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Supplying the Adverb: Corporate Risk-Taking and the Business Judgment Rule

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I. Introduction

The business judgment rule prevents courts from reviewing the decisions of corporate directors as long as the directors “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.” This means that aggrieved shareholders cannot hold directors legally responsible for even their most disastrous decisions unless the complaint clears a very high threshold indeed. In justifying the broad protections provided by the business judgment rule, commentators and jurists make much of the policy objective of encouraging risk-taking by corporate decision-makers. In order for a corporation to succeed in a highly competitive marketplace, they argue, it must test new ideas, pursue new markets and create new products. Since many such inspired actions often end in failure, the business judgment rule is necessary to protect directors from liability for such failures.

2 Associate Professor, Law Department, Zicklin School of Business, Baruch College, City University of New York., and Associate Director, Robert Zicklin Center for Corporate Integrity, Baruch College. The author would like to thank Barry Adler, Andrew Gold, Larry Ribstein and Nathan Rosenberg for their helpful comments. All errors and shortcomings are mine alone.
4 The corporate marketplace of course provides other means (of various levels of effectiveness) of sanctioning ineffective directors.
The business judgment rule exists, according to the conventional wisdom, to allow directors to feel free to take risks without fear that they will face personal liability for potential losses resulting from those risky actions. Supporters of a strict interpretation of the rule point out the dangers of “hindsight review” in this context. When faced with claims that corporate directors acted improperly in making a decision which later turned out to be unfavorable, courts might second guess the reasonableness of the directors’ decision simply because something went wrong and therefore hold them legally responsible for the consequences. According to the Delaware Court of Chancery (the nation’s leading court applying corporate law), allowing such review would result in the destruction of “the entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation… with disastrous results for shareholders and society alike.”

Virtually every legal decision on the business judgment rule emphasizes the importance of protecting risk-taking by corporations as the best justification for the rule’s broad scope although those decisions themselves very rarely address allegations of excessive risk-taking or foolhardy speculation. Rather, most business judgment rule cases have concerned either disloyalty on the part of corporate directors (actions which clearly violate the duty of good faith) or gross negligence based on their failure to be fully informed in making a decision or their failure to perform their oversight role properly. As the rule is currently applied, it can prevent the imposition of liability even where there is little evidence that the directors exercised any business judgment at all. Courts justify this kind of deference to directors because imposing liability in such cases would inhibit faithful directors from ever taking risks on behalf of the corporations which

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5 *In re The Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693, 698 (Del. Ch. 2005)
they oversee and lead. Judges are essentially acknowledging that the facts of a case might show that the directors knew that they were neglecting their duties, but the courts will nonetheless not impose liability because it would inhibit other more faithful directors from taking risks that ultimately will benefit the shareholders.

This attitude is perhaps illustrated best in an opinion by Delaware Chancellor Allen in *Gagliardi v. Trifood International* in which he disapproves of the possibility of holding directors liable for losses arising from a risky project where “the investment was too risky (foolishly risky! stupidly risky! egregiously risky! – you supply the adverb).” To allow such liability, he goes on to say, “would be very destructive of shareholder welfare in the long-term.” Reluctant to supply an adverb that would result in liability, Allen says that all the business judgment rule requires from directors is good faith and adherence to “minimalist proceduralist standards of attention.” Nonetheless, as this article will argue, surely the obligation of good faith requires that directors not make decisions that they know are “too risky” (in that the potential payoff is not justified by the likelihood of failure) or where they know that they are ill-informed.

The corporate law of Delaware and most states requires that allegations of breach of fiduciary duty against directors claim that, not only did the directors make a bad decision, but that they made that decision in “bad faith.” In addition to allowing

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6 *Gagliardi*, 683 A.2d at 1052.
7 *Id.* at 1053.
8 *Id.* at 1052.
9 Allen is plainly using the term “too risky” in this sense. Neither Allen nor this article is suggesting that directors might be held liable for decisions in which the likelihood of success is low but the payoffs disproportionately handsome. It is not a question of how much risk is tolerable; it is a question of whether the contemplated reward justifies the degree of risk.
10 This article will focus on the law of Delaware because of its centrality as a source of American corporate law.
11 Until recently, the jurisprudence regarding the definition of bad faith was quite muddled. After years of inconsistent pronouncements, the Supreme Court of Delaware finally resolved most inconsistencies in the
recovery when directors act disloyally, this standard allows shareholders to recover when they can show, for example, that the directors knew that they were making an uninformed decision, or an unreasonable decision, or an irrational decision -- a high, but not unreachable threshold. Adverse decisions against directors might be based on the directors’ failure to get the best price in a merger or acquisition, while knowingly shirking their duty to obtain the information necessary to make that decision. For the most part, however, courts seem unwilling to impose liability in such cases, not because they cannot find knowing disregard of duty on the part of the directors in each particular case, but because they fear that imposing liability will stifle the atmosphere of risk-taking that promotes innovation and increases shareholder wealth even though the case in question had little to do with that kind of risk and even if the defendants failed to present much evidence of good faith adherence to duty by the directors.

I propose that the apparent obsession with promoting and protecting risk-taking by corporate directors has lead Delaware courts to create a jurisprudence that resists applying its own standard of good faith to cases in which plaintiffs might accuse directors of taking risks in violation of that duty. Further, courts could impose liability in such cases without threatening the culture of corporate risk-taking. Just as a director should not be liable because he made an informed-but-bad decision, he should also not be protected simply because he took a risk. Where directors take a risk knowing that they have not been adequately informed or knowing that the gravity of the risk plainly outweighs the potential gains, allowing shareholders to recover would be appropriate if they can show that the directors’ failures rose to the level of bad faith. The decision to

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12 See e.g. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
take a bold risk is ultimately not different from any other kind of decision except that the chances that it will succeed are lower and, presumably, that the gain will be greater. Courts are certainly qualified to balance the unlikelihood of success with the substantial benefits that will flow to the corporation in the event that the decision does succeed.\textsuperscript{13}

The widely accepted notion that the business judgment rule should protect virtually all risk-taking by corporate directors therefore goes too far. Under Delaware law, a director should still be liable for risky decisions that go wrong if the plaintiffs can show that the director knew that the decision was, to use Chancellor Allen’s phrase, “too risky”\textsuperscript{14} or if the director did not even care to find out what the risks were. The burden that the law places on the plaintiff is to supply the adverb that brings the director’s failing beyond the threshold of bad faith.

