

Remarks of Chief Justice Myron T. Steele

*Is Good Faith a Viable Standard of Conduct for
Corporate Governance, or Vehicle for Second-Guessing By Hindsight?*

Third Annual Symposium on the Law of Delaware Business Entities

October 5, 2006

CHIEF JUSTICE STEELE: Good morning, everyone. I welcome the opportunity to be here. Thank you, Ann, for the invitation, though I must admit I was a bit disconcerted when Ann said the next speaker will be the Chief Justice of Delaware. Well, Bill, you might be one day, but I think Delaware is going to have to elect a Republican Governor in order for that to happen, and I'm not sure when or if that's going to happen in our lifetimes.

As far as Frank Balotti is concerned, I thought he was a Miami lawyer. And I'm under no assumption whatsoever from any of the evidence I've seen recently, that he practices at Richards, Layton & Finger. Perhaps he does. (Laughter.)

First thing I want to do before I begin the substance of my remarks is to congratulate my two law clerks, Alison Britten and Lauren Hoelzer, for having passed the Bar exam and having shown up at this meeting at 9 o'clock in the morning. Congratulations. It wouldn't have happened in 1970. And with that, of course, I congratulate all those persons fortunate enough to have passed the Delaware Bar yesterday and welcome them into our fraternity/sorority of elitist lawyers, because you now have at least achieved the next-to-final step. Finish your scavenger hunt, and we'll admit you in December. And I look forward to that opportunity.

You may have noted that Bill asked a number of questions, and gave you absolutely no answers. This is my opportunity to repeat all of his questions, and add a few, and give you absolutely no answers.

You'll notice from the title of my talk, *Is Good Faith a Viable Standard of Conduct for Corporate Governance or Vehicle for Second-Guessing by Hindsight?*, one of my colleagues said, "Well, I guess I know where you stand if you titled your speech the way you did." Well, of course, he doesn't know where I stand, and I don't know where I stand. But I am capable under that rubric of raising some issues that I think are going to come before us, and give you some idea of a doctrinal framework within which we can work.

I think good faith conceptually is a term of art. It's one that's firmly rooted in trust and agency law. It's probably a useful tool for developing an analysis of compliance with fiduciary duties in the context of corporate governance, but I can't be confident of that. And there are three issues underlying all of this that I'll try to use to illustrate why I can't be confident of that. The first is our case law. The second is the politics of the time wrapped in federalism. And the third is a statutory framework within which we work where good faith appears three times, and each time without definition.

I think the first person who wrote about good faith with Delaware corporate and alternative-entity law in mind was Shakespeare. He said, "Life's but a walking shadow, a poor player that struts and frets his hour upon the stage, and then is heard no more. It is a tale told by an idiot, full of sound and fury, signifying

nothing.” Now that, as you all know, is *Macbeth*, Act 5, Scene 5, Page 19. And I think he was writing about good faith and its role in Delaware corporate law and alternative-entity law. We all know he’s a prescient, probably the most prescient of all English writers. I had no idea he was a lawyer at heart.

When you examine good faith, you can take the view that someone like Sean Griffin, who’s now at Fordham Law School, but who wrote in the *Duke Law Journal* some time ago, that everyone understands conceptually what good faith means. All lawyers have a good sense of good faith versus bad faith. But that doesn’t mean that good faith can serve as a vehicle for transferring liability. Nor does it necessarily signal to people that it’s a standard of conduct with sufficient definition at its heart that people can, who are acting in the real world taking on the responsibility of fiduciary duties for others, understand what they can and cannot do. What does it add to the existing framework, which is pretty well defined by our common law of fiduciary duties of loyalty and care? What does good faith add to the mix?

Sean Griffin would suggest to you that it’s merely a rhetorical device, a rhetorical device that’s used by the Delaware Courts to explain in certain factual context in our great common law tradition, how we balance in a given fact situation the fundamental question in all of corporate and alternative-business management law: How do you balance the accountability of those who are acting for others without adversely affecting risk-taking? How do you balance their authority with their accountability to the people for whom they are managers, the investors for

whom they work, the entity in which the investors have placed their money in good faith in anticipation that the people who are going to manage it for them are going to manage it in the in the interest of the vehicle and the interest of the investors, and not in their own personal interest and not controlled by somebody else who may have interests contrary to the investors? It's all about the balance between authority and accountability. And the question I put to you is this: With the standards of fiduciary duty that are encompassed in loyalty and care, what does good faith have to offer in addition?

