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THE DUTY OF CARE IN AMERICAN CORPORATE LAW

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THE DUTY OF CARE IN
AMERICAN CORPORATE LAW

By

Melvin Aron Eisenberg

I. INTRODUCTION

This Article concerns the duty of care in American corporate law. To fully understand that duty, it is necessary to distinguish between roles, functions, standards of conduct, and standards of review. A *role* consists of an organized and socially recognized pattern of activity in which individuals regularly engage. In organizations, roles take the form of positions, such as the position of the director. A *function* consists of an activity that an actor is expected to engage in by virtue of his role or position. A *standard of conduct* states the way in which an actor should play a role, act in his position, or conduct his functions. A *standard of review* states the test that a court should apply when it reviews an actor's conduct to determine whether to impose liability, grant injunctive relief, or determine the validity of his actions.

In many or most areas of law, standards of conduct and standards of review tend to be conflated. For example, the standard of conduct that governs automobile drivers is that they should drive carefully, and the standard of review in a liability claim against a driver is whether he drove carefully. Similarly, the standard of conduct that governs an agent who engages in a transaction with his principal is that the agent must deal fairly, and the standard of review in a claim by the principal against an agent, based on such a transaction, is whether the agent dealt fairly.

The conflation of standards of conduct and standards of review is so common that it is easy to overlook the fact that whether the two kinds of standards are or should be identical in any given area is a matter of prudential judgment. In a corporate world in which (i) information was perfect, (ii) the risk of liability for assuming a given corporate role was always commensurate with the incentives for assuming the role, and (iii) institutional considerations never required deference to a corporate organ, the standards of conduct and review in corporate law might be identical. In the real world, however, these conditions seldom hold, and in American corporate law the standards of review pervasively diverge from the standards of conduct.

Traditionally, the two major areas of American corporate law that involved standards of conduct and review have been the duty of care and the duty of loyalty. The duty of loyalty concerns the standards of conduct and review applicable to a director or officer who takes action, or fails to act, in a matter that does involve his own self-interest. (I will hereafter refer to such action or inaction as *self-interested conduct*.) The duty of care concerns the standards of conduct and review applicable to a director or officer who takes action, or fails to act, in a matter that does not involve his own self-interest. (I will hereafter refer to such action or inaction as *disinterested conduct*.)

II. FUNCTIONS OF DIRECTORS AND OFFICERS

The duty of care of corporate directors and officers is a special case of the duty of care imposed throughout the law under the general heading of negligence. All law builds on moral, policy, and experiential propositions. The law of negligence is no exception. Under the moral and policy propositions that underlie the law of negligence, if a person assumes a role whose performance involves the risk of injury to others, he is under a duty to perform that role carefully, and is subject to blame if he fails to do so. For example, an actor who assumes the role of driver is under a duty to drive carefully; an actor who assumes the role of doctor is under a duty to practice medicine carefully.

I begin by considering the *functions* of officers and directors. Under American corporate law and practice, the function of officer*s* is to manage the business of the corporation. As stated in Section 3.01 of the American Law Institute's *Principles of Corporate Governance*:

> The management of a business of a publicly held corporation should be conducted by or under the supervision of such principal senior executives as are designated by the board of directors, and by those other officers and employees to whom the management function is delegated by the board or those executives, subject to the functions and powers of the board under § 3.02. [1]

In contrast, under American corporate law and practice the board of directors does not usually have the function of managing the business of the corporation, although it has the power to do so (and typically some managers will also sit on the board). Instead, the board has a variety of functions other than managing. Section 3.02 of the *Principles of Corporate Governance* states the functions of the board of directors of a publicly held corporation as follows:

> (1) Select, regularly evaluate, fix the compensation of, and where appropriate, replace the principal senior executives;
>
> (2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed;
>
> (3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions;
>
> (4) Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements;

[1] Bracketed cross-references in the provisions of the Principles of Corporate Governance are omitted throughout this paper.

(5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.[2]

Section 8.30 of the Model Business Corporation Act sets forth a somewhat different list of director functions:

(c) In the case of a public corporation, the board's oversight responsibilities include attention to:

(i) business performance and plans;

(ii) major risks to which the corporation is or may be exposed;

(iii) the performance and compensation of senior officers;

(iv) policies and practices to foster the corporation's compliance with law and ethical conduct;

(v) preparation of the corporation's financial statements;

(vi) the effectiveness of the corporation's internal controls;

(vii) arrangements for providing adequate and timely information to directors; and

(viii) the composition of the board and its committees, taking into account the important role of independent directors.[3]

Generally speaking, the difference between *Principles of Corporate Governance* § 3.02 and Model Act § 8.31 is one of emphasis. *Principles* § 3.02 emphasizes the board's role in selecting the principal senior executives and in monitoring their performance. The idea here is

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[2] Section 3.02(a) states the functions that the board of a publicly held corporation is *required* to perform. Section 3.02(b) states the functions that a board of directors also has *power* to:

(1) Initiate and adopt corporate plans, commitments, and actions;
(2) Initiate and adopt changes in accounting principles and practices;
(3) Provide advice and counsel to the principal senior executives;
(4) Instruct any committee, principle senior executive, or other officer, and review the actions of any committee, principal senior executive, or other officer;
(5) Make recommendations to shareholders;
(6) Manage the business of the corporation;
(7) Act as to all other corporate matters not requiring shareholder approval.

[3] MODEL BUSINESS CORPORATION ACT § 8.30. Chapter 8 of the Model Act is in the process of being revised. In this paper, I refer to sections in Chapter 8 as they will be when revised, rather than to the existing sections. I expect the revisions to be finally approved in June 2004.

that the chief executive officer ("CEO")—manages the business, and the most important function of the board therefore is to select the right person as CEO and thereafter to monitor his performance. Model Act § 8.31 reflects the post-Enron atmosphere, and contemplates a somewhat more active board than *Principles* § 3.02. Section 8.31 requires the board to actively pay attention to business performance, plans, and major risks, and to be actively involved in the process or preparing corporation's financial statements, the effectiveness of the corporation's internal controls, and the systems for providing information to directors.

In summary, the functions of directors can be categorized as follows. Directors must monitor or oversee the conduct of the corporation's business to evaluate whether the business is being properly managed—primarily by regularly evaluating the corporation's principal senior executives and ensuring that appropriate information systems are in place. This is known as the duty to monitor. Directors must follow up on information, acquired through monitoring systems or otherwise, that should raise cause for concern. This is known as the duty of inquiry. Directors must make decisions on matters that the board is obliged or chooses to act upon. Officers have comparable duties, although for most officers decisionmaking is likely to be more important than monitoring.

III. STANDARDS OF CONDUCT

I now turn to standards of conduct. Section 4.01 of the *Principles of Corporate Governance* sets out the traditional standard of care applicable to directors and officers in the performance of their functions, in relation to matters in which they are not interested:

> A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

This standard of conduct has both subjective and objective elements. Requiring the "care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances" is an objective standard. Requiring the director or officer to act "in a manner that he or she reasonably believes to be in the best interests of the corporation" is both subjective and objective. First, the director or officer must subjectively believe that his conduct is in the best interests of the corporation. Second, that belief must be objectively reasonable.

In contrast to the *Principles of Corporate Governance*, the Model Business Corporation Act (1) draws a distinction between the standards of conduct applicable to officers, on the one hand, and to directors, on the other; (2) significantly changes the traditional formulation of the standard of care; and (3) explicitly distinguishes between standards of conduct and standards of liability.

Model Act § 8.42 (a) sets out the following standard of conduct for officers:

> An officer, when performing in such capacity, has the duty to act:
>
> (1) in good faith;
>
> (2) with the care that a person in a like position would reasonably exercise under similar circumstances; and
>
> (3) in a manner the officer reasonably believes to be in the best interests of the corporation.

Model Act § 8.30 sets out the following standard of conduct for directors:

> (a) Each member of the board of directors, when discharging the duties of a director, shall act:
>
> (1) in good faith, and
>
> (2) in a manner the director reasonably believes to be in the best interests of the corporation.
>
> (b) The . . . [directors], when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall

> discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

Sections 8.30 and 8.42 differ as follows. One standard of conduct under section 8.42 is that an officer "shall act with the care that a person in a like position would reasonably exercise under similar circumstances." Section 8.31 does not have a precise counterpart to this provision. Instead, it provides that directors, "when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances."

The Official Comment to section 8.30 stresses that this standard differs from the traditional standard:

> In earlier versions of the Model Act the text [read]: ''[a] director shall discharge his duties . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances.'' The use of the phrase ''ordinarily prudent person'' in a basic guideline for director conduct, suggesting caution or circumspection vis-a-vis danger or risk, has long been problematic given the fact that risk-taking decisions are central to the directors' role. . . . In order to facilitate its understanding, and analysis, independent of the other general standards of conduct for directors, the duty of care element has been set forth as a separate standard of conduct in subsection (b).

