice; or (6) that the decision of the board constituted waste or fraud.\footnote{113}

In 2003, the Disney shareholders returned to chancery court with an amended complaint alleging that the directors should be held personally liable for a knowing or intentional lack of due care in their decision-making process regarding Ovitz's employment and termination.\footnote{114} This time, Chancellor Chandler denied Disney's motion to dismiss, noting that the plaintiffs' complaint suggested that "the Disney directors failed to exercise any business judgment and failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders."\footnote{115} According to the complaint, Disney's CEO, Michael Eisner, unilaterally made the decision to hire Ovitz and the directors' compensation committee rubber-stamped the employment agreement, where (1) no draft employment agreements were presented to the compensation committee for review before it voted to approve the hiring; (2) the committee met for less than an hour to approve the hiring, and most of the discussion time was spent on other topics; (3) the committee received only a summary of the employment agreement's terms and conditions; and (4) the committee did not question the agreement or review the documents for approval.\footnote{116}

Following the approval of the compensation committee, the board of directors immediately approved the employment agreement under similar circumstances. The board spent very little time discussing the issue during the meeting, during which no presentations made regarding the terms of the draft agreement, and board members made no further inquiries. Additionally, no further review of the employment agreement occurred, even though the agreement was a "work in progress" at the time of its approval.\footnote{117} The final negotiations over the remaining terms in Ovitz's employment agreement took place solely between Eisner, Ovitz, and their

\footnote{113. Id. at 262.} \footnote{114. In re The Walt Disney Co. Derivative Litig., 825 A.2d 275, 278 (Del. Ch. 2003).} \footnote{115. Id.} \footnote{116. Id. at 287.} \footnote{117. Id.}
attorneys. The final version differed substantially from the original draft, but no further committee or board review ever occurred. At no point during the course of negotiations with Ovitz was an expert retained to advise the board, the compensation committee, or Eisner.

Ovitz performed poorly as Disney's president and subsequently asked Eisner for a non-fault termination. Eisner granted this request, which entailed a payout to Ovitz of more than $38 million in cash plus stock options. The shareholders charged the board of directors with an “ostrich-like” approach regarding this non-fault termination. The board apparently never sought to negotiate with Ovitz regarding his departure nor did it consider whether to seek a termination based on fault. The plaintiffs' complaint alleged that the board (1) failed to ask why it had not been informed; (2) failed to inquire about the conditions and terms of the agreement; and (3) failed even to attempt to stop or delay Ovitz's termination until more information could be collected.

The Disney opinion distinguished between (1) the negligent or grossly negligent failure of directors “to inform themselves or to deliberate adequately about an issue of material importance to the corporation”; and (2) a conscious and intentional disregard for their directorial responsibilities, characterized by a “we don’t care about the risks” attitude toward material corporate decisions. According to the chancellor, this latter kind of knowing or deliberate indifference constitutes a “breach of the directors' obligation to act honestly and in good faith in the corporation’s best interests.” Put differently, stated the chancellor, the plaintiffs’ complaint implied that “the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care....” Viewed in this light, the

118. Id.
119. Id.
120. Id. at 288.
121. Id.
122. Id. at 289.
123. Id. at 288.
124. Id. at 289.
125. Id.
126. Id. at 289. According to the court, the facts alleged in the amended complaint suggested that the Disney directors' actions constituted the latter. Id.
127. Id.
128. Id.
directors’ alleged conduct fell outside the protection of the business judgment rule.\textsuperscript{129}

Chancellor Chandler’s finding that the directors breached their duty of good faith was of particular significance because Disney’s exculpatory charter provision protected its directors from personal damages liability for any breach of their duty of care.\textsuperscript{130} As discussed previously, however, under Delaware law Disney cannot exempt its directors from liability for acts or omissions not in good faith.\textsuperscript{131} Because the chancellor framed the issue as one of good faith and not due care, the exculpatory provision did not mandate dismissal of the case.\textsuperscript{132}

B. Other Jurisdictions

Two recent federal circuit court cases that applied Delaware law—\textit{McCall v. Scott}\textsuperscript{133} and \textit{In re Abbott Laboratories Derivative Shareholders Litigation}\textsuperscript{134}—took Disney-like approaches in considering directors’ liability for failing to prevent abusive practices by management. These cases predate the 2003 \textit{Disney} chancery court decision, but present interesting applications of the \textit{Caremark} analysis to directorial nonfeasance in deciding questions of bad faith. Like \textit{Disney}, these cases involved claims that directors consciously disregarded their responsibilities. In effect, these are other instances of the “we don’t care about the risks” attitude decried by Chancellor Chandler in \textit{Disney}.\textsuperscript{135}

1. The Sixth Circuit

In the 2001 decision \textit{McCall v. Scott}, the U.S. Court of Appeals for the Sixth Circuit applied \textit{Caremark} to determine whether a board of directors faced liability for failing to take action with respect to systematic fraud occurring at their healthcare company.\textsuperscript{136} The plaintiff shareholders brought a derivative action alleging that the

\begin{itemize}
  \item \textsuperscript{129} \textit{Id.}
  \item \textsuperscript{130} \textit{Id.} at 286.
  \item \textsuperscript{131} \textit{Id.} (citing \textsc{Del. Code Ann.} tit. 8, § 102(b)(7) (2003)); see also discussion supra Part II.A.3.
  \item \textsuperscript{132} \textit{Disney}, 825 A.2d at 286.
  \item \textsuperscript{133} 239 F.3d 808, 817-24 (6th Cir. 2001), modified by 250 F.3d 997 (6th Cir. 2001) (clarifying the original opinion’s discussion of \textit{Caremark} and the duty of good faith without rehearing).
  \item \textsuperscript{134} 325 F.3d 795, 805-11 (7th Cir. 2003).
  \item \textsuperscript{135} \textit{Disney}, 825 A.2d at 289.
  \item \textsuperscript{136} 239 F.3d at 817-19.
\end{itemize}
company's senior management, "with board knowledge, devised schemes to improperly increase revenues" and "perpetuated a management philosophy that provided strong incentives for employees to commit fraud." 137 Having failed to make a pre-suit demand on their board of directors, the plaintiffs alleged demand futility on the ground that a majority of the directors "had an interest in the wrongdoing or could not exercise independent judgment with respect to the asserted claims." 138 Specifically, the plaintiffs claimed that at least five directors could not have exercised independent judgment due to the likelihood of their liability for breach of their duty of care. 139

The court then considered the question of whether the directors' alleged nonfeasance presented a substantial likelihood of liability for breach of a fiduciary duty, such that there was a reasonable doubt as to the disinterestedness of a majority of the board. 140 The court applied the Caremark analysis to the directors' failure to act, stating that unconsidered inaction can be the basis for director liability. 141 The issue was complicated by the fact that the company's certificate of incorporation, as in the Disney case, included a waiver of liability which exempted the directors from liability for breaches of their duty of care. 142 The defendant directors argued that their ability to exercise independent judgment was not hampered by fear of personal liability for a breach of their duty of care, as the waiver exempted them from such liability. 143 The court conceded that "[w]hen the validity of such a provision is not contested and the

137. Id. at 814.
Fraudulent practices included (1) upcoding by providers, which refers to billing for services . . . for illnesses with a higher degree of complexity and severity than a patient's condition actually warranted; (2) improper cost reporting . . . (3) offering financial incentives to physicians to increase referrals of Medicare patients to [the company's] facilities . . . and (4) acquisition practices that offered inducements to executives of target companies and interfered with existing physician relationships.

