

Good faith in corporate law – an independent fiduciary duty or an element of the duty of loyalty?¹

Ph.D. student Adina PONTA²

Abstract

Taking the duty of loyalty as a starting point, which we consider to be the director's core fiduciary duty, this paper aims at identifying the contours of good faith in corporate law and the interpretations of this institution in corporate governance. The objective of the paper is to demonstrate the autonomy of good faith, along with the duty of care and the duty of loyalty. The paper displays the traditional legal approaches of this institution, both in continental civil law and in common law literature and jurisprudence and exhaustively describes the obligations that compose or even define this concept. Due to its amplitude, the duty of good faith enabled courts to articulate subsidiary fiduciary duties that meet social changes and transformation within business law. By means of cited case law, the conclusion will show that due to the nature, content and effects of situations where specific obligations are met, these may not be incorporated as elements of the traditional duty of care or duty of loyalty.

Keywords: good faith, duty of loyalty, duty to duly inform, fiduciary duties, agency, directors' liability.

JEL Classification: K22

1. Introduction

The acknowledgement of the duty of good faith in business law is a response of the common-law jurisprudence in the last 20 years. This development is enshrined in that directors owe good faith to the company, in addition to the traditional fiduciary duties, namely the duty of care and duty of loyalty. However, this duty was not created *per se* by the common law jurisprudence, but it has always existed in corporate governance regulations, in documents of incorporation and, in the United States, in compensation clauses of directors³ in the event of termination of their contracts.

The duty of good faith has always been an *innuendo* of case law, the most paradigmatic example being the definition of the Business judgement rule in early

¹ This article was submitted to 6th International Conference “Perspectives of Business Law in the Third Millennium”, 25 -26 November 2016, the Bucharest University of Economic Studies, Bucharest, Romania.

² Adina Ponta - Faculty of Law, Babeş-Bolyai University, Cluj-Napoca, ponta.adina@gmail.com

³ The term “director” used in the paper at hand also refers to the members of the board of directors in companies that adopt the dualist management system in continental law.

corporate governance cases in which there was no legal definition of this rule⁴. Common law jurisprudence explicitly recognized good faith as a distinct fiduciary duty only around the year 2006, which triggered the necessity to shape this obligation, to clarify it from a business law point of view and to delineate it from the other two traditional fiduciary duties.

In essence, good faith in business law can be described by two concepts, namely by the basic concept of the institution and by the obligations which compose and even define this concept⁵. From the perspective of a legal definition of this fiduciary duty, the paper will reveal the reasons for which it is desirable to view good faith as a distinctive fiduciary duty, because the duty of care and duty of loyalty fail to cover by their meaning all types of directors' misconduct. Good faith is more generous concept that covers situations that exceed the scope of traditional fiduciary duties.

Moreover, case law has shown that certain legal or conventional provisions may exhaustively limit directors' liability in certain situations, but these rules would be inapplicable in cases governed by the fiduciary duty of good faith. Finally, due to the scale and generosity of the notion of good faith, this allows courts to articulate specific fiduciary duties that meet social changes and transformations within business law. Due to their nature, content and effects, these subsidiary duties cannot be incorporated as subsidiary components of the enshrined fiduciary duties.

This paper examines the explicit recognition of good faith in business law, a duty which is owed by directors and executive officers⁶ of the company and highlights the controversy generated by the emergence of the new independent fiduciary duties. The objective of this paper is to identify the contours of this duty and to demonstrate the need for enacting applicable legislation. The connection between these matters has been ascertained since the beginning of doctrinal

⁴ Currently, the Business judgement rule is provided for in art. 144 ind. 1 of the Romanian Companies Act, law no. 31/1990. The elaboration of the duty of care and explanation of applications of the business judgement rule are not within the scope of the present paper. For more details on the application of the Business judgement rule, see Ponta, A. *The Business Judgement Rule. Approach and application*, „Juridical Tribune – Tribuna Juridica”, vol. 5, issue 2, December 2015, p. 25-44 and for a comparative approach of the Business judgement rule in the European Union, see Prof. Dr. Catană, R. N., Ponta, A., *The Business Judgement Rule and its reception in European Countries*, The Macrotheme Review 4(7), Austin, Texas, 2015.

⁵ Eisenberg, M. A., *The Duty of Good Faith in Corporate Law*, „Delaware Journal of Corporate Law”, vol. 31, no. 1, 2005, p. 4.

⁶ We will use the term “officer” [„funcționar”] in the Romanian version of this article to refer to the concept of *officer* in the *common law* doctrine and case law. The term *officer* includes persons who bear the current responsibilities of managing the company, such as the CEO, the financial director, etc., the incumbents of high management positions who were directly hired or appointed by the board of directors, by shareholders, by other executive directors. These persons generally have an apparent or real authority to act on behalf of the company. In the UK, *officers* are regarded as „authorized persons to act on behalf of the company”, whereas in the USA, *officers* are employees who bear greater responsibilities and who apply the policies established by the board of directors. See *Cambridge Dictionary for Business English*, Cambridge University Press, 2006 and *Oxford Dictionary of Business and Management*, Oxford University Press, 2009.

controversy, because the legal status of good faith depends on the justification of certain legal rules, and codification is a direct consequence of identifying the limits of this duty.