The Comment also stresses that section 8.30 sets out a standard of conduct, not a standard of liability:

> . . . Section 8.30 deals only with standards of conduct (the level of performance expected of every director entering into the service of a corporation and undertaking the role and responsibilities of the office of director). The section does not deal directly with the liability of a director (although exposure to liability will usually result from a failure to honor the standards of conduct required to be observed by subsection (a). . . . Section 8.30 does, however, play an important role in evaluating a director's conduct and the effectiveness of board action. . . . Finally, section 8.30 compliance may have a direct bearing on a court's analysis where transactional justification (e.g., a suit to enjoin a pending merger) is at issue. . . .

The Comment also explicates as follows two of the important terms used in the text:

> (4) The phrase ''reasonably believe appropriate'' refers to the array of possible options that a person possessing the basic director attributes of common sense, practical wisdom and informed judgment would recognize to be available, in terms of the degree of care that might be appropriate, and from which a choice by such person would be made. The measure of care that such person might determine to be appropriate, in a given instance, would normally involve a selection from the range of options and any choice within the realm of reason would be an appropriate decision under the standard of care called for under subsection (b). However, a decision that is so removed from the realm of reason, or is so unreasonable, that it falls outside the permissible bounds of sound discretion, and thus an abuse of discretion, will not satisfy the standard.
>
> (6) The combined phrase ''in a like position . . . under similar circumstances'' is intended to recognize that (a) the nature and extent of responsibilities will vary, depending upon such factors as the size, complexity, urgency, and location of activities carried on by the particular corporation, (b) decisions must be made on the basis of the information known to the directors without the benefit of hindsight, and (c) the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care. Even though the combined phrase is intended to take into account the special background, qualifications and management responsibilities of a particular director, it does not excuse a director lacking business experience or particular expertise from exercising the basic director attributes of common sense, practical wisdom, and informed judgment.

IV. STANDARDS OF REVIEW

I now turn to standards of review. A standard of review may come into play in determining (1) whether a director or officer will be liable; (2) whether corporate action generally, or board action in particular, will be valid or at least should be given deference; and (3) whether injunctive relief should be issued. I will focus primarily on standards review for purposes of liability.

There are three strong reasons why, in the case of the director's duty of care, the standard of liability should in at least some kinds of cases differ from the standard of conduct. The first reason is that able persons should not be discouraged from serving as directors by the prospect of liability that vastly exceeds the monetary gains from such service. The second reason is that an inappropriate standard of conduct might lead to the unfair imposition of liability. The third reason is that the law should not provide an incentive to directors to make less risky rather than more risky business decisions, because more risky business decisions often have a higher expected value than less risky decisions. For example, suppose that Corporation C has $100 million in assets. C's board must choose between Decision X and Decision Y. Each decision requires an investment of $1 million. Decision X has a 75% likelihood of succeeding. If the decision succeeds, C will gain $2 million. If it fails, C will lose its $1 million investment. Decision Y has a 90% chance of succeeding. If the decision succeeds, C will gain $1 million. If it fails, C will recover its investment. It is in the interest of C's shareholders that the board make Decision X, even though it is riskier, because the expected value of Decision X is $1.25 million (75% of $2 million, minus 25% of $1 million) while the expected value of Decision Y is only $900,000 (90% of $1 million). If directors were unduly concerned with liability for decisions that turned out badly, they will be tempted to make Decision Y, even though it is less valuable than Decision X.

I now consider the standards of review applicable to decisionmaking, monitoring, and the duty of inquiry. I begin with decisionmaking.

A. The Substance or Quality of Decisions

Decisionmaking has two elements: the *process* of arriving at the decision, and the *substance* of the decision itself. The standard of conduct that applies to both elements is normally a standard of reasonability. Thus an actor playing a given role, such as a driver, doctor, or director, should follow a reasonable decisionmaking process and should make reasonable decisions. In the corporate context, however, the standard of review of the process of making decisions, on the one hand, and of the substance, or quality, of decisions, on the other, is often very different. Consider first the substance or quality of decisions, which is often reviewed by the application of a special standard of review under the business-judgment rule.

1. *The business-judgment rule*. Outside corporate law, when liability turns on decisionmaking, normally the focus is on the quality of the decision rather than on the decision-making process. For example, if an automobile driver makes a bad decision—that is, a decision that falls short of the decision that a reasonable person would make—the driver will be liable regardless of the process he followed to arrive at the decision. In corporate law, in contrast, where the issue is whether directors should be liable for a decision that caused harm to the corporation, different standards of review are applied to the decisionmaking process and to the quality of the decision. Under *the business-judgment rule*, the standard of review applied to the quality of a director's decision—that is, the reasonableness of the decision—is much less demanding than the standard of review applied to the reasonableness of the decisionmaking process.

The business-judgment rule consists of four conditions, and a special standard of review that is applicable, if the four conditions are satisfied, in suits that are based on the *substance* or *quality* of a decision a director or officer has made, as opposed to the decision-making process he utilized to arrive at his decision.

The four conditions are as follows[4]:

First, a judgment must have been made. So, for example, a director's failure to make due inquiry, or any other simple *failure* to take action (as opposed to a *decision* to not take an action) does not qualify for protection of the rule.

Second, the director or officer must have informed himself with respect to the business

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[4] *See* Principles of Corporate Governance § 4.01(c).

judgment to the extent he reasonably believes appropriate under the circumstances—that is, he must have employed a *reasonable decision-making process*.

Third, the decision must have been made in good faith.

Fourth, the director or officer may not have a financial interest in the subject-matter of the decision. For example, the business-judgment rule is inapplicable to a director's decision to approve the corporation's purchase of his own property.

If the conditions of the business judgment rule are *not* satisfied, then the standard by which the quality of a decision is reviewed is entire fairness or reasonability. This is nicely illustrated by the Delaware Supreme Court's decision in *Cede & Co. v. Technicolor, Inc*., in 1993.[5] In that case, Perelman, the CEO of MacAndrews & Forbes, Inc. ("MAF"), entered into negotiations with Kamerman, the CEO of Technicolor, with a view to an acquisition of Technicolor by MAF. On the basis of limited information, Goldman Sachs, an investment banker, told Kamerman that a price of $20-22 per share for Technicolor was worth pursuing; that a price of $25 might be feasible; and that Kamerman should consider other possible purchasers. Six days later, Kamerman and Perelman agreed on a price of $23. That evening, Kamerman called a special meeting of Technicolor's Board, to be held two days later. At the meeting, the board approved an agreement with Perelman's company at the $23 price, and recommended that Technicolor's shareholders accept that price.

At the trial, the Chancellor found that it was a matter of grave doubt whether Technicolor's board had exercised due care in *making* its decision, for the following reasons, among others. (1) The agreement was not preceded by a prudent search of alternatives. (2) Given the terms of the merger and the circumstances, the directors had no reasonable basis to

[5] Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993), modified, 636 A.2d 956 (Del. 1994), on remand, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134 (Del. Ch. 1994), aff'd, 663 A.2d 1156 (Del. 1995).

assume that a better offer from a third party could be expected once the agreement was signed. (3) Most of the directors had little or no knowledge of an impending sale of the company until they arrived at the meeting, and only a few of them had any knowledge of the terms of the sale.

On the basis of these conclusions, the Delaware Supreme Court held that Technicolor's board failed to reach an informed decision when it made its decision, so that the business-judgment rule did not apply. As a result, the court held, the directors had the burden of showing that the transaction was entirely fair. If the $23 price was not entirely fair, the directors would be liable for damages equal to the difference between $23 per share and the fair price. And, the court added, because the business-judgment rule did not apply, the directors had the burden of proving that the price was entirely fair.[6]

In contrast, if the four conditions of the business-judgment rule ***are*** satisfied, then the substance or quality of the decision will be reviewed, not under the basic standard of conduct, to determine whether the decision was ***reasonable***, but only under a much more limited standard. The prevalent formulation of the standard of review under the business-judgment rule, if the four conditions to that rule have been satisfied, is that the decision must be ***rational***.[7] This rationality standard of review is much easier to satisfy than a reasonability standard. To see how exceptional a rationality standard is, we need only think about the judgments we make in everyday life. It is common to characterize a person's conduct as imprudent or unreasonable, but it is very uncommon to characterize a person's conduct as irrational.

An obvious example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained. For example, in ***Selheimer v. Manganese Corp. of***

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[6] The court said that in the review of a transaction involving a sale of a company, the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). On remand, the Chancellor held that the price was entirely fair, and the Delaware Supreme Court affirmed.

[7] ***See*** Principles of Corporate Governance, § 4.01(c)(3).

