

Galactic Stupidity and the Business Judgment Rule

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The only real difference I detect in various formulations of the [business judgment] rule involves the question whether if good faith and due care are established, there nevertheless remains room for a judicial judgment concerning the *wisdom* of the decision.¹

I. Introduction

It is a truth almost universally acknowledged that American courts will not review the substance of the business decisions of corporate directors except under extraordinary circumstances. Embodied in the much-debated “business judgment rule,”² the deference displayed towards the decisions of corporate directors arises not from a belief that directors are always right, or even always honorable, but from a belief that “investors’ wealth would be lower if managers’ decisions were routinely subjected to strict judicial

^{*} Associate Professor, Department of Law, Zicklin School of Business, Baruch College, City University of New York. The author is particularly indebted to the weblogs (usually called “blogs,” sometimes, “blawgs”) of Professor D. Gordon Smith (www.theconglomerate.org – Smith now shares his blog with others, but his comments on the business judgment rule discussed here was made when he was blogging alone at www.venturpreneur.com) and Professor Stephen Bainbridge (www.professorbainbridge.com). Their lively, but always scholarly, exchange on the issue of good faith gave rise to many of the ideas in this article. These and other blogs by legal scholars are among the best examples of innovative uses of the internet in what appears to be the dawning of a new era in legal “publishing.” The importance (and credibility) of law blogs was confirmed when the Supreme Court of the United States cited its first blog in January, 2005. See [United States v. Booker, 125 S. Ct. 738, 775 n.4 \(2005\)](#). This article will make citations to law blogs as with any other legal source. The reader will be left to his own devices to determine the value as authority of such sources. Thanks are due to Barry Adler for first suggesting the term “galactic stupidity” to me and to Baruch College for the financial support it provided during the writing of this article.

¹ In re RJR Nabisco, Inc. Shareholders Litigation, 1989 WL 7036 at *13 n. 13 (Del. Ch.) (italics added).

² Indeed the very term “business judgment rule” has come under criticism. One commentator, for example, insists that it is not a “rule,” but a “standard” with no “bright-line” separating acceptable from prohibited conduct. Stephen M. Bainbridge, “The Business Judgment Rule as Abstention Doctrine,” 57 Vand L. Rev. 83, 128 (2004).

review.”³ Corporate directors take the kind of risks that investors want them to take because the directors know that, whatever the outcome, stockholders will not have any legal recourse for losses arising from those actions unless the decisionmakers violated a duty such as loyalty or good faith. The belief in this general principle of the business judgment rule is so widespread that, despite the recent scandals and negative publicity surrounding the conduct of corporate directors, few participants in the debate are calling for significant changes to the rule’s deference to actions taken by corporate decisionmakers.

There is plainly broad agreement that shareholders make more money when directors know that they can make decisions – especially risky decisions – without the fear that they⁴ or the company will be the subject of successful legal actions should those decisions not ultimately benefit the company or the shareholders themselves. This does not mean that the legislative, judicial, legal, financial, academic and investor communities do not view with disdain directors who make bad decisions, foolish decisions or excessively risky decisions. It simply means that these communities do not wish to impose legal liability on directors or the corporations they oversee for the

³ Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law*, 93 (1991). *See also*, *In Re Caremark Intern. Inc. Deriv. Lit.*, 698 A.2d 959, 967 (Del. Ch. 1996) (“To employ a different rule – one that permitted an ‘objective’ evaluation of the decision – would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run be injurious to investor interests.”), E. Norman Veasey and Christine T. Di Guglielmo, “What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments,” 153 U. Pa. L. Rev. 1399, 1413 (2005) (Retired Chief Justice of the Delaware Supreme Court and co-author note that “Good governance practices permit the time-honored business judgment rule regime to operate with integrity by checking self-interest and sloth while permitting valuable and prudent risk taking.”).

⁴ This article does not focus on the issue of the *personal liability* of corporate directors, but rather on the ability of shareholders to bring any kind of successful legal action (for example, an injunction) against them or against the company itself for decisions made by the directors on the company’s behalf. While section 102(b)(7) of Delaware’s corporate code permits exculpation of directors for certain breaches of fiduciary duty, that is a separate issue from the question of the breadth of the business judgment rule’s protection. For a recent discussion of the exculpation issue, see David Rosenberg, “Making Sense of Good Faith in Delaware Corporate Fiduciary Law,” 29 Del. J. Corp. Law 491 (2004).

negative consequences of such decisions.⁵ A board of directors that pig-headedly leads a corporation in the wrong direction is worthy of our contempt and deserves to be voted out or abandoned by investors. But our corporate law does not allow the aggrieved to seek legal action against a corporation just because its directors made a bad decision. As such, the business judgment rule does not seem to have a moral or ethical dimension. Rather, it is one of our most utilitarian rules. Wealth is maximized when corporations are run by directors who know that their decisions will be reviewed by investors, by analysts, by stockholders and by business partners – but not by the courts.⁶

From a practical point of view, the business judgment rule is “simply a policy of judicial non-review.”⁷ It is -- except when it allows review. The problem is, as a noted

⁵ Of course, the marketplace provides effective extra-legal remedies and incentives that work to promote good conduct by directors. See, Edward B. Rock and Michael L. Wachter, “Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation,” 149 U. Pa. L. Rev. 1619, 1672.

⁶ In the recent decision in the much-litigated case involving Disney’s hiring and firing of Michael Ovitz, Chancellor Chandler began with an almost-sentimental affirmation of the importance of allowing directors discretion to create wealth through their own decision-making:

The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike.

In re The Walt Disney Co. Derivative Litig., 2005 WL 1875804 (Del. Ch. Aug. 9, 2005) (“Disney IV”). In the most recent decision, the Delaware Court of Chancery appeared to adopt a shorthand system for referring to the many decisions in the dispute. This article will follow the Court’s lead. The Delaware Supreme Court heard oral argument in an appeal of the case on January 26, 2006. The reader will notice the conspicuous absence of Disney III (In re The Walt Disney Co. Derivative Litig., 2004 WL 2050138 (Del. Ch. Sept. 10 2004) from this discussion. That ruling is not relevant here because it largely concerned the issue of whether or not Michael Ovitz owed a fiduciary duty to Disney at the time he was negotiating his employment package. It did not focus on whether the decisions of the various directors should receive the protection of the business judgment rule for their decision to approve Ovitz’s compensation package.

⁷ Lyman Johnson, “The Modest Business Judgment Rule,” 55 Bus. Law. 625, 631 (2000). A more purist view of the business judgment rule is exemplified by the work of Stephen Bainbridge whose conception of the corporation requires an almost-reflexive refusal by courts to review director decision-making. See, Bainbridge “Abstinence Doctrine,” *supra*, note ___. Bainbridge argues that, whatever the standard is that allows review, courts should approach allegations of director misconduct with the presumption that they will abstain from reviewing the directors’ actions. Such an approach, he says, makes review “the exception rather than the rule.” *Id.* at 128. This article attempts to determine when Delaware courts will make that exception.

scholar has put it, to identify the circumstances in which review is necessary.⁸ While many academics and judges repeatedly assert that the business judgment rule does not allow for review of the substance of director decision-making, Delaware courts nonetheless display an apparent willingness to do just that when the directors' actions approach the borderline of good faith.⁹ Indeed, in cases in which the plaintiffs allege bad faith but the facts do not present evidence of disloyalty or knowing breach of a duty, courts must review the substance of the directors' decision in order to determine whether or not the directors have complied with the all of their fiduciary obligations.

