

11-1-2004

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Recommended Citation

Matthew R. Berry, Notes and Comments, *Does Delaware's Section 102(b)(7) Protect Reckless Directors from Personal Liability? Only If Delaware Courts Act in Good Faith*, 79 Wash. L. Rev. 1125 (2004).

Available at: <https://digitalcommons.law.uw.edu/wlr/vol79/iss4/3>

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DOES DELAWARE'S SECTION 102(b)(7) PROTECT RECKLESS DIRECTORS FROM PERSONAL LIABILITY? ONLY IF DELAWARE COURTS ACT IN GOOD FAITH

Matthew R. Berry

Abstract: Section 102(b)(7) of the Delaware Corporate Code allows a corporation to amend its certificate of incorporation to exculpate directors from all duty of due care violations. The Delaware General Assembly enacted this law in response to the shrinking pool of qualified directors, which was caused by the Delaware State Supreme Court's decision in *Smith v. Van Gorkom* that imposed personal liability on directors for gross negligence. Delaware courts have unequivocally stated that section 102(b)(7) protects directors against personal liability arising from gross negligence, but not against liability arising from a lack of good faith. However, Delaware courts have not provided clear guidance as to whether the statute protects directors from personal liability arising from recklessness. If Delaware courts classify reckless conduct as a breach of the duty of due care, then section 102(b)(7) protects directors from liability arising from recklessness. Conversely, if Delaware courts classify reckless conduct as a breach of the duty of good faith, then section 102(b)(7) offers reckless directors no protection. This Comment proposes that section 102(b)(7) protects directors from personal liability arising from reckless decisions for two reasons. First, recklessness is merely a subset of gross negligence in Delaware corporate law. Because section 102(b)(7) unambiguously protects directors from liability arising from gross negligence, it also protects them from liability arising from recklessness. Second, recklessness by definition is conduct that involves no intention to cause harm. Because the Delaware State Supreme Court requires an illicit motive or bad faith state of mind to establish bad faith conduct, a reckless director breaches only the duty of due care and is protected by section 102(b)(7).

Directors play a crucial role in the corporate decisionmaking process.¹ They oversee and advise managerial decisions and provide a necessary check on top managerial power.² In fulfilling these tasks, the directors owe fiduciary duties to the corporation and its shareholders,³ and face personal liability for damages arising from the breach of any of these fiduciary duties.⁴ However, directors in a typical corporation face time and budget constraints and cannot always make decisions based on full

1. See E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 400 (1987).

2. See *id.*

3. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (stating that directors are charged with a fiduciary duty to the corporation and its shareholders when carrying out their managerial roles).

4. See *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (stating that directors are personally liable for monetary damages if they breach any of their fiduciary duties).

and accurate information.⁵ Holding directors personally liable for negligence, or even gross negligence, in the decisionmaking process might harm corporations⁶—many qualified directors may become reluctant to serve on boards because they desire to limit their personal exposure to liability.⁷ Those directors who do serve on boards would become increasingly risk-averse causing them to avoid risky projects with potentially high returns for the corporation.⁸

The Delaware General Assembly enacted section 102(b)(7) of the Delaware Corporate Code⁹ to provide directors with additional protection from personal liability. The legislators attempted to remedy directors' difficult position of making material decisions on incomplete information, and to encourage them to act in the shareholders' best interests.¹⁰ Section 102(b)(7) provides shareholders with an option to amend their corporation's certificate of incorporation to include an exculpation provision.¹¹ Delaware courts have interpreted this provision to protect directors from personal liability arising from simple and gross negligence.¹² Further, section 102(b)(7) provides that directors are not

5. See William T. Allen, Jack B. Jacobs & Leo E. 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, 451–52 (2002).

6. See *id.* at 449.

7. See *id.*; see also E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 692–93 (1998) (discussing the shortage of directors after the *Van Gorkom* court held directors liable for their grossly negligent conduct).

8. See Veasey, *supra* note 7, at 693–94.

9. DEL. CODE ANN. tit. 8, § 102(b)(7) (2003). Section 102(b) reads in relevant part:

In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

.....

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

Id.