The rules applicable in Delaware offer basic forms of corporate decision-making mechanisms, enabling companies to adopt their own practices and procedures. The rationale of this scheme is that "it is more appropriate to allow businesses to be handled by those who are responsible for it, than to legislators and judges"⁷. In our opinion, the same concept would be desirable in civil law jurisdictions.

2. Legal status and limits of good faith

2.1. Good faith regulations in business law

Undeniably, good faith is a core business law institution and lies within the essence of the triad of fiduciary duties, both in civil law of French origin and in common law. This institution has been recognized at the onset of the twentieth century in the jurisprudential formulation of the Business judgment rule, initially in the state of Delaware and it was then exported to most European countries⁸. The European trend is the jurisprudential derivation of the good faith from ordinary civil law, namely from the law of obligations (tort law) or from the provisions governing the agency, rather than the express regulation of this fiduciary duty. However, although a significant number of states only provide for the duty of care and the duty of loyalty among fiduciary duties, we cannot automatically infer that business law excludes the autonomy of good faith⁹.

Good faith is a core element of proper administration of a company and of the Business judgement rule even in Romanian business law, although it is not expressly provided for along with the two classical fiduciary duties in art. 144 index 1 of the Companies Act.

The legislature chose to provide for the obligation to fulfill the managerial responsibilities in good faith in art. 271 and art. 272 of Law no. 31/1990, within the definition of the malfeasances that a director can perpetrate, by showing in "bad faith" untrue data on the constituting process or on the economic situation of the company, by presenting an inaccurate financial report or by hiding similar data in bad faith.

⁷ *Idem* 3.

⁸ For more details on the application of the Business judgement rule and for a comparative approach of the Business judgement rule in the European Union, see footnote 2.

⁹ Some states among which Bulgaria, Greece, Latvia, Romania, Slovakia and Slovenia included in their Companies Act direct references to the agency contract for complementing the rules on directors' liability in cases of breach of fiduciary duties and implicitly, of good faith. *Study on Directors' Duties and Liability, prepared for the European Commission*, by Carsten Gerner-Beuerle, Philipp Paech and Edmund Philipp Schuster (Department of Law, London School of Economics), London, April 2013, LSE Enterprise, p. 233

We note that although good faith is not provided by the Romanian legislature in the same section along with the traditional fiduciary duties, this institution is not ignored as component of an appropriate behavior, which is expected from a director. However, from the wording of art. 271 and art. 272 of the Law no. 31/1990, good faith appears to be inextricably linked to the duty of loyalty. The criminal law provisions seem to exclude cases where good faith could be breached by a loyal director who is only guilty of conflict of interests. We appraise that this interpretation is not correct and we tend to believe that the intention of the Romanian legislature was not to assimilate good faith to the duty of loyalty or to encompass good faith within the elements of this classic fiduciary duty.

Although the Companies Act contains no express provisions on the manner to carry out the role as a corporate director, the Civil Code provisions applicable to the agency can be used for filling these gaps. These rules include among others the general duty of any person to act in good faith - art. 14 Civil Code, but the interpretation of this obligation is to the effect that it would represent the essence of the duty of loyalty. In addition, art. 803 par. 2 Civil Code relating to the partnership agreement, provides for a general duty of loyalty and for the duty of the trustee to act with honesty and loyalty in order to achieve the best interests of the beneficiary or the intended purpose.

3. The baseline conception of good faith

In the mid-twentieth century, a famous American professor¹⁰ advocated that good faith would not have an independent meaning in contract law, but it would be a way to exclude many heterogeneous forms of bad faith. Undoubtedly, this idea was rebutted over time by theoretical and etymological analyzes of good faith and by of case law. However, given the magnitude of the concept of good faith, it is much easier to include or exclude certain conduct or a particular business decision in the application of good faith than to define this new and controversial fiduciary duty.

A relevant feature of good faith in the context of urging its independent existence as fiduciary duty is its protective and complementary function, because its scope is contractually defined by the parties. Unlike contract law, where practitioners prefer to define good faith by excluding some elements of the vast scope of this notion, in terms of corporate governance, inclusion of conduct or business decisions in the field of application of good faith is much more technical.

From an objective analysis of definitions of the other fiduciary duties and by consideration of the assessment methods and subjectivism of a referee or judge who has to establish the existence of good faith conduct, corporate governance renders not only the possibility to exclude a business decision from the scope of good faith, but it also offers the possibility to characterize that particular business

¹⁰ Summers, Robert S., "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, Virginia Law Review no. 195, Richmond, SUA, 1968.

decision. It is rather a practical test that can be applied exclusively to a concrete decision rather than a theoretical test as it is in contract law.

In evaluating a directors' decisions, good faith focuses on the position of fiduciaries, who are under the obligation to serve the interests of others. Business law principles are often defined by their composing elements. First, the duty of care (diligence and prudence) has as prerequisites rational thinking, while loyalty is composed of fairness (equity) and sincerity. Thus, good faith is defined by the baseline conception, composed of several elements.