America,[8] a corporation's managers poured a corporation's funds into the development of a single plant even though they knew the plant could not be operated profitably because of various factors, including lack of a railroad siding and proper storage areas.[9] The court imposed liability because the managers' conduct "defie[d] explanation; in fact, the defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures."[10]

Bill Allen, formerly the Chancellor of Delaware[11] and now a professor of law at New York University, has argued in several contexts that if a judgment has been made, and the director reasonably informed himself, acted in good faith, and was disinterested, then the director's conduct should not be subject even to a review for rationality. This argument was most recently made in an article, *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*,[12] which Chancellor Allen co-authored with Jack Jacobs (then a Vice-Chancellor of Delaware, now a member of the Delaware Supreme Court) and Leo Strine, also a Vice-Chancellor. In that article, the argument against even a rationality standard of review is made on the basis of two propositions.

The first proposition is that a decision cannot be irrational if it was made by directors who were disinterested and independent, acted in good faith, and employed a reasonable decisionmaking process.[13] The proposition is incorrect. For example, an automobile driver deciding whether to pull out and pass a very slow car on the highway may consider all the

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[8] 224 A.2d 634 (Pa. 1966).
[9] *See id.* at 639.
[10] *Id.* at 646.
[11] The Delaware Court of Chancery is a trial court. The chief judge of this court is the Chancellor. The other judges are Vice-Chancellors. The Court of Chancery is not the only trial court in Delaware, but it hears almost all corporate-law cases, and specializes in such cases. Each case is heard, and decided, by the Chancellor or a Vice-Chancellor, not by a jury, and not by a panel of judges. Accordingly, the position of the Chancellor is not too different from the position of the Vice-Chancellors. However, the position of Chancellor does carry certain weight, and Chancellor Allen was undoubtedly one of the leading corporate-law judges of the last part of the twentieth century.
[12] 56 BUS. LAW. 1287 (2001)
[13] *Id.* at 870.

variables carefully, act in good faith and without self-interest (in the sense that under appropriate circumstances it is always permissible to pass a very slow driver), and yet make an irrational decision that results in an accident. Similarly, a doctor may irrationally conclude that a certain nutritional regimen cures cancer of the brain, and may treat patients accordingly, thereby deflecting patients from getting proper care. He may reach that irrational conclusion even though he has studied the literature about cancer and nutrition carefully, and acted in good faith and without self-interest.

Similarly, a director may do his homework, act in good faith and without self-interest, and nevertheless make a decision that is so bad as to be irrational—as happened in the *Selheimer* case. Maybe the driver, the doctor, or the director was just not very smart. Maybe the driver, the doctor, or the director had terrible judgment.

Do actors often make irrational decisions? Probably not; and probably directors make irrational decisions even more seldom than other actors, because directors usually act as a group, and it will be unlikely that a whole group will be irrational. But to say that directors seldom make irrational decisions is far different from saying that they cannot and never do make irrational decisions, as *Selheimer* illustrates. Unfortunately, both history and everyday experience teaches that small groups and even large groups sometimes do act irrationally. It is therefore not the case, as Chancellor Allen argues, that an actor—driver, doctor, or director—cannot make an irrational decision if he is disinterested and independent, acts in good faith, and employs a reasonable decisionmaking process.

The second proposition underlying the argument that a rationality standard of review should not be applied to a decision by a director if the director reasonably informed himself, acted in good faith, and was disinterested, is that if those conditions are satisfied, there is no moral or practical basis for the law to impose liability on a director.[14] This proposition is also incorrect.

First, an actor who plays a role has a duty to play the role with care, whether the actor is a driver, a doctor, or a director. A driver or a doctor can fairly be held morally responsible for an injury even though *he has done his best*, if he has not lived up to the manner in which his role should be played. The same is true of a director.

Second, a review for a rationality standard serves a very important practical purpose. It is not always easy to directly determine whether a director *did* act in good faith, *was* completely disinterested, and *did* make a reasonable inquiry. A review for rationality provides an indirect check on whether these conditions have been satisfied. That a decision lacks rationality provides strong although indirect evidence that one or more of these conditions have not really been satisfied.

In the balance of this paper, I will refer to the standard of review that is applied if the conditions of the business-judgment rule are satisfied as the *business-judgment standard*. Under this standard, a director or officer will not be liable for a decision that resulted in a loss to the corporation, even if the decision is unreasonable, as long as the conditions of the business-judgment rule have been satisfied and the decision is rational.

A rationality standard of review is more demanding of a director than a subjective-good-faith standard of review. However, it is considerably less demanding than the relevant standard of conduct, which is based on reasonableness. Why should such a relatively undemanding standard of review be applicable to the quality of decisions by corporate directors and officers? The answer to this question involves considerations of both fairness and policy.

a. *Fairness*. To begin with, the application of a reasonability standard of review to the

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[14] *Id*. at 870 n. 22.

substance or quality of disinterested decisions by directors and officers could lead to the unfair imposition of liability. In paradigm negligence cases that involve relatively simple decisions, such as automobile accidents, there is often little difference between decisions that turn out badly and bad decisions. Typically, in such cases, only one reasonable decision could have been made under a given set of circumstances, and decisions that turn out badly therefore almost inevitably were bad decisions.

In contrast, in the case of business decisions it may often be difficult for factfinders to distinguish between bad decisions and good decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable. A business decisionmaker faced with uncertainty must make a judgment concerning the relevant probability distribution, and must act on that judgment. If the decisionmaker makes a reasonable assessment of the probability distribution, and the outcome falls on the unlucky tail of the distribution, the decisionmaker has not made a bad decision, because in any normal probability distribution some outcomes will inevitably fall on the unlucky tail. By way of analogy, a weather forecaster may correctly say that there is an 80% chance of rain, and yet it may not rain. That doesn't mean the forecaster was wrong. The weather has fallen on the unlucky (20%) tail of the probability distribution.

Similarly, a director faced with a promising but expensive and untried new technology may have to choose between investing in the technology or forgoing such an investment. Each alternative involves certain negative risks. If the director chooses one alternative, and the associated negative risk materializes, the decision has turned out badly, but that doesn't mean it was a bad decision when made.

In a world with perfect information, and no cognitive biases, directors would have no constraint in selecting a more risky investment with a higher expected value over a less risky investment with a lower expected value. In the real world, however, there are both informational and cognitive constraints that come into play when the board makes a decision that turns out badly, and suit is brought against the directors on the ground that the decision was a bad one. In particular, there is a tendency for people judging a decision after the fact to conclude that a decision that turned out badly was a bad decision. This tendency results in part from a limit of cognition known as the hindsight bias.

Experimental psychology has shown that in ***hindsight***, people consistently exaggerate the ease with which outcomes could have been anticipated in *foresight*. People view what *has* happened as relatively inevitable.[15] Accordingly, people who know that a bad outcome resulted from a decision overestimate the extent to which the outcome was predictable, and therefore overestimate the extent to which the decisionmaker was at fault for making a bad decision.[16] Essentially, people find it difficult or even impossible to disregard information they possess about an outcome.[17] That information, in turn, renders those circumstances that originally

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[15] ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 119-20 (1988); BARUCH FISCHHOFF, FOR THOSE CONDEMNED TO STUDY THE PAST: HEURISTICS AND BIASES IN HINDSIGHT, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341-43 (Daniel Kahneman et al. eds., 1982) [hereinafter HEURISTICS AND BIASES]; Baruch Fischhoff, *Hindsight/Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 Journal of Experimental Psychology: Human Perception and Performance, 288-299 (1975); Baruch Fischhoff & Ruth Beyth, *"I Knew It Would Happen"—Remembered Probabilities of Once-Future Things*, 13 ORGANIZATIONAL BEHAV. AND HUM. PERFORMANCE 1-16 (1975) [hereinafter Fischhoff & Beyth].

[16] *See* Hal Arkes & Cindy Schipani, *Medical Malpractice and the Business Judgment Rule*, 73 ORE. L. REV. 587 (1994) [hereinafter Arkes & Schipani, *Medical Malpractice*]; Jonathan Baron & John C. Hershey, *Outcome Bias in Decision Evaluation*, 54 J. PERSONALITY & SOC. PSYCHOL. 569 (1988); Jonathan D. Casper et al., *Juror Decision Making, Attitudes, and the Hindsight Bias*, 13 L. & HUM. BEHAV. 291 (1989); Scott A. Hawkins & Reid Hastie, *Hindsight Biased Judgments of Past Events After the Outcomes Are Known*, 107 PSYCHOL. BULL. 311 (1990); Raanan Lipshitz, *"Either a Medal or a Corporal:" The Effects of Success and Failure on the Evaluation of Decision Making and Decision Makers*, 44 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 380 (1989) [hereinafter Lipshitz, *Success and Failure*]; Terence R. Mitchell & Laura S. Kalb, *Effects of Outcome of Knowledge and Outcome Valence on Supervisors' Evaluations*, 66 J. APPLIED PSYCHOL. 604 (1981).