10. See *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001); Veasey, *supra* note 7, at 692–93.

11. DEL. CODE ANN. tit. 8, § 102(b)(7); Veasey et al., *supra* note 1, at 402.

12. See, e.g., *Malpiede v. Townson*, 780 A.2d 1075, 1093, 1094–95 (Del. 2001) (concluding that section 102(b)(7) protects directors from liability arising from gross negligence).

protected from liability arising from their bad faith conduct.¹³ However, the courts have not provided clear guidance as to whether section 102(b)(7) protects directors from personal liability arising from their reckless conduct.¹⁴

This Comment argues that the Delaware State Supreme Court should interpret section 102(b)(7) to exculpate directors from personal liability arising from reckless conduct because recklessness is a breach of the duty of due care. Part I discusses directors' fiduciary duties. Part II outlines how Delaware courts have interpreted section 102(b)(7) to alter directorial liability arising from breaches of those fiduciary duties. Part III posits two arguments that section 102(b)(7) protects directors from liability arising from their reckless conduct. First, Part III.A argues that section 102(b)(7) protects directors from liability arising from recklessness because recklessness is a subcategory of gross negligence under Delaware corporate law. Next, Part III.B argues that section 102(b)(7) protects directors from liability arising from recklessness because reckless directors lack the bad faith intent that Delaware courts require to establish a breach of the duty of good faith. Finally, Part IV concludes that section 102(b)(7) protects directors from liability arising from recklessness because recklessness is a breach of the duty of due care.

I. UNDER DELAWARE COMMON LAW, DIRECTORS OWE SHAREHOLDERS DUTIES OF GOOD FAITH, LOYALTY, AND DUE CARE

Delaware common law charges directors with an “unyielding fiduciary duty to the corporation and its shareholders.”¹⁵ This fiduciary duty is commonly divided into the duty of good faith, duty of loyalty, and duty of due care.¹⁶ If directors breach any of these three fiduciary duties, then the shareholders can hold them personally liable for resulting monetary damages.¹⁷

13. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii).

14. See Veasey et al., *supra* note 1, at 403.

15. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

16. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

17. See Emerald Partners v. Berlin, 787 A.2d 85, 90–92 (Del. 2001).

A. *Directors Owe Shareholders a Duty of Good Faith*

Delaware courts do not agree whether the duty of good faith is an independent fiduciary duty or merely a part of the duty of loyalty,¹⁸ but the courts do agree that directors who act in bad faith are personally liable for any resulting damages.¹⁹ To establish bad faith, the Delaware State Supreme Court requires proof that the directors acted with a bad faith motive.²⁰ However, the Delaware Court of Chancery²¹ recently has held that directors could act in bad faith without proof that the directors had a bad faith motive.²²

1. *The Delaware State Supreme Court Requires Proof of a Bad Faith Motive Before Finding a Breach of the Duty of Good Faith*

The Delaware State Supreme Court evaluates directors' motives to distinguish breaches of the duty of due care from breaches of the duty of good faith.²³ For example, in *Zirn v. VLI Corporation*,²⁴ the Delaware

18. Some Delaware courts have concluded that the duty of good faith is merely a subset of the duty of loyalty. *See, e.g., Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) (stating that the duty of good faith is not independent of the duty of loyalty); *Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000) ("By definition, a director cannot simultaneously act in bad faith and loyally towards the corporation and its stockholders."). Other Delaware courts have implied that the duty of good faith is an independent duty. *See, e.g., Cede & Co.*, 634 A.2d at 361 (dividing directors' fiduciary duties into the duty of good faith, the duty of due care, and the duty of loyalty); *see also* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 483–84 (2004) (asserting that recent Delaware decisions have treated the duty of good faith as an independent fiduciary duty). Whether the duty of good faith is independent from the duty of loyalty is beyond the scope of this Comment.

19. *See, e.g., Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) (stating that the purpose of section 102(b)(7) was to protect directors from duty of due care claims and not duty of good faith or duty of loyalty claims).

20. *See, e.g., Zirn v. VLI Corp.*, 681 A.2d 1050, 1061–62 (Del. 1996) (stating that the directors acted in good faith because they lacked any motive to deceive or harm the corporation or its shareholders).

21. Delaware's use of chancery courts is unusual in the Anglo-American judicial system. The Delaware chancery court is a court of equity consisting of one chancellor and four vice chancellors, all of whom are selected by the governor. *See Cyril Moscow, Michigan or Delaware Incorporation*, 42 WAYNE L. REV. 1897, 1917 (1996). The chancery court hears all equitable cases, but is especially capable of adjudicating complex corporate issues given each chancellor's extensive experience in corporate law. *Id. See generally* William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery*, 18 DEL. J. CORP. L. 819 (1993).