Focusing on the current law in Delaware in light of the 2006 Delaware Supreme Court decision in \textit{Stone v. Ritter} which refined the definition of “good faith,” I propose that courts are perfectly well-equipped to hear cases in which aggrieved shareholders claim that directors took improper risks in ways that ought to result in liability for those directors.\textsuperscript{15} I attempt to show that such review – even if the courts have for the most part refused to engage in it – would neither fall outside the prevailing boundaries of the business judgment rule nor damage the ability of corporations to take the kind of bold risks that have resulted in years of innovation and growth in the American corporate sector.


\textsuperscript{14} Gagliardi, 683 A.2d at 1052.

\textsuperscript{15} This article does not address whether the directors’ D & O insurance covers or ought to cover such misconduct.
Further, and perhaps most vitally, if the doctrine of good faith is to have any teeth at all, it must address all areas of director decision making including risk-taking. It is well within the ability of courts to decide whether or not a risky decision by a board was intentionally made, as *Stone* puts it, “with a purpose other than that of advancing the best interests of the corporation.”\textsuperscript{16} Although *Stone* and its most important predecessor, *Caremark*, involved the oversight function of the board, the good faith obligation imposed by those decisions should apply equally to the state of mind of boards when they make affirmative decisions to take actions, including risky actions. By seeming to exclude the possibility of review of decisions to take risks, the Delaware courts are disregarding their own definition of the duty of good faith and limiting the scope of the fiduciary duties of corporate directors to nothing more than the obligation not to self-deal. If consistency and clarity are to remain a hallmark of Delaware corporate law, the business judgment rule and the duty of good faith should apply to risky decisions in the same way that they apply to other actions and inactions taken by corporate directors.

II. The Primacy of Risk-Taking

Arguments in favor of the risk-taking justification for the business judgment rule rely on three key notions: the role of risk-taking in wealth creation; the ability of shareholders to diversify their portfolios; and the dangers of hindsight review. Taken together, these do indeed make a compelling case for the proposition that the decisions of America’s business leaders should not be reviewed by courts except in extraordinary circumstances. Not surprisingly, the great body of cases applying the business judgment rule and scholarship commenting on the nuances of the rule emphasize the importance of

\textsuperscript{16} *Stone*, 911 A.2d at 369
these elements in justifying application of the rule’s protections even where corporate directors did not engage in “best practices.”

Students of American law and economic history agree that much of our nation’s technological progress and resulting economic growth was created not just through the inspired tinkering of a few great inventors but through the bold risk-taking of our great corporate innovators. When a corporation embarks on a risky venture, its leaders will likely justify the action on the grounds that, although the likelihood of failure is high, if successful it will greatly benefit the corporation and its shareholders. Often such risky projects fail, but there is little dispute that, by taking risks, corporate decision-makers are consciously attempting to maximize the present value of the expected income of the corporation and thereby benefit the shareholders. Anyone with an interest in the future profitability of a corporation will likely want that corporation to take risks and will likely insist that the governance mechanisms in place allow its leaders to do so. And a fair

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17 See, e.g., Disney IV, 907 A.2d at 697:
This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not – indeed, the common law cannot – hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices… It is important to note that advocates of near absolute business judgment rule protection for risk-taking acknowledge the distinction between the standard the law imposes and the standard of conduct that most of us would expect from reasonable and prudent directors. See, e.g., William T. Allen, Jack B. Jacobs & Leo Strine, Jr. “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, 450 (2002).


19 Allen et al. explain how a very risky decision might be in the best interest of the corporation: “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.

20 As Stephen Bainbridge explains, we can view the business judgment rule as an “off-the-rack rule” that essentially imposes by default a rule that the shareholders would willingly agree to by contract – a promise on their part “to refrain from challenging the reasonableness of managerial business decisions.” Stephen Bainbridge, “The Business Judgment Rule as Abstention Doctrine,” 57 Vand. L. Rev. 83, 114-116 (2004).
summary of American corporate legal history would show that this model has been followed for at least the last one hundred years.

While individual corporations may indeed maximize the wealth of their shareholders by embarking on risky ventures, many of the arguments in favor of the business judgment rule rely on the ability of shareholders to diversify their holdings across many corporations and therefore diversify their risk as well. 21 In Gagliardi, for example, Chancellor Allen justifies the broad protections of the business judgment rule on the ground that shareholders should not rationally want directors to be risk averse because “[s]hareholders’ investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm’s cost of capital.” 22 Similarly, Stephen Bainbridge invokes portfolio theory to argue that, since shareholders can diversify their portfolios, they should be indifferent to decisions by directors that affect the risks faced by an individual corporation as long as those decisions are designed to increase the rate of return of that specific corporation.” 23 Plainly, if we are trying to maximize the overall value of a diversified portfolio of holdings, the broad protections of the business judgment rule serve the shareholder well by encouraging the directors to take risks

21 This argument seems to disregard the contractarian view of the corporation, a theory which many of the business judgment rule’s strongest proponents embrace. To a contractarian, a director owes fiduciary duties to the shareholders in a way that is similar to the duties a party assumes under an ordinary contract. David Rosenberg, “Making Sense of Good Faith in Delaware Corporate Fiduciary Law,” 29 Del. J. Corp. Law 491(2004). Surely in defining those duties, the parties do not assume that the shareholders must hold shares in other corporations. The duties owed by a director, whatever they might be, ought to be defined within the confines of the conglomeration of relationships within that specific corporation. To define the duties owed by a director to a shareholder with reference to the fact that the shareholder likely owns stock in other corporations seems akin to mitigating the liability of a negligent babysitter on the grounds that, well, the parent probably has other children who will not have been harmed by that babysitter’s lack of care.