Id.

138. Id. at 815.
139. Id. at 817.
140. Id. at 817-24.
141. Id. at 817.
142. Specifically, the waiver stated that:
[a] director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director; provided, however, that the foregoing shall not eliminate or limit the liability of a director (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 law . . . or (iv) for any transaction from which the director derived an improper personal benefit.

Id. at 818 (emphasis in original). In other words, the waiver agreement provided that directors could only be personally liable if their conduct implicated self-dealing or bad faith.

143. Id.
factual basis for the claims implicates only a breach of the duty of care, the waiver may properly be considered and applied in deciding a motion to dismiss for failure to make a pre-suit demand.”

The plaintiffs maintained that their claims were not barred by the waiver agreement because there was an exception for “acts or omissions not in good faith.” The court agreed with the plaintiffs that something less than intentional conduct might signal bad faith, relying upon treatise commentary that “[t]o the extent that recklessness involves a conscious disregard of a known risk, it could be argued that such an approach is not one taken in good faith and thus could not be liability exempted[.]” Also, under the Caremark analysis, “a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish [a] lack of good faith.” The court then engaged in a lengthy discussion of the particularized facts of the case and concluded that those facts were “sufficient to create a reasonable doubt as to the disinterestedness of the board,” where there was “a substantial likelihood of director liability for intentional or reckless breach of the duty of care.”

After its initial decision in McCall, the Sixth Circuit amended its opinion to clarify its reasons for finding an issue as to the directors’ good faith. Discussing Delaware law, the court stated that “Delaware courts do not discuss a breach of the duty of care in terms of a mental state more culpable than gross negligence. Rather, allegations of intentional or reckless director misconduct are more commonly characterized as... a breach of the duty of good faith.” The court concluded, therefore, that while “duty of care claims alleging only grossly negligent conduct are precluded by [an exculpatory charter provision], it appears that duty of care claims based on reckless or intentional misconduct are not.”

144. Id.
145. Id. (quoting the waiver provision).
146. Id. (quoting BALOTTI & FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATION § 4.29, at 4-116 to 4-116.1 (3d ed. Supp. 2000)).
147. Id. at 817 (quoting In re Caremark Intl Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996)).
148. Id. at 819-24.
150. Id. at 1000.
151. Id.
2. The Seventh Circuit

In 2003, the Seventh Circuit applied the Caremark decision in In re Abbott Laboratories Derivative Shareholders Litigation, a shareholders' derivative action that questioned the directors' good faith. The plaintiff shareholders sought to hold the directors personally liable for extensive corporate losses caused by continuing FDA violations. Specifically, the company failed to heed multiple FDA warnings that it was violating regulations in manufacturing various medical diagnostic products. The plaintiffs claimed that the directors were aware of the company's noncompliance problems and that they breached their fiduciary duty by failing "to take necessary action to correct these problems." The Seventh Circuit agreed with the plaintiffs that the directors were not "blamelessly unaware of the conduct leading to corporate liability." Under the company's corporate governance procedures, "information of the FDA violations would have been shared at the board meetings." In addition, plaintiffs alleged that "the directors all signed the annual SEC forms which specifically addressed government regulations of the company's products." The alleged facts implied that the directors were aware of the company's noncompliance problems, and their failure to act was not the product of "unconsidered" inaction.

For the purposes of establishing demand futility, the court then considered whether the directors' decision not to address the company's noncompliance problems fell outside the protections of the business judgment rule. Despite having already concluded that the directors' inaction was not "unconsidered," as was the case in Caremark, the court proceeded to use the Caremark analysis in

152. 325 F.3d 795, 808-809 (7th Cir. 2003).
153. Id. at 801.
154. Id. at 799-801.
155. Id. at 802.
156. Id. at 806 (citation omitted).
157. Id.
158. Id.
159. Id. (citation omitted). In this respect, the Abbott directors differed from those in Caremark, whose liability was "predicated upon ignorance of liability creating activities." Id. at 806 (citation omitted).
160. Plaintiffs failed to make any demand on the company's directors to "institute an action against themselves for breach of their fiduciary duties, stating that such a demand would have been futile." Id. at 802. Under Delaware law, demand futility is established if "the alleged particularized facts raise a reasonable doubt that . . . the challenged transaction was the product of a valid exercise of the directors' business judgment." Id. at 807 (citing Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)).
161. Id. at 807-09.
determining whether the directors' actions established a lack of good faith.\textsuperscript{162} Quoting \textit{Caremark}, the court stated that "a sustained or systematic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to [director] liability."\textsuperscript{163} The court found that the extensive paper trail of FDA warnings implicated a sustained and systematic failure of the board to exercise oversight, where the directors took no steps to prevent or remedy the situation.\textsuperscript{164} Thus, "six years of noncompliance, inspections, . . . Warning Letters, and notice in the press . . . indicate[d] that the directors’ decision to not act was not made in good faith and was contrary to the best interests of the company."\textsuperscript{165}

\textbf{C. SEC Enforcement Action}

In addition to enforcing the reforms wrought by the Sarbanes-Oxley Act, the Securities and Exchange Commission (SEC) has increased its efforts to "punish corporate fraud by pursuing charges against board members who ignore misconduct."\textsuperscript{166} In its April 2003 complaint filed in the pending case of \textit{SEC v. Chancellor Corp.},\textsuperscript{167} the SEC charged an outside director of a corporation with securities fraud for "fail[ing] to oversee [the company's] financial reporting, exercising no care to ensure that the company had appropriate accounting procedures and internal controls and that its financial records were accurate."\textsuperscript{168} This action marks the first time the SEC has brought a case against an outside director not directly involved in the company's fraud\textsuperscript{169} and probably is a "sign of things to come."\textsuperscript{170} According to SEC

\begin{itemize}
\item \textsuperscript{162} Id. at 808-09.
\item \textsuperscript{163} Id. at 808.
\item \textsuperscript{164} Id. at 809 (quoting \textit{In re Caremark Int'l Inc. Derivative Litig.}, 698 A.2d 959, 971 (Del. Ch. 1996)). Interestingly, the \textit{Abbott} court focused on the "sustained and systematic failure of the board to exercise oversight" language from \textit{Caremark} in its analysis, although this language was used in \textit{Caremark} in the context of an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss. \textit{Id.} at 808-09. The \textit{Abbott} court made clear that the facts in that case were inapposite to \textit{Caremark} ("reasonable inferences determined from all of the facts taken together are exactly the opposite of \textit{Caremark}; members of the board in \textit{Abbott} were aware of the problems"), yet used the same analysis. \textit{Id.} at 806, 808-09.
\item \textsuperscript{165} Id. at 809.
\item \textsuperscript{166} Bilodeau, \textit{supra} note 13, at 51.
\item \textsuperscript{167} SEC v. Chancellor Corp., No. 03-10762 MEL (D. Mass. filed Apr. 24, 2003).
\item \textsuperscript{169} Bilodeau, \textit{supra} note 13, at 51.
\item \textsuperscript{170} See \textit{id.} (quoting former SEC chairman Harvey Pitt, who stated that "[t]his is definitely a sign of things to come. The commission has made it clear it wants outside directors to uphold the highest standards. This case definitely shows the agency's determination to go after them.").
\end{itemize}
enforcement chief Stephen Cutler, this complaint is the “first salvo in this area [of holding outside directors liable]” and will serve as a model for future enforcement actions.171