22. *See, e.g., In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 290 (Del. Ch. 2003) (concluding that the plaintiff could proceed on her breach of duty of good faith claim without proof of directors' motives).

23. *See, e.g., Zirn*, 681 A.2d at 1061–62 (stating that the directors acted in good faith because they lacked any motive to deceive or harm the corporation or its shareholders); *Smith v. Van*

State Supreme Court required the plaintiff to demonstrate that directors had an illicit motive before the court would conclude that the directors acted in bad faith.²⁵ In *Zirn*, the court considered whether directors' material misrepresentations made during a tender offer breached the duty of good faith.²⁶ Instead of focusing on the severity of the misrepresentation or the resulting harm to the shareholders, the court evaluated whether the directors acted with a bad faith motive.²⁷ The court concluded that the directors acted in good faith because they lacked any motive to deceive the shareholders.²⁸

Similarly, in *Smith v. Van Gorkom*,²⁹ the Delaware State Supreme Court approached the question of good faith by stating that it need not inquire into the directors' motives unless there were allegations or proof of bad faith conduct.³⁰ In *Van Gorkom*, the court held that the directors breached their duty of due care by relying too heavily on the chief executive officer's judgment and failing to perform an adequate independent analysis.³¹ In dicta, the court noted that because the plaintiff had not alleged or provided proof of bad faith conduct, the directors' motives were irrelevant.³² This suggests that, had the plaintiff alleged that the directors acted in bad faith, a court would have to evaluate the directors' motives.

The Delaware State Supreme Court has also evaluated defendants' motives to define bad faith conduct outside the corporate director context.³³ In *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity*

Gorkom, 488 A.2d 858, 873 (Del. 1985) (stating that because there were no allegations that the directors breached the duty of good faith, the directors' motives were irrelevant).

24. 681 A.2d 1050 (Del. 1996).

25. *See id.* at 1061–62.

26. *Id.* at 1053–54.

27. *See id.*

28. *Id.* (“The record reveals that any misstatements or omissions that occurred were made in *good faith*. The VLI directors lacked any *pecuniary motive* to mislead the VLI stockholders *intentionally* and no other plausible *motive* for deceiving the stockholders has been advanced.” (emphasis added)).

29. 488 A.2d 858 (Del. 1985).

30. *See id.* at 873.

31. *See id.* at 893.

32. *See id.* at 873 (“[T]here were no allegations of fraud, bad faith, or self-dealing, or proof thereof. Hence, it is presumed that the directors reached their business judgment in good faith, and *considerations of motive are irrelevant* to the issue before us.” (emphasis added) (internal citation omitted)).

33. *See, e.g., Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1206 (Del. 1993) (evaluating a general partner's state of mind to determine if he acted in bad

Fund, II, L.P.,³⁴ the court concluded that a bad faith motive is a required element of bad faith conduct.³⁵ The court considered whether a general partner acted in bad faith by excluding the plaintiff from participating in its investment funds.³⁶ The court reasoned that a bad faith claim depends upon the defendant's "tortious state of mind."³⁷ The court defined bad faith as "not simply bad judgment or negligence, but rather . . . the *conscious* doing of a wrong because of *dishonest purpose* or *moral obliquity*."³⁸ Distinguishing, bad faith from negligence, the court reasoned that bad faith "contemplates a *state of mind* affirmatively operating with *furtive design* or *ill will*."³⁹ Therefore, the court concluded that a "dishonest purpose" and "ill will" are required elements of a bad faith claim.⁴⁰

2. *Despite Delaware State Supreme Court Precedent, Some Delaware Chancery Courts Have Found a Breach of the Duty of Good Faith Even Without Proof of a Bad Faith Motive*

Although the Delaware State Supreme Court requires a bad faith motive to prove a breach of the duty of good faith,⁴¹ Delaware chancery courts have not consistently enforced this requirement.⁴² For example, the Delaware chancery court in *In re Caremark International, Inc.*

faith). The Delaware Court of Chancery recently applied *Desert Equities'* "bad faith" analysis to the section 102(b)(7) context in *McGowan v. Ferro*, No. CIV.A-18672, 2004 WL 2340041, at *15-16 (Del. Ch. Oct. 8, 2004) (granting the defendants' motion for summary judgment on the bad faith claims).