First, good faith requires subjective honesty, which in turn implies the existence of several types of sincerity. A corporate director should sincerely believe that his attitude is towards the highest interest of the company, that any of his disclosures in his capacity as representative of the management body are consistent with the reality and that his attitude is circumscribed to a decent behavior. However, it is not enough for a director to act honestly in the sense of acting sincerely, for instance in situations where by different systems of belief, a person is convinced that his or her attitude represents a moral behavior¹¹.

Apart from practical issues of proving good faith, if the standard of good faith exclusively focused on directors' motivation, then this standard would completely ignore the functions of this duty. In applying the standard of good faith to a precise business decision, the standard tests the director's fidelity for the appropriate interests that he should serve. The subjective motivation and the sincere belief are imprecise surrogate measures for measuring fidelity. A director is able to wrongly appreciate the purpose and effects of his actions. The fact that he or she was wrong without any fault about the content or the consequences of the undertaken actions will not be identified as a breach of his or her obligations as trustee. Fiduciary standards are mandatory and prohibit the creation of conflict of interests to the detriment of the beneficiary of the protected relationship. These duties deprive the trustee of the benefit which was derived from the breach of a duty, irrespective whether the director cause any proven harm.

Therefore, good faith in corporate governance includes subjective and objective elements, but business law jurisprudence stressed the dominance of factual elements over the subjective elements¹².

Three objective elements were identified in jurisprudence to underlie good faith in business law. First, good faith in corporate governance requires a director not to breach generally accepted standards of decency applicable to business conduct. This item reflects the reasonable expectations of the company and complies with the good faith standard in everyday language, i.e. compliance with standards of decency.

¹¹ This absolute belief of a person in his or her own virtues, as being rather a commitment towards their own will than towards the personal virtuous behavior was underlined in the referral to Hitler's last days. This is a comparison we do not intend to elaborate in this context, LaSalle, Mike, *Downfall*, San Francisco Chronicle Datebook, August 2005, p. 28.

¹² *First National Bank v. F.C. Trebein Co.*, N.E. 834, 837, Ohio 1898, *T.S. Kaung v. Cole National Corp.*, 163-N, Delaware Chancery Court, August 2004.

Secondly, good faith in business law requires a corporate director not to violate basic generally accepted rules¹³. This element is often reflected in the articles of incorporation and is analogous to the meaning of good faith in commercial codes of different US states. The United States are the only jurisdiction that distinguish between good faith in ordinary common law and rules of good faith applicable to corporate governance¹⁴.

Third, good faith in business law requires directors to demonstrate fidelity to their position, to their office. This item reflects the reasonable expectations of shareholders and compliance to standard behavior, including loyalty to their duties or responsibilities. In this context, the *office* represents a position of responsibility, of trust or authority in an organized structure. The fidelity to the office is the approach to the performance of this function and the role it involves in the manner in which its performance is reasonably expected, considering the status of the office and of the organization in which it is incorporated.

The role of this baseline conception of the duty of good faith ought to be understood in the context of the distinction between the standard of conduct and the standard of liability¹⁵. A standard of conduct reveals how an actor should address a role he or she receives. A standard of control reveals the test that should be applied by courts when analyzing the actor's conduct to determine liability. In most jurisdictions, it so common to combine the two standards – the ideal standard of conduct and the standard of conduct assessment, that their correct differentiation remains just a matter of prudent judgment¹⁶.

Similarly, if the basic concept of good faith as fiduciary duty is the standard of conduct, lack of compliance with this apprehension does not in itself determine liability. Liability will be engaged only on the condition of breach of a particular duty, which is triggered by the duty of good faith. In this respect, the duty of good faith is applied in the same manner as the duty of care and duty of loyalty. Courts do not adjudicate directors' liability simply because they acted without diligence and prudence. Liability is justified on the ground that the director violated a specific obligation based on diligence and prudence, such as the duty to be properly informed before making a business decision. Likewise, courts do not hold directors liable only under unfair actions, but liability is based on specific

¹³ Veasey, N. E., *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, Wake Forest Law Review no. 38, 2003, „the lack of fulfillment of minimum expectation of conduct standards can question the good faith”.

¹⁴ According to art. 2 din *Uniform Commercial Code (UCC)*, good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing”. *UCC* is a collection of rules, enacted in the USA to harmonize business law rules and commercial transactions between the different states. This collection gained international influence after contributing to the draft of the United Nations Convention on Contracts for the International Sale of Goods (1980).

¹⁵ Eisenberg, Melvin A., *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, „Fordham Law Review”, no. 52, 1993

¹⁶ An analogy for better understanding of the two standards would be the evaluation of a conduct of vehicle drivers. The standard of conduct governing traffic is that drivers should drive carefully and the standard engaged in a liability claim of a driver is the verification if he indeed drove carefully in a particular situation.

duties which have their ground on the duty of loyalty, such as the duty not to engage in transactions in their own interest at an unfair price.

The fact that the baseline conception of good faith does not in itself represent a liability rule, does not mean that this concept lacks legal significance. The elements of the baseline conception of good faith in business law are subjective honesty, compliance with generally accepted standards of decency applicable to business conduct and devotion to the office. This baseline conception has three basic functions. First, it represents a standard of conduct, secondly, its elements help to determine whether a manager has fulfilled the condition of good faith and thirdly, it serves as a platform for the development of specific obligations, which expand the content of good faith in cases when good faith acts as rule to determine liability.