According to the SEC, the Chancellor Corporation’s “former Chairman, CEO, and controlling shareholder orchestrated a scheme to inflate reported assets, revenue and profits using fabricated documents and fraudulent accounting.”174 The defendant director, Rudolph Peselman, was on Chancellor’s board from 1996-2001 and a member of the board’s audit committee from 1999-2001.175 In 1999, Peselman became aware of a disagreement between Chancellor’s officers and outside auditors concerning an acquisition.176 At the CEO’s direction, Chancellor had overstated its revenue and income for 1998 by improperly accounting for the acquisition, which closed in January 1999.177 When Chancellor’s outside auditors objected to this improper consolidation of Chancellor’s financial results with those of the acquired company, Chancellor’s CEO and chief operating officer fired them.178 Peselman approved the dismissal of the auditors and did not determine whether Chancellor’s position on the accounting issue was incorrect.179

In 1999, Chancellor filed a Form 10-KSB for the year ending December 31, 1998, which was signed by Peselman.180 According to the SEC, Peselman signed this form “without taking any steps to ensure that it did not contain materially misleading statements.”181 He did not inquire into the reasons for the 1998 consolidation of Chancellor’s and the acquired company’s financial statements, even though Chancellor’s auditors had opposed it.182 Also, Peselman “knew that Chancellor had written off $1.14 million in related party payments in 1997.”183 Despite this knowledge, he signed the “1998 financial statements reflecting millions of dollars in side payments without checking whether there was adequate support for the

171. Id.
174. SEC Sues Former Top Officers, supra note 14, at 130-31.
175. Complaint, supra note 168, ¶ 17.
176. Id. ¶¶ 26-29.
177. Id. ¶ 22.
178. Id. ¶¶ 23-28.
179. Id. ¶ 29.
180. Id. ¶ 44.
181. Id. ¶ 48.
182. Id.
183. Id.
amounts and whether the related party arrangements were adequately disclosed.”

Peselman also signed two subsequent restatements of Chancellor’s 1998 financial results, which were contrary to representations made in the original Form 10-KSB. Peselman allegedly “ignored these red flags and never questioned whether there was any basis for the change and whether it was appropriate.” The SEC claimed that in so acting, Peselman had “completely neglected to fulfill his duties as a director and as an audit committee member.” Specifically, he allegedly “failed to oversee Chancellor’s financial reporting, exercising no care to ensure that the company had appropriate accounting procedures and internal controls and that its financial records were accurate.”

III. BARK OR BITE: EVALUATING THE EFFECT OF POST-ENRON CASE LAW AND REGULATORY ACTION

The recent developments in Delaware and other case law and the SEC’s recent foray into the area of directors’ fiduciary duties indicate, at the very least, heightened judicial and regulatory concern for enforcing existing corporate governance standards. The critical questions for corporate directors are whether and to what degree courts and the federal government are actually changing those standards in ways that will affect directors’ personal liability exposure. These questions can be addressed by considering (1) whether recent case law has created new standards for applying the business judgment rule and (2) whether the SEC’s recent move to regulate directors broadens directors’ liability exposure beyond state law standards.

A. Post-Enron Application of the Business Judgment Rule

In the wake of Enron and other corporate governance scandals, courts have resuscitated Van Gorkom-style procedural review by framing the issue as one of good faith. The good faith exception to directors’ exculpatory provisions “now seems inextricably tied to due care; gross negligence, or reckless violations of the duty of due care,

184. Id.
185. Id. ¶ 59.
186. Id.
187. Id. ¶ 60.
188. Id.
indicate that the directors failed to act in good faith." The critical question for directors—whether this new judicial approach heightens their standard of care—is informed by the *Disney*, *McCall*, and *Abbott* decisions.

1. Case law

Many believe that the *Disney* decision signals a higher standard of care for directors. But despite these misgivings about *Disney* and the continued viability of the business judgment rule, there is no real indication in that case that Delaware has changed the standards by which courts apply the rule. The *Disney* finding that the plaintiffs had satisfactorily alleged bad faith was based on facts that, if true, "[did] more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation." In other words, the court's finding that there might be a breach of the duty of good faith was not supported simply by a run-of-the-mill duty of care violation. Instead, there was more to the plaintiffs' claim: "[T]he facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities . . . . Knowing or deliberate indifference by a director . . . . is conduct, in my opinion, that may not have been taken honestly and in good faith . . . ."

The court's analysis, therefore, did not substantially depart from the standard by which courts have traditionally determined a breach of the duty of good faith. Delaware case law has measured bad faith in terms of the irrationality of directors' decisions. Under this approach, there are substantive limits to what courts will consider a good faith decision if the decision appears to be grossly inadequate.

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190. This belief was explicitly stated at an ALI-ABA Course of Study in 2004. See Roger C. Siske, *Legal Standards for Adoption of Executive Compensation Programs and Contracts, in EXECUTIVE COMPENSATION: STRATEGY, DESIGN, & IMPLEMENTATION* 1, 8 (ALI-ABA Course of Study, June 17-18, 2004).
191. See *Gibeaut*, supra note 8, at 41 ("[Delaware Supreme Court Chief Justice Norman Veasey] often comes across directors who wonder whether Delaware has abandoned the old rules.").
193. *Id.*
194. *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000); see also discussion supra Part II.A.1.
195. See *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 610 (Del. Ch. 1974) (noting that the case did not involve "blatant self-dealing" because "arm's length bargaining marked the transaction and the vote of interested directors was not necessary to approve the transaction").
Also, the Delaware Supreme Court has included procedural review in determining directors' good faith. The basic idea seems to be that some decisions—albeit made by independent and disinterested directors—are so substantively or procedurally unsound that they could not have been made in good faith. In effect, this is what the Disney decision says about the directors' approval of the Ovitz severance package and Ovitz's subsequent no-fault termination. The directors' procedural failings were so severe that they appeared to be knowing and deliberate.

Other jurisdictions also have not fundamentally changed the standards of the business judgment rule. In McCall, the Sixth Circuit found the defendant directors' good faith to be at issue where their failure to exercise oversight of management suggested an intentional or reckless breach of the duty of care. In its amended opinion, the court took care to differentiate this type of breach from an ordinary breach of the duty of care involving only gross negligence (which does not implicate bad faith). Likewise, in Abbott, the Seventh Circuit found that the directors acted in bad faith because they intentionally failed to exercise oversight of the company. The court inferred that the directors' procedural failures were intentional because "the directors knew of the violations of law [and] took no steps in an effort to prevent or remedy the situation . . . ." Both McCall and Abbott (like Disney) involved breaches of the duty of care that went beyond the traditional standard of gross negligence.