34. 624 A.2d 1199 (Del. 1993).

35. *Id.* at 1208.

36. *Id.* at 1202.

37. *Id.* at 1208.

38. *Id.* (emphasis added).

39. *Id.* at 1208 n.16 (quoting BLACK'S LAW DICTIONARY 337 (5th ed. 1983) (emphasis added)) (internal quotations omitted).

40. *See id.*

41. *See, e.g., Zirn v. VLI Corp.*, 681 A.2d 1050, 1061-62 (Del. 1996) (evaluating the directors' motives for a duty of good faith claim); *Desert Equities*, 624 A.2d at 1206 (stating that a claim of bad faith relies upon a person's state of mind); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) (stating that the directors' motives were irrelevant because there were no allegations that the directors breached their duty of good faith).

42. *See, e.g., In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289-90 (Del. Ch. 2003) (failing to evaluate the directors' motives on a duty of good faith claim); *Nagy v. Bistricher*, 770 A.2d 43, 49 n.2 (Del. Ch. 2000) (stating that regardless of their motives, directors may be held personally liable for harm resulting from the conscious disregard of their duties).

*Derivative Litigation*⁴³ noted in dicta that directors' sustained or systematic failure to oversee the corporate decisionmaking process is sufficient to prove bad faith even without proof of a bad faith motive.⁴⁴ *Caremark* involved directors who allegedly failed to monitor adequately the corporation's compliance with the law.⁴⁵ The *Caremark* chancellor stated that, to prevail, the plaintiffs must prove that the directors knew or should have known that illegal activities were occurring, that the directors made no good faith effort to prevent or address the situation, and that their failure to act proximately caused the damage.⁴⁶ However, the chancellor did not require the plaintiff to prove that the directors had a bad faith motive or intent.⁴⁷

Consistent with *Caremark*, the Delaware chancery court recently concluded that directors' conscious and sustained failure to fulfill their oversight duties was sufficient to establish bad faith in *In re Walt Disney Co. Derivative Litigation*.⁴⁸ The *Disney* court considered whether Disney's directors acted in bad faith by allowing the chief executive officer (CEO), Michael Eisner, to unilaterally negotiate an employment contract with Disney's new president, Michael Ovitz.⁴⁹ The directors had almost no involvement in either the decision to hire Ovitz or the drafting of his employment agreement.⁵⁰ Instead, the directors granted Eisner full power to negotiate and approve the final terms and conditions of the contract without the directors' further approval.⁵¹ A year after Disney hired Ovitz, both Eisner and the directors realized their mistake, but the board again did not oversee Ovitz's termination.⁵² Without the directors' oversight, Eisner granted Ovitz a non-fault termination agreement that enabled Ovitz to realize \$100,000,000 in compensation from stock options.⁵³

43. 698 A.2d 959 (Del. Ch. 1996).

44. *See id.* at 971. *Caremark* is often credited for establishing the foundation for imposing personal liability on directors for a breach of the duty of good faith. *See Sale, supra* note 18, at 468–69.

45. *Caremark*, 698 A.2d at 960–62.

46. *Id.* at 971.

47. *See id.*

48. 825 A.2d 275, 278 (Del. Ch. 2003).

49. *See id.* at 279–81.

50. *See id.* at 287.

51. *Id.* at 281.

52. *See id.* at 282–85.

53. *Id.* at 284.

Based upon this directorial misconduct, the chancellor concluded that the plaintiffs were entitled to proceed with their claim that the Disney directors breached the duty of good faith.⁵⁴ The chancellor found that the plaintiffs sufficiently pleaded that the directors “consciously and intentionally disregarded their responsibilities,”⁵⁵ acted with “deliberate indifference,”⁵⁶ and “adopt[ed] a ‘we don’t care about the risks’ attitude”⁵⁷ The chancellor stated that when directors abdicate all responsibility in making a material corporate decision, it raises the question of whether the board’s decisionmaking process was conducted in good faith.⁵⁸ Without citing any authority, the chancellor concluded that if directors caused harm to shareholders by consciously ignoring their corporate duties, then the directors acted in bad faith or committed intentional misconduct.⁵⁹

Unlike the Delaware State Supreme Court in *Van Gorkom*, *Zirn*, or *Desert Equities*, the *Disney* chancellor did not inquire into the directors’ intent or motives.⁶⁰ Instead, the chancellor assumed that, given the severity of the directors’ conduct and the resulting harm, the directors must have acted in bad faith.⁶¹ The *Disney* chancellor also avoided addressing whether recklessness is sufficient to prove bad faith. In fact, the chancellor never used the term “reckless,” even though the plaintiffs alleged that the board members “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.”⁶²

In sum, although courts agree that directors who act in bad faith are liable for any resulting damages,⁶³ the Delaware State Supreme Court

54. *See id.* at 278.