22 Gagliardi, 683 A.2d at 1052.

23 Bainbridge, supra note __, at 112-114.
without fear that the directors will be held liable if those specific risks do not result in added value to the individual corporation which they lead. And indeed it is extremely likely that the holder of shares in a publicly traded corporation owns shares in other publicly traded corporations as well.24

The problem with allowing courts to review the decisions of corporate directors is not that sometimes the directors get it wrong. No one seriously suggests that investors should be able to recover from directors anytime a decision ends up hurting the corporation.25 This is implicit in any discussion of the workings of a market economy that recognizes the corporate form.26 The problem with reviewing bad decisions by corporate directors, as many commentators have pointed out, is that, given the responsibility, courts will sometimes get it wrong in their judgments about how and why the directors got it wrong. Both common sense27 and empirical studies28 tell us that any attempt to judge or analyze a decision after the effects of the decision are already known might well be tainted by “hindsight bias.”29 Whatever the standard a court might use in evaluating a claim regarding a decision made in the past, it will be difficult for the court

24 Still it is unclear why this should have an effect at all on the culpability of the directors. Although the misconduct in the Enron debacle was far worse than the kind of borderline bad faith contemplated here, its impact was made far more devastating by the fact that the retirement plans of many Enron employees were made up almost entirely of stock in Enron itself. Michael W. Lynch, “Enron’s 401(k) Calamity,” Reason Magazine, December 27, 2001 (available at http://www.reason.com/news/show/34293.html). The failure of the Enron employees to diversify was a bad investment decision for them, but even if they had diversified, it should not have mitigated the culpability of the Enron leadership.

25 Indeed, it might be said that the business judgment rule (which to a degree prohibits recovery even when the actor made a bad decision) is the polar opposite of strict liability (which imposes liability even where the plaintiff cannot prove that the actor made a bad decision).

26 Judge Winter described this assumption nicely in his oft-cited opinion in the well-known case of Joy v. North: “First, shareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers…. [t]he business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.” 692 F.2d 880, 885-886 (2nd. Cir. 1982).

27 For a non-legal example of hindsight bias, listen to a random five minute segment of any sports-related radio call-in show anywhere in the world on a Monday morning.

28 Allen et al, supra note__, at 455. See also Bainbridge, supra note__, at 114.

to ignore what it knows were the actual consequences of this decision. As Bainbridge puts it: “[d]ecision makers tend to assign an erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring.”

Hence the fear that, absent the strong protections of the business judgment rule, courts would be tempted to hold directors libel for good faith decisions that did not end up benefiting the corporation.

What makes the business judgment rule so important is what Chancellor Allen in *Gagliardi* called “this stupefying disjunction between risk and reward for corporate directors.” As he explains, corporate directors generally do not own a large percentage of the stock in the corporations which they oversee. When they take a risk that succeeds in producing wealth for the corporation, the upside for them is perhaps a decent gain in their equity share of the corporation and certainly a gain for their reputation as good leaders and decision-makers. Similarly, if they take a risk that produces losses for the corporation, the directors will take a small equity hit and a concomitant dent in their reputations as good leaders. However, as Allen emphasizes, if directors were to be held personally liable for the damages arising from their risky decisions that do not turn out to benefit the corporation, their incentive to take the kind of risks that shareholders would

30 Bainbridge, supra note__, at 114.
31 As other commentators have pointed out, however, this does not stop our legal system from allowing judges and juries to determine the reasonableness of an actor’s actions in a variety of areas of professional endeavor or indeed everyday life after something goes wrong. See, e.g., Franklin A. Gevurtz, “The Business Judgment Rule: Meaningless Verbiage or Misguided Notion,” 67 S. Cal. L. Rev. 287, 305 (1994); Telman, supra note__, at 841-842; Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 94 (1991) (pointing out that judges routinely “decide whether engineers have designed the compressors on jet engines properly” and “whether the farmer delivered pomegranates confirming to the industry’s specifications”).
32 *Gagliardi*, 683 A.2d at 1052. See also, Allen et al. supra note__, at 456. (“But directors will tend to deviate from this rational acceptance of corporate risk if, in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss”).
33 *Gagliardi*, 683 A.2d at 1052. Stephen Bainbridge however notes that corporations sometimes require directors to buy stock in corporations which they serve. Bainbridge, supra note__, at 117. This would work to align the interests of directors and shareholders and lessen, to a degree, the disproportion between the reward for successful risks and the penalty for those that fail.
The business judgment rule, then, simply puts the potential personal damages in line with the potential personal payoff that might result from the authorization of a risky venture by corporate directors. Since the potential financial payoff for most directors is very low (because they possess little equity in the corporation), the potential liability should be very low as well.

III. The Legal Framework for Evaluating Corporate Risk-Taking

The bottom line for supporters of a strong business judgment rule is the bottom line. Its justification to many lies in the overall value it creates. Much of Delaware’s jurisprudence on the rule and scholarly commentary as well dwell heavily on the policy justifications for shielding directors from liability for risk-taking through the protections of the business judgment rule. And yet in their embrace of the centrality of risk-taking, they appear to ignore the legal structure of fiduciary obligations under which corporate directors function. When used to evaluate a claim of actionable risk-taking, Delaware law is confusing and inconsistent at least partly because, until recently, the Delaware

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34 See Allen et al., supra note __, at 455. (“A standard of review that imposes liability on a board of directors for making an ‘unreasonable’ (as opposed to an ‘irrational’) decision could result in discouraging riskier yet socially desirable economic decisions, because an ordinary negligence standard of care will tend to make directors unduly risk averse”).

35 In Gagliardi, Allen writes, “Given this disjunction, only a very small probability of director liability based on “negligence”, “inattention”, “waste”, etc., could induce a board to avoid authorizing risky investment projects to any extent!” Gagliardi, 683 A.2d. at 1052. It appears that Allen means that even a small probability of liability would cause a director to avoid risks because the rewards for success are disproportionately small compared to the damages resulting from failure. Effectively, the business judgment rule allows directors to take risks without fear of that liability.