Viewed in this light, none of these cases represent a departure from the traditional application of the business judgment rule. Directors should not worry that an "ordinary" (i.e., unintentional and non-reckless) breach of the duty of care will trigger a good faith violation rendering them personally liable to shareholders. To the extent that courts have increasingly integrated procedural review into their good faith determinations, one might conclude that the judicial

196. See Scattered Corp. v. Chicago Stock Exch., Inc., 701 A.2d 70, 76-77 (Del. 1997) (finding no abuse of discretion by the Chancery Court when it reviewed the procedures taken by the defendant-directors).

197. Note that the Disney court did not approach the question of the directors' good faith under a Gimbel-like substantive review of the challenged decision. See 825 A.2d at 285-91. One might argue that the alleged $140 million value of Ovitz's severance package would have qualified as "grossly inadequate," for the purpose of establishing lack of good faith under a Gimbel analysis. Id. at 279. The Brehm court, however, undertook substantive review of the Ovitz severance package under the plaintiffs' waste claim and found the package to be within the acceptable bounds. 746 A.2d at 262-64.


201. Id.
conception of "irrationality"—used to show a lack of good faith—
involves tighter scrutiny of directors' actions. But this focus on
process has not gone so far as to erase the distinction between the
duty of care and good faith elements of the business judgment rule.
As seen in cases like Disney, McCall and Abbott, courts have retained
different standards for applying these elements.

2. Judicial Commentary

It also is instructive to consider the words of the decision-
makers themselves. Delaware's Chief Justice E. Norman Veasey and
Vice Chancellor Leo E. Strine, Jr. have provided valuable insight for
directors about changing judicial expectations in this area. Their
comments reinforce the notion that while the business judgment rule
continues to offer the same protections to directors in the post-Enron
era, courts will now subject directors' actions to stricter procedural
review. The Chief Justice's and Vice Chancellor's remarks also
illustrate the particular usefulness of procedural review in certain
circumstances: (1) for courts when substantive review of the directors'
decision is impossible (or nearly so); and (2) for plaintiffs when the
defendant directors are protected by an exculpatory charter provision
from personal liability for a breach of the duty of care.

According to Chief Justice Veasey, "the business judgment rule
still applies to protect directors' decisions made in good faith [but]
what has evolved in this new era is a sharper judicial focus on
process." This scrutiny reflects increased expectations for directors
to be proactive. In a recent roundtable discussion on executive
compensation, the Chief Justice described a change in the way courts
should now review director conduct:

[There has been] created a new set of expectations for directors. And that is changing
how courts look at these issues. . . . If directors claim to be independent by saying, for
example, that they base decisions on some performance measure and don't do so, or if
they are disingenuous or dishonest about it, it seems to me that the courts in some
circumstances could treat their behavior as a breach of the fiduciary duty of good
faith.

Notably, Chief Justice Veasey mentioned that directors' bad
faith might be shown by a failure to base decisions on predetermined
performance measures. This statement appears to distinguish

202. E. Norman Veasey, Policy and Legal Overview of Best Corporate Governance Principles,
203. Id.
204. Id.
205. What's Wrong with Executive Compensation?, supra note 109, at 76.
206. Id.
between a director's negligent failure to make an informed decision—the standard for a breach of the duty of care—and a director's failure to follow predetermined decision-making procedures. The latter situation suggests something more than mere negligence; courts rightfully can infer that this type of disregard for process must be intentional or at least recklessly indifferent.

Chief Justice Veasey's comments also identify a particular benefit of procedural review in a court's good faith analysis: procedural review is useful in contexts where it is impossible (or nearly so) for courts to judge directors' good faith on the substantive outcome of their decisions. For example, in the area of executive compensation, the Chief Justice has stated that there are no set limits on dollar amounts that can be paid in good faith, but there may be limits defined by process. In Disney, the lucrative terms of Michael Ovitz's compensation package were insufficient in themselves to create an issue of fiduciary breach, but the plaintiffs' facts, "if true, [implied] that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."

Delaware's Vice Chancellor Strine also commented on the post-Enron state of corporate governance law, specifically with regard to new approaches to the duty of good faith. According to Vice Chancellor Strine:

Enron will also generate increased pressure on courts to examine carefully the plausibility of directors' claims that they were able to devote sufficient time to their duties to have carried them out in good faith. . . . Enron and situations like it suggest to me that skilful plaintiffs' lawyers will begin making common-sense arguments about the disconnect between the routine tasks directors [undertake] to perform and the effort they put in to accomplish them. These arguments might sharpen the importance of "state of mind" determinations in the adjudication of corporate cases . . . [due to] the prevalence of exculpatory charter provisions that exonerate directors for due care breaches . . . . [I]n the absence of evidence that the outside directors had a financial interest in the underlying misconduct, they force plaintiffs' counsel to challenge the state of mind (i.e., the good faith) of the outside directors.

207. See Veasey, supra note 6, at 850 ("There is a belief—I suggest it is a myth—that there is no limit to what compensation committees may award CEO's and other senior managers. Of course, there is no bright-line dollar limit. [According to one metaphor,] 'large, heavy ships can float.' Likewise, there is no such thing as pay that is abstractly too high—it is like asking, 'How high is up?'") (footnote omitted).

208. Veasey, supra note 202, at 2141.


This language highlights the practical motivations for plaintiff shareholders who want to hold directors liable for injuries to the corporation, but must overcome the obstacle of an exculpatory charter provision. The plaintiffs can use the same facts to allege a breach of the duty of good faith instead of a breach of the duty of care (and thereby sidestep the directors’ exculpatory provision), as long as the directors’ procedural failings are sufficiently egregious to suggest intentional or reckless conduct. So, while plaintiffs face a different, more demanding standard to create a good faith issue, they at least have a chance to hold the directors personally liable under the same set of facts.

B. The SEC’s Expanded Regulatory Focus

The true significance of SEC v. Chancellor Corp. remains to be seen; at this point, it is clear only that the SEC considers the action to be a blueprint for future prosecutions of outside directors who are “reckless in their oversight of management and asleep at the switch.”211 This approach is noteworthy because the SEC effectively is transforming a matter of state law—“a classic case of director breach of fiduciary duty”212—into an enforcement action under the federal securities laws.213 Former SEC insiders have speculated about the meaning and long-term consequences of the SEC’s move.214 According to former SEC enforcement director and retired federal judge Stanley Sporkin, “the Chancellor action “may well be a landmark case, where the person didn’t profit, didn’t buy and sell, but just fiddled while Rome burned . . . . It means that people who take these jobs as outside directors have got to be careful and make sure they’re really prepared to do the job.”215 But others have voiced concerns about the SEC’s apparent broadening of its regulatory focus. Former SEC general counsel David Becker has said that “[t]he SEC may be expanding its enforcement authority without sufficient consideration or planning.”216 According to Becker, “[i]f the SEC is in effect going to be federalizing state corporate law, it means the agency is undertaking a huge new

211. Bilodeau, supra note 13, at 51.
212. Loewenstein, supra note 189, at 368.
213. Id. at 368-69.
216. Id.
responsibility, and it means directors are going to be vulnerable not only to private litigants, but also to the feds.”