Although few courts or commentators are willing to use the term, substantive due care analysis is in fact alive in Delaware fiduciary law, and has been for at least two decades. Whether they call it irrationality, inexplicable behavior, egregious decisionmaking, gross abuse of discretion, inadequacy, action that is beyond the realm of human comprehension, sustained inattention, disloyalty or bad faith, judges and commentators from all sides of the debate must recognize that sometimes courts cannot avoid reviewing the substantive merits of directors actions. Culminating in the recent decision in the Disney litigation, Delaware courts express an unwillingness to engage in substantive review, do it anyway, but almost inevitably find in favor of the defendants.

⁸ Bainbridge, "Abstention Doctrine," *supra* note__ at 127.

⁹ This article focuses exclusively on Delaware law because it is considered the default source for American corporate law and because the debate over substantive due care has begun to play out in its courts. While not the subject of this article, a comparison of Delaware's approach to that of other states is a subject ripe for research.

II. Is Substantive Due Care “Foreign” to the Business Judgment Rule?

Courts have a relatively easy time reviewing allegations of disloyalty or self-dealing by corporate directors. Virtually every formulation of the business judgment rule precludes protection of directors who do not act in the best interests of the company but rather for their own benefit.¹⁰ Rebutting the presumption of director loyalty is a fairly straightforward matter for the plaintiff. He must simply show that the director herself benefited from the decision, and that the decision was not fair. The rule therefore allows aggrieved shareholders to recover when a director made a decision that was tainted by self-interest and that was not a good deal for the company. To allow a court to review a disloyal decision and even to impose liability on a company for a disloyal and unfair decision does not threaten the freedom of directors to act with discretion because in such a situation one might say that the director did not exercise discretion at all. Rather, the director acted in direct contradiction to her obligation to make decisions on behalf of the well-being of the corporation and its shareholders rather than herself.

The appropriateness of judicial review becomes trickier, however, when the plaintiff alleges not that the director breached his duty of loyalty, but rather that the director breached some other duty (we will attempt to define it) that did not apparently involve self-interest. A director breaches no duty simply because he makes a decision that does not turn out to benefit the corporation even if it was obvious to most observers at the time that it was a bad decision. It is well-settled that the business judgment rule

¹⁰ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). This justifiably much-maligned decision also held that courts will presume that directors acted “on an informed basis” and in “good faith.” *Id.* What these terms mean is plainly open to question. Its holding regarding loyalty, however, is less controversial.

will not allow review of director decisions that, in retrospect are “pretty dumb,”¹¹ “substantively wrong, or degrees of wrong extending through ‘stupid’ to ‘egregious’ or ‘irrational.’”¹² Delaware courts will not, as Chancellor Chandler recently wrote, “hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices.”¹³ Put another way, Delaware courts will not review the substantive wisdom of decisions made by corporate directors; put another way, courts will not engage in substantive due care analysis.

Although the phrase “substantive due care” had been used in various jurisdictions over the years, it became code for that-which-is-not-reviewable in the wake of the Delaware Supreme Court’s decision in *Brehm v. Eisner*¹⁴ in 2000, the first pivotal decision in the Disney litigation. In that decision, the court reviewed a lower court ruling dismissing a shareholder derivative suit against the Walt Disney Company for approving an extremely generous employment contract for executive Michael Ovitz. The deal allowed Ovitz to leave the company fourteen months after his hire with a severance package worth \$140 million.¹⁵

That shareholders of Disney wanted a court to review the directors’ conduct in approving such a payout is not surprising. Nor is it surprising that the Delaware Supreme Court failed to embrace that prospect with much enthusiasm.¹⁶ The court took particular pains to address the plaintiffs’ allegation that the directors failed to exercise “substantive

¹¹ Rock and Wachter, *supra* note__ at 1672.

¹² *In Re Caremark Intern. Inc. Deriv. Lit.*, 698 A.2d 959, 967 (Del. Ch. 1996).

¹³ *Disney IV*, at 1.

¹⁴ 746 A.2d 244 (Del. 2000) (“*Brehm*”).

¹⁵ *Id.*

¹⁶ *Id.*, at 266 (noting that it runs “counter to the foundation of our jurisprudence” for courts to “become super-directors, measuring matters of degree in business decision-making”).

due care.” In a now much-quoted passage¹⁷, the court attempted to dispose of the idea of substantive due care review in Delaware law:

As for the plaintiff’s contention that the directors failed to exercise “substantive due care,” we should note that such a concept is foreign to the business judgment rule. Courts do not measure or quantify directors’ judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.¹⁸

Nonetheless, the court allowed the plaintiffs to amend their complaint so that it would allege more specific facts that might present doubt that the decision of the directors to approve Ovitz’s employment package was protected by the business judgment rule.¹⁹

The language quoted above ought to have put to rest the idea that courts might be willing to review director decisions based on the substantive wisdom of the decision itself. Indeed, the author of the opinion, former Chief Justice Veasey has taken to quoting its language as an unambiguous affirmation of a rule that requires little interpretation.²⁰

Far from it. In fact that ruling led the Court of Chancery to reassert the possibility of

¹⁷ A few years after the decision, one commentator said that the decision actually served as a “reinvigoration of substantive due care” by putting a greater emphasis on the duty of good faith which might ultimately lead to examination of the substance of a director’s decision. D. Gordon Smith, http://www.theconglomerate.org/2003/11/the_fiduciary_d.html, November 26, 2003. Smith has since changed his mind and more recently has described the case as “a modern version of Van Gorkom.” http://www.theconglomerate.org/2005/01/emthe_good_fait.html. January 9, 2005. I point out that Smith changed his mind not to suggest that he is fickle, but rather to illustrate the fluidity of the debate on substantive due care. It perhaps also illustrates the dangers of using law blogs as legal authority since they are intended to, among other things, allow their authors to air ideas without committing those ideas to the permanence of traditional publications.

¹⁸ Brehm 746 A.2d at 264.

¹⁹ Brehm 746 A.2d at 266.

²⁰ See, E. Norman Veasey, “Juxtaposing Best Practices and Delaware Corporate Jurisprudence,” 18 No. 12 Insights 5 (2004). It is worth pointing out though, that in Brehm, he said that the business judgment rule had been “well formulated by Aronson...”, Brehm at 264, fn. 64, although that formulation has been almost universally condemned. See, e.g. Johnson, *supra*, note ___, at 626.

reviewing director decisions on the substantive merits by simply calling it by another name.²¹

III. The “Reinvigoration”²² of Substantive Due Care

In 2003, the Court of Chancery finally got a chance to hear the plaintiffs’ amended complaint in the Disney litigation.²³ In refusing to dismiss the complaint, the court took a hard look at the actions (and inactions) of the company’s directors when they approved Ovitz’s seemingly preposterous no-fault termination agreement. More or less ignoring the language used by the Supreme Court in *Brehm*, the Court of Chancery focused on the state of mind of the directors, ultimately framing the issue around the question of good faith.²⁴ The court said that the complaint depicted the directors’ actions as failures going beyond mere negligence or even gross negligence because the plaintiffs had claimed 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.”²⁵ The court placed heavy emphasis on the allegation that the directors knew that they were making a decision without adequate information and that they “simply did not care if the decisions caused the corporation and its stockholder to

²¹ See D. Gordon Smith, http://www.theconglomerate.org/2003/11/the_fiduciary_d.html, November 26, 2003.