Well, what we know from the case law is that the term has been used by the Delaware Supreme Court over time beginning, I think, with *CD2*. *CD*, of course, I always like to think of—continue with—my English Literature illustrations. Our answer to Dickens's *Jarndyce v. Jarndyce*. I know there's at least one person in the room that might agree with me on that, although it's been—since I left Chancery in 1994, no one on the Court of Chancery listens to me anymore, but I can live with that. But at least in *CD*, we saw for the first time the idea that there's a triad or a troika or a trident or a triumvirate, or whatever you want to call it, of fiduciary duties, theoretically all of equal standing, of equal import, with clear meaning.

The difficulty for those of us who have inherited that law is that nowhere in *CD* and nowhere since, until it was touched upon by the first—for the first time in depth and in substance by Chancery in *Disney* and by Justice Joseph and the follow-up with *Disney*—no one has put any doctrinal framework to it. No one has explained what it means, or how it's supposed to work, or how it interacts with the

other two fiduciary duties of loyalty and care. Search as you may, but you will find no answer to the relationship between good faith and loyalty and care when it was first announced by the Delaware Supreme Court that it is, in fact, arguably, a free-standing, independent, self-meaning fiduciary duty which all managers or directors with fiduciary duties must adhere to.

Now, if you take Sean Griffin's analysis—which is, it's really not important whether you characterize it as a free-standing, independent fiduciary duty. What's important is to watch the Courts work their way, at least in Delaware, through our common-law system in using it as a rhetorical device to balance authority and accountability. It will sometimes look like it's a discussion of loyalty. It will sometimes look like it's an enhanced discussion of care. But it will be couched in the rhetorical term "Good Faith." He suggests the Thaumatrope Analysis, if you've read his article. I find it rather fascinating and sort of adopted it in my own mind as the best explanation of how one can put in an opinion that this is a free-standing, independent, fiduciary duty and then not explain why and not explain how it interacts with the other fiduciary duties.

His explanation—"Don't worry about it. You don't have to worry about it. It's merely a rhetorical device"—makes sense to me. And his Thaumatrope Analysis is—a Thaumatrope is a device developed in the 19th century, either a little spinning oval, or a spinning rectangle, two sides, picture of a man on one side or a person on one side. They wouldn't have said that in the 19th century, but we're obligated to say it in the 21st century. A person on one side, a horse on the other side, you spin

them around, and it turns into a different figure altogether. And in that way you have, in his analogy, loyalty on one side of the coin, care on the other side of the coin. Spin them one way, you get good-faith mix. Spin the other way, you get good-faith mix. They're so intertwined, you don't need to separate them; they all work so well together because we have a firm understanding of what good faith means intuitively. And we know from the case law clearly that loyalty is a combination of independence and disinterestedness. And we know that care is in a tort continuum. And all of us know from torts what due care means. We know it's a standard of care. We know in corporate law that it's a basis to be well-informed, spend time with the work, and make a reasoned decision as best you can.

Now, if life was simple enough that we could take it all from the case law, and use Sean's rationale—"It's a rhetorical device, don't worry about it"—all would be well. But we can't overlook the fact that good faith is mentioned by our legislature in our statutes, in Title 8 at least three places, and two important places: Section 145 dealing with indemnification and the famous Section 102(b)(7), which is exculpation. And interestingly, when you try to follow what I'm not really advancing but discussing—and that is that there's no reason to believe that good faith is independent of loyalty or care in any meaningful way. Use it as you wish to come to the right result for the right reason, when the factual context allows you. You get troubled a bit by the wording of 102(b)(7), because good faith is mentioned as an alternative to intentional conduct, and loyalty is mentioned as an alternative to intentional conduct. So if good faith truly is the absence of intentional

wrongdoing, the absence of bad faith, which we probably could all agree is intentional wrongdoing, or intentional acts of omission that cause harm, how do we deal with the language in 102(b)(7) that seems to say that intentional conduct is something different than the exercise of good faith?