Commentators also have debated the wisdom of bringing regulatory actions against outside directors. Questioning the policy behind the SEC's move, John Olson, chairman of the ABA's corporate responsibility task force, stated that “[t]he SEC should be careful in going after directors, because it could make it difficult to find people who will serve on boards...” In an opinion piece, another commentator considered both sides of the issue. On the one hand, “[some argue that] directors' conduct should be policed only by the states, which have historically exercised that authority, and not by the SEC. And if directors are also going to be held accountable to the feds, ... it will become tougher than ever to recruit capable directors.” But, in considering the other side, Olson stated that “[h]owever tough it becomes to recruit and retain competent directors, shareholders have the absolute right to demand that board members protect them from executives who are scoundrels or fools. Directors who don't direct, those who are ineffective at countering arrogant managers who lose their moral bearings, invite questionable practices.”

Putting aside policy concerns and assuming that SEC v. Chancellor does indeed portend a new trend of regulatory enforcement against outside directors, the key question for directors is whether this development will expand their liability exposure. The answer seems to be that such enforcement actions will not expand state law standards for director conduct, but may expose directors who are otherwise protected by exculpatory charter provisions. A comparison of the Chancellor action to existing case law reveals no material expansion of the standards imposed by state corporate law. For example, the SEC complaint charged Rudolph Peselman with ignoring “red flags,” which is hardly a new ground for directorial liability. The Delaware Supreme Court contemplated liability for this type of misconduct over forty years ago in Graham v. Allis-Chalmers

217. Id.
218. Id. According to Olson, “[t]his is a risky path for the SEC to start down... You've got to be careful you only use this weapon in cases where everyone would say 'this was a total failure by this director.'” Id.
220. Id.
221. Id.
222. Complaint, supra note 168, ¶ 59.
Of course, the type of liability involved in the SEC action—securities fraud under federal law—differs from that presented by a shareholders' action in a case like *Graham*. But in a general sense, the "red flag" language in *SEC v. Chancellor* does not require more of directors than existing state law.

Likewise, the SEC's claim that Peselman "failed to oversee Chancellor's financial reporting, exercising no care to ensure that the company had appropriate accounting procedures and internal controls and that its financial records were accurate" implicates the Caremark duty to maintain a corporate "information and reporting system." The claim that Peselman "acquiesced in [the CEO's] complete control of accounting decisions, including those relating to payments to [the CEO's] own company" seems to parallel the claims in *Disney* against the directors who adopted a "we don't care about the risks" attitude and acquiesced in Michael Eisner's compensation decisions. In making these claims, the SEC reflects the same concern for proactive action by directors that is emphasized in recent jurisprudence. But although the SEC seems to be jumping on the courts' bandwagon to heighten expectations for directors, it has not yet advocated for a more expansive approach than that already employed by Delaware and other courts.

The greater significance of SEC v. *Chancellor* is that the SEC has added another type of liability threat for directors, one that is not barred by an exculpatory provision in the corporate charter. Just as directors' exculpatory provisions cannot protect them when courts frame their misconduct in terms of good faith (and not duty of care), so too directors cannot escape liability for securities fraud. In effect, "the SEC is now filling the void created by [exculpatory provisions], and while Delaware directors may be freed from liability for monetary damages to their shareholders for breach of the duty of care, they face enforcement actions from the SEC."

223. 188 A.2d 125, 130 (Del. 1963) ("It appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow . . . .").

224. Complaint, supra note 168, ¶ 60.


226. Complaint, supra note 168, ¶ 60.


228. See, e.g., *id. passim*.

229. See *Loewenstein*, supra note 189, at 369-70.

230. *Id.* at 369-70.
IV. GUIDANCE FOR DIRECTORS

A. Procedural Failures that May Expose Directors to State Law or SEC Liability

In both recent corporate governance jurisprudence and the SEC's expanded focus on director liability, the key theme is the use of procedural review to hold certain directors personally accountable in nontraditional ways. The cases make clear, however, that the standards of the business judgment rule remain intact. A negligent or grossly negligent procedural failure is insufficient to trigger a good faith violation; there must be something akin to intentional or reckless directorial conduct. The critical issue for directors is the types of failures or nonfeasance that are sufficiently egregious to implicate such a finding of bad faith. Admittedly, the variously-described indicia of bad faith procedural failures—knowing or deliberate indifference, egregiousness, conscious disregard of a known risk—may leave some confusion about the differences between recklessness or gross negligence and bad faith. The cases and select judicial commentary suggest three general courses of conduct that directors should avoid in this context: (1) failure to maintain a reasonable corporate monitoring and reporting system; (2) failure to address proactively warning signs of employee misconduct; and (3) failure to observe predetermined processes or industry norms in decision making.

231. See discussion supra Part III.
232. See, e.g., McCall v. Scott, 250 F.3d 997, 1000 (6th Cir. 2001):

Indeed, Delaware courts do not discuss a breach of the duty of care in terms of a mental state more culpable than gross negligence. Rather, allegations of intentional or reckless director misconduct are more commonly characterized as . . . a breach of the duty of good faith. . . . Thus, while it is true that duty of care claims alleging only grossly negligent conduct are precluded by [an exculpatory] waiver provision, it appears that duty of care claims based on reckless or intentional misconduct are not.

234. Sale, supra note 5, at 484.
235. McCall, 239 F.3d at 818 (quoting BALOTTI & FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATION § 4.29, at 4-116 to 4-116.1 (3d ed. Supp. 2000)).

236. See id. ("[T]o the extent that the conduct alleged to be reckless is predicated solely on allegations of sustained inattention to the duty it is arguable whether such conduct is 'grossly negligent,' but not conduct amounting to bad faith.").
1. Failure to Maintain a Reasonable Monitoring and Reporting System

Under Caremark, directors are obligated to "attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists." Otherwise stated, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith." At the very least, this language requires directors to install and maintain some type of reporting system to satisfy the duty of good faith.

But does the Caremark good faith analysis also consider the level of detail of the directors' reporting system? Although the court's specific reference to an "attempt to assure a reasonable information and reporting system exists" might imply such an approach, the rest of the Caremark opinion suggests otherwise. Chancellor Allen requires an "utter failure" by directors to establish a lack of good faith. Earlier in the opinion, the chancellor also states that "the level of detail that is appropriate for such an information system is a question of business judgment," and "it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate." Thus, the Caremark analysis does not hinge upon whether the directors maintained a successful or detailed reporting system; rather, the analysis considers whether the directors made a good faith attempt to maintain a system that they felt would be reasonable and adequate.

Although Caremark involved an alleged breach of the duty of care and not, strictly speaking, an allegation of bad faith, courts subsequently have adopted Caremark as an integral part of their good faith analyses. The duty of good faith thus requires directors to maintain a reporting and disclosure system that they believe is reasonable and adequate for their corporation. As long as the directors' decision does not suggest "irrationality" to the court, the

238. Id. at 971.
239. Id. (emphasis added).
240. Id.
241. Id. at 970.
242. See, e.g., McCall v. Scott, 239 F.3d 808, 817-18 (6th Cir. 2001); In re Abbott Labs. Derivative S'holders Litig., 325 F.3d 795, 805-06 (7th Cir. 2001).
243. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (stating that even if a judge or jury disagrees with the substance of a decision, there is no ground for director liability "so long as the court determines that the process employed was either rational"
specifics of the reporting system, including the level of detail, are left to the directors' discretion.