²² http://www.theconglomerate.org/2003/11/the_fiduciary_d.html, November 26, 2003

²³ *In Re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (2003). (“Disney II”).

²⁴ This was not the first time the Court of Chancery boldly departed from the guidance offered by the state’s highest court regarding the fiduciary duties of corporate directors. In determining the meaning of the term “good faith” as it appears in Section 102(b)(7), the law which allows corporations to waive the liability of directors for certain breaches of fiduciary duty, the Court of Chancery has criticized the Supreme Court’s language and formulated its own definition of that crucial term. See Rosenberg, *supra* note__.

²⁵ *Disney II*, 825 A.2d at 289. The court said that the complaint charged the board of directors with taking an “ostrich-like approach regarding Ovitz’s non-fault termination.” *Id.* at 288. It’s a nice metaphor (presumably alluding to the popular belief that an ostrich sticks its head in the sand when it encounters trouble) because it plainly indicates that the board did not merely fail to consider what it might have seen, but rather it deliberately failed to see.

suffer injury or loss.”²⁶ If such allegations are true, the court said, defendants might have breached their obligation “to act honestly and in good faith in the corporation’s best interests” and their conduct therefore could well have fallen outside the protection of the business judgment rule.²⁷

This decision made news not only because it concerned two high profile executives at a world famous company. It made news -- among legal academics at least - - because of the court’s apparent new enthusiasm for the duty of good faith. But the response to the decision led to widely divergent conclusions. At least one commentator, Hillary Sale, embraced the decision as an indication of the emergence of a “third, and separate, duty: that of good faith,” distinct from the other two fiduciary duties of care and loyalty.²⁸ She argued that since the court was not willing to categorize the alleged misconduct as purely a breach of the duty of care (and thus allow exculpation under 102(b)(7)), it could only be a question of good faith.²⁹ She concluded that “conscious disregard of one’s duties to the company presents a good faith issue, not simply a procedural lapse of due care.”³⁰ A key element, then, of Sale’s vision of the duty of good faith is the state of mind of the director. In order for a director to violate the duty of good faith, he must have been aware that he was failing to do what he was obligated to do. Sale, however, does make clear what kind of behavior might constitute a breach of the duty of good faith but not a breach of the duties of loyalty or care.³¹

²⁶ Disney II, 825 A.2d at 289.

²⁷ Disney II, 825 A.2d at 289.

²⁸ Hillary Sale, “Delaware’s Good Faith,” 89 Cornell L. Rev. 456, 482.

²⁹ *Id.*

³⁰ *Id.* Sale is perhaps suggesting here that since a breach of good faith is not a “procedural lapse of due care,” it must therefore be a substantive breach, although she does not use the phrase “substantive due care.”

³¹ For my earlier discussion of Sale’s article, *see*, Rosenberg, *supra* note ___, at 508-509.

Other commentators were more hesitant to view good faith as described in *Disney II* as a separate duty. The author of this article, for example, took essentially the opposite view. He argued that the decision in *Disney II* fit into a string of cases by the Court of Chancery that increasingly treat good faith not as a separate duty but rather as a term that encompasses all of the obligations of corporate officers in the same way that parties to a contract have a duty of good faith.³² That is to say, the duty of good faith requires corporate directors to make an honest effort to adhere to the duties of care and loyalty. A knowing breach of the duties of care or loyalty (or indeed any other duty) is a breach of the duty of good faith.³³ Good faith, however, does not exist as a duty that can be defined on its own terms without reference to other duties.

In an article that turned out to have a great deal of influence on Chancellor Chandler's later decision in *Disney IV*, Sean Griffith also rejected the idea that a separate duty of good faith had emerged from *Disney II*. Rather, he described good faith in *Disney II* as a duty that alternates between loyalty and care without actually encompassing either.³⁴ In that decision, Griffith says, good faith covered ground that was

³² *Id.* My approach in that article arose from an ideological view (contractarianism) embraced by many lawyers and academics, that corporations, like other business entities or indeed other business agreements, should be viewed as simply conglomerations of contractual promises that require adherence to certain duties by the various parties. *Id.*, at 493-494. While that article suggested that Delaware courts ought to approach corporate fiduciary duties from a contractarian perspective, the accuracy of my assessment of the bounds of good faith under Delaware law does not necessarily require adherence to the contractarian view by the courts.

³³ In this article, I will argue that the duty of good faith is in fact more expansive. Delaware courts appear willing to find that a director acted in bad faith simply because his decision was egregious, even if the director did not know that he was making an egregiously bad decision. See *infra* text and accompanying notes __-__.

³⁴ Sean J. Griffith, "Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence," 55 *Duke L. J.* 1, at 21-23 (2005). In his article, Griffith employs one of the all-time great legal metaphors. He says that the duty of good faith alternates between the duty of care and the duty of loyalty like the image of a caged bird in a thaumatrope. He explains:

[A thaumatrope] is an optical toy involving a disc with a different image on each side – a horse and a man, for example, or a bird and a cage – and a string attached to either edge of the disc enabling the device to spin. When the viewer spins the thaumatrope, the images on either side of the disc seem to blend together to produce a third image that is a composite of the other two – the

not defined precisely by care or loyalty because the claim in that case could not have survived a motion to dismiss on either of those traditional fiduciary duties.³⁵ So if a court is relying on good faith to allow a case alleging director misconduct to go forward, what is the content of that duty? Griffith believes that good faith ultimately can boil down to one question: “Are the directors doing their best in acting for someone else?”³⁶ When framed this way, that duty could indeed include conduct that violates either the duty of loyalty or the duty of care as well as perhaps other conduct.³⁷

Lyman Johnson views Disney II’s definition of good faith as prohibiting behavior where the director consciously knows he is disregarding the duties of care or loyalty.³⁸ To Johnson, good faith is all about motive. Focusing on the allegations that the Disney directors acted with “deliberate indifference” and adopted a “we don’t care about the risks’ attitude,” Johnson asserts that the court in Disney II made inferences about the directors’ motives by evaluating their conduct. Bad faith (that is conduct that is not properly motivated) can be construed from the nature of the conduct itself. Johnson presciently explains that, “this allows the court an indirect way to do what the business

man atop the horse or the bird in the cage. Good faith, I argue, is simply the application of the thaumatrope to the duties of care and loyalty.

Id. at 7-8.

³⁵ *Id.* at 20.

³⁶ *Id.* at 43. As we will see, the court in Disney IV did indeed follow Griffith’s dictum by hinting that bad faith might arise from indifference although the directors might not be aware that they are acting with indifference.

³⁷ It is therefore not all that different from this author’s view in Rosenberg, *supra* note ___. Both Griffith and I hold open the possibility that a director can act in bad faith in a way that does not necessarily breach either the duty of loyalty or care.

³⁸ Lyman Johnson, “The Sarbanes-Oxley Act and Fiduciary Duties,” 30 Wm. Mitchell L. Rev. 1149, 1202-1203 (2004). On his blog, D. Gordon Smith expressed a similar view: that good faith review and substantive review are essentially the same thing and that the rise of good faith might be leading to greater substantive review in the future. http://www.theconglomerate.org/2003/11/the_fiduciary_d.html

judgment rule precludes –consider the substance of director conduct; not to assess it outright, but to draw an inference of bad motive if it is sufficiently egregious.”³⁹

Another scholar, Stephen Bainbridge, addressed the implications of the Disney II decision on his blog. Bainbridge is an ardent proponent of the “director primacy” view of the corporation which regards directors as the ultimate powerbrokers in publicly held corporations.⁴⁰ Such a view prefers that the business judgment rule be understood as a doctrine of abstention, “pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied.”⁴¹ On his blog, Bainbridge attempted to reconcile the Disney II decision with existing law by offering two competing interpretations of the court’s decision that allowed judicial review of the Disney directors’ vote to approve Ovitz’s compensation package.