[17] *See* Michael J. Saks & Robert F. Kidd, *Human Information processing and Adjudication: Trial by Heuristics*, 15 L. & SOC'Y. REV. 123, 144 (1980).

pointed to the actual outcome more salient in people's minds, because those circumstances can easily be integrated into a cohesive story that ends with the actual outcome, while circumstances pointing in other directions cannot. Attempting to understand why a particular outcome occurred increases the salience of data and reasons that can be integrated into coherent explanatory patterns. Data that cannot easily be integrated in this way tend to be deemphasized or reinterpreted to fit the dominant explanation.[18]

The hindsight bias is nicely illustrated by an experiment in which 112 anesthesiologists reviewed the anesthesiological care in 21 pairs of case files that were based on actual cases. Each anesthesiologist was presented with one case file from each pair. The patient and the treatments described in each of the two paired case files were identical, and the outcomes described in all the case files were adverse. However, the case files were edited so that in one case file in each pair the adverse outcome was described as temporary, while in the other case file the adverse outcome was described as permanent. The anesthesiologists were instructed to determine, in each of the 21 case files they reviewed, whether the anesthesiologal care was less than appropriate, appropriate, or impossible to judge. When the adverse outcome was described as permanent, rather than temporary, the distributions of the anesthesiologists' judgments concerning the appropriateness of the care was shifted by 30 percent.[19] Comparable results have been obtained in other experiments, even when the subjects have been explicitly instructed to

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[18] Fischoff & Beyth, *"I Knew It Would Happen"—Remembered Probabilities of Once-Future Things*, 13 ORGANIZATIONAL BEHAV. AND HUM. PERFORMANCE 1 (1975) at 1; *see also* Casper, *Juror Decision Making, supra*, at 293:

> The hindsight bias process appears to involve an integration of outcome information into one's understanding of the story, influencing judgments about the inevitability of the outcome, perhaps by affecting the recall of material or its weighting.

[19] Robert A. Caplan et al., *Effect of Outcome on Physician Judgments of Appropriateness of Care*, 265 J. AM. MED. ASSN. 1957 (1991). This experiment, as well as the hindsight bias, its application to the business judgment rule, and other hindsight experiments in the medical area, are discussed in a very illuminating way in Arkes & Schipani, *Medical Malpractice, supra* 20.

disregard outcomes in evaluating fault.[20] The hindsight bias is also well-supported by survey evidence concerning the attribution of responsibility, and by casual empiricism.[21]

As a result of the hindsight bias, under a reasonableness standard of review, fact-finders might too often erroneously treat decisions that turned out badly as bad decisions, and unfairly hold directors liable for such decisions. The business-judgment rule protects directors and officers from liability as a result of decisions by fact-finders who erroneously conclude, as a result of the hindsight bias, that a proper decision that turned out badly was a bad decision.[22]

b. *Shareholder interests*. By providing directors and officers with a large and proper zone of protection when their decisions are attacked, the business-judgment rule makes it easier for directors to make sensible but high-risk decisions with high expected value, which will benefit shareholders more than low-risk decisions with a lower expected value, as in the case of Decisions X and Y in the example discussed earlier. Thus, the shareholders' own best interests may often be served by conducting only a very limited review of the quality or substance of directors' and officers' decisions.

An important point here is that there is an asymmetry between the liability exposure of directors who make sensible but high-risk decisions and directors who make low-risk decisions. A sensible high-risk decision can be a good decision if it has a high expected value. If a high-risk decision has a positive outcome, the corporation, not the directors, will gain. However, if a high-risk decision has a negative outcome, then under a reasonability standard of review, as a

[20] *See, e.g.*, Casper, *Juror Decision Making, supra*, at 20.
[21] *See* Lipshitz, *Success and Failure*, *supra*, at 38 1-82.
[22] Other kinds of decision makers who must make decisions on the basis of incomplete information and in the face of obvious risks can often shield themselves from liability for decisions by showing that they followed accepted protocols or practices. *See, e.g.*, Osborn v. Irwin Memorial Blood Bank, 5 Cal. App. 4th 234, 278 n.13 (Ct. App. 1992) (recognizing that medical practitioners have this defense available because "compliance with accepted practice is generally taken as conclusive evidence of due care.") (quoting Allan H. McCoid, *The Care Required of Medical Practitioners*, 12 VAND. L. REV. 549, 560 (1959)). In contrast, directors and officers can seldom shield themselves in that way, because almost every business decision is unique.

result of the hindsight bias the directors might be judged at fault and required to make up the corporate loss. A low-risk decision can be a bad decision if it has a low expected value. As a practical matter, however, bad low-risk decisions will almost never result in liability, or even suit. No one gets sued for not taking *enough* risk, partly because low-risk decisions result only in forgone profits, while high-risk decision that turn out badly result in losses, and partly because courts would be reluctant to insist on directors taking more risk. Accordingly, without the protection of the business-judgment rule, directors would have an incentive to prefer low-risk-and-low-expected-value decisions to sensible high-risk-and-high-expected-value decisions, even though the shareholders, who can diversify their risks, would prefer that directors make the latter kind of decision. The business-judgment rule helps to offset that incentive.

c. *Disproportionate liability*. Finally, at least in the case of non-management directors, liability for the losses caused by an unreasonable business decision would often be far out of proportion to the incentives for accepting a directorship. Outside directors of publicly held corporations typically earn approximately $40,000-$50,000 or so annually in directors' fees. In contrast, liability for an unreasonable decision can be in the millions.[23] Therefore, in the absence of some brake on liability for violation of the duty of care, it might become more difficult to attract qualified candidates as non-management directors, which also would be contrary to the shareholders' own best interests.

2. *The Decisionmaking Process*. In contrast to the rationality standard of review, which applies to a review of the *substance* or quality of decisions, if the conditions of the business-judgment rule are satisfied, a more rigorous standard of review applies to the decisionmaking *process*. For example, under section 4.01 of the *Principles of Corporate Governance*, it is a condition to the application of the business-judgment rule that the director or officer must have

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[23] *See, e.g.*, Smith v. Van Gorkum, 488 A.2d 858, 899 (Del. 1985) (Christie, J., dissenting).

duly informed himself to the extent he reasonably believes appropriate under the circumstances—that is, he must have employed a ***reasonable decision-making process***. Similarly, Model Act § 8.30(b) sets out as a standard of conduct for directors that "The . . . [directors], when becoming informed ***in connection with their decision-making function*** or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would ***reasonably*** believe appropriate under similar circumstances."[24]

There are two primary reasons why in American corporate law a more rigorous standard of review should and does apply to the decisionmaking process, than to the substance or quality of the decision itself.

First, the desirability of not giving directors a disincentive to make sensible but more risky decisions does not apply the decisionmaking process. Second, the *premise* of giving directors a wide zone of discretion in their decisions is that they have employed a careful decisionmaking process.

The difference is reflected in both statutory and case law. For example, Model Act § 8.31(a), which governs standards of liability—as opposed to the standards of conduct—for directors, provides that "A director shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as a director, unless

[24] The Comment to Section 8.30(b) states:

> The phrase ''becoming informed,'' in the context of the decision-making function, refers to the process of gaining sufficient familiarity with the background facts and circumstances in order to make an informed judgment. Unless the circumstances would permit a reasonable director to conclude that he or she is already sufficiently informed, the standard of care requires every director to take steps to become informed about the background facts and circumstances before taking action on the matter at hand. The process typically involves review of written materials provided before or at the meeting and attention to/participation in the deliberations leading up to a vote. It can involve consideration of information and data generated by persons other than legal counsel, public accountants, etc., retained by the corporation . . . forexample, review of industry studies or research articles prepared by unrelated parties could be very useful. It can also involve direct communications, outside of the boardroom, with members of management or other directors. . . .

the party asserting liability in a proceeding establishes that . . . the challenged conduct consisted or was the result of . . . a decision . . . as *to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances*."[25]

To put this differently, although the law should *not discourage* directors and officers from making sensible but more risky decisions, it should *encourage* directors and officers to prepare carefully in making those decisions. Furthermore, a review of whether a director or officer has prepared carefully will usually be subject to less risk of error than a review of whether a director or officer made a good decision. More broadly, a substantive review of the quality of directors' decisions for reasonability would typically involve, among other things, a determination of what risk levels the corporation should have accepted and what risks it should have undertaken—a kind of review that would not only be extremely difficult, but would threaten to impinge seriously on corporate autonomy. In contrast, a review of the decisionmaking process typically does not involve such determinations.

For all these reasons, the business-judgment rule does not shield the decisionmaking process. Accordingly, the standard of review for liability concerning the decisionmaking process is not rationality, but reasonability, or some variant of reasonability.