2. Failure to Address "Red Flags"

Directors' duty of good faith also requires them to address proactively any warning signals of employee misconduct. This requirement is rooted in the 1963 *Graham* decision, which placed liability on a director who "has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing."244 Although written over forty years ago, this language reflects a concern for the same types of conduct that have figured into more recent cases' procedurally-based good faith analyses. The *Graham* court was concerned about "reckless[]" and "willful[]" ignorance by directors of warning signs at their companies.245 Likewise, in the recent *McCall* and *Abbott* cases, the circuit courts considered the directors' good faith in terms of an "intentional or reckless breach of the duty of care"246 and "a "failure of the board to exercise oversight [that was] intentional."247

These circuit court cases provide some general guidance as to the kinds of "red flags" that require a proactive response by directors. One factor that courts may consider is the experience of the directors. In *McCall*, where the court found a substantial likelihood that the defendant directors could be liable for good faith violations, "[a] significant factor in [the court's] assessment of the factual allegations was the prior experience of a number of the defendants as directors or managers [in the industry]."248 A second factor is the nature of the "red flags" themselves. The *McCall* court stated that "the magnitude and duration of the alleged wrongdoing [that the directors ignored] is relevant in determining whether the failure of the directors to act constitutes a lack of good faith."249

The *McCall* analysis seems to involve two general types of "red flags" that directors cannot ignore in good faith: internal information

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245. *Id.* (emphasis added).
246. *McCall*, 239 F.3d at 817.
247. *Abbott*, 325 F.3d at 809.
248. *McCall*, 239 F.3d at 819.
249. *Id.* at 823 (citation omitted).
(e.g., audit committee reports) that reasonably suggests employee misconduct; and challenges or communications from outside the company (e.g., third party lawsuits, media investigations, etc.) that reasonably suggest employee misconduct. For example, the court concluded that the directors must have understood the significance of audit reports that showed accounting discrepancies and suspicious billing practices.\textsuperscript{250} Also, the court inferred directorial knowledge of company fraud based on various signals from third parties: a \textit{qui tam} action brought against the company by a doctor; an extensive federal investigation of the company's billing practices; and a prominent newspaper's investigation of the company.\textsuperscript{251}

\textit{Abbott} also involved instances in which the defendant directors ignored warning signals from third parties. Over six years, the directors failed to respond adequately to thirteen separate FDA inspection reports and four certified FDA Warning Letters regarding various regulatory violations.\textsuperscript{252} Given the "extensive paper trail" documenting "six years of noncompliance, inspections, [inspection reports], Warning Letters, and notice in the press, ... the directors' decision to not act was not made in good faith[.]")\textsuperscript{253} In reaching its conclusion, the court considered the magnitude and duration of these "red flags" per the \textit{McCall} approach.\textsuperscript{254} The magnitude and duration of the FDA violations were so great that they occasioned the highest ever fine imposed by the FDA.\textsuperscript{255} Neither FDA censures nor public notice motivated the directors to take any action concerning the compliance problem over a \textit{six-year} period (as opposed to an approximately two-year period in \textit{McCall}).\textsuperscript{256}

In these cases, the Sixth and Seventh Circuits have adopted an approach that considers the duration and magnitude of the warning signals when determining whether directors' failure to respond constitutes a lack of good faith. These warning signals can come from within the company or from the outside (in the form of third party actions, regulatory pressure, or media coverage). While there appears to be no bright line for this type of inquiry, \textit{McCall} and \textit{Abbott} involved "red flags" that continued for a matter of years without an adequate, proactive response from the defendant directors. Both cases

\begin{itemize}
  \item \textsuperscript{250} Id. at 821 ("We find that it would be just as reasonable to infer that the consistently high CMIs and DRGs was a sign of possible improper billing activities.").
  \item \textsuperscript{251} Id. at 822-23.
  \item \textsuperscript{252} \textit{Abbott}, 325 F.3d at 799.
  \item \textsuperscript{253} Id. at 809.
  \item \textsuperscript{254} Id.
  \item \textsuperscript{255} Id.
  \item \textsuperscript{256} Id.
\end{itemize}
also involved directorial failures to respond to federal regulatory pressures. In evaluating directors' inaction in the face of these types of warning signals, the Sixth Circuit also found the prior experience of the directors in that industry to be a significant factor.

3. Failure to Observe Predetermined Processes and Industry Norms

Directors also may be found to have acted in bad faith by failing to observe predetermined processes or industry norms in decision making. In *Disney*, for example, the directors failed to ask even the most basic questions about the Ovitz employment agreement and, at various steps in the compensation approval process, agreed to unresolved terms or terms that they had not reviewed. Effectively, the Disney board rubber-stamped Eisner's decision to hire Ovitz and left the two of them to work out the terms of the agreement. Likewise, the Disney directors never met to discuss Eisner's proposed no-fault termination of Ovitz, a decision that resulted in a $38 million cash payout plus stock options. In finding that the alleged facts, if true, were sufficient to support a finding of bad faith, the *Disney* court concluded that the defendant directors must have known that they were making material decisions without adequate information and simply did not care.

*Disney* suggests that bad faith is implicated when a director knows that he is breaching his duty of care. The notion seems to be that some predetermined processes or directorial norms are so obvious that a director's disregard for them must be either intentional or recklessly indifferent. The key feature of this analysis is that the court will infer knowledge on the part of the director that he is not acting in the best interests of the corporation. Delaware's Vice Chancellor Strine has commented that "[plaintiffs] might well ask courts to infer not only that audit committee members did not know enough about their company's financial and accounting practices, but also that the committee members knew that their inadequate knowledge disabled them from discharging their responsibilities with fidelity." In other words, the Vice Chancellor suggests that a

257. In *McCall v. Scott*, 239 F.3d 808, 822 (6th Cir. 2001), where the FBI and other agencies conducted dozens of raids to search company facilities in several states, the magnitude of the federal investigation was particularly great.

258. *Id.* at 819.


260. *Id.* at 288-89.

261. *Id.* at 289.

process violation must be accompanied by some type of awareness by directors that they are short-changing the corporation.

In this context, it is impossible create a bright-line rule for the types of process that, if disregarded, necessarily indicate that a director knew he was short-changing the corporation. Delaware's Chief Justice Veasey has stated that there is no definitive answer for the types of procedural failures that might implicate good faith concerns, but "the utter failure to follow the minimum expectations of the evolving standards of director conduct, the minimum expectations of Sarbanes-Oxley, or the NYSE or NASDAQ Rules" might raise a good faith issue. Thus, the Chief Justice provides some guidance for directors concerned about the procedural standards by which courts will judge their good faith. Other observers agree that "federal and stock exchange governance requirements will come to inform a court's analysis of whether a director has met his obligation to act in good faith." But these possible guideposts cannot completely define the boundaries of good faith; directors must accept that courts will scrutinize their actions for intentional or reckless duty of care violations using standards, not-bright line rules.

B. Corporate Governance Solutions

In the context of this Note, the most important question for directors is how they can be sufficiently proactive so that courts will find that the directors exercised due care and, most importantly, acted in good faith—even if the directors' conduct resulted in injury to the corporation. In the area of corporate governance, "one size doesn't fit all" and there is no single, best solution for practitioners with corporate clients. Corporate governance best practices depend upon a company's stage of development, ownership structure and size, and the mix of skills and personalities of the individual directors. But regardless of their configuration, in the wake of Enron and other scandals, boards need to shift their emphasis beyond their traditional

263. Veasey, supra note 202, at 2141.
265. See Sale, supra note 5, at 491 ("Delaware courts deploy standards, not rules.").
267. Id.
Boards can no longer act as “advisors” who wait for management to approach them, but must become active overseers of the company's business. On this topic, Chief Justice Veasey has stated:

I would urge boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in court from a properly presented complaint. Compensation committees should have their own advisers and lawyers. Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently.