55. *Id.* at 289 (emphasis omitted).

56. *Id.*

57. *Id.*

58. *See id.* at 289–90.

59. *Id.* at 290 (“Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director’s actions are either ‘not in good faith’ or ‘involve intentional misconduct.’” (quoting DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (2003))).

60. *Compare Zirn v. VLI Corp.*, 681 A.2d 1050, 1061–62 (Del. 1996), *and Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 (Del. 1993), *and Smith v. Van Gorkom*, 488 A.2d 858, 871, 873 (Del. 1985), *with Disney*, 825 A.2d at 286.

61. *See Disney*, 825 A.2d at 289.

62. *Id.* (emphasis omitted).

63. *See, e.g., Malpiede v. Townson*, 780 A.2d 1075, 1094–95 (Del. 2001) (stating that the purpose of section 102(b)(7) was to protect directors from duty of due care claims and not from duty of good faith or duty of loyalty claims).

has not clearly defined the duty of good faith.⁶⁴ The court expressly requires a bad faith motive to establish bad faith.⁶⁵ However, some recent chancery court decisions have concluded that directors acted in bad faith even without proof of a bad faith motive.⁶⁶

B. Directors Owe Shareholders a Duty of Loyalty

Although the duty of good faith still floats in murky waters, Delaware courts have consistently described the duty of loyalty as the conflict between the directors' duty to the corporation and their self-interest.⁶⁷ Within the duty of loyalty is an affirmative duty to protect the corporation's interests and avoid any conduct that would injure the corporation or its shareholders or deprive either of a benefit.⁶⁸ Directors breach the duty of loyalty when their economic or other interests conflict with the corporation or its shareholders' interests.⁶⁹

C. Directors Owe Shareholders a Duty of Due Care

The duty of due care requires that directors exercise an informed business judgment when making corporate decisions and authorizes courts to impose personal liability on directors for negligence or recklessness.⁷⁰ If directors make a well-informed business decision, courts apply the business judgment rule, which limits judicial review to scrutiny of directors' decisionmaking process rather than to the substantive decision itself.⁷¹ Courts interpret the business judgment rule to protect directors from liability arising from negligence, but not from gross negligence.⁷² Because Delaware courts consider recklessness to be

64. See, e.g., Sale, *supra* note 18, at 468 (“[E]xplication of the good faith obligations—indeed, even the use of that term—is dicta.”).

65. See, e.g., Zirn, 681 A.2d at 1061–62 (stating that the directors acted in good faith because they lacked any motive to deceive or harm the corporation or its shareholders).

66. See, e.g., Disney, 825 A.2d at 290 (holding that the plaintiff could proceed on her breach of the duty of good faith claim without proof of the directors' motives).

67. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

68. *Id.*; see also 1 RODMAN WARD, JR., EDWARD P. WELCH & ANDREW J. TUREZYN, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.2.1.1 (4th ed. 2004) (describing the duty of loyalty).

69. WARD ET AL., *supra* note 68, § 141.2.1.1.

70. See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

71. See *Cede & Co.*, 634 A.2d at 360–61.

72. *Van Gorkom*, 488 A.2d at 873.

a subset of gross negligence,⁷³ the business judgment rule similarly does not protect directors from liability arising from recklessness.