In his preferred⁴² interpretation, he suggested that the court simply understood the case as one of “egregiously flawed process due care.”⁴³ Viewed in this way, the court focused not so much on the merits of the decision, but on the procedures through which the board approved it. This view rejects the possibility that the decision can be interpreted as a reinvigoration of substantive due care because it focuses exclusively on the alleged procedural deficiencies of the directors’ decision-making and not on the substantive wisdom of the decision itself.

³⁹ Johnson, *supra* note __, at 1203. This seems to come closest to a prediction of what the Court of Chancery would later do in Disney IV.

⁴⁰ See, e.g., Stephen M. Bainbridge, “Director Primacy: The Means and Ends of Corporate Governance,” 97 Nw. U. L. Rev. 547 (2003).

⁴¹ Stephen M. Bainbridge, “The Business Judgment Rule as Abstention Doctrine,” 57 Vand. L. Rev. 83, 88 (2004). The crucial question, of course, is what *are* those exacting pre-conditions, and what *should they be*? This article attempts to answer only the former question.

⁴² “Preferred,” both in the sense of what he thinks the court was saying in its decision and in the sense that he believes that this interpretation is preferable.

http://www.professorbainbridge.com/2003/11/substantive_due.html, November 29, 2003.

⁴³ *Id.*

Bainbridge's second proposed interpretation is more consistent with those who have suggested that the decision opens the door to substantive review. He suggests, as an alternative to his preferred interpretation, that the court found the Disney board's decision to be "so egregiously unsound on the merits as to shock the court's conscience and, therefore, fall outside the protections of the business judgment rule."⁴⁴ This sounds like Bainbridge is leaving open the possibility that the court was reintroducing the doctrine of substantive due care. But he does not really buy this interpretation. Bainbridge goes on to say that the facts of the case suggest that more than mere irrationality was motivating the directors: "The story that emerges is one of cronyism and backroom deals in which preservation of face was put ahead of the corporation's best interest... [T]his looks like another case in which 'we have reason to disbelieve the protestations of good faith by directors who reach "irrational" conclusions.'"⁴⁵ To Bainbridge, almost any action that does not receive business judgment rule protection inevitably contains at least some elements of disloyalty or self-dealing even if plaintiffs are alleging only breaches of the duty of care or so-called good faith. This comports with the Court of Chancery's earlier view that good faith "is a subset or 'subsidiary requirement' that is subsumed within the duty of loyalty."⁴⁶ According to this formulation, any act of bad faith must be disloyal, but not every act of disloyalty must be bad faith.⁴⁷

IV. Substantive Due Care and the Reasonable Director

While the first two Disney decisions, *Brehm* and *Disney II*, appear to have done little to reconcile the various competing views of the business judgment rule, a hard look

⁴⁴ *Id.*

⁴⁵ *Id.* (quoting Michael P. Dooley, *Fundamentals of Corporation Law* 263 (1995)).

⁴⁶ *Emerald Partners*, 2001 Del. Ch. LEXIS 20, at *89 n. 63.

⁴⁷ A director could make a decision that is disloyal without knowing that he is being disloyal.

at Delaware law reveals that the rule allows for review of the merits of director decisionmaking in extreme cases and that the conduct of the Disney directors is one such case. That the court was willing to do so in Disney IV is not surprising. The apparent rise of the duty of good faith even in the absence of disloyalty is merely a manifestation of the willingness of the Delaware Court of Chancery to allow substantive due care review despite the Delaware Supreme Court's earlier insistence that it is "foreign to the business judgment rule."⁴⁸ However, although courts do engage in such review, they rarely are willing to hold directors liable for even such awful decisions as the one by the Disney directors to approve Michael Ovitz's compensation package. The Court of Chancery's decision in Disney IV exemplifies such substantive review.

Virtually every formulation of the business judgment rule under Delaware law contains a requirement that the directors act honestly or in good faith.⁴⁹ But that is merely the starting point. It is difficult to come up with a definition of the business judgment rule that does not beg the question, "what do we mean by 'good faith?'" For example, former Chancellor Allen, probably the Chancery Court's clearest thinker of the last twenty years, described the bounds of the business judgment rule in the following way in an influential decision:

Whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational" provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests."⁵⁰

⁴⁸ Brehm, 746 A.2d at 264.

⁴⁹ Courts and commentators must take as their starting point, the Delaware Supreme Court's definition in the highly problematic *Aronson v. Lewis* which held that the business judgment rule presumes "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." 473 A.2d 805, 812 (Del. 1984). The body of literature criticizing that decision on various grounds is voluminous and continues to grow.

⁵⁰ Caremark, 698 A.2d at 967.

Stephen Bainbridge usefully points out that in an earlier decision, Chancellor Allen said that rationality and good faith are essentially the same thing: “such limited substantive review as the rule contemplates (i.e. is the judgment under review “egregious” or “irrational” or “so beyond reason,” etc.) really is a way of inferring bad faith.”⁵¹ And Bainbridge himself does not dispute that rationality is necessary for an action to receive business judgment rule protection.⁵² Despite the abundance of such formulations of the business judgment rule, we are still left to define “good faith” and “rational” on our own.

Most students of corporate law are extremely reluctant to suggest that the concept of the reasonable person that pervades other areas of law (such as torts) should be applicable to corporate directors. We hesitate to speak of what a reasonable director might do in a given situation because, unlike in a situation involving everyday torts, a reasonable director might have chosen many different paths for the corporation he oversees.⁵³ The “reasonable” director standard seems too strict because the very term

⁵¹ Stephen Bainbridge, *Corporation Law and Economics*, 274 (quoting *In Re RJR Nabisco, Inc. Shareholders Litig.*, 1989 WL 7036 at *13, n. 13 (Del. Ch. 1989) . Interestingly, in the same discussion, Bainbridge then goes on to equate irrationality with self-interest alone, a position that seems to be unique to him. *Id.* Numerous other commentaries have equated rationality with good faith, including one by the then-Chief Justice of the Delaware Supreme Court. E. Norman Veasey, “Musings on the Dynamics of Corporate Governance Issues, Director Liability Concerns, Corporate Control Transactions, Ethics and Federalism,” *U. Pa. L. Rev.* 1007, 1009 (2003) (“Although the concept of good faith is not fully developed in the case law, an argument could be made that reckless, irresponsible, or irrational conduct but not necessarily self-dealing or larcenous conduct could implicate concepts of good faith.”).

⁵² Bainbridge, *Corporation Law and Economics*, *supra* note __, at 274. *See also*, http://www.professorbainbridge.com/2003/11/substantive_due.html, November 29, 2003, (“an essential precondition for application of the business judgment rule long has been the absence of irrationality.”). But he is not willing to say that an inquiry into the rationality of a decision would constitute substantive review of the merits of the decision. Bainbridge, *Corporation Law*, *supra* note __ at 274.