36 And indeed many judges do not seem to insist that the rule has moral or ethical justifications. They often point out, for example, that directors who receive the rule’s protection should have behaved differently. See, e.g., Disney IV, 907 A.2d at 697. This is not to say, however, that moral failings on the part of directors are irrelevant to application of the business judgment rule. It is often a moral failing (e.g. greed) that gives rise to a violation of fiduciary duty and a resulting substantial loss to the corporation.

37 See, e.g., Easterbrook and Fischel, supra note __, at 93 (“Behind the business judgment rule lies recognition that investors’ wealth would be lower if managers’ decisions were routinely subjected to strict judicial review”).
Supreme Court had not come up with a workable definition of the fiduciary obligations owed by corporate directors.\(^{38}\)

Although the justifications for the business judgment rule seem to prohibit it, cases involving allegations of director misconduct through excessive risk-taking often inevitably address the state of mind of the directors in deciding to take the risk. For example, in *Trenwick v. Ernst & Young*, a case better known for its discussion of the directors’ duties to creditors, Chancellor Strine first quotes *Gagliardi* for the proposition, discussed here earlier, that plaintiffs cannot hold directors liable for decisions to invest, “no matter how foolish the investment may appear in retrospect.”\(^{39}\) Strine later addresses the role of the business judgment rule in encouraging risk-taking by directors and in protecting those directors when the risks end in failure. He says:

> But business failure is an ever-present risk. The business judgment rule exists precisely to ensure that directors and managers acting in good faith may pursue risky strategies that *seem to promise great profit*. If the mere fact that a strategy turned out poorly is in itself sufficient to create an inference that the directors who approved it breached their fiduciary duties, the business judgment rule will have been denuded of much of its utility.\(^{40}\)

Strine states the conventional rule that a court must avoid evaluating a director’s decision based on its eventual outcome so that the director will receive the rule’s protection where he acted in good faith and where his state of mind was such that the risk “seem[ed]” like a decent idea. The implication is that the business judgment rule goes further than necessary – i.e. that it protects even strategies that do not “seem to promise great profit” – so that directors will still be willing to take the kind of calculated chances that we want them to take. The problem here is that, under current Delaware law, a strong case can be

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\(^{38}\) See *infra* Section IV on good faith.

\(^{39}\) *Trenwick America Litigation Trust v. Ernst & Young*, 906 A.2d 168 (Del. Ch. 2006), citing *Gagliardi*.

\(^{40}\) *Id.* at 193, italics added.
made that it is bad faith for a director to pursue a strategy that does not seem to him calculated to promise great profit. Such a decision would therefore fall outside the protections of the business judgment rule.

The Disney litigation was fun to watch over the years because it allowed us to see Hollywood big shots (Eisner!, Ovitz!, Sidney Poitier!) squirming in the wake of a very bad business decision. But it was also fun to watch because it provided a pretty clear-cut set of facts which allowed students of corporate governance to engage in our own hindsight analysis regarding a risky decision made by corporate directors who did not adhere to what one court referred to as “best practices.” An underlying theme of the opinions that came out of the Disney cases was the apparent failure of directors to recognize and evaluate the risks involved in approving the hiring of an untested new president at a high price and with an extraordinarily generous severance package. The courts’ discussions of the directors’ approach in approving Michael Ovitz’s hiring suggest that the business judgment rule does not necessarily preclude review of risky forward-looking decisions.

In Disney II, in which the Court of Chancery, relying in part on Gagliardi, found that the plaintiffs had indeed pled facts sufficient for a finding of breach of fiduciary duty by the directors, Chancellor Chandler held that a “‘we don’t care about the risks’ attitude concerning a material corporate decision” on the part of the directors could constitute a breach of the duty of good faith. Under Disney II, making a decision and not caring if that decision helps the corporation and its shareholders is evidence of bad faith. Two years later, in an opinion known as “Disney IV,” Chandler revisited his earlier decision

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41 Disney IV, 907 A.2d at 697.
42 In Re Walt Disney Co. Derivate Litigation (Disney II), 825 A.2d 275, 289 (Del. Ch. 2003).
and delved more deeply into the issue of risk. In the first few pages of a seventy-plus page opinion, he jumped into a _Gagliardi_-like discussion of the centrality of risk-taking in the business world. Like so many other courts, when faced with evaluating the culpability of directors in the wake of a decision that, in hindsight, was a bad idea, Chancellor Chandler points out that any kind of business involves risk and that courts will not apportion liability simply on the grounds that a director took a risk that did not turn out to benefit the company.43 While conscious of the primacy of risk-taking, Chandler also displays a clear willingness to hold a directors liable for risks they take knowing that they have not been sufficiently informed:

But the essence of business is risk-the application of informed belief to contingencies whose outcomes can sometimes be predicted, but never known. The decision-makers entrusted by shareholders must act out of loyalty to those shareholders. They must in good faith act to make informed decisions on behalf of the shareholders untainted by self-interest. Where they fail to do so, this Court stands ready to remedy breaches of fiduciary duty.44

By insisting that directors be _informed_ when making a risky decision, Chandler is equating the kind of risk-taking at issue in Disney with the oversight function at issue in the many Delaware cases in which the duty of good faith evolved. As with decisions made by directors in overseeing a company, the business judgment rule protects directors for risks that they take, but only when they have consciously informed themselves of the risks.

Later in the opinion, Chandler revisits his statement in _Disney II_ that it might be bad faith where directors “‘consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material

43 _Disney IV_, 907 A.2d at 698 (“…under our corporate law, corporate decisionmakers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and abilities dictate, free of _post hoc_ penalties from a reviewing court using perfect hindsight.”).

44 _Id._
Affirming himself, Chandler announces that he will evaluate the behavior of the Disney directors based on the standard that “[a] failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation…” The clear meaning of his ruling is that it can be bad faith where a director takes a risk without consciously believing that the risk is in the best interests of the corporation. Not caring about the risks is not merely negligence or even gross negligence; rather it rises to the level of bad faith and is therefore not protected by the business judgment rule.