A few courts have adopted a rule that the standard of review of a director's decisionmaking process is gross negligence."[26] The concept of gross negligence is notoriously ambiguous, and in practice it is common to find that courts that purport to apply that standard actually apply a standard that is either more or less demanding. Courts that purport to adopt a gross-negligence standard in reviewing the decisionmaking process probably do so because the performance of these duties seldom presents a cut-and-dried issue, and the gross-negligence

[25] Model Act § 8.31(a)(2)(ii)(b) (emphasis added).
[26] *See*, *e.g*., Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985).

standard of review emphasizes the importance of leaving a play in the joints in determining whether the relevant standard of conduct was satisfied. However, play in the joints is built into the very concept of due care. For example, in ***Rabkin v. Phillip A. Hunt Chemical Corp***.,[27] then-Vice-Chancellor Berger stated that even under an ordinary-negligence standard, corporate directors will not face liability for the failure to focus on an isolated bit of information.

C. Monitoring

A crucial function of directors is to monitor the conduct of the business. Much oversight will be performed through the board's ongoing review of the corporation's business performance, business plans, and major risks to which the corporation is exposed. This kind of monitoring is ***reactive*** to the information that flows to the board naturally. In addition, however, monitoring must be ***proactive***. To properly exercise its monitoring function the board must also ensure that arrangements are in place to provide adequate and timely information to the board. More specifically, the board or its committees must ensure that the corporation has appropriate mechanisms for preparing the corporation's financial statements; appropriate policies and practices to foster the corporation's compliance with law and ethical conduct; and effective internal controls.

The board's responsibility for giving attention to the adequacy of internal controls is a relatively new and particularly important component of the monitoring function. The most authoritative statement concerning internal controls is to be found in the "COSO Report," a comprehensive four-volume report on internal control authored by five accounting organizations known as the Committee of Sponsoring Organizations, and entitled ***Internal Control: Integrated***

[27] 13 DEL. J. CORP. LAW 1210 (Del. Ch. 1987).

Framework.[28] The COSO Report defines internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories: "effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."[29] Internal control over each of these objectives consists of five interrelated components: the control environment, risk assessment, control activities, information and communication, and monitoring. A system of internal control is deemed to be effective only if all five components are functioning effectively.

The board's role is to use due care to assure itself that an internal control structure is in existence, is appropriate, and is effective. The board's responsibility in these matters is not to ensure that specific controls never fail. Accordingly, a breakdown in a specific control does not in itself establish that the board has not discharged its responsibility. Furthermore, the board need not ensure that every conceivable control is in place. In determining whether any given control should be installed, and the extent and contours of a control, the risk of failure if the control is not in place must be balanced with the control's costs.[30]

The board should, however, be responsible for using due care to assure itself that the five components of internal control—control environment, risk assessment, control activities, information and communication, and monitoring—are in place in such a way as to provide reasonable assurance regarding the effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with corporate policies and legal rules.[31]

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[28] COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, AICPA, INTERNAL CONTROL-INTEGRATED FRAMEWORK (1992) [hereinafter COSO REPORT].
[29] *Id*. at 9.
[30] *See* COSO REPORT, *supra* note 26, at 77; *Reports on Internal Control*, *supra* note 13, at 912-13.
[31] *See* COSO REPORT, *supra* note 26, at 12-14.

To this end, the board should be especially concerned with overseeing the design and integrity of appropriate systems for producing reliable financial and operational information, and for assessing the likelihood or frequency of significant risks and considering how such risks should be managed.

The board should also be especially concerned to assure that appropriate compliance programs are in place. These programs should include the creation and distribution of codes of conduct based on corporate policies and legal rules, procedures for ensuring that the substantive rules are complied with, and methods for effectively disseminating the programs. The board should monitor the remedial actions taken in response to departures from compliance programs and, more generally, the remedial actions taken in response to violations of established corporate policies and legal rules, whether or not embodied in corporate codes of conduct. In addition, the board should regulate management interventions to override compliance programs, either by prohibiting such interventions without board approval, or by requiring documentation and reports to the board if such interventions occur.

Also of special importance is the design and integrity of protocols for reporting on deficiencies and reportable conditions in internal control. A *deficiency* is a condition in the internal control structure that is "worthy of attention."[32] A deficiency "may represent a perceived, potential, or real shortcoming, or an opportunity to strengthen the internal control system to provide a greater likelihood that the entity's objectives will be achieved."[33] A *reportable condition* is a "significant deficienc[y] in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the

[32] *Id*. at 70.
[33] *Id*.

financial statements."[34] The board should assure itself that protocols are in place for reporting deficiencies to appropriate persons and for reporting reportable conditions to both senior executives and the board.

Finally, the board should assure itself that periodic evaluations of internal control are conducted. This responsibility includes determining that appropriate portions of the internal control structure are reevaluated by personnel with the requisite skills, that the reevaluations have adequate scope and depth of coverage and are conducted with adequate frequency, and that the methodology for evaluating internal control is logical and appropriate.

In addition to being responsible for assuring itself that the design of the internal control structure is appropriate and effective, the board is responsible for assuring itself of the proper administration of internal control. The most significant instrument for executing this responsibility, at least in large publicly held corporations, is an internal auditing function, consisting of a senior internal auditing executive, an internal auditing staff, and in some cases, outsourcing.

An important case on the duty to monitor is *In re Caremark International*,[35] decided in 1996 by Chancellor Allen. Caremark conducted a patient-care and a managed-care business. The patient-care business included alternative-site services, and the managed-care business included prescription drug programs and the operation of multi-specialty group practices. A substantial part of Caremark's revenue was derived from third-party payment programs, including Medicare and Medicaid. These payments were subject to the Anti-Referral Payments Law ("ARPL"), which prohibited health-care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients.

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[34] ***Id***. at 72; *see also* Auditing Standards Board, AICPA, Statement on Auditing Standards No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit (1988).
[35] In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

From its inception, Caremark entered into a variety of agreements with health-care providers, including consultation agreements with, and research grants to, physicians. At least some of these physicians prescribed or recommended Caremark services or products to Medicare recipients and other patients. Based on these agreements and grants, Caremark was indicted for violating ARPL. Caremark pleaded guilty to mail fraud and agreed to pay civil and criminal fines. Subsequently, it also reimbursed various private and public parties. In all, Caremark was required to make payments of approximately $250 million.

Derivative actions based on these payments were brought against the directors, and settled. The issue in Caremark was whether the settlements should be judicially approved. That issue, in turn, depended in part on the duty of the board in connection with the installation of monitoring systems. Chancellor Allen's important opinion is worth quoting at length:

> As the facts of this case graphically demonstrate, ordinary business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals. [This raises] the question, what is the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes? . . .
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> . . . Can it be said . . . that, absent some ground giving rise to suspicion of violation of law, . . . corporate directors have no duty to assure that a corporate information gathering and reporting system exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations? I certainly do not believe so.
>
> . . . I note the elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law. . . .
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> . . . [It] would, in my opinion, be a mistake to conclude that . . . corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to

> allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance. . . .
>
> Thus, I am of the view 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 failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.

However, Chancellor Allen set the standard of review for an alleged breach of this duty at a very high (difficult to prove) level, analogous to the business-judgment rule:

> . . . Generally where a claim of directorial liability for corporate loss is predicted upon ignorance of liability creating activities within the corporation, as . . . in this case, in my opinion 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. Such a test of liability—lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight—is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.

Somewhat similarly, Model Act § 8.31(a)(2)(iv) makes a director liable for "a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation."

It is not entirely clear why only a "sustained" failure to devote attention to the oversight of the corporation's business should result in liability. The concern may be that liability should not be imposed for an occasional minor lapse, like missing a few meetings. The requirement that the failure be "sustained" is best interpreted as meaning a failure that is significant, not defensible, and uncorrected. In that connection, Section 8.31(b)(2)(iv) goes on to provide for liability for "failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefore."

D. Inquiry

The duty to monitor requires, among other things, that the directors take steps to ensure that systems are in place that will produce relevant information. The duty of inquiry is a duty to follow up on information that is either deliberately produced by these information systems, or fortuitously comes to the attention of one or more directors or the board as a whole, which a reasonable person would follow up by further inquiry. For example, if the board acquires information, either deliberately or fortuitously, which suggests that the corporation may be using misleading accounting methods, or that the Chief Financial Officer may be embezzling, the board is under a duty to launch inquiries to determine if the information is correct, and if so, to either itself take appropriate action or order appropriate action to be taken.

Because a failure to make inquiry normally does not involve a judgment, the business-judgment rule does not apply. The standard of review for liability for failure to make a inquiry should be and presumably is the same standard of review that applies to the failure of a director to adequately inform himself before making a decision, that is, a reasonability test—either negligence or, perhaps, gross negligence.