⁵³ William T. Allen, Jack B. Jacobs and Leo E. Strine, “Realigning the Standard of Review of director Due Care With Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem,” 96 *Nw. U. L. Rev.* 449, 454 (2002). The chancellors use as an example the case of automobile accidents. They point out that in that context, “only one decision is reasonable in a given set of circumstances, so decisions that turn out badly almost invariably turn out to have been bad decisions.” *Id.* In contrast, if the business judgment rule stands for anything at all, it is that decisions that turn out badly are not necessarily bad decisions.

carries with it the suggestion that only one – or perhaps a few – courses of conduct were reasonable under any given set of circumstance.

Since the “reasonable director” standard is disfavored, some other standard, not too strict and not utterly lacking in teeth must prevail. Rather than asking whether a director acted “reasonably,” courts often asked whether she acted “rationally.” Former Chancellor Allen and Chancellors Jacobs and Strine argue that “a rationality standard gives directors greater freedom to make risky decisions than a reasonableness standard.”⁵⁴ And they attempt to draw a distinction between these two standards (reasonable and rational) by defining an irrational decision as one “that is so blatantly *imprudent* that it is inexplicable, in the sense that no *well-motivated* and minimally informed person could have made it.”⁵⁵ But it is not obvious how much broader this standard really is than a reasonable director standard. What kind of behavior does not pass the reasonable director standard that would pass the rationality test as described above? Neither the requirement of prudence, good motivation nor minimal information seems to allow much behavior that would not already be permissible under the requirement that a director act reasonably. It is not clear, then, how the widely accepted rationality standard differs in reality from the much-shunned reasonableness standard. And indeed, application of the rationality standard often sounds a lot like an application of the reasonableness standard and therefore an inquiry into the substance of the directors’ decision.

In a well-known case in which a board of directors was accused of breaching its fiduciary duty to accept the highest price available in a tender offer, Chancellor Allen

⁵⁴ *Id.*, at 452.

⁵⁵ Allen et al. *supra* note ___, at 452 (italics added).

allowed the directors to be protected by the business judgment rule.⁵⁶ Though he explicitly rejects the idea that he has engaged in substantive review of the directors' action, much of his language, sounds very much like an inquiry into its substance:

...it was not beyond the range of *reasonable responses*, in the circumstances in which the overall objective was to get a committed deal at \$64 per share cash from [the bidder]... These are precisely the sort of debatable questions that are beyond the expertise of courts and which the business judgment rule generally protects from substantive review for wisdom... certainly, the decision... *in these circumstances does not fall so far afield of the expected range of responses* to warrant an inference that [they] must have been motivated by a concern other than maximizing the value of shareholders interest.⁵⁷

Here, Chancellor Allen appears to be asking whether a reasonable director might have done the same thing under the circumstances; whether the director's actions were of the type that might have been expected under the circumstances. Because the directors' actions appeared to be reasonable, they did not allow for an inference that the directors were motivated by improper concerns. That is to say, because the directors' actions were reasonable, they were in good faith. The case does not stand for the proposition that anything worse than "reasonable" or "expected" is actionable but it does suggest that decisions outside of the usual range of what is expected might lead to an inference that the director acted in bad faith. Allen explicitly rejects the possibility of substantive review of the decision, but then seems to be reviewing its substance. How can a court decide if a decision is "reasonable" or if it falls within the "expected range of responses"⁵⁸ without first examining the substantive wisdom of the decision itself?

⁵⁶ In re J. P. Stevens & Co., Inc., 542 A.2d 770 (Del. Ch. 1988).

⁵⁷ *Id.* at 783. Italics added.

⁵⁸ Here, the wisdom of Allen et al.'s contrasting of corporate decisionmaking with other kinds of decisionmaking becomes crucial. The range of unactionable decisions by a driver when approaching a stop sign is very narrow. Pretty much any decision other than to stop at the white line could give rise to a cause of action in negligence. Anything else is "far afield of the range of expected responses." But given the innumerable variables at work in corporate decisionmaking, the range of expected responses is very wide indeed. A court can only determine if a decision is within that range by evaluating its substance.

Justice Veasey explicitly rejected any notion of the reasonableness standard in *Brehm I* only to embrace it more recently in a speech, perhaps inadvertently. In *Brehm I*, Veasey wrote, “Courts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context.”⁵⁹ But a few years later, in a speech in which he quoted much of the *Brehm I* opinion verbatim, Veasey said, “If the board’s decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, lack of good faith may, in some circumstances, be inferred.”⁶⁰ This too is beginning to sound like the reasonableness standard. When a court is willing to ask, “would a reasonable director have approved this decision,” it is indeed measuring or quantifying a director’s judgment.⁶¹

Once we are asking what a reasonable director would have done, we must decide what we mean by “reasonable.” Volumes of literature already exist on this question in other contexts, particularly torts. Studies of corporate law have not inquired into the definition of a reasonable director because the prevailing wisdom has been that the law calls for no such inquiry. But as the above discussion demonstrates, in order to know whether an action receives the protection of the business judgment rule, it might be relevant to ask whether a reasonable director would have approved it.

The reasonable standard works well in torts because, as Allen et al. point out, there, “typically only one decision is reasonable in a given set of circumstances.”⁶² In an area like traffic safety, the law is plainly designed to discourage risk-taking because such

⁵⁹ *Brehm*, 746 A.2d at 264.

⁶⁰ Veasey, *supra* note ___, at 1010.

⁶¹ Another commentator has used similar language. See, Ryan Houseal, “Beyond the Business Judgment Rule: Protecting Bidder Firm Shareholders From Value-Reducing Acquisitions,” 37 *U. Mich. J. L. Reform*. 193, 224 (2003) (“A lack of substantive due care on the part of a firm’s board of directors may be found when the board consummates a deal that is so bad that no reasonable director could possibly have approved it. In other words, the deal had no proper business purpose.”).

⁶² Allen et al., *supra* note ___, at 454.

behavior offers virtually no social utility. In the corporate marketplace however, risk-taking is an inherent part of virtually every decision a director makes – and we want it that way.⁶³ While most corporate lawyers hesitate to use this kind of language, it is oftentimes reasonable for a corporate director to make a decision – even one that an impartial observer might call rash or risky – that is *unlikely* to benefit the shareholders of the corporation because corporate decision-making requires taking risks.⁶⁴ It is even reasonable for a corporate director to make a decision that turns out to harm his company and that a judge might later find to be puzzling or misguided. We want directors to make these kinds of decisions because often enough they turn out to enrich the shareholders. And indeed, the law allows a great deal of discretion for directors to take such risks -- as long as they act rationally and in good faith. Although few commentators are willing to say so explicitly, the law seems to be saying that a rational director is simply one who has made a decision that a reasonable director might also have made. In tort law, we ask what a reasonable person would have done *under the circumstances*. Perhaps, the business judgment rule is really simply asking what decision would a reasonable director have made under the circumstances, implicitly acknowledging that the circumstances of a corporation call for very different standards of risk taking, uncertainty and tolerance for failure.

⁶³ Allen et al. put it nicely: “Because the expected value of a risky business decision may be greater than that of a less risky decision, directors may be acting in the best interest of the shareholders when they choose the riskier alternative.” Allen et al., *supra* note ___ at 455. For a discussion of how the law can encourage risk-taking in other kinds of business organizations, see, David Rosenberg, “Venture Capital Limited Partnerships: A Study in Freedom of Contract,” 2002 Colum. Bus. L. Rev 363 (2002).

⁶⁴ Again, this is in contrast to automobile driving in which there will always be liability for calculated risks that turn out badly. Perhaps my use of the term “calculated” begs the question. We expect directors to take risks based on their knowledge of the extent of the risk. But if no calculation is made and the decision turns out badly, that might very well constitute bad faith on the part of the director.