In applying this standard, Chandler ultimately found that, while the directors’ conduct “fell significantly short of the best practices of ideal corporate governance,” they were still protected by the business judgment rule because their conduct did not amount to bad faith as the duty was then understood. Chandler’s dismissal of the allegations against each defendant director has been discussed at length elsewhere, but it is worth focusing briefly on the language he uses regarding the conduct of Raymond L. Watson, then a director and formerly Chairman of Disney’s board. In holding that the evidence did not lead to the conclusion that Watson breached his fiduciary duties, Chandler said, “Nothing in his conduct leads me to believe that he took an ‘ostrich-like’ approach to considering and approving” Ovitz’s compensation package. That is to say, not bothering to look at the consequences of your actions can be bad faith even if your less-than-best-practices actions (or inactions) do not seem to benefit you in any way.

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45 Id. at 754-755.
46 Id. at 755.
47 The Supreme Court of the State of Delaware explicitly upheld this definition in Disney V, 907 A.2d 27, 63. (Del. Supr. 2006). That not caring is bad faith is made plain in Stone.
48 Disney IV, 906 A. 2d. at 697.
50 Disney IV, 906 A.2d at 766.
If an authority like Chandler has suggested that the business judgment rule does not protect failure to pay attention to risk, it must arise from an identifiable legal doctrine. *Disney IV*’s broad sense of the duty of good faith seems to presage the formulation in *Stone*, which, for the first time, drew the line indicating where a breach of the duty of care might also constitute bad faith. *Stone* more explicitly held what Chandler and others were hinting at (and which *Gagliardi* shied away from): that knowing breaches of the duty care are bad faith and can therefore constitute disloyalty even if those actions did not benefit the directors themselves.


For years, the Delaware courts and academic commentators could not agree on the meaning of “good faith” in the context of the business judgment rule. Much of the confusion regarding the definition of good faith and its relationship to the duties of care and loyalty arises from the 1986 passage of Section 102(b)(7) of the Delaware General Corporations Law. As is well-known, the Delaware legislature passed the law in the wake of the Delaware Supreme Court’s decision in *Smith v. Van Gorkom*, a case in which corporate directors were held personally liable for acts which the court found amounted to gross negligence. Intended to provide assurance to would-be directors that they would not risk their personal fortunes by agreeing to serve on the boards of Delaware-based

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51 As the Delaware Supreme Court noted in *Disney V*, “the good faith concept has recently been the subject of considerable scholarly writing.” For a nearly exhaustive then-current list, see *Disney V*, 906 A.2d at footnote 99. In the wake of the decision in *Stone v. Ritter*, yet more ink has been spilled on the subject. See, Gold, supra note __, Bainbridge, et al., supra note __, and two articles by Claire A. Hill and Brett H. McDonnell, “Disney, Good Faith, and Structural Bias,” 32 J. Corp. Law 833 (2007) and “*Stone v. Ritter* and the Expanding Duty of Loyalty,” 76 Fordham L. Rev. 1769 (2007).

52 Just about everyone agrees that the primary problem with the decision in *Van Gorkom* was not the imposition of liability for gross negligence but that the facts did not justify the conclusion that the directors had been grossly negligent.
corporations, 102(b)(7) allows corporations to voluntarily limit the liability of directors for breaches of their fiduciary duties, but not for “any breach of the director’s duty of loyalty,” or “for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.” Because of the well-known legislative history of the law and the case from which it sprang, many commentators summarize 102(b)(7) as permitting a corporation to eliminate the possibility of director liability for “breaches of the duty of care.” That was indeed its intent – to allow directors to make decisions without the fear that they would be held personally liable for negligent conduct, even conduct that constitutes, as in *Smith v. Van Gorkom*, gross negligence.

After the passage of 102(b)(7) Delaware courts had a hard time reconciling the duty of good faith as used in that law with the duty of good faith as it already existed in the abundant case law on the subject. Since at least 1993, the Delaware Supreme Court had seemed to insist that a director’s fiduciary obligations consisted of three different duties: care, loyalty and good faith. At the same time, the rather ornery Delaware Court of Chancery followed its own formulation, insisting that good faith was merely a “subsidiary requirement” of the duty of loyalty. The Delaware Supreme Court finally addressed the issue head-on in its 2006 decision in the case of *Stone v. Ritter* which involved a shareholder derivative lawsuit alleging that the board of directors violated their duty of good faith by failing to institute adequate measures to ensure compliance with Federal financial regulations. In the wake of the decision, a number of commentators quickly pointed out that the Court’s opinion did not fully resolve the

54 See e.g. Bishop, supra note __ , at 905-906.
56 In re Gaylord Container Corp. Shareholders Litigation, 753 A.2d 462 (Del. Ch. 2000).
widespread confusion on the issue of good faith. Nonetheless, a close reading of the case in fact provides a pretty clear understanding of the parameters of the duty.

Oddly, the Court’s formulation of the duties of good faith and loyalty describes good faith as a “subsidiary element” of the duty of loyalty although instinctively most of us would think it should be the other way around. At first blush, the duty of “good faith” seems broader than the duty of “loyalty” because it is hard to think of a disloyal act that would not also be in bad faith, but it is easy to think of an act that is bad faith that is not necessarily disloyal (at least in the sense of self-interested). Stone resolves this apparent inconsistency by defining the duty of loyalty to encompass much more than merely actions taken in self-interest.

A close reading of Stone and these earlier cases makes clear that, under Delaware law, a director acts disloyally if he does not believe in good faith that his actions are in the best interests of the corporation whether or not those actions benefit the director at the expense of the corporation. Chancellor Strine first chiseled out this definition in Guttman v. Huang, a case heavily relied upon by the Court in Stone. In Guttman, a case involving a shareholder derivative lawsuit against corporate directors for their failure to prevent certain accounting irregularities, Strine emphasizes that disloyalty encompasses actions which do not necessarily benefit the party acting disloyally. Under his

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58 Stephen Bainbridge and his co-authors, for example, argue that the opinion’s formulation of good faith “makes little sense.” Stephen M. Bainbridge et al., “The Convergence of Good Faith and Oversight,” 55 UCLA L. Rev. 559, 584 (2006).