V. LIABILITY-LIMITING MECHANISMS

If we focus on the effect, as opposed to the purpose, of the business-judgment rule, the rule is a liability-limiting mechanism. As shown above, however, the business-judgment rule only applies to a portion of the duty of care, namely, the portion in which a judgment has been made and the four conditions of the rule have been satisfied. Accordingly, the business-judgment rule does not protect a director who has not prepared reasonably in making a judgment, has failed to reasonably perform the monitoring function, or has failed to reasonably follow up on information that gave rise to a duty of inquiry. In all these cases, liability is appropriate, but the issue remains, how much liability? Violation of the duty of care is much less serious than violation of the duty of loyalty; involves only economic, not physical harm. Furthermore, such liability may be out of all proportion to the compensation of a director. Accordingly, mechanisms to limit liability for violation of the duty of care, in addition to the business-judgment rule, seem appropriate, and have in fact been widely adopted in American corporation law. In this Part, I will consider four such mechanisms: indemnification, insurance, special litigation committees, and exculpatory provisions.

1. *Indemnification*. All American corporation statutes include a provision concerning the indemnification of directors and officers. The statutes vary in some significant details but are comparable in their basic structure. The Delaware statute is typical:

> (b) A corporation shall have *power* to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that the person is or was a director, officer, employee or agent of the corporation . . . against expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.
>
> (c) To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person *shall* be indemnified

> against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.[36]

The indemnification mechanism does not provide complete protection for a director who is sued for violation of the duty of care, for two reasons.

First, a corporation normally does not have power to indemnify the director for the amount of a judgment against him based on such a violation, although the corporation does have power to indemnify him for his expenses in defending a duty-of-care lawsuit, and for the cost of a settlement, provided that he acted in good faith and in a manner that he reasonable believed to be in, or not opposed to, the best interests of the corporation.

Second, although the corporation has the *power* to indemnify a director or officer for expenses incurred in defending a duty of care lawsuit, and for the cost of a settlement, provided that the director acted in good faith and in a manner that he reasonable believed to be in, or not opposed to, the best interests of the corporation, the corporation normally is not *required* to grant such indemnification unless either the director or officer was successful on the merits or otherwise, or the corporation has given the director a right to such indemnification in the by-laws or by contract. Accordingly, the corporation may refuse to make indemnification in a case where indemnification is discretionary rather than required.

Third, the corporation may have become insolvent, and unable to pay indemnification.

2. *Directors' and officers' liability insurance*. All American corporate statutes also allow corporations to purchase insurance to reimburse directors and officers for liability incurred in that capacity ("D & O insurance"), with certain exceptions, and for attorneys' fees in defending against suits based on such liability. Again, the Delaware statute is typical:

> A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the

[36] DEL. GEN. CORP. LAW §§ 145(b), (c).

> corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power to indemnify such person against such liability under this section.[37]

Among approximately 1,325 participants in a 1999 survey, D & O insurance was carried by 92% of those corporations with $100-400 million in assets, and those with under $50 million in assets; 94% of those with $1-2 billion in assets; and 97% of those with over $10 billion in assets.[38]

Unlike indemnification, D & O insurance covers liability for judgments against directors based on violation of the duty of care. Like indemnification, however, D & O insurance does not render directors and officers completely risk-free with regard to claims based on the duty of care.

To begin with, the policy limits in D & O insurance typically apply to the combined amount of liability and legal expenses, and in any given case the combination of the two may exceed the policy limit.[39]

Furthermore, many D & O policies contain an "insured v. insured" exclusion, under which the insurer is not liable in connection with claims made against a director or officer by the corporation, except a claim made in a shareholder's derivative action (that is, a claim made by a shareholder on the corporation's behalf). Accordingly, D & O insurance may not protect a director against liability for duty of care if suit for violation of the duty is brought by the corporation, rather than by a shareholder in a derivative action. This may occur either because (1) the existing board believes that suit should be brought; (2) a new board takes office, through

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[37] DEL. GEN. CORP. LAW §§ 145(g).

[38] D & O insurance is commonly referred to as—and often captioned—"liability" insurance, because it insures against liability and legal expenses. Technically, however, D & O is indemnification insurance, because it does not require the insurer to defend (although it does require the insurer to indemnify for losses, including defense costs), and the insurer's obligations do not accrue until the claim is settled or adjudicated. See J. Bishop, The Law of Corporate Officers and Directors—Indemnification and Insurance § 8.05 (G. O'Gradney rev. 1994).

[39] See Helfand v. National Union Fire Ins., 10 Cal. App.4th 869, 13 Cal.Rptr.2d 295 (1992).

a takeover or otherwise, and the new board believes that suit should be brought; or (3) the corporation becomes insolvent, and a bankruptcy trustee brings suit.

Another characteristic of American D & O insurance that is relevant to the protection afforded by such insurance is that such insurance is written on a "claims made" basis—that is, the insurance applies to, but only to, claims made while the policy is in force. To illustrate, suppose C Corporation procured a D & O policy from X Insurance Company for 2004. A claim that is based on events that occurred in 2002 may be covered by the policy even though X was not C's insurer in 2002. Conversely, however, a claim based on events that occurred in 2004 may not be covered by X's policy if the claim is not made until 2005, unless a new claims-made policy is in effect.[40]

3. *Special litigation committees*. Liability for the duty of care usually, although not invariably, arises in the context of a derivative action brought by a shareholder on the corporation's behalf. Often, under American corporate law and practice, the board will create a special litigation committee ("SLC") to investigate the facts giving rise to such an action, and the desirability of litigation against a director based on those facts. Typically, although not invariably, the SLC determines that is in the best interest of the corporation that the litigation be terminated. The board, acting for the corporation, then brings a motion to the court requesting such termination.

[40] The claims-made nature of D & O insurance is often modified by several features. First, a policy may contain a "retroactive date" provision, under which events occurring before a designated date will not be covered by a policy even if a claim based on the events is first made during the policy period. Second, a policy may include a right of "discover," which allows an insured to extend the coverage for a claim made during a limited period after the policy has terminated, provided the claim is based on wrongful acts that occurred prior to termination of the policy. In addition, many policies permit an insured to present a notice of occurrence of a possible claim during the policy period, which has the same effect as an actual claim made against the insured. Subject to these exceptions, an effect of the claims-made nature of D & O insurance is that a director or executive cannot be positive that he will be covered for his present conduct if a claim arises in the future, after the policy has expired or has been canceled.

The law concerning the effect of such a motion is extremely complex, and varies considerably from state to state. For present purposes, it suffices to say that if (1) a majority of the board is disinterested and independent; (2) the SLC itself is composed of disinterested and independent directors, and does its job carefully and responsibly; and (3) the committee's recommendation is reasonably related to the facts it finds, then the committee's recommendation will be followed by the court. Accordingly, the SLC is another mechanism that can and does serve to limit directors' liability for violation of the duty of care.

Like indemnification and D&O insurance, the SLC mechanism does not provide complete insulation against disproportionate liability for violation of the duty of care. In some cases, an SLC may not be appointed for tactical reasons. In other cases, the SLC that is appointed may not conduct itself in a proper way. Finally, as in the case of indemnification, the existing board, or the SLC itself, may conclude that the derivative action has merit; or a new board may have taken office, and may conclude the derivative action is merited and not appoint an SLC; or the corporation may have become insolvent and the bankruptcy trustee may bring an action against the director.

4. *Exculpatory provisions*. Given the limitations on the business-judgment rule, indemnification, D & O insurance, and SLCs, to the extent that it is undesirable to subject directors to duty-of-care liability that is completely disproportionate to normal director compensation, some other mechanism may be required to limit such liability. In the 1980s, when the *Principles of Corporate Governance* was being drafted, the Reporters suggested such a mechanism—allowing a corporation's certificate of incorporation to include a provision that sets a cap on liability. As finally adopted, Section 7.19 of the *Principles* provides:

> Except as otherwise provided by statute, if a failure by a director or an officer to meet the standard specified in Part IV [Duty of Care and the Business

Judgment Rule] did not either:

> (1) Involve a knowing and culpable violation of law by the director or officer;
>
> (2) Show a conscious disregard for the duty of the director or officer to the corporation under circumstances in which the director or officer was aware that the conduct or omission created an unjustified risk of serious injury to the corporation; or
>
> (3) Constitute a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant's duty to the corporation;

and the director or officer . . . did not receive a benefit that was improper under Part V [The Duty of Fair Dealing], then a provision in a certificate of incorporation that limits damages against an officer or a director for such failure to an amount not less than such person's annual compensation from the corporation should be given effect, if the provision is adopted by a vote of disinterested shareholders after disclosure concerning the provision, may be repealed by the shareholders at any annual meeting without prior action by the board, and does not reduce liability with respect to pending actions or losses incurred prior to its adoption.

The rationale of the provision is stated as follows in the Comment:

. . . Under present law, a corporate director or officer who is found to have violated the duty of care faces potentially enormous liability, depending on the magnitude of the economic consequences to the corporation. Although such liability has rarely been imposed, it is disturbing that the potential damages are often likely to be higher in due care cases than in cases of a willful breach of the duty arising under Part V (Duty of Fair Dealing), where defendants generally only have to make restitution. The impact of potential liability in this amount may be counterproductive. . . . [T]he threat of such liability may chill the willingness of independent directors to serve if the potential burdens of office are perceived to outweigh the corresponding benefits. . . . More generally, the threat of liability may make corporate officials excessively risk-averse in their decisionmaking, thereby injuring shareholders and diminishing efficiency. Although the business judgment rule should serve as the primary bulwark of protection for the board, even the diligent and prudent director who complies fully with the requisite standard of care may fear that the fact-finder will misperceive the actual facts. . . .