As Allen et al. acknowledge, it is very difficult to come up with a meaningful distinction between the standards of “reasonable” and “rational” as they apply to corporate directors.⁶⁵ It is perhaps impossible, because a rational director is one who makes only decisions that he believes to be reasonable. After all, it would not be rational for a director to make a decision that he believes does not rise to the level of what a reasonable director would do.⁶⁶ If the director knew that his decision was unreasonable, then surely his action would constitute irrationality or bad faith. If the director did not know that his decision was unreasonable, then he himself is by definition an unreasonable director and he has come very close to the kind of irrationality that is not protected by the business judgment rule. Further, if the director’s decision is objectively reasonable, it does not matter whether he employed a rational procedure to arrive at that decision.

But the standard for culpability for a breach of the duty of care by a corporate director is not merely negligence (by reviewing the reasonableness of the director’s actions), but rather gross negligence, which, in the corporate context, means “”reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are ‘without the bounds of reason.’”⁶⁷ Or as Allen et al. paraphrase the Delaware Supreme Court’s decision in *Brehm*, “the gross negligence standard applicable in due

⁶⁵ They explain:

Admittedly, the distinction between “reasonable” and “rational” action is often subtle and elusive to grasp. Linguistically, it is odd to think of a board decision as unreasonable yet “rational,” since both concepts rest in great part on whether the conduct was logical in the circumstances.

Allen et al., *supra* note __, at fn. 13.

⁶⁶ For a similar argument regarding the definition of good faith under Section 102(b)(7), see Rosenberg, *supra* note __.

⁶⁷ Allen et al., *supra* note __ at 453, citing *Tomczak v. Morton Thiokol, Inc.*, No. 7861, 95 Fed. Sec. L. Rep. (CCH) 327 (Del. Ch. Apr. 5, 1990). That is to say, an unknowingly bad action on the part of a director will be considered reasonable unless it is “without the bounds of reason.”

care cases is, functionally speaking, a proxy for the rationality standard of the business judgment rule.”⁶⁸

All commentators agree that courts ought to be able to review director decisions if those decisions are either irrational or made in bad faith. Some, however, believe that such review is never substantive because any irrational or bad faith act on the part of a director must necessarily implicate his duty of loyalty. These commentators cannot conceive of examples in which director conduct rose to the level of irrationality or bad faith for some reason other than self-interest. Stephen Bainbridge, for example, says that “inquiry into the rationality of a decision is a proxy for an inquiry into whether the decision was tainted by self-interest.”⁶⁹ Since, to Bainbridge, irrationality is bad faith, the only kind of breach that should not be protected by the business judgment rule is a breach of the duty of loyalty. Yet one case he cites to support this proposition is clearly not a borderline case: in *Parnes v. Bally Entertainment*, cited in Bainbridge’s treatise, the plaintiff had alleged bribery on the part of the CEO. That case is plainly one in which self-interest plays a key role and is not merely being inferred from the substantives awfulness of the board’s decisions.⁷⁰

Yet even Bainbridge seems to allow for the possibility that courts will allow review of the substantive merits of a decision:

it may be that there are some board decision that are so dumb that the business judgment rule will not insulate them from judicial review. Even if the set of such decision is not an empty one, however, the tail ought not wag the dog. Because a prerequisite of rationality easily can erode into a prerequisite of reasonableness,

⁶⁸ Allen et al. *supra* note __ at 457. In the same article, the authors assert that the “gross negligence standard limits the ability of judges to intervene in business decisions made by *properly motivated* directors.” *Id.* at 450 (italics added).

⁶⁹ Bainbridge, *Corporation Law and Economics*, *supra* note __, at 274.

⁷⁰ *Id.* at 275. Bainbridge paraphrases, “Bally’s CEO allegedly demanded bribes from prospective takeover bidders and, moreover, allegedly received such a bribe from the successful bidder.” *Id.* at 275.

courts must tread wearily here. If they want to persist in requiring that there be a rational business purpose, at least they can ensure that that requirement lacks teeth.⁷¹

There must be a point at which a court will look at a decision that appears to be free from any hint of disloyalty and review it simply because of its utter galactic stupidity.⁷²

Bainbridge is merely saying that he prefers that point to be relatively far in the direction of stupidity because he does not want courts reviewing director decision-making using a reasonableness standard. But this is precisely what the Disney IV court did.

V. The Application of Substantive Due Care Analysis

The central holding in Chancellor Chandler's decision in Disney IV cleared the defendant directors of personal liability for allegedly acting in bad faith in approving Michael Ovitz's stupendously generous compensation package. Given that the directors' cursory approval of that package was, in retrospect, a truly awful decision from a business point of view, the court's refusal to impose liability can be interpreted, at least superficially, as a victory for supporters of a broad interpretation of the business judgment rule's protection. Certainly these facts looked like a rather compelling case for bad faith. While Chandler acknowledged that the directors failed "to comply with the aspirational ideal of best practices," in most of the opinion he seemed defiantly opposed to allowing courts to review the substance of their decision-making.⁷³ And yet, when faced with the task of justifying his decision not to impose liability on any of the directors, Chandler, like other Delaware judges before him, indeed showed a willingness to review the substance of the decision the directors had made.

⁷¹ *Id.*

⁷² While this term has not yet entered the legal lexicon, it does have a semi-legal source. See, *A Few Good Men*, (Columbia Pictures 1992) (motion picture).

⁷³ Disney IV, 2005 WL 1875804 at 2.

At the outset of his discussion of the legal standards for imposition of liability in the case, Chandler says that his decision will not hinge on the duty of loyalty, but rather on whether the directors adhered to their duties of care and good faith⁷⁴, although he later also admits that “[d]ecisions from the Delaware Supreme Court and the Court of Chancery are far from clear with respect to whether there is a separate duty of good faith.”⁷⁵ The reader must already have the sense that, even with these made-to-order facts, Chandler is not going to provide a definition of the duty of good faith that will unify the various versions provided by Delaware courts in the past. Nonetheless, what emerges from the opinion is at least one example of what the limits of good faith conduct might be when the conduct of directors is pushed to the very edge of business judgment rule protection. Based on his discussion of the failings of the various directors, it is clear that Chandler would find bad faith when a director takes action that he knows is not in the best interests of the corporation although that action in no way benefits the interests of the director himself either. The key to Chandler’s analysis is his examination of the *intentions* of the directors. While the conduct of most of the directors did not suggest to Chandler that they acted in bad faith – and their intentions did not need to be examined -- the conduct of the two most uninvolved directors came very close indeed. Since there was scant evidence regarding their deliberations, it was impossible to determine whether or not these directors *knew* that they were making a bad decision. Therefore, in order to establish that their conduct did not rise to the level of bad faith, Chandler did what all judges must do when assessing allegations of non-disloyal bad faith: he evaluated the substantive wisdom of their decision.

⁷⁴ Disney IV, 2005 WL 1875804 at 105.

⁷⁵ Disney IV, 2005 WL 1875804 at 119.