If that weren't enough to trouble us, we also have to think about the role that good faith plays in your entitlement to protection from the Business Judgment Rule. He or she who does not act in good faith is not entitled to the protection of the Business Judgment Rule. Is there a definition of good faith in any case law in that context? If there is, none of my law clerks have pointed it out to me. I mean, I haven't found it in the sports section of *USA Today*, which is generally my reading. And the law clerks haven't found for me where it's defined in any other place. So I'm not sure what that good faith means as opposed to the good faith in 102(b)(7), or the good faith articulated as part of the triad in the fiduciary duties. But I take, again, great comfort in Sean Griffin, who says I don't need to worry about that. I can simply continue to use it as a rhetorical device because intuitively we all know good faith, or the absence thereof, when we see it.

Now, if that's what the case law teaches us, and if it teaches us anything given the statutory framework that accompanies it, what do we do about it? Well, scholars have written tomes about good faith in the last decade. It probably began with Hillary Sale's article—Hillary Sale from Widener for the Pileggi Lecture coming up. And I'm happy to say I look forward to hearing her. She probably wrote the seminal article that kicked it off. It was an article basically exhorting Delaware

to use good faith as something more than a rhetorical device, or use good faith as something more than just an overlay before you got the protection of the Business Judgment Rule, but to really put some teeth in it. And, of course, you can't advocate that you put some teeth into something you've never defined or never truly explained doctrinally, unless someone helps you explain it doctrinally.

So she kicked it off by saying scienter should apply. Good faith should be a basis for independent liability and the linchpin should be scienter. And as part—as a rationale for that, it would make life easier for all of us, because it is the same scienter that's generally thought of as well-defined in federal securities law. And in that way it would be easier to teach corporate law in law school, because you would have an alignment between the way in which the Feds deal with the issue and the way in which Delaware deals with the issue.

Of course, whenever I see an article that suggests we ought to do things the way the Federal Government does it, I immediately reach for my wallet and panic, because it says two things to me. If it's done the way the Federal Government does it, it would be far more expensive than any benefit justifies. And secondly, it will push Delaware out of the limelight, as the home for interpretation of corporate law. Both of those propositions, at least to me, are anathema.

Now, at this point, I want to interject again that anything I say today is not attributable to any of my colleagues. I have a hard enough time getting two other votes to adjourn, much less to agree with any position I take. So, rather than watch Justice Jacobs or others wince in the back of the room, I disclaim any responsibility

for any other member of the Court for anything I say today. I've already protected the Court of Chancery by satisfying you, I hope, that they don't listen to me anyway. So both the Courts are absolved of any of the sins that I commit today.

When Bill Johnston raised all the issues that he raised, I immediately thought, by way of the old Churchill story—when Churchill is sitting at dinner, drunk as usual (and this is not the one you're thinking of, by the way), and a member of the opposite party in Parliament says to him, “Mr. Churchill, it's 10 o'clock, you're drunk again. If you continue this pace of drinking you will, by the time you have died, fill this room from floor to ceiling with bottles of brandy.” Churchill, without skipping a beat, paused, looked at the floor, looked at the ceiling and said—shook his head and said—“So much work, so little time.” I feel the same way, in terms of trying to reach the questions that Bill Johnston addressed.

I'm not sure, in the alternative-entity area, that the questions haven't been answered. Now I've seen the papers that have been prepared and available to you today. And they're all very thoughtful. But is the good faith that we talk about in corporate law the good faith that ought to apply in the business relationships that are structured in the alternative business entities? It seems to me the question was answered with the 2004 Amendments. Of course, it seemed to me that it was answered with my LOM Thesis in 2003. But it got answered, I think, clearly by the legislature in 2004. And that is: freedom of contract governs; people should be able, despite Delaware case law that suggested otherwise before those Amendments, people should be able to shape their own business framework. If Delaware doesn't

stand for anything else, it is for a climate where people are treated like adults and can be presumed to act in their own best interests, so long as they have equal access to information, an opportunity to bargain and structure the entity itself. So why shouldn't parties to an alternative business organization be able—without Government interference before, during, or after—to structure their own business relationship in the way in which they want to take on risk and the way in which they want that risk to be managed, that is, by others who are seemingly more capable of doing so? After all, no one knowingly invests their money to be managed by other people who they don't think are going to do a better job than they are. When the business climate changes and their expectations are unfulfilled, some people make a living by suing those who didn't fulfill those expectations. But, should you be making a living by challenging the structure that set up that relationship in the first place?