Directors can facilitate these goals (and satisfy their Caremark oversight and monitoring duties) through an effective internal control framework. Such a framework might include three broad categories of internal controls: (1) financial reporting controls; (2) operation controls; and (3) compliance controls. Financial reporting controls cover the preparation of reliable financial statements and other financial information. Operational controls address a company's basic business objectives, including adherence to performance standards and the safeguarding of resources. Finally, compliance controls cover laws and regulations to which a company is subject to avoid damage to a company's reputation or other negative consequences. These controls address and hopefully prevent a range of employee misconduct that can create liability questions for directors under state or federal law (e.g., fraudulent accounting practices, irrational business transactions, or regulatory noncompliance). Of course, an effective monitoring and oversight program may require modification when necessary to accommodate changed conditions. This adjustment can be accomplished through ongoing monitoring activities, self-assessments, and internal audits.

Directors also can ensure that they do not disregard “red flags” by conducting regular reviews of management's operations, with an

269. Id. at 11.
270. Id.
271. What's Wrong with Executive Compensation?, supra note 109, at 76.
272. See BRANCATO & PLATH, supra note 267, at 54 (noting that “as part of its duty of care the board needs to play an active oversight role in the area of internal controls by ensuring the company has an effective internal control framework in place”).
273. Id.
274. Id.
275. Id.
276. Id.
277. Id. at 55.
278. Id.
eye toward certain types of misconduct. For example, directors should watch for business transactions that are not well-understood and appear to serve little practical purpose. Discrepancies in financial documents, such as unusual balance sheet changes or accounting policies that vary from industry norms, also might constitute "red flags." Moreover, directors should be suspicious if the company is doing too well; for example, directors should look closely at financial results that are significantly better than competitors' without substantive differences in operations; overly optimistic news releases by management; or a consistently close or exact match between reported results and planned results. This is not an exhaustive list of "red flags," but it illustrates the potential benefits for directors of having predetermined review procedures for management activities.

In the context of Disney and, more generally, executive compensation, companies should have entirely independent compensation committees to ensure that compensation programs are reasonable in view of company economics and the relevant practices of similar companies. The minimum duties for a compensation committee should include reviewing and approving CEO compensation on the basis of performance goals; and making recommendations to the board with respect to incentive and equity-based compensation plans. The committees should link compensation to rational, strategic performance measures such as cost of capital, return on equity, economic value added, and compliance goals. There are many such quantitative and qualitative performance metrics upon which a compensation committee can choose to base executive compensation. Regardless of which metrics are used, they need to be determined at the outset of the decision-making process. Agreed-upon performance metrics generally should not be subsequently

279. Id. at 48.
280. Id.
281. Id.
282. Id.
283. For more financial reporting "red flags," see id.
284. Id. at 26.
285. Id.
286. Id. at 27.
288. Id.
adjusted to provide additional compensation despite failure to achieve stated objectives.289

Regarding severance packages (like the one at issue in Disney), “boards and compensation committees should carefully consider the terms, triggers, and potential costs of various exit scenarios.”290 The National Association of Corporate Directors recommends that the value of a severance package should be tied to base pay only (for example, a simple multiple of 2x or 3x base pay).291 This package could be reduced in cases where the CEO was fired over performance issues or resigned.292 Also, the compensation committee might consider tying the size of the severance package to the length of the executive’s tenure through some type of vesting formula.294 Apart from these approaches, the Disney case suggests a more general lesson for directors in the area of severance packages: do not approve the package if the terms are unfamiliar.

V. POLICY AND RECOMMENDATIONS

A. Policy: Benefits Trump Concerns

To the extent that recent case law and the SEC regulatory enforcement action have tightened scrutiny of directors’ processes and good faith, it should be noted that the merits of such an increased threat of liability are not uncontested. Professor Langevoort asserts that increased liability for directors “too easily misconceives the role of the outside director and introduces a chill that redirects attention away from the handful of things outsiders do well.”295 From his perspective, “norms rather than law ought to be the main drivers of directorial diligence.”296 The chill effect mentioned by Professor Langevoort is readily understandable. An increased threat of personal liability seemingly would deter qualified candidates from taking positions on boards of directors; however, the idea that norms can be

289. Id.
290. Id. at 28.
291. Id.
292. Id. This approach only works if the directors do not acquiesce in a no-fault termination, as happened in Disney. In re The Walt Disney Co. Derivative Litig., 825 A.2d 275, 288-89 (Del. Ch. 2003).
294. REPORT OF NACD, supra note 287, at 28.
296. Id.
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depended upon to guarantee directors' diligence and good faith seems to be refuted empirically by Enron and other scandals.

On the other hand, Professor Sale argues that "[s]trong enforcement of the duty of good faith creates an incentive to prompt fiduciaries to better behavior, even if we cannot change their character."297 This type of judicial enforcement protects shareholders.298 If one considers directorial conduct like that seen in Disney, McCall, or Abbott to be problematic, then there would seem to be a need for judicial review that can overcome the obstacle created by exculpatory charter provisions. In addition, the good faith analysis is well-suited for addressing these concerns because it is flexible enough to accommodate changing norms. The traditionally-emphasized duties of loyalty and care may not prevent certain types of undesirable behavior, but the duty of good faith can play an "ex ante role... in changing the behavior and incentives of corporate fiduciaries and, thereby changing corporate governance."299

The chilling effect of increased directorial liability should not be ignored, but does not pose an insurmountable obstacle. Companies can overcome this problem and attract qualified, competent board members by increasing director compensation. Although the company faces higher out-of-pocket costs in increasing directors' salaries, the company and its shareholders can expect long-term benefits that will cover their short-term costs. Companies will end up with directors who have an incentive to observe good process and make rational decisions. In the long run, these companies will face fewer management scandals and injurious, irrational business decisions.

B. Recommendations for Courts and the SEC

1. Courts

"[G]ood faith claims must be different from negligence and gross negligence,"300 but directors may have difficulty seeing the difference, particularly with regard to gross negligence. One is reminded of the joke that there are three types of negligence: negligence; damned negligence; and goddamned negligence. Joking aside, this illustrates the point that there are few bright lines to guide directors in this area. Courts should therefore attempt to provide

297. Sale, supra note 5, at 495.
298. Id.
299. Id. at 494.
300. Id. at 489.
objective, ascertainable criteria in their good faith analyses that will provide *ex ante* guidance for directors. One option is to establish guideposts by drawing from case law in other, related areas. Professor Sale considers the scienter standard for a federal Rule 10b-5 claim instructive on the question of good faith. According to Sale, federal securities cases "provide guidance on what is simply gross negligence and what amounts to severely reckless or egregious behavior." Under the scienter standard, "motive is relevant, but not required" and "board members are at risk when they fail to ask questions and monitor officers and material corporate decisions." Professor Sale advocates using scienter cases as "examples of... the type of egregious, subversive, or deliberately indifferent conduct" that indicate a lack of good faith.