Chandler acknowledges that “issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty,”⁷⁶ and his opinion wrestles with distinguishing between the two. At the outset of his discussion of the business judgment rule, Chandler quotes at length from Sean Griffith’s article on the subject in which Griffith points out what should be obvious but has been absent from most discussions of the business judgment rule: that an ordinarily prudent corporate director would not behave disloyally; that an ordinarily prudent corporate director would not knowingly act against the best interests of the corporation.⁷⁷ The key point which Chandler extracts from Griffith is that an egregious breach of the duty of care can be disloyalty and that disloyalty is necessarily bad faith. This point emerges later on in Chandler’s opinion:

Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty, a conscious disregard for one’s responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.⁷⁸

This statement clearly equates actionable negligence with disloyalty and therefore bad faith.⁷⁹ Directors will be free from liability if they unknowingly or unintentionally act against the best interests of the corporation. On the other hand, a director who knowingly

⁷⁶ Dinsey IV, 2005 WL 1875804 at 105.

⁷⁷ Disney IV, 2005 WL 1875804 at 106, *quoting* Griffith, *supra* note__.

⁷⁸ Disney IV, 2005 WL 1875804 at 123.

⁷⁹ Chandler is not being careless in equating bad faith negligence with disloyalty here. His use of the term disloyal means not necessarily self-interest (as Bainbridge suggests it must always be) but rather a knowing failure to take the necessary action to make a decision that would benefit the corporation – a failure to engage in the kind of deliberation that would make a decision “rational.” Later in the opinion he says it again: “Acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable because they are disloyal to the corporation.” Disney IV, 2005 WL 1875804 at 125, FN 463.

or intentionally acts against the best interests of the corporation will have acted disloyally and therefore in bad faith even if his actions did not benefit him personally.

So how can a court know if a director's conduct falls in that narrow area between self-serving disloyalty and gross negligence? If the director acted with a malicious motive, then bad faith is easy to infer. But Chandler purports to be unsure about the possibility of establishing bad faith, absent such evidence: "It is unclear, based upon existing jurisprudence, whether motive is a necessary element for a successful claim that a director acted in bad faith, and, if so, whether that motive must be shown explicitly or whether it can be inferred from the director's conduct."⁸⁰ Although Chandler expresses such doubts, his discussion of some of directors' failings plainly relies on an analysis of their conduct itself absent any reference to their possible motive to act as they did.

Chandler addresses the alleged liability of each defendant director in separate sections because the evidence presented regarding the alleged misconduct of each director was different. He begins with CEO Michael Eisner, "clearly the person most heavily involved in bringing Ovitz to the Company."⁸¹ Although he points out Eisner's many failings as a corporate leader, Chandler rejects the possibility that Eisner acted with gross negligence because the plaintiff failed to establish that Eisner was not aware of "all material information reasonably available" regarding Ovitz's employment package.⁸² Further, because Eisner was so involved and because the evidence of Eisner's motives in hiring Ovitz were so well-documented, Chandler has an easy time probing Eisner's mind and concluding that his actions, "were taken with the subjective belief that those actions

⁸⁰ Disney IV, 2005 WL 1875804 at 122.

⁸¹ Disney IV, 2005 WL 1875804 at 134.

⁸² Disney IV, 2005 WL 1875804 at 140.

were in the best interests of the company.”⁸³ That is all that is required to free Eisner from liability because that subjective belief establishes Eisner’s good faith.

Chandler next discusses the allegations against Irwin Russell who was chairman of the compensation committee. Here again, Chandler criticizes Russell’s conduct as falling far short of the ideal course of action, but also finds that such shortcomings did not constitute gross negligence because “Russell for the most part knew what he needed to know... and was doing *the best he thought he could* to advance the interest of the company...”⁸⁴ Note here that Chandler is not evaluating the substantive worthiness or wisdom of the decision. Rather, he is saying that Russell’s decision passes muster because he based it on the information that was reasonably available to him at the time. There appears to be nothing about the way that the decision was reached that might implicate Russell’s good faith. As with Eisner, Chandler’s conclusion about Russell’s motives and state of mind are sufficient to clear him of any allegations of bad faith.

Chandler evaluates the conduct of director Raymond Watson in a similar fashion. He points out that Watson was familiar with Ovitz’s proposed package and with the executive compensation decisions more generally. Alluding to the decision in Disney II, Chandler says that “[n]othing in his conduct leads me to believe that he took an ‘ostrich-like’ approach to considering and approving,”⁸⁵ Ovitz’s contract. He means that the evidence does not suggest that Watson deliberately avoided important facts in reaching his decision. Since Chandler finds no evidence that leads him to believe that Watson “had anything in mind other than the best interests of the Company,”⁸⁶ he finds that

⁸³ Disney IV, 2005 WL 1875804 at 141.

⁸⁴ Disney IV, 2005 WL 1875804 at 145.

⁸⁵ Disney IV, 2005 WL 1875804 at 146.

⁸⁶ Disney IV, 2005 WL 1875804 at 147.

Watson did not act in bad faith. Again, the holding regarding Watson focuses solely on the nature of Watson's conduct rather than his substantive decision.

Chandler's analysis however takes a radical turn when he addresses the conduct and decision of two other directors, Sidney Poitier and Ignacio Lozano. It is clear from the outset that these two were much less involved in the decisionmaking regarding Ovitz's hiring and that, of all the directors, their conduct comes closest to gross negligence or bad faith.⁸⁷ But what sets apart the opinion's discussion of Poitier and Lozano is that, unlike in his discussion of all the other directors, here Chandler takes a close look at the substantive reasonableness of their decision in order to conclude that they were neither grossly negligent nor acting in bad faith.⁸⁸

As in his discussion of the other directors, Chandler presents Poitier and Lozano as less than ideal directors who nevertheless were made aware of "all material reasonable available" to them.⁸⁹ But unlike in his analysis of the other directors, Chandler here takes the time to judge the reasonableness of the decision based on the information available.

Viewed objectively, the compensation committee was asked to make a decision knowing that: 1) Ovitz was a third party with whom Russell negotiated at arms' length; 2) regardless of whether Ovitz truly was "the most powerful man in Hollywood," he was a highly-regarded industry figure; 3) Ovitz was widely believed to possess skills and experience that would be very valuable to the Company, especially in light of the CapCities/ABC acquisition, Wells' death, and Eisner's medical problems; 4) in order to accept the Company's presidency, Ovitz was leaving and giving up his very successful business, which would lead a reasonable person to believe that he would likely be highly successful in similar

⁸⁷ Disney IV, 2005 WL 1875804 at 147.

⁸⁸ Curiously, Chandler also takes several pages to distinguish between the facts in this case and those of *Smith v. Van Gorkom*, the case which set the standard for gross negligence in Delaware. Disney IV, 2005 WL 1875804 at 149-155. The main distinction which Chandler draws is that the decision at issue in *Van Gorkom* was of much greater magnitude and had much larger "financial implications" than did the decision to hire Ovitz at terms so favorable to him. The financial implications of a decision surely matter in a discussion of the potential damages a court might award if the decision is actionable, but it does not seem to matter a great deal to a discussion of the bad faith or alleged gross negligence of those who made the decision -- at least it shouldn't.

⁸⁹ Disney IV, 2005 WL 1875804 at 155.

pursuits elsewhere in the industry; 5) the CEO and others in senior management were supporting the hiring; and 6) the potential compensation was not economically material to the Company.⁹⁰

From this, Chandler concludes that Poitier and Lozano “acted in a manner that they believed was in the best interests of the corporation.”⁹¹ But viewing the facts in the paragraph excerpted objectively (as Chandler does) does not necessarily lead to that conclusion. Rather, it leads to the conclusion that a *reasonable director* might have approved Ovitz’s package based on the facts at hand. Here, Chandler is holding that Poitier and Lozano breached no duty, not because the evidence suggests that they took the appropriate care and had the appropriate motives, but because the decision itself was reasonable based on the facts presented to them. With regard to Poitier and Lozano, therefore, Chandler has reached his decision by judging the substantive wisdom of their actions. This is precisely what a strict interpretation of the business judgment rule is supposed to prohibit.