The rationale for such a limitation rests on a variety of considerations. . . .

First and most fundamentally, it is justified on grounds of fairness, because the potential liability in cases in which it applies would otherwise be excessive in relation to the nature of the defendant's culpability and the economic benefits expected from serving the corporation.

> Second, such a limitation should reduce the pressures on directors to act in an unduly risk-averse manner. Realistically, the risk of liability for due care violations tends to be one-sided: directors can be held liable for excessively risky acts or decisions, but not, as a practical matter, for excessively cautious ones. Given the frequently nominal investment of directors in their corporation's stock, a substantial risk of liability for negligence might lead risk-averse directors to opt for more hesitant policies than shareholders desire (particularly to the extent that shareholders hold reasonably diversified portfolios and so are substantially protected against any firm- specific risk).

While section 7.19 was still in draft, but in wide circulation, many states adopted variants of the idea that underlies that section. Although the details of these statutes vary, Delaware General Corporation Law § 108(b)(7) is both prototypical and of central importance, given the role of Delaware in American corporation law. That section provides as follows:

> (b) The certificate of incorporation . . . may contain . . . :
>
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision 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 of omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under §174 of this title [dividends]; or (iv) for any transaction from which the director derived an improper personal benefit.

Section 102(b)(7) and like provisions in other states do not in themselves exculpate directors from liability. Rather, these statutes only authorize corporations to adopt exculpatory provisions in their certificates within the limits set by the statutes. It is highly likely that all or almost all publicly held American corporations have adopted such certificate provisions. For convenience, I will refer to such provisions as "Section 102(b)(7) certificate provisions."

It might appear that Section 102(b)(7) provides a way to eliminate the duty of care, or at least to make that duty meaningless. In fact, however, this is not the case.

To begin with, Section 102(b)(7) has several exceptions, the most important of which, for present purposes, is the exception for conduct that is not in good faith. Two important cases, *McCall v. Scott* and *In re The Walt Disney Corporation Derivative Litigation*, have held, in effect, that certain kinds of violations of the duty of care are also violations of the duty of good faith, and therefore do not come within the protection of a Section 102(b)(7) certificate provision.

McCall v. Scott[41] was a derivative action against former directors of Columbia/HCA Healthcare Corporation, a Delaware corporation ("Columbia"). The claims arose out of wide-spread and systematic fraudulent schemes engaged by Columbia, such as systematic overbilling. The complaint claimed that Columbia's senior management, with the board's knowledge, devised these fraudulent schemes to improperly increase Columbia's revenue and profits, and to that end perpetuated a management philosophy that provided strong incentives for employees to commit such frauds.

The technical issue in *McCall* was whether the allegations in the complaint, if true, created a reasonable doubt that a majority of the board was disinterested, so that a derivative action could be brought without first making demand on the board. The governing rule was that "While the mere threat of personal liability is not sufficient, reasonable doubt as to the disinterestedness of a director is created when the particularized allegations in the complaint present 'a substantial likelihood' of liability on the part of the director." The directors argued that the allegations in the complaint did not create a substantial likelihood of liability, because the complaint essentially alleged that the board had violated the duty of care, and the directors were exculpated from duty-of-care liability under Columbia's Section 102(b)(7) certificate provision. The district court agreed, and dismissed the complaint.

[41] 239 F.3d 808 (6th Cir. 3001).

On appeal, plaintiffs argued that the directors were not protected by Columbia's Section 102(b)(7) certificate provision, because their conduct was reckless, and recklessness was equivalent to intentional misconduct, and therefore fell within the exception under Section 102(b)(7) for intentional misconduct. The Court of Appeals concluded that on the basis of the complaint the behavior of the directors did not constitute intentional misconduct within the meaning of Section 102(b)(7), but arguably did fall within the exception to Section 102(b)(7) for conduct that was not in good faith:

> Plaintiffs argued that the Board's failure to take action with respect to the systematic fraud occurring at Columbia was tantamount to a conscious decision to refrain from acting. Plaintiffs' duty of care claims, however, arise out of allegations of nonfeasance by the Board (***i.e.***, "intentional ignorance of," or "willful blindness to" the "red flags" that were signs of potentially fraudulent practices) and challenge the Board's failure to take action or investigate under the circumstances. The claims do not allege a conscious Board decision to refrain from acting. . . .
>
> Plaintiffs maintain that their duty of care claims are not barred as the second exception [to Section 102(b)(7)] excludes protection from director liability for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." Although plaintiffs urge us to interpret "intentional misconduct" to include "recklessness," we do not believe the Delaware Supreme Court would interpret the provision in this way. Still, it is unclear whether some reckless acts or omissions may be excluded from the protection of provisions adopted pursuant to § 102(b)(7). As one treatise explained:
>
>> Whether the statute would protect a director against reckless acts is not altogether clear. To 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 under [Section 102(b)(7)]. . . . Balotti & Finkelstein, Delaware Law of Corporations and Business Organizations § 4.29 at 4-116 to 4-116.1 (3d ed. Supp. 2000).
>
> Thus, we find the district court erred in concluding that only intentional conduct would escape the protection of the provision adopted in Columbia's . . . Certificate of Incorporation.

In re The Walt Disney Company Derivative Litigation[42] concerned Disney's employment of Michael Ovitz and Ovitz's later severance payments. Michael Eisner was (and is) Disney's chief executive officer. Disney needed a new president to be Eisner's second-in-command. Eisner chose Michael Ovitz who had been Eisner's close friend for over twenty-five years. Ovitz was the founder and head of a well-known talent agency. However, he had never been an executive of a publicly owned entertainment company.[43]

In September 1995, Disney prepared a draft employment agreement for Ovitz. At a meeting of the board's compensation committee, the committee members were provided with a rough summary of the agreement, but the draft agreement itself was not provided to the committee. Furthermore, even the summary was incomplete. The summary stated that Ovitz was to receive options to purchase five million shares of stock, but did not state the exercise price. Furthermore, no analytical document showing the potential payout to Ovitz, or the possible cost of his severance package, was either created or presented to the committee. Nor did the committee request or receive any information as to how the draft agreement compared with agreements in the entertainment industry with similarly situated executives. The committee also lacked the benefit of an expert to guide them through the Ovitz employment process. The committee nevertheless approved the general terms and conditions of the employment agreement, based on the summary. The committee did not condition its approval on review of the final agreement. Instead, the committee granted Eisner the authority to approve the final terms and conditions of the contract, as long as they were within the framework of the draft.

Disney's board met immediately after the compensation committee met. Again, no documents were produced for the board to review before the meeting, no expert was present to

[42] 825 A.2d 275 (Del. Ch. 2003).
[43] The facts as stated here are as stated in the complaint, which was taken as true by the court for purposes of the motion before it.

advise the board, and the board did not consider the various payout scenarios if a termination occurred. Final negotiation of the employment agreement was left to Eisner, Ovitz's close friend for over twenty-five years.

The final employment agreement with Ovitz was executed on December 12, 1995. Neither the board nor the compensation committee reviewed or approved the final agreement before it was executed. The final agreement differed significantly from the draft summarized to the compensation committee. One major difference concerned the circumstances surrounding Ovitz's severance benefits. The draft provided that in the case of a "non-fault" termination Ovitz would receive substantial benefits, and that a non-fault termination would occur only if Disney wrongfully terminated Ovitz or Ovitz died or became disabled. The final agreement, however, stated that Ovitz would receive non-fault termination benefits if he was terminated by Disney and had not acted with gross negligence or malfeasance. Therefore, under the final agreement Ovitz would receive non-fault termination benefits even if even if he was terminated by Disney because he acted negligently or was unable to perform his duties, as long as his behavior did not reach the level of gross negligence or malfeasance.

Ovitz's employment agreement had a five-year term. The agreement provided that he would receive an annual salary of $1 million; an annual bonus between $0 to $10 million; and "A" stock options that would enabled Ovitz to purchase three million shares of Disney stock at its October 16, 1995 price. One million of these options would vest in each of the contract's last three years. If a non-fault termination occurred, however: (1) Ovitz would receive his salary for the remainder of the contract, discounted at a risk-free rate keyed to Disney's borrowing costs. (2) Ovitz would also receive a $7.5 million bonus for each year remaining on his contract, discounted at the same risk-free rate, even though no set bonus amount was guaranteed in the contract. (3) All of Ovitz's "A" stock options would vest immediately, instead of waiting for the final three years of his contract. (4) Ovitz would be paid a lump-sum termination payment of $10 million.