4. Normative considerations

Following the broadness of the baseline conception, we assess that good faith ought to be regarded as a distinct fiduciary duty and regulated as such.

First, the importance of applying good faith in situations where directors' misconduct goes beyond care and loyalty arises from the fact that these duties have well-defined limits in their traditional meaning. In *Disney IV*¹⁷, the court has extensively underlined the importance and the vast meaning of good faith, even more in situations where there is a controlling shareholder or an "imperial" director who is part of a passive or indifferent board. The noted professor and judge Chancellor Chandler¹⁸ considers that "*the fiduciary duties of care and loyalty, as traditionally defined, might not be aggressive enough to protect shareholder interest when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as patently self-dealing transactions. Good faith may serve to fill this gap and ensure that the persons entrusted by shareholders to govern Delaware corporations do so with an honesty of purpose and with an understanding of whose interests are there to protect*".

Therefore, the first argument emerging from doctrine and case law that supports the existence of good faith as a distinctive fiduciary duty is that this obligation covers several types of situations, in which directors' actions or conduct, although inadequate, does not breach the duty of care or the duty of loyalty.

Secondly, several rules limiting the duty of care and duty of loyalty prove inapplicable in situations governed by good faith. A wide range of rules limit a director's liability in the application of traditional fiduciary duties. A director shall

¹⁷ *In re The Walt Disney Co. Derivative Action (Disney IV)*, no. 15,452, Delaware Chancery Court, 2005

¹⁸ William B. Chandler was the President of Delaware Court of Chancery between 1997-2011 and the majority of his rulings are considered by doctrine to be referential. Delaware Court of Chancery is a court which adjudicates as exclusive equity jurisdiction and is one of the three Constitutional Courts in Delaware, along with the Supreme Court and the Superior Court.

not be liable for breach of duty of care, even if he acts negligently, if his conduct is protected by the business judgment rule or by the standard of gross negligence. In cases where the duty of loyalty arises, conflict of interest can eschew judicial evaluation, even when business decisions are approved by the other board members, by the director's colleges. Similarly, a director who sells a building, own property, to the company priced at the higher market price level, shall not be liable for breach of the duty of loyalty.

However, the damage caused to the company or the director's gain should not be an element of the breach of the fiduciary duty of good faith. For example, a director who knowingly causes the company to break the law, violates the fiduciary duty of good faith even if the law violation maximizes corporate profits. The director who acts based on illegitimate grounds which have no financial implications, will violate the duty to act in good faith even if his "random" action does not harm the company.

Third, the good faith works as a foundation principle for the articulation of new specific fiduciary duties. Business law is one of the branches of law which is subject to most changes in response to social changes. Circumstances, business practices and efficiency purposes are changing and business conduct rules also evolve. By analogy of the characteristics of good faith in business law and in contract law, this institution reaches the fundamental objectives of the policies of any system of rules. By invoking good faith in the absence of general legal resources, a judge has the possibility of settling the case both in accordance with law or in equity.

5. Specific obligations in the scope of good faith field

5.1 The duty not to consciously put the company in the position to violate the law

A principle enshrined under the auspices of the fiduciary duty of good faith is that the director is bound not to deliberately and knowingly determine the creation of a situation where the company is obliged to break the law, even if according to rational ideation, the predictable effect is the maximization of shareholders' wealth as a result of infringement. Regardless whether the reasoning for the decision was based on the fact that legal penalties and reputation damage caused to the company are manifestly disproportionate to the probability of detection and if penalties are slightly lower than the expected profit resulting from the infringement. The rationale for establishing this obligation is that a complex society in which individuals are subject to the law just because they fear legal sanctions, cannot survive. In order to achieve the success of a complex society, the majority of its members must internalize the moral obligation to obey the law.

We encounter a strong social interest in prohibiting directors to consciously determine the company to breaking the law in search of profit growth. Compliance with this duty primarily attaches to directors, who are responsible for guiding the

behavior and the conduct of transactions of the company. The compatibility of the principle of lawful conduct with the principle of maximizing profits and shareholder wealth is uncontested, the latter being the core objective of the establishment and of the existence of a company. The principle of lawful conduct does not inhibit this goal, but only traces channels for appropriate achievement of the objectives.

In *Roth s. Robertson*¹⁹, the CEO of an amusement park consciously placed the company in the position to offer money to people who lived in the vicinity of the park and who threatened with referral to authorities because the park was operated on Sundays, contrary to legal norms concerning rest hours. Indubitably, the manager made the decision to maximize the profits of the company and because he had rationally foreseen that the expected profits of the company due to the park opening on Sunday would exceed the cost of possible economic sanctions, taking into account the chance of discovery and the effective punishment. The court noted that the director is responsible for granting such illegal payments and ordered the return of these funds which were “wasted at shareholders’ expense”.

5.2. *Duty of candor*²⁰

Another set of duties that has its foundation in good faith is the duty of candor, which can be seen in the business context in two ways. First, in their capacity as managers, directors are required not to take positions or make statements likely to mislead, i.e. *the duty not to mislead*²¹. Second, directors have an obligation not to intentionally or with gross negligence infringe their duty to inform the company bodies, including the board of directors and shareholders on matters known to them as relevant or useful for decision making processes or task delegation, i.e. *the duty to duly inform*²². Although the obligation not to mislead and the duty to duly inform intertwine and may lose autonomy in some cases, the differences between them cannot be ignored.