59 Indeed, this author took the broadest possible view of the duty of good faith, arguing that “[t]he duty of good faith should apply to all the obligations of a corporate director and not just to the duty of loyalty…” Rosenberg, Making Sense, supra note __, at 515. Although this definition seems entirely irreconcilable with that of the Delaware Supreme Court, the disjunction hinges more on the definition of “loyalty” than the definition of “good faith.

60 A decision that I believe will hurt the company but that will not necessarily help me is plainly made in bad faith but is not plainly disloyal in the sense of deliberately benefiting myself rather than my fiduciaries.

61 823 A.2d 492 (Del. Ch. 2003).
formulation, a director acts disloyally if he believes that his actions are not in the best interests of the corporation regardless of whether or not those actions in turn benefit the director himself: “the reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic\textsuperscript{62}) for conscious action not in the corporation’s best interest does not make it faithful, as opposed to faithless.”\textsuperscript{63} With the \textit{Gagliardi} opinion’s string of adverbs\textsuperscript{64} several years passed, Strine reaches for the thesaurus and conjures up a string of adjectives instead.

Subsequent Court of Chancery opinions closely followed Strine’s \textit{Guttman} formulation and made it clear that bad faith (and therefore disloyalty) is not limited merely to actions which plainly benefit the director at the expense of the corporation but can also include any of a number of “moral failings.”\textsuperscript{65} In \textit{Disney IV}, Chancellor Chandler enumerates (with some apparent delight) these failings, with a string of nouns, worthy of the adverbs and adjectives of his colleagues:

Bad faith can be the result of “any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation” including greed, “hatred, lust, envy, revenge, … shame or pride.” Sloth could certainly be an appropriate addition to that incomplete list if it constitutes a systematic or sustained shirking of duty.\textsuperscript{66}

\textsuperscript{62} I suspect that Strine thought long and hard about including “nihilistic” motives among those that can constitute disloyalty. It suggests that shareholders ought to be able to overcome the presumptions of the business judgment rule even without alleging specific bad motives on the part of the directors. It comes very close to suggesting that the ineffectiveness of the directors’ action itself is enough to constitute bad faith. For a discussion of how courts do this while claiming that they don’t, see David Rosenberg, “Galactic Stupidity and the Business Judgment Rule,” 32 J. Corp. Law 301 (2007).

\textsuperscript{63} \textit{Guttman}, 823 A.2d at 506, fn 34. Italics added.

\textsuperscript{64} \textit{Gagliardi}, 683 A.2d at 1052 (“foolishly risky! stupidly risky! egregiously risky!”)

\textsuperscript{65} \textit{Disney IV}, 907 A. 2d at 754.

\textsuperscript{66} Id., wrongly citing Guttman, 823 A.2d at 506 n. 34. (in fact, the quote comes from \textit{In re RJR Nabisco, Inc. Shareholders Litigation}, 14 Del. J. Corp. L. 1132, 1159 (1989). Italics added. Impressively, between the quotations from Chancellor Allen’s opinion in \textit{RJR Nabisco} and Chancellor Chandler’s opinion here, the Delaware Court of Chancery officially recognizes as bad faith in the context of corporate director actions, 71% of the Catholic Church’s seven deadly sins (i.e. greed, lust, envy, pride and sloth). I leave it to other scholars to contemplate the implications of this apparent invocation of religious doctrine on the United States Constitution’s prohibition on governmental establishment of religion.
The faithless director described here knows that he is acting against the best interests of the corporation due to a “moral failing” embodied in the above list of vices. Ignorance, by itself, Chandler notes, is probably not enough, “but ignorance attributable to any of the moral failings previously listed could constitute bad faith.” Once he has established that bad faith is a knowing failure to act in the interests of the corporation due to a bad (immoral?) motive, it is not hard to equate bad faith with disloyalty: “Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation.”

The Delaware Supreme Court’s decision in Stone v. Ritter finally confirmed the counterintuitive proposition that, under Delaware law, any act made in bad faith is also disloyal. There is no “triad” of separate fiduciary duties; when a director acts in bad faith he has violated his duty of loyalty. Put another way, knowing breaches of any duty (including knowing breaches of the duty of care) are henceforth considered disloyal. As Stephen Bainbridge et al. explain:

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67 Disney IV, 907 A.2d at 754.
68 It is unclear whether ignorance on the part of a corporate director could possibly exist without the commission of at least one of the other enumerated vices by the director himself -- or by someone else who has similar duties. A director might act in good faith and yet remain ignorant, due perhaps to the failure of a seemingly reliable expert to keep the director properly informed. In such a case, the director ought to be free from liability, but the aggrieved plaintiffs should be able to hold the expert responsible for failing to fulfill his obligations.
69 Disney IV, 907 A.2d at 755. In a case decided only a few weeks after Disney V, Chancellor Strine called it “conscious torpor,” where a director knowingly makes a decision to fail to discharge his fiduciary obligations. Teachers’ Retirement System of Louisiana v. Adinoff, 900 A.2d 654, 668 (Del. Ch. 2006).
70 Stone thus explicitly affirms Strine’s assertion in Guttman that, “[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.” Stone, 911 A.2d at 370. The terminology gets very confusing here because the opinion also explicitly affirms Guttman’s definition of good faith as a “subsidiary element,” i.e., a condition, “of the fundamental duty of loyalty.” Stone, 911 A.2d at 370, citing Guttman. At the same time, however, Stone expands the meaning of disloyalty to include acts for which the director did not have a “good faith belief that her actions are in the corporation’s best interest.” Stone, 911 A.2d at 370. While the definition of bad faith is narrowed so that it becomes merely a subset of disloyalty, the definition of disloyalty is expanded to include acts which earlier might have simply met the definition of bad faith but not necessarily disloyalty in the sense of self-serving.
By subsuming good faith into the duty of loyalty… Stone extends the domain of the duty of loyalty to cases in which the defendant received no financial benefit… [and thus,] liability for acts in bad faith … will look a lot more like that imposed in cases involving a breach of the duty of care than the duty of loyalty.\footnote{Bainbridge et al. \textit{supra} note\textemdash, at 585. The authors are right: including as disloyalty acts that do not benefit the director does indeed make the duty of good faith look a lot like the duty of care. Essentially, \textit{Stone}'s duty of loyalty includes breaches of the duty of care in bad faith.}