Why the special treatment for Poitier and Lozano? The court took the extreme measure of evaluating the substance of the actions of these directors because it could not establish good faith and the absence of gross negligence based on the procedural evidence alone. While the other directors had appeared at least to attempt to acquire the necessary information to arrive at a decision in the best interests of the company, thereby demonstrating good faith and care, there was virtually nothing in Poitier and Lozano’s conduct from which adherence to those duties could be construed. Indeed, it might be said that their action comes close to being outside the protections of the business

⁹⁰ Disney IV, 2005 WL 1875804 at 157-158.

⁹¹ Disney IV, 2005 WL 1875804 at 158.

judgment rule because there is not much evidence that it had any rational basis whatsoever.

Chandler was of course aware of the requirement that a directors' decision be arrived at in a rational way. Earlier in his opinion, he quoted at length from Chancellor Allen's decision in *Caremark*, in which Allen explained why business judgment rule analysis requires a focus on procedure and not substance:

What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational," provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule—one that permitted an "objective" evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.⁹²

But Chandler could not find any real evidence of rational behavior by Poitier or Lozano, so he had to look elsewhere to justify their decision. The only way for Chandler to establish the good faith of these directors was to examine the substance of the decision and conclude that it was reasonable under the circumstances even it was not arrived at through a rational procedure.

As discussed earlier, the conventional view of the business judgment rule is that it requires that directors make rational – not necessarily reasonable – decisions.⁹³ But in *Disney IV*, Chandler was unable to find evidence that the directors employed a rational

⁹² *Disney IV*, 2005 WL 1875804 at 113, quoting *Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959, 967-68 (Del. Ch. 1996).

⁹³ See *supra* text and accompanying notes ___-___.

process in arriving at their decision. He therefore looked at the substantive reasonableness of the decision by the two most uninvolved directors and found that their decision was not actionable because “viewed objectively”⁹⁴ it was reasonable and therefore in good faith. This is precisely what Chancellor Allen seems to have done in *In Re J.P. Stevens*.⁹⁵ In that case, Allen refused to impose liability on directors because their decision “was not beyond the range of reasonable responses...” and did not “fall so far afield of the expected range of responses to warrant an inference that [they] must have been motivated by a concern other than maximizing the value of shareholders’ interest.”⁹⁶

VI. Applying the “Galactic Stupidity” Standard

The distinction between a rational director (the accepted standard) and a reasonable director (the standard occasionally applied) is perhaps meaningless. While demonstrating rationality (for example by showing that the director considered the information available in making his decision) is enough to warrant the protection of the business judgment rule, rationality is not the only way for a director to avoid liability. In the absence of such evidence, Delaware courts may well consider the reasonableness of the decision to establish the good faith of the director even though the evidence does not suggest that the director acted rationally in arriving at that decision. Absent evidence of rational deliberation, a court may then examine the substantive reasonableness of a

⁹⁴ *Disney IV*, 2005 WL 1875804 at 157.

⁹⁵ See *supra* text and accompanying notes ___-___.

⁹⁶ *J.P. Stevens* at 783. Chancellor Allen used similar language in the increasingly cited case of *Gagliardi v. Trifoods International*, 683 A.2d 1049 (1996). In discussing the business judgment rule’s protection for directors who make risky decisions, Allen said:

[the business judgment rule] in effect provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty.

Gagliardi, at 1052-1053, citing *Saxe v. Brady*, Del. Ch. 184 A.2d 602 (1962). Again, regardless of the process used to arrive at the decision, courts will not impose liability for a decision as long as a person acting in good faith might also have made that decision. The only way that a court can know if the decision rises to that level is to examine its substantive wisdom.

director's decision in order to infer the director's good faith. But this inquiry does not really have to do with the motives or good faith of the director. Rather it is plainly an inquiry into the substantive reasonableness of the decision using gross negligence as the standard. Directors therefore get two swings of the bat: they show good faith if they have demonstrated that they made their decision rationally; and they can show good faith if their decision was reasonable, even if they did not arrive at that decision in a rational manner.⁹⁷

Even the most ardent opponent of substantive review agrees that in extreme cases, courts might have to engage in such analysis. While insisting that bad faith almost always arises from self-interest, Stephen Bainbridge nonetheless agrees that sometimes substantive analysis will be necessary, although in keeping with his "abstention doctrine" he would like to set the bar very high indeed.⁹⁸ The set of such cases in which a judge might engage in substantive review under the business judgment rule is perhaps small because virtually any decision by a director that is not disloyal can in some way be found to be rational. But where a court finds no evidence of rationality, it will inevitably ask if

⁹⁷ This also seems to fit nicely with Robert Thompson and D. Gordon Smith's paraphrase of Justice Vesey's opinion in *Brehm*: "[c]ourts will sometimes use substance ('irrationality') as a proxy for determining good faith." Robert Thompson and D. Gordon Smith, "Toward a New Theory of the Shareholder Role: 'Sacred Space' in Corporate Takeovers," 80 *Tex. L. Rev.* 261 (2001). The section of Sean Griffith's article that was quoted at length in the *Disney III* opinion also hints at this, although Chancellor Chandler did not emphasize the language Griffith uses:

Would an ordinarily prudent person lease a corporate asset to a third party on exceedingly generous terms? Would an ordinarily prudent person lavish compensation on a third party and permit the third party to divert investment opportunities that would otherwise come her way?

These are duty of loyalty concerns framed as duty of care questions.

Griffith, *supra* note__ at __, quoted in *Disney IV*, 2005 WL 1875804 at 106. According to Griffith, some decisions are so imprudent that they must implicate the duty of loyalty and therefore the duty of good faith. In *Disney IV*, Chandler examined the conduct of the most imprudent *Disney* directors in this way, but ultimately without insisting that a finding of bad faith would necessarily constitute a finding of disloyalty.

⁹⁸ Bainbridge, *supra* note__ at 275. In his discussion, Bainbridge himself finds three well-known Delaware cases that suggest that substantive review is appropriate in extreme circumstances. *Disney IV* is surely a fourth.

the substance of the decision was reasonable. As such, a court may very well find bad faith by simply evaluating the sheer galactic stupidity of a decision.

VII. Conclusion

Courts correctly shy away from reviewing the substance of directors' decisions unless it is clear that the director had a conflict of interest that influenced his decision. This policy serves the goal of allowing directors to take risks in the interests of the corporation. But it wrong to insist that courts never examine the substantive reasonableness of directors' decisions. This approach ignores the ability of courts to evaluate what a reasonable director would do by taking into account the speculativeness and inherent risk-taking necessary to run a corporation. Where disputes do not present evidence regarding the procedural reasonableness of a director's decision or evidence regarding the director's state of mind, courts must inevitably evaluate the substance of the director's decision. Courts do not usually have to make such an inquiry, but they will in cases that approach the edge of the business judgment rule's protections. Courts will not often impose liability for the galactic stupidity of directors, but the possibility must exist or else the duty of good faith dissolves completely (and therefore uselessly) into a duty of loyalty and nothing more. There is no danger in asking what a reasonable director would do because the answer is: a reasonable director would make the kind of decision that a rational director acting in good faith would make. And that standard is not any more strict than the one that already prevails under the business judgment rule.