The duty not to mislead refers to the expected conduct of a manager when he or she makes a statement. The duty to properly inform imposes directors a positive obligation to make certain statements. The duty of candor is not limited to the certainty that all statements made by a director are true. This obligation imposes rather the obligation to express what is necessary in certain situations. The duty of candor will be viewed from three perspectives: communication

¹⁹ *Roth s. Robertson*, New York Supreme Court, 18.351, 1909.

²⁰ We will use the term *candor* in its broadest sense to refer to a director’s franc and open attitude in his oral disclosures and actions. Considering the difficulty of translating this concept from common law in the Romanian version of the present article and due to the lack of a doctrinal definition of this element of good faith in continental law, we will utilize the definition provided by *Random House Unabridged Dictionary* to highlight the duty to disclose certain pieces of information in various contexts which do not contain directors’ transactions that might be in conflict of interests.

²¹ See *supra* 3, page 30

²² See *supra* 3, page 31

between the board of directors and shareholders, communication between board members and communication between executive officers and board of directors.

The duty to duly inform should not be mistaken with the directors' obligation to adequately inform themselves before making any corporate decision. This duty is part of due diligence and of the duty of care, according to which directors are mandated to properly inform themselves before making a business decision. This element of the duty of candor mainly relates to informing shareholders when these are deciding on corporate policy, it reflects the attitude of directors, their initiative of informing and the content of the provided information. Directors are required to disclose the pieces of information they reasonably have available²³, but in a comprehensive and accurate manner²⁴, without omitting for any reason the disclosure of matters that could influence the shareholders' decision from any point of view²⁵.

The most telling example is the case *Malone v. Brincat*²⁶, in which the court defined the duty not to mislead as the obligation of the management board to reveal material information when requiring the contribution or decision making by shareholders. The Delaware Supreme Court held that directors are required to communicate honestly with shareholders, even in contexts when they do not request their intervention. In these circumstances the question is whether directors have only failed to comply with their duty to inform or if they also breached the much broader and general duty of loyalty and good faith by conscious dissemination of false information on the financial situation of the company. This aspect is to be approached from the perspective that fiduciary duties also include the duty to manifest honesty towards shareholders.

Although in the case *Malone v. Brincat* the court referred both to the duty of loyalty and good faith, and the first court even mentioned the duty of care, we assert that the duty of the board not to mislead shareholders is best explained by good faith. Duty of loyalty is not a satisfactory basis for this requirement, because the board of directors may violate the duty not to mislead shareholders, even in situations where it does not act in the personal interest of directors. Neither the duty of care or diligence and prudence is an adequate foundation because, in the present circumstances, a board of directors can make a rational decision, which lacks honesty (innocence), but that maximizes the profits of the company and protects at a very high level the existing wealth of shareholders.

Good faith can substantiate this duty on several aspects. First, a board of directors that knowingly makes false statements acts dishonestly to shareholders. Secondly, by providing incorrect information to shareholders, directors demonstrate lack of fidelity to their office because shareholders have a reasonable expectation of trustworthy, fair and open communication with the directors they approve.

²³ *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 137, Delaware Supreme Court, 1997

²⁴ *Stroud v. Grace*, 606 A.2d 75, Delaware Supreme Court, 1992

²⁵ *Alessi v. Beracha*, 849 A.2d 939, Del. Chancery Court, 2004

²⁶ *Malone v. Brincat*, 722 A.2d 5, 9, Delaware Supreme Court, 1998

Good faith may explain the duty of the management board to inform shareholders accordingly, fully and without omitting information that might be considered useful, because fidelity to office requires directors to satisfy shareholders' reasonable expectations, namely to provide information which is known to them as being the substance of a decision required to be made by shareholders. It is obvious that these factors will be concretely assessed in each case, because not every failure to inform is a breach of good faith, just as not every breach of law automatically excludes good faith²⁷.

Another context in which the duty of candor is expected is in the communication between the director and the entire board of directors. We appraise that in this relationship, directors have again the obligation to adequately inform the other implied persons on all material matters about which they have knowledge and that could be relevant for the decision-making and supervisory responsibilities of the board, even if it doesn't concern a decision in which the director might be interested.

One aspect that cannot be neglected is related to the communications provided by *officers*, i.e. the executive officers of the company towards the persons who own the decision-making power. It is obvious that some important information for qualitative decision making by the company is not directly available to those who have the responsibility for making that decision, but this data is supplied or produced by individuals who have no decision-making power, but may have a direct interest in the effects of this decision. The concern for the risk of exploitation of information asymmetry by officials to promote their own interests overlaps the risk that these executive officers will try to lead the board to acts or decisions which they consider to be in the best interests of the company. For example, a board of directors is faced with the decision to vote on opening a new factory, but only the division whose products will be manufactured in the new plant can generate large parts of relevant information regarding the likelihood of returns on investment in the new production facility.