After Stone, certain breaches of the duty of care (i.e. knowing breaches of the duty of care) will not enjoy the protection of the business judgment rule because they will be breaches of the duty of loyalty as well.\footnote{Further, in the wake of \textit{Disney V} and \textit{Stone}, the scope of the protections granted by 102(b)(7) must be re-evaluated. Focusing on the language of the law itself (and not its widely accepted paraphrase), it appears that 102(b)(7) allows waivers of liability for most breaches of duty of care, but not those breaches of that duty that might be considered disloyal according the Delaware Supreme Court’s definition in \textit{Stone}. It is entirely possible then, after \textit{Stone}, that a 102(b)(7) waiver would no longer protect directors for the authorization of a risky project where the directors deliberately ignored the chances of success of the project in relation to its rewards for the corporation.}

Two other commentators, Claire A. Hill and Brett H. McDonnell, nicely parse out how a knowing breach of the duty of care might be defined as a breach of the duty of loyalty. As they note, a breach of the duty of loyalty in the classic sense takes places when a director takes for himself a benefit that should otherwise be the corporation’s.\footnote{Claire A. Hill & Brett H. McDonnell, “Stone v. Ritter and the Expanding Duty of Loyalty,” 76 Fordham L. Rev. 1769, 1795 (2007). In a nice turn of phrase, Carter G. Bishop characterizes this aspect of the duty of loyalty as “an obligation of devotion” to the corporation that includes more than simply not enriching oneself at the company’s expense. Carter G. Bishop, “Directorial Abdication and the Taxonomic Role of Good Faith in Delaware Corporate Law,” 2007 Mich. St. L. Rev. 905, 924 (2007).}

On the other hand, “[c]lassic duty of care cases also involve a director taking for herself something which should otherwise be the corporation’s: her attention and diligence.”\footnote{Hill and McDonnell, \textit{supra} note\textemdash, at 1795.}

Therefore, it makes sense to label it disloyalty when a director knowingly fails to pay attention or knowingly acts in a slothful manner. Such a director has indeed deliberately acted against the best interests of the corporation and in her own interests. The diligence and attention that was supposed to benefit the corporation may now be used (or perhaps...}
saved up) by the director himself for pursuits unrelated to decision-making on behalf of the corporation itself.

V. Where Risk-Taking and Oversight Meet

With the notable exception of the *Disney* cases, most of the decisions that gave rise to this definition of good faith and loyalty involved the oversight function of the board of directors rather than its function as manager and strategic decision-maker. Nonetheless, the jurisprudence of good faith that has evolved in these cases can be easily applied to situations in which directors choose (or choose not) to take affirmative risks on behalf of the corporation. Bainbridge et al. note that, when designing oversight and compliance programs, directors must inevitably take risks that may or may not turn out to benefit the company.\(^75\) Weighing the costs and benefits of certain safeguards against rules violations, a board might decide that the safeguards are simply not worth the price, given the likelihood and harm done by a potential violation.\(^76\) According to Bainbridge et al., assuming that the directors acted in good faith in arriving at the decision not to implement the safeguards, they would plainly be protected under the *Caremark* standard.\(^77\) The decision to take a risk by avoiding implementing a costly safeguard is therefore not different from the decision to take a risk by pursuing, for example, a new and untested technology; at least they are not different regarding the way a court should evaluate the good faith of the corporate authorities who chose to take the risk in the first place.

\(^{75}\) Bainbridge et al. *supra* note __, at 600-601.
\(^{76}\) *Id.* at 601.
\(^{77}\) *Id.* (“After all, a decision not to act does not differ from a decision to take action. Accordingly, the thrust of Allen’s opinion [in *Caremark*] suggests that the business judgment rule ought to protect directors who rationally elect against adopting a compliance program after weighing the costs against the benefits.”).
By clarifying the definition of good faith in *Stone*, the Supreme Court of Delaware has created the opportunity to re-evaluate the way that the business judgment rule addresses risk-taking by corporate directors. If, as *Stone* held, it is not good faith, “where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation,” then deliberately failing to pay attention to the risks of pursuing a new idea would be bad faith and would therefore fall outside the protections of the business judgment rule. Perhaps, as Bainbridge and his co-authors fear, this looks a lot like a breach of the duty of care masquerading as a case involving a breach of the duty of good faith. But given the very high threshold imposed by *Stone* whereby only knowingly careless conduct becomes disloyal conduct and therefore bad faith, the new standard should not threaten the culture of innovation and risk-taking enjoyed by corporate directors.

Other commentators have already argued that some kind of negligence standard ought to be used in this context and that such a standard would not really change the way that corporate boards operate. For example, in a prescient article, Franklin A. Gevurtz recognized that the law plainly acknowledges in numerous contexts that risk-taking that results in a negative outcome is not necessarily negligence. He explains that any simple application of the negligence standard to corporate board activity will only impose liability where the decision is unreasonable – i.e. where the expected probability of

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78 *Stone*, 911 A.2d at 369.
79 Bainbridge et al. *supra* note__, at 585.
80 Gevurtz, *supra* note__, at 305.
failure of a chosen risky action is high in relation to the magnitude of gain should the action proved successful.\textsuperscript{81}

In fact, this does not seem all that different from an application of the \textit{Stone} standard of good faith to a risky decision. Suppose that a board of directors were to make a decision to embark on a series of costly and risky projects knowing that the available information suggested a 10\% chance of success for each project with a potential gain of 500\% of the cost for every successful outcome. One need not wait to review this decision in the hindsight of its likely failure to be able to say that the directors did not act “in the good faith belief that [their] actions [were] in the corporation’s best interest.”\textsuperscript{82}