1. *The Business Judgment Rule Does Not Allow Courts to Substantively Evaluate Directors' Well-Informed Decisions*

The business judgment rule offers directors limited protection from personal liability arising from business decisions.⁷⁴ The rule creates a presumption that in making a business decision, directors acted on an informed basis, in good faith, and with the honest belief that their decision was in the corporation's best interest.⁷⁵ In light of this presumption, courts may evaluate only the decisionmaking process and not the substantive decision itself.⁷⁶ However, courts apply the business judgment rule only when the directors actually make a decision.⁷⁷ Thus, when directors abdicate their duties or fail to make a conscious decision, the rule provides no protection.⁷⁸

2. *The Business Judgment Rule Protects Directors from Liability Arising from Negligence, but Not Gross Negligence*

The business judgment rule protects directors from liability arising from negligence, but not from gross negligence.⁷⁹ This limitation of the business judgment rule became clear when the Delaware State Supreme Court imposed personal liability on directors for their grossly negligent conduct in *Van Gorkom*.⁸⁰ The directors in *Van Gorkom* approved a proposed sale of the company without prior consideration of the sale,

73. See, e.g., *Tomczak v. Morton Thiokol, Inc.*, No. CIV.A-7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) ("In the corporate context, gross negligence means 'reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason.'" (quoting *Allaun v. Consol. Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929)) (emphasis added)). Unpublished decisions may be cited to in Delaware under the Delaware State Supreme Court Rules if a copy of the decision is attached to the brief. See DEL. SUP. CT. R. 14(b)(vi)(4), 17(a); *Oglesby v. Penn Mut. Life Ins. Co.*, 877 F. Supp. 872, 896 n.2 (D. Del. 1994); *New Castle County v. Goodman*, 461 A.2d 1012, 1013 (Del. 1983).

74. See, e.g., *Cede & Co.*, 634 A.2d at 361 (noting that a plaintiff must rebut the business judgment rule before directors can be held personally liable).

75. See *Van Gorkom*, 488 A.2d at 872.

76. See *Cede & Co.*, 634 A.2d at 361.

77. *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984).

78. See *id.*

79. *Van Gorkom*, 488 A.2d at 873.

80. See *id.* at 893.

even though there were no time constraints;⁸¹ the directors approved amendments to the merger agreement without reading them;⁸² and the directors gave the CEO authority to execute the merger without further board approval.⁸³ Moreover, when the CEO did execute the merger, he did so at a party without reading the final agreement.⁸⁴ Because the directors' decision did not involve fraud, bad faith, or self-dealing, the court analyzed the decision under the business judgment rule.⁸⁵ However, the business judgment rule protects directors only against personal liability arising from negligence, and the court held that the directors' conduct amounted to gross negligence.⁸⁶ Accordingly, the court imposed personal liability on the directors for their grossly negligent conduct.⁸⁷

3. *The Business Judgment Rule Does Not Protect Directors from Liability Arising from Recklessness Because Recklessness Is a Subset of Gross Negligence*

The business judgment rule does not protect directors from liability arising from reckless conduct because Delaware courts deem corporate recklessness as a subset of gross negligence.⁸⁸ "Recklessness" is the "knowing disregard of a substantial and unjustifiable risk."⁸⁹ Reckless actors have no intent to cause harm;⁹⁰ instead they have an "I don't care" attitude.⁹¹ While most courts distinguish recklessness from gross negligence,⁹² Delaware courts depart from the majority view by

81. *See id.* at 874.

82. *Id.* at 869.

83. *See id.* at 879.

84. *Id.*

85. *See id.* at 873.

86. *See id.* at 873, 893 (stating that the relevant standard is gross negligence and that the directors breached that standard).

87. *See id.* at 893.

88. *See, e.g., Tomczak v. Morton Thiokol, Inc.*, No. CIV.A-7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (noting that in the corporate context, gross negligence means recklessness).

89. Pattern Jury Instructions for Civil Practice in the Superior Court of the State of Delaware, DEL. P.J.I. CIV. § 5.9 (2000); *see also* *Cont'l Ins. Co. v. Dooley*, No. CIV.A.02C-07-065JOH, 2003 WL 1903771, at *6 (Del. Super. Ct. Feb. 4, 2003) (applying the definition of recklessness from DEL. P.J.I. CIV. § 5.9).

90. *See Dooley*, 2003 WL 1903771, at *6 (quoting DEL. P.J.I. CIV. § 5.9).

91. *See* DEL. P.J.I. CIV. § 5.9; *see also Dooley*, 2003 WL 1903771, at *6 (applying the definition of recklessness from DEL. P.J.I. CIV. § 5.9).