5.3. Gaining an advantage by a body of the company through the use of manipulative means that violate generally accepted corporate rules

In general, this principle rather operates as a condition than as a liability rule, because when applicable, its main effect is to execute or to contribute to an action of the corporation bodies. If the action is ineffective, then the director's violation of the principle will not harm the company and the director will not be liable. In the case *VGS, Inc. v. Castiel (VGS)*, the company ran into financial difficulties and after some intrigues among directors, one of them, who did not support the majority trend, was removed from the decision making process on the matter in which he considered other best interests of the company. The culpable elements are related to manipulative actions and on the board's breach of the duty

²⁷ *Arnold v. Soc'y for Sav. Bancorp., Inc.*, 650 A.2d 1270, 1288, Delaware, 1994

to lead the company's business with a minimum standard of fairness and equity, because the attitude of the involved directors obviously lacks good faith. The obligation to achieve the objectives of the company without resorting to manipulative processes is an integral part of good faith and not of the duty of loyalty. This imperative is applicable even when the intended result does not imply a conflict of interest and the conduct that results in the creation of a benefit to the company does not necessarily have to violate the duty of loyalty just for this reason. Instead, the duty of the company's bodies not to unfold action by using manipulative procedures that violate the basic rules of corporate governance is applicable even when the outcome is beneficial to the company.

5.4. Satisfying unpermitted financial interests

Sometimes a director can manifest a conduct that, although not in his own financial interest, conflicts with his capacity as manager. This context is called by doctrine "intolerable motive". His attitude on these grounds is not in accordance with good faith, this description is very suggestively explained in the case *In re RJR Nabisco, Inc. Shareholders Litigation*²⁸, when the court considered that a director does not act in good faith if he is motivated by "hate, greed, envy, revenge, shame or pride".

There is a strong rationale to include the prohibition of this type of behavior under the duty of good faith. While such conduct mainly falls within the duty of loyalty due to the personal interests advanced by the director, this inclusion cannot be clearly established according to positive law or case law, because traditionally, the duty of loyalty applies in cases where the directors' conduct is directly or indirectly motivated by promoting his own financial interests. On the other hand, placing this prohibition of conduct in the scope of good faith, a conduct based on unpermitted grounds, but not connected with financial incentives, shows without a doubt that this is a question of inappropriate conduct even though it does not violate the traditionally perceived duty of loyalty²⁹.

An example of a quite common situation occurs when unauthorized or not tolerated motives refer to directors' actions that seek to exclude the liability of a colleague. The success of these alternatives is the impartial mindset of members of the board who have the power to decide to follow up of an action against one of their colleagues. This is another case where the "lack of interest" is narrowly defined and only refers to financial interests. After the year 2000, Delaware courts have extended the fairness test, adding the analysis of independence and by determining the lack of financial interest, in addition to pecuniary motives³⁰. In our

²⁸ *In re RJR Nabisco, Inc. Shareholders Litigation*, no. 10,389, Delaware Chancery Court, 1989

²⁹ See also Di Guglielmo Christine T., Veasey, E. Norman, *What Happened to Delaware Corporate Law and Governance from 1992-2004?* University of Pennsylvania Law Review no. 153, 2005.

This article promotes separating good faith from the duty of loyalty, partly also because the existence of conflict of interest is not a condition of breach of good faith.

³⁰ *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, Delaware Chancery Court, 2003.

opinion, courts should not exaggerate in assessing human relations when establishing the impartiality of directors³¹.

5.5. *Substantial disregard of responsibilities*

Lack of consideration shown sometimes by directors towards their responsibilities is almost always a violation of the duty of care, even though liability itself can be avoided by applying the Business judgement rule, a statutory standard or a legal assessment standard of actions based on serious negligence. In some cases, however, the lack of consideration amounts to such a high level, that the violation also infringes the duty of good faith, because the neglect of duties constitutes a lack of fidelity to the office held, it violates basic generally accepted corporate governance standards and sometimes the lack of honesty is so pronounced that the director himself is not even convinced that he is acting properly.

In the case *In re Abbott Laboratories Derivative Shareholders Litigation*³², the claimants argued that the board of directors of a pharmaceutical company ignored the warnings of a state institution that controls the content of food and medicines, as well as various press article allegations for seven years. These warnings claimed that two of Abbott Laboratories' production facilities would not meet the legal standards imposed by that authority (*Food and Drug Administration - FDA*). Following these deficiencies and failure of the board to take any measures, the production facility was closed and the company suffered substantial losses. The court held that the directors mainly failed to fulfill their duty of good faith, due to the “*sustained and systematic failure of the board to exercise oversight, in this case intentional in that the directors knew of the violations of law, took no steps in an effort to prevent or remedy the situation, and that failure to take any action for such an inordinate amount of time resulted in substantial corporate losses, establishing a lack of good faith. We find that six years of noncompliance, inspections, warning Letters, and notice in the press, all of which then resulted in the largest civil fine ever imposed by the FDA [...] including the destruction and suspension of products [...] indicate that the directors' decision to not act was not made in good faith and was contrary to the best interests of the company*”.

Although Delaware Supreme Court has not defined in its case law the exact conduct that is likely to violate this duty, the court noted that liability of directors is very possible in situations where they have breached good faith if “*they knowingly*

³¹ In *Beam v. Stewart*, 845 A.2d 1040, Delaware 2004, Delaware Supreme Court assessed that the claimants' assertions according to which it is obvious that the board tried to avoid the liability of one of the directors because they were part of the same group of friends, they attended the same events and had business relationships even before being part of the same board of directors, are insufficient to overthrow the independence presumption of the female director.