Bill raised what I think cuts through both good faith in the corporate law and either the implied covenant of good faith in fair dealing or this idea that you can extrapolate good faith—whatever it may mean—from the corporate law into the alternative business entity when he said: “Will that having a chilling effect on competent people wanting to manage, if you expand liability? And will it make those who nevertheless take on that relationship more risk averse such that the entity itself and the investors in it do not profit, like they might otherwise have profited, but for the fear that they'll be subject to suit if not ultimately liability?” I think that's a question that's often overlooked, both by Congress when it passes

Federal legislation authorizing the SEC to expand its already enormous power and by us in shaping the case law if we're not consistently tuned into predictability, clarity, and consistency. But with one eye on that balance between authority and accountability and one eye on: "Do we chill or instill a sense of risk averseness that is ultimately not in the best interest of either the investor or the entity that's being managed by those with the fiduciary obligations?"

Well, there's a lot to be answered. And a lot of the answers you're not hearing from me, I admit. But in posing the questions, I can pose potential answers, because I'm confident that the Bar will present the issues to our Courts in the context of specific fact situations which allow us to depart from the normative views of most scholars and force us to focus on, in a particular fact situation: "How does this really play out?" We don't have as judges the opportunity to think normatively. It's not our own personal views that get imposed in these cases, or in their outcomes. I know there's some that like to try, particularly in an election year, judges for being activists. But I don't think it is a fair criticism of our Superior Court, our Court of Chancery or our Supreme Court. We play the cards that are dealt. The facts are dealt to us by the way in which the lawyers shape the case as discovery develops it, and before that, in large measure, the way in which the clients make the facts that the lawyers shape. Then the lawyers frame the issues for us, and there's a good school of thought that we have no business framing the issues differently or going beyond the issues that the lawyers frame for us. Because, after all, it's the job of the jurist to dispose of the case before him or her—

or before them—and not to use cases as a sounding board for our own personal views. So, to the extent that anything I said suggested to you that I have a personal view on any of the outcomes of any of these issues, dispel them. I'm wholly unreliable. There's no telling what I will ultimately decide.

My only philosophy is that, when the issues are fairly presented by clever lawyers, as they are 95 percent of the time in Delaware based on my 18 years' experience on the bench, and my 18 years before that experience getting regularly trashed by good lawyers in practice, they will be developed by the facts. There will be clear issues put to us. And we'll have the opportunity to resolve the questions that Bill has raised. Probably not in the way that Mel Isenberg, Hillary Sale, or even Anne Conaway may want us to resolve them, but we'll resolve them in the common-law tradition, in a case-dispositive way, on a case-by-case basis.

And as far as the Supreme Court is concerned, we have the greatest of all benefits. We have the Court of Chancery that comes before us. The best fact-finders, and the best business-law minds that can be imagined—and I'm not just saying this because at least two of them are here and perhaps even more, although a couple may have walked out when they saw who the speaker was, anticipating that Bill would actually be the next Chief Justice of Delaware, and not me. (Laughter.) I guess I can't be the next, can I? I have to deal with what I've got now.

In any event, we'll plod our way through these issues and you'll get your answers. Do what you will in the General Assembly in the meantime. We are all devotees of following what the legislature says. But so long as some of the statutes

don't define terms like "good faith" for us, we're forced in particular factual contexts to define it on a case-by-case basis. We'll keep the bigger picture in mind, the balance of authority and accountability, whether good faith is intuitively known to all of us or not, or whether it's simply a rhetorical device. We'll keep the even bigger picture in mind, of this balance between—under federalism—between federal power and Delaware's authority. It's politics with a small *p*—we're aware of it.

We want Delaware to remain the home where those who incorporate and those who invest in those corporations both feel comfortable, where there's a level playing field for the investor and a level playing field for management; not skewed in any direction one way or another. But an enabling statute that allows us to balance it on a case-by-case basis, in a way that takes both those interests in mind—in the hope that, as long as we continue to do our business well, do it efficiently, and dispose of cases quickly, that Delaware will remain the primary home not only for corporations, but for alternative business entities. We're very much aware that that's in your interest, and it's in Delaware's interest, and it's in our interest. We have no desire to relegate the balance of our professional lives to criminal law and termination of parental rights. We want to continue to do the business of business in Delaware.

And all I can pledge to you is that the five Members of the Supreme Court, the five Members of the Court of Chancery, and the 19 Members of the Superior Court will do all they can to keep the issues in mind, resolved the questions raised

by those issues in a fair and efficient way, and continue to make this a wonderful place to practice law.

Thank you very much.