Ovitz's tenure as Disney's president was very unsuccessful. Even though he admittedly did not know his job, he studiously avoided attempts to be educated. Instead of working to learn his duties as Disney's president, Ovitz began seeking alternative employment. Under his contract, Ovitz could only terminate his employment properly if: (1) he was not elected or retained as president and a director of Disney; (2) he was assigned duties materially inconsistent with his role as president; (3) Disney reduced his annual salary; or (4) Disney failed to grant his stock options, pay him discretionary bonuses, or make any required compensation payment. None of these events ever occurred. However, Eisner re-wrote Ovitz's contract so that in the event of Ovitz's voluntary departure for any reason, Disney would pay him the benefits provided for a non-fault termination, and Ovitz's stock options would immediately vest. The benefits to Ovitz from this modification allegedly totaled $140 million—for doing a terrible job.

Plaintiffs, Disney shareholders, brought a derivative action against Disney's directors. The directors argued that plaintiffs alleged that the suit should be dismissed, because the complaint alleged the board had violated its duty of care, and the directors were exculpated from such liability under Disney's Section 102(b)(7) certificate provision. The court held that the directors were not protected by Section 102(b)(7), because their conduct fell within the exception to Section 102(b)(7) for conduct that was not in good faith:

> . . . [T]he facts belie any assertion that the [board] exercised *any* business judgment or made *any* good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders.
>
> No draft employment agreements were presented to the compensation committee or to the Disney board for review before the September 26, 1995

meetings. . . . With respect to the employment agreement itself, the committee received only a summary of its terms and conditions. No questions were asked about the employment agreement. No time was taken to review the documents for approval. Instead, the committee approved the hiring of Ovitz and directed Eisner, Ovitz's close friend, to carry out the negotiations with regard to certain still unresolved and significant details. . . . No presentations were made to the [board] regarding the terms of the draft agreement. No questions were raised, at least so far as the minutes reflect. At the end of the meeting, the [board] authorized Ovitz's hiring as Disney's president. No further review or approval of the employment agreement occurred. Throughout both meetings, no expert consultant was present to advise the compensation committee or the Old Board. . . . The [board] simply passed off the details to Ovitz and his good friend, Eisner.

. . . The final employment agreement . . . differed substantially from the original draft, but evidently no further committee or board review of it ever occurred. The final version of Ovitz's employment agreement was signed (according to the new complaint) without *any* board input beyond the limited discussion on September 26, 1995.

Eisner and Litvack [a director] alone granted Ovitz's non-fault termination, which became public on December 12, 1996. Again, Disney's board did not appear to question this action, although affirmative board action seemed to be required. On December 27, 1996, Eisner and Litvack, without explanation, accelerated the effective date of the non-fault termination, from January 31, 1997, to December 27, 1996. Again, the board apparently took no action; no questions were asked as to why this was done.

The . . . complaint . . . charges the . . . Board with a similar ostrich-like approach regarding Ovitz's non-fault termination. Eisner and Litvack granted Ovitz a non-fault termination on December 12, 1996, and the news became public that day. . . . [No board] member even asked for a meeting to discuss Eisner's and Litvack's decision. On December 27, 1996, when Eisner and Litvack accelerated Ovitz's non-fault termination by over a month, with a payout of more than $38 million in cash, together with the three million "A" stock options, the board again failed to do anything. Instead, it appears from the . . . complaint that the . . . Board played no role in Eisner's agreement to award Ovitz more than $38 million in cash and the three million "A" stock options, all for leaving a job that Ovitz had allegedly proven incapable of performing.

The . . . Board apparently never sought to negotiate with Ovitz regarding his departure. Nor, apparently, did it consider whether to seek a termination based on fault. During the fifteen-day period between announcement of Ovitz's termination and its effective date, the . . . Board allegedly chose to remain invisible in the process. 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 the termination until more

> information could be collected. If the board had taken the time or effort to review these or other options, perhaps with the assistance of expert legal advisors, the business judgment rule might well protect its decision. In this case, however, the . . . complaint asserts that the . . . directors refused to explore any alternatives, and refused to even attempt to evaluate the implications of the non-fault termination—blindly allowing Eisner to hand over to his personal friend, Ovitz, more than $38 million in cash and the three million "A" stock options.
>
> These facts, if true, do 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. Instead, the facts alleged in the new complaint suggest that the defendant directors ***consciously and intentionally disregarded their responsibilities,*** adopting a "we don't care about the risks" attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply 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. Viewed in this light, plaintiffs' new complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, if the facts are true, that the defendant directors' conduct fell outside the protection of the business judgment rule.

McCall and *Disney* turn on, and explicate, the meaning of the director's duty of good faith. It is well-established that directors do have such a duty. For example, the Delaware Supreme Court has repeatedly stated that the directors of Delaware corporations "have a ***triad*** of primary fiduciary duties: due care, loyalty, and good faith."[44] Similarly, the Delaware legislature has recognized the duty of good faith in Section 108(b)(7): Subsection (i) of that Section sets out an exception "for any breach of the director's duty of loyalty," while Subsection (ii) ***separately*** sets out an exception for "acts or omissions not in good faith."

Although the existence of a duty of good faith is well established, the precise meaning of that duty is not. One reason for this is that the duty of good faith has several different elements.

[44] ***See***, ***e.g.***, Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (emphasis added).

One of these elements, established in *Caremark*, *McCall*, and *Disney*, overlaps with the duty of care.

Recall that the duty of care itself has several elements, including the duty to monitor and the duty of inquiry. These two elements are not sharply discontinuous, but instead are the ends of a spectrum. The duty of inquiry requires directors to follow up on information that comes to them, when a reasonable person would follow up on that information. The duty to monitor has a proactive and a reactive aspect. The proactive element requires directors to pay attention to internal controls and other mechanisms to ensure that appropriate kinds of information flow to the board. The reactive aspect requires directors to pay attention to the stream of information that arrives to the board. Since the duty of inquiry is also reactive, this aspect of the duty to monitor overlaps with the duty of inquiry.

Caremark, *McCall*, and *Disney* hold, in effect, that a glaring failure to perform the duty of inquiry or the duty to monitor is not only a violation of the duty of care, but also a violation of the duty of good faith. In *Caremark*, Chancellor Allen stated 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 . . . ." In *McCall*, the court quoted with approval the statement that "'To 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'" under Section 102(b)(7). In *Disney*, the court stated that "Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company."

If a glaring failure to perform the duty of inquiry or the duty to monitor is a violation of the duty of care, are there any functional consequences to also conceptualizing such a failure as a violation of the duty of good faith? In fact, there are several such consequences. The most important, for present purposes, is that when conduct constitutes a violation of the duty of good faith, the director is not protected by a Section 102(b)(7) certificate provision.

To summarize, Section 102(b)(7) does not eliminate the duty of care or its significance partly because the exception for conduct that is not in good faith overlaps the duty of care. There are three additional reasons why Section 102(b)(7) does not eliminate the duty of care or its significance.

First, Section 102(b)(7) applies only to directors. Officers, acting in that capacity, cannot be exculpated for violation of the duty of care by a Section 102(b)(7) certificate provision.

Second, Section 102(b)(7) applies only to liability, not to the validity or effectiveness of board action. So, for example, in reviewing the recommendation of a board to dismiss a derivative action pursuant to the recommendation of an SLC, a court is likely to take into account the care with which the SLC made its determination. Similarly, under Delaware law the validity of the action of a board in adopting a defensive action against takeover bids is subject to review under an "enhanced" duty of care.

Third, the duty of care is a standard of conduct, and standards of conduct have a real bite notwithstanding the divergent standards of review and other mechanisms that protect a director. A director who makes a decision that conforms to the reasonability standard of *conduct* will be protected against liability. Accordingly, from the perspective of a director, the reasonability standard of conduct is a "safe" rule. In contrast, the rationality standard of *review* under the business-judgment rule, and the other mechanisms that protect directors against liability for breach of the duty of care, are “risky” rules. The business-judgment rule is applicable only if the conditions to the rule are satisfied, and even then only protects a director if his decision was not irrational. Indemnification is often not mandatory, and sometimes not even permissive. D & O insurance has various exceptions, in particular the exception for “insured v. insured” suits, that is, suits by the corporation, as opposed to derivative actions. SLCs may or may not be appointed, and if appointed may or may not recommend dismissal of the action; and even if dismissal is recommended, under various circumstances the court may not follow an SLC’s recommendation. Section 102(b)(7) and many like provisions have various exceptions, including particularly the exception for conduct that is not in good faith. In short, a director who consciously fails to adhere to the duty-of-care standard of conduct, that requires a director to act reasonably, on the premise that he will be protected by the business-judgment rule or any of the other protective mechanisms, would be taking a significant risk of liability.

The point here is not that the business-judgment rule and these various mechanisms are not protective. On the contrary, they are extremely protective. Rather, the point is that they are not *fully* protective. If a director wants full protection against liability for the duty of care, he must try to conform to the standard of reasonability.

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