³² *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795, 7th Circuit, Delaware Chancery Court, 2003.

and intentionally disregarded their responsibilities, by adopting an attitude of indifference towards the risks posed by a corporate decision”³³.

As in the above mentioned cases, case law shows various tests to determine the extent of the neglect of responsibilities by a director to such a level, that he does not only breaches the duty of care, but also good faith. These tests include “sustained or systematic failure of the board to exercise supervision”³⁴ or “careless or intentional misbehavior”³⁵ or “aware disregard of known risks” or “conscious and deliberate neglect of responsibilities”³⁶ or the adoption of an attitude of indifference towards the risks involved in a company's decision, namely a “willful abandonment of duties”³⁷. In addition, the evaluation performed by a judge can take into consideration “a conscious disregard of responsibilities”³⁸ or “manifest and deliberate indifference shown to the performance of the duty to act fairly and with proper care”³⁹. These tests do not exclude each other, but are rather ways, variations to indicate the magnitude of disregard and neglect that has to be established in order to find a breach of the duty of good faith on the basis of infringement of responsibilities.

The last reference case for revealing the essence of good faith in business law is *Smith v. Van Gorkom*⁴⁰, when the court resolved a collective action of shareholders and noted that directors neglected their duty of care because they failed to deeply enough explore the combination presented to them by the CEO. The duty of care is an important starting point because it is closely related to liability. It is much less likely that managers and executive officers who constantly act by fulfilling this duty would be violating other fiduciary duties. These directors, who comply with diligent and prudent behavior, are more likely to weigh the decisions they adopt, to consult appropriate advisers and to disclose conflicts of interest. Not least, it is much more likely that they act fairly and in good faith and manage their companies in an ethical manner. In essence, the premise is that appropriate procedures usually lead to appropriate content.⁴¹

From the perspective of good faith, we provide the duty of care a procedural valence and assimilate it to the premise of operation in good faith, rather than investing it with substance. Courts pursue due diligence and prudent

³³ *In re Emerging Communications, Inc. Shareholders Litigation*, 415, 2004 Del. Chancery Court, May 2004.

³⁴ *In re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, Delaware Chancery Court, 1996.

³⁵ *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795, 7th Circuit, Delaware Chancery Court, 2003.

³⁶ *Brehm v. Eisner (Disney II)*, 746 A.2d 244, Delaware Chancery Court, 2000, *In re The Walt Disney Co. Derivative Action (Disney IV)*, no. 15,452, Delaware Chancery Court, 2005, *In re Emerging Communications, Inc. Shareholders Litigation*, 415, 2004 Del. Chancery Court, May 2004.

³⁷ *In re the Walt Disney Co. Derivative Action (Disney III)*, 825 A.2d 275, Delaware Chancery Court, 2003.

³⁸ *Supra, Disney IV*.

³⁹ *Supra, Disney III*.

⁴⁰ *Smith v. Van Gorkom* 488 A.2d 858, Delaware Supreme Court, 1985.

⁴¹ Sale, Hillary, *Delaware's Good Faith*, Cornell Law Review no. 89, 2004.

business judgment by applying the business judgement rule. This Rule assumes that, within the decision-making process and the administration of the company, the fiduciaries acted in an informed manner, in good faith and in the reasonable belief that the actions they took are in the best interests of the company⁴².

Therefore, the value of an independent fiduciary duty of good faith lies in its potential to address those extravagant and defiant separations from the appropriate fiduciary conduct which are not mere consequences of a faulty process or a conflict of interest. Its value certainly does not only lie in the restoration of the caused damage, but also in the *ex ante* role it plays in changing behavior and exhortations offered to corporate fiduciaries and thus the positive changes it brings to corporate governance. If the trustee's role has expanded so much, the same should happen with those who are responsible for compliance and supervision, namely the directors.

6. Conclusion

An important development of business law in the last decade is the explicit recognition of good faith as a distinct fiduciary duty of company directors. However, it should be noted that this fiduciary duty was not created by law, but it was long explicitly or implicitly mentioned in various legal provisions applicable in corporate law which required directors to handle corporate business in good faith. Moreover, good faith always existed in the wording of the Business judgment rule and in the formulation of other obligations that can only be explained by this duty.

However, the explicit recognition of good faith as distinct fiduciary duty in recent case law highlights its importance and the necessity of this duty to be considered in its individuality, it outlines the development of its contours and the importance of examining this obligation from a regulatory perspective.

Good faith can be viewed from several perspectives. On the one hand, it rationalizes and explains a variety of specific obligations enshrined, that cannot be placed within the scope of diligence and prudence and of loyalty, such as the obligation not to cause the company to violate the law or such as the duty of candor.