Under \textit{Stone}, such action (whether or not you are willing to call it careless, negligent or unreasonable) breaches the duty of good faith (by knowingly making a decision against the corporation’s interest) and therefore breaches the duty of loyalty and is outside the protections of the business judgment rule.\textsuperscript{83}

Such an interpretation of \textit{Stone} might lead to the conclusion that it has eviscerated Gagliardi’s lofty vision of the business judgment rule. Another close look at \textit{Gagliardi} suggests otherwise. The decision in \textit{Gagliardi} is correctly premised on the belief that shareholders want directors to take risks because that is how the interests of the shareholders are best served. Although Chancellor Allen plainly says that foolish, stupid

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\item \textsuperscript{81} Gevurtz, \textit{supra} note\textsuperscript{__}, at 305-306. \textit{See also}, Telman, \textit{supra} note\textsuperscript{__}, at 846. Gevurtz is careful to take into account the state of mind of the decisionmaker at the time the decision was made. His standard does not call for applying what might ultimately be a true assessment of the risk of an action. Rather he uses the \textit{expected} gain and probability of success \textit{ex ante}. This is no different from the standard under \textit{Stone} which might impose liability where a director knowingly takes a risk in which the expected gain is disproportionately low in relation to the likelihood of success. \textit{Stone}, 911 A.2d at 370, quoting Guttman.
\item \textsuperscript{82} Note that this example does not bring \textit{Stone} as far as Bainbridge and his co-authors fear. They warn that “the point of the business judgment rule is that shareholders should not be allowed to recover monetary damages simply because the directors made the wrong decision.” Bainbridge et al. \textit{supra} note\textsuperscript{__}, at 593.
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and egregious risks taken by directors should be protected, even he seems to allow for the kind of examination of the attentiveness and care of the directors contemplated by *Stone*. He states that it is “an elementary precept of corporation law,” that “in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith.” He later says that there cannot be director liability without a conflict of interest or “suspect motivation.” Since he mentions self-dealing and conflicts of interest separately, it is clear that he intends “improper motive” and “suspect motivation” to include some other kind of potentially actionable shortcoming by directors. And Allen seems to leave open the possibility that a range of director misconduct other than self-dealing might indeed be actionable. After all, it is easy to think of examples of conflict of interest decisions that are not bad faith, but it is harder to conjure up a decision that is based on an improper or suspect motive that is in good faith.

*Stone* broke no new ground in its treatment of self-dealing and conflicts of interests (because they were already clearly bad faith) but it did change the way Delaware law approaches all those other bad decisions (from simple well-meaning but wrong decisions to those very bad decisions which, because the directors knew they were bad, rise to the level of bad faith). *Stone*’s equation of knowing lack of care with disloyalty bridges the gap between bad faith conflicts of interest and decisions based on “improper” or “suspect” motivations for which Allen might search his thesaurus to label. It does

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84 Gagliardi 683 A.2d at 1052.
85 Id. at 1051. (italics added).
86 Id. at 1053. (italics added).
87 For example, a decision in which a director has an interest but that is also fair.
little damage to the strength of the business judgment rule’s protections to allow actions for knowing breaches of the duty of care because, just as with traditionally disloyal behavior, those breaches do indeed “involve a director taking for herself something which should otherwise be the corporation’s.” Chancellor Allen grasps for the adverb to modify such action and cannot find it because, like most jurists and commentators, pre-Stone, he does not equate knowing negligence with disloyalty. When, in Gagliardi, Allen allows for the “theoretical” possibility of recovery by shareholders for “egregious” misconduct that is not necessarily self-dealing, he must have in mind the kind of conduct that Stone would label disloyalty because the directors have failed to act “in the good faith belief that [their] actions are in the corporation’s best interest.” Under Stone, a knowing failure to pay, as Allen says, “minimalist proceduralist standards of attention,” would constitute bad faith and therefore fall outside the protection of the business judgment rule.

VI. Conclusion

With the decision in Stone, courts should at last be able to address risky business decisions in a way that neither pays excessive deference (or perhaps reverence) to risk-takers nor that stifles the ability of corporate leaders to pursue innovative ideas, technologies and markets. Operating in an environment in which it is accepted that risky decisions often end in failure, corporate directors can still take those kinds of risks without fear that such failure will result in personal liability for them. What they plainly

88 Hill and McDonnel, supra note __, at 1795.
89 Stone, 911 A.2d at 370.
90 Gagliardi, 683 A.2d at 1052.
91 Bainbridge et al. therefore seem to go too far when they state that, “Under Stone it seems possible that a conscious decision by the board that the costs of a law compliance program outweighs the benefits no longer will be protected by the business judgment rule.” Bainbridge et al. supra note __, at 47. Such a decision would be actionable only if the plaintiffs could show that the directors knew or believed that they were making a bad decision. Stone comes nowhere close to that.
cannot do is choose a risky course of action knowing that the decision is a bad one or knowing they have not taken care to evaluate whether or not the risks involved will benefit the corporation. Delaware courts will now consider either of such failures to be disloyalty whether or not it involved self-dealing in the traditional sense.

*Stone’s* extension of the duty of loyalty to knowing breaches of the duty of care simply clarified the definition of good faith under Delaware law.\(^92\) The possibility that courts may now impose liability for knowing failures to pay attention when authorizing affirmative risks on behalf of the corporation should do little to undermine the culture of innovation that is so central to the success of American corporations because it would only penalize directors who have indeed acted disloyally by failing to pay attention or to engage in any kind of business judgment at all. This would simply bring Delaware law regarding risk-taking into line with its already existing law on oversight. It is this kind of consistency, of course, that has made Delaware a center of American corporate law for generations.

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\(^92\) Sarah Helene Duggin and Stephen M. Goldman argue that “The old good faith addresses improper motivation; the new good faith addresses dereliction of duty.…” “Restoring Trust in Corporate Directors: The Disney Standard and the “New” Good Faith,” 56 Am. U. L. Rev. 211, 240 (2006). But there is something implicit in the dereliction of a director’s duty that still brings us back to an improper motive even if it is not self-dealing in the traditional sense.