Similarly, federal regulations and self-regulatory organization (SRO) rules may guide directors on the procedures and norms that, if disregarded, could support a finding of bad faith. Chief Justice Veasey has suggested that:

'It is arguable—but not settled—that the issue of good faith may be measured not only by the evolving expectations of directors in the context of Delaware common law fiduciary duty, but also it may well be measured against the backdrop of relevant Sarbanes-Oxley, SEC Rules and the SRO requirements, even though there may be no express private right of action in the federal legislation.'

In addition, "recent case law supports the suggestion of an emerging heightened duty of good faith, which at least implicitly looks to compliance with elements of the NYSE's definition of independence." Courts may therefore use federal and SRO regulations as benchmarks for determining good faith procedural issues.

To the extent that related case law, regulations and SRO rules accurately reflect courts' intentions for the emerging and increasingly significant fiduciary duty of good faith, courts should expressly adopt

301. See id. at 489-94 (noting that unintentional but flagrantly reckless actions or inactions are breaches of good faith responsibility). Section 10(b) of the Securities Exchange Act of 1934 makes it "unlawful for any person ... [t]o use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C § 78j(b) (2005). Rule 10b-5 implements section 10(b) and forbids the use, "in connection with the purchase or sale of any security," of "any device, scheme or artifice to defraud" or any other "act, practice, or course of business" that "operates . . . as a fraud or deceit." 17 C.F.R. § 240.10b-5 (2005).

302. Sale, supra note 5, at 490.

303. Id. at 493.

304. Id. at 492.

305. Id. at 490.

306. Mirvis, supra note 264, at 689.

307. Id.
these standards. Courts should take the earliest possible opportunity to give this type of *ex ante* guidance in decisions, even if only in the form of dicta. While it is impossible to define the duty of good faith solely by reference to other, existing standards, rules and regulations, this type of guidance—when appropriate—helps directors understand evolving expectations for their conduct.

2. The SEC

Directors' exculpatory charter provisions cannot protect them from liability under the federal securities laws, which may allow the SEC to sue directors even if injured shareholders cannot; however, if *SEC v. Chancellor* portends a pattern of holding directors liable for procedural failures under the federal securities laws, such liability should not attach to simple or even gross negligence. Instead, the SEC should pursue a framework similar to that in *Disney* and other good faith cases, where courts look for directors' "knowing or deliberate indifference" to their corporate responsibilities.

By adopting such an approach, the SEC will avoid causing the previously-discussed "chill effect" for directors. While an unduly burdensome chill effect is unlikely with regard to procedure-based good faith review, it could be problematic if the SEC sues directors for negligent actions that are unaccompanied by indicia of bad faith. First, qualified and well-meaning directors would nonetheless hesitate to accept positions if there is a risk of liability for negligent, albeit good faith decisions. Second, liability for negligent decisions would dampen risk-taking by acting directors. State corporate governance law promotes good decision making by requiring directors to act with good faith and through proper procedures, while still allowing directors to take business risks. Although it is perhaps arguable whether legislatures should allow exculpatory charter provisions that protect grossly negligent directors, it is necessary and beneficial to excuse directors for some degree of negligent conduct. As Chief Justice Veasey said, "the new corporate culture is not intended to stifle risk-taking or to raise undue concerns about increased liability exposure."

308. See Veasey, *supra* note 202, at 2146 (stating that "the expectations of directors are constantly evolving").

309. See *In re The Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003) (stating that such conduct violates the duty to act faithfully and with appropriate care).

310. See discussion *supra* Part V.A.

VI. CONCLUSION

A key theme in corporate governance law over the last twenty years has been the increased use of procedural review to hold directors personally liable. In Van Gorkom, the Delaware Supreme Court distinguished the duty of care as a standalone, effective element of the business judgment rule. After Delaware provided directors a statutory shield from liability for duty of care violations, procedural review crept into Delaware and other courts’ good faith analyses. Today, the good faith issue is the courts’ best tool for enforcing directors’ fiduciary duties. If it appears that a board of directors intentionally or recklessly disregarded process in their decision making or ignored “red flags,” those directors will be held personally liable. The SEC similarly has indicated that it will pursue directors who are “reckless in their oversight of management and asleep at the switch.”

Directors should not be concerned about this type of personal liability if they adhere to basic guidelines for corporate governance. First, the maintenance of an internal reporting system will satisfy the directors’ good faith duty under Caremark and will better enable the directors to address “red flags” of employee misconduct. Second, an independent compensation committee which observes predetermined review processes and performance metrics can avoid a Disney-like problem in the area of executive compensation. Third, if directors are willing to take a firm stance with management and reject proposals that are not adequately explained or do not make sense, they can avoid participating in fraudulent activities that might expose them to SEC sanctions.

For their part, courts and the SEC should promote consistency and uniformity in this area. Courts can do this by adopting objective, ascertainable criteria for evaluating directors’ good faith. Whether courts rely on scienter standards, federal regulations, SRO rules, or something else, to the extent possible courts should identify the “guideposts” that define good faith conduct. Likewise, the SEC can promote consistency and uniformity by adopting the state law approach to good faith. Rather than create varying degrees of liability exposure for directors (and possibly cause a chill effect for qualified directors), the SEC should pattern its enforcement actions on Disney and other good faith cases.

Directors can rest assured that as long as they exercise good faith, courts will not second-guess the substance of their decisions.

312. Bilodeau, supra note 13, at 51.
Although directors cannot look to bright-line rules in the area of good faith analysis, the standards by which courts approach the issue are not unduly burdensome or inaccessible. Moreover, only an egregious failure to observe these standards will create personal liability for directors. As Chief Justice Veasey said, "[I]f a company genuinely and in good faith has good corporate practices in place, if independent directors have the guts to make sure those practices are followed . . . then we don't dampen risk taking. I trust that at the end of the day, the system will correct itself."\(^{313}\)

*Thomas Rivers*
Since the terrorist attacks of September 11, 2001, federal agents and prosecutors have sought and obtained the detention of dozens of individuals as so-called “material witnesses.” Though charged with no crime, these people have been subjected to secret weeks- or months-long incarcerations. Nearly all have been released after the government was satisfied they had no terrorist ties. Despite the outrage that the government’s tactic has engendered, the constitutionality of detaining material witnesses has not been seriously questioned by litigants, courts, or legal commentators. Laboring under the misapprehension that the incarceration of witnesses has long been held constitutional, commentators have been constrained merely to echo the mainstream media’s complaint that the Department of Justice is “abusing” the material witness statute. Court challenges to such detentions have likewise been rebuffed on the ground that such detentions have long been held constitutional. This Article examines the federal government’s unprecedented and calculated reliance on the material witness statute in its post-September 11th terrorism investigation. Examining the cases cited in support of the idea that prolonged incarceration of witnesses is constitutional, the Article shows how historical practice, Supreme Court precedent, and the Constitution itself have been misread to justify a tactic offensive to the Fourth Amendment. Authorities from the earliest days of the Republic to the present make clear that, rather than supporting the incarceration of witnesses, the practice is at best of dubious constitutionality. The Article concludes that the Executive’s reliance on the statute for investigative detentions and the Judiciary’s credulous acquiescence in this practice pose a potentially long-term threat to the Fourth Amendment’s basic safeguard against unreasonable seizures.