This discussion also illustrates cases involving good faith, but that do not necessarily imply the duty of care or the duty of loyalty. Although good faith must exist as a component of loyalty and of diligence and prudence, its limitation to these situations would diminish its power as prophylactic tool or as incentive to urge good faith conduct. Diligence and prudence or the duty of care is a matter of procedure, not of substance. If we instilled good faith to violations of diligence and prudence, we would limit their procedural context. Similarly, loyalty is limited to

⁴² See *Aronson v. Lewis*, 473 A.2d, Delaware Supreme Court, 1984, commented by Stephen M. Bainbridge, *Corporation Law and Economics*, Foundation Press, UCL School of Law/ New York, 2002, page 269.

situations involving conflicts of interest and is generally viewed through the procedural telescope of lack of interest and independence.

The independent nature of good faith was evident in the cases where the court concentrated rather on the questioned decisions and on allegations of defiant decisions than on traditional violations of the duty of loyalty or duty of care. These cases show how fiduciaries may act in bad faith for other reasons than for stressing their personal material interests and underline that, regardless of their motivations, fiduciaries who consciously neglect their responsibilities towards the company and the shareholders may be personally liable for the financial damage they caused.

This reasoning opens a wider understanding of the differences between good faith and duty of care or duty of loyalty. Fiduciaries who act in good faith comply with corporate governance rules and legal standards, and those who fail through extravagant decisions are liable to sanctions. Consequently, deliberate indifference to duties or deliberate subversive attitude will direct the conduct of directors to the sphere of bad faith.

In this context we refer to cases where no mismanagement or wrong intentional conduct can be proven to lead to bad faith. These examples of measurement of careless, subversive or deliberately indifferent behavior are the ones able to create the application scope and the definition of good faith in corporate governance. Under this standard, the known or apparent violations of rules or standards of corporate governance or the failure to create such standards would be punishable.

The value of an independent fiduciary duty of good faith thus lies in its potential to address those extravagant and defiant abandonments of appropriate fiduciary conduct, which are not mere consequences of a faulty process or a conflict of interest. Its value obviously does not only consist in the amount of compensation they offer, but in the effectiveness of the *ex ante* role it plays in changing behavior and in exhortations offered to corporate fiduciaries with the consequence of creating positive changes to corporate governance as a whole.

On the other hand, the broad meaning of good faith can open doors to the articulation of new and specific fiduciary duties that prove to be appropriate in response to social changes, but that cannot be embodied within the duty of care or duty of loyalty.

In the current corporate structure, directors are less involved in management and the role of subordinate executive officers has acquired particular importance, therefore good faith has become an important tool for controlling defiant or careless fiduciary behavior.

If in situations as those encountered in the *Disney* cases, an official only provides part of the available information to the board to be considered in the decision making process and if the board fails to investigate or to ask additional questions before making a decision based on this information, this omission represents a breach of good faith. This obligation does not only involve a process or a conflict of interest or loyalties, but also refers to the material circumstances that define the outcome. Thus, good faith is a separate duty from diligence and

prudence and from the duty of loyalty. Fiduciaries who ignore the shortcomings of information they receive or the reporting system they rely on, violate the duty of good faith they owe to the company and to its shareholders. By ignoring these deficiencies, fiduciaries contribute to creating an atmosphere of permissiveness, carelessness or deliberate indifference which may result in mismanagement and bad business decisions, or worse, in activities which are not certainly within legal boundaries. A strict imperative to comply with the duty of good faith urges fiduciaries to adopt a behavior in compliance with the law and morality, even if this can not change their character. This constraint imposed by Delaware case law will instead protect shareholders who do not hold management positions. Shareholders are certainly aggrieved by failures of their fiduciaries and those failures which result from lack of compliance with the law or with other applicable rules will likely fall under the category of good faith. Effective coercion of managers and directors to comply with the law contributes to the efficiency of corporate governance rules.

Bibliography

1. Carsten Gerner-Beuerle, Philipp Paech and Edmund Philipp Schuster, *Study on Directors' Duties and Liability, prepared for the European Commission*, (Department of Law, London School of Economics), London, April 2013, LSE Enterprise;
2. Catană, R. N, Ponta, A., *The Business Judgement Rule and its reception in European Countries*, „The Macrotheme Review” 4(7), Austin, Texas, 2015;
3. Easterbrook, F. H., Fischel, D. R., *The Economic Structure of Corporate Law*, Harvard University Press, 1991.
4. Eisenberg, M. A., *The Duty of Good Faith in Corporate Law*, „Delaware Journal of Corporate Law”, vol. 31, no. 1, 2005;
5. Eisenberg, Melvin A., *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, „Fordham Law Review” no. 52, 1993;
6. LaSalle, Mike, *Downfall*, San Francisco Chronicle Datebook, August 2005;
7. Ponta, A. *The Business Judgement Rule. Approach and application*, „Juridical Tribune – Tribuna Juridica”, vol. 5, issue 2, December 2015, p. 25-44;
8. Sale, Hillary, *Delaware's Good Faith*, „Cornell Law Review” no. 89, 2004;
9. Stephen M. Bainbridge, *Corporation Law and Economics*, Foundation Press, UCL School of Law/ New York, 2002;
10. Summers, Robert S., *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, „Virginia Law Review” no. 195, Richmond, SUA, 1968;
11. Veasey, N. E., *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, „Wake Forest Law Review” no. 38, 2003;
12. *Cambridge Dictionary for Business English*, Cambridge University Press, 2006;
13. *Oxford Dictionary of Business and Management*, Oxford University Press, 2009.