92. *See* *Allen et al.*, *supra* note 5, at 453 (noting that the gross negligence standard in Delaware

designating corporate recklessness as a subset of gross negligence.⁹³ For example, in *Tomczak v. Morton Thiokol, Inc.*,⁹⁴ a Delaware chancellor considered whether directors breached their fiduciary duties in approving a sale of one of the corporation's divisions.⁹⁵ Upon holding that the directors acted in good faith, the chancellor stated, "In the corporate context, gross negligence means '*reckless indifference* to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason.'"⁹⁶ Other Delaware courts have also concluded that gross negligence includes corporate recklessness.⁹⁷ In addition to Delaware case law, three Delaware chancellors⁹⁸ concluded in a recent law review article that plaintiffs must establish that directors acted recklessly to prove that they acted with gross negligence.⁹⁹ Moreover, one of the leading Delaware corporate law treatises agreed with the three chancellors that recklessness is merely an element of a gross negligence claim in Delaware corporate jurisprudence.¹⁰⁰ Because the business judgment rule offers directors no protection from liability arising from gross negligence,¹⁰¹ it similarly offers them no protection

corporate cases is harder to establish than the gross negligence standard courts normally apply in tort or criminal cases); see also *Rabkin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 970 (Del. Ch. 1986) (stating that Delaware corporate law has a different standard for gross negligence than other areas of the law).

93. See, e.g., *Tomczak*, 1990 WL 42607, at *12 ("In the corporate context, gross negligence means '*reckless indifference* to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason.'" (quoting *Allaun v. Consol. Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929) (emphasis added)); see also *Rabkin*, 547 A.2d at 970 (noting that corporate gross negligence is similar to recklessness); Allen et al., *supra* note 5, at 453 (noting that courts in Delaware corporate cases have adopted a gross negligence standard that is similar to the recklessness standard).

94. No. CIV.A-7861, 1990 WL 42607 (Del. Ch. Apr. 5, 1990).

95. *Id.* at *12.

96. *Id.* (quoting *Allaun*, 147 A. at 261 (emphasis added)).

97. See, e.g., *Rabkin*, 547 A.2d at 970 (noting that corporate gross negligence is similar to recklessness); see also WARD ET AL., *supra* note 68, § 141.2.2.4 (noting that corporate gross negligence is similar to recklessness); Allen et al., *supra* note 5, at 453 (same).

98. William T. Allen is a former vice-chancellor of the Delaware Court of Chancery. Jack B. Jacobs is a former vice-chancellor of the Delaware Court of Chancery and is currently a justice on the Delaware State Supreme Court. Leo E. Strine, Jr. is currently a vice-chancellor on the Delaware Court of Chancery.

99. See Allen, *supra* note 5, at 453 ("Delaware corporate cases have adopted a gross negligence standard that requires a plaintiff to demonstrate a degree of culpability on the part of the directors that is akin to the recklessness standard employed in other contexts.").

100. See WARD ET AL., *supra* note 68, § 141.2.2.4.

101. See *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (holding directors personally liable for gross negligence).

from liability arising from reckless conduct.¹⁰²

II. SECTION 102(b)(7) PROTECTS DIRECTORS FROM LIABILITY ARISING FROM BREACHES OF ONLY THE DUTY OF DUE CARE

The Delaware legislature enacted section 102(b)(7)¹⁰³ in response to *Van Gorkom* to allow shareholders to further protect directors from personal liability.¹⁰⁴ Although the statute's protections are broad in that it protects directors from liability arising from all breaches of the duty of due care,¹⁰⁵ it expressly states that it offers directors no protection if they do not act in good faith.¹⁰⁶ However, courts have not clarified whether section 102(b)(7) also protects directors from liability arising from recklessness.¹⁰⁷

A. *The Delaware Legislature Enacted Section 102(b)(7) in Response to Van Gorkom*

After *Van Gorkom*, the Delaware legislature responded to directors' fears of potential liability and shareholders' desire to retain quality, risk-taking directors by enacting section 102(b)(7).¹⁰⁸ The Delaware State Supreme Court's decision in *Van Gorkom*, which held directors personally liable for shortcomings in the merger approval process, sent shock waves of apprehension throughout the corporate world.¹⁰⁹ This apprehension led many qualified directors to resign out of fear of future personal liability, which caused the pool of qualified directors to decrease substantially.¹¹⁰ Even when a corporation could find qualified directors, the directors knew they might be personally liable if a court declared their conduct grossly negligent.¹¹¹ This exposure to liability caused many directors to become risk-averse in corporate

102. *See id.*

103. DEL. CODE ANN. tit. 8, § 102(b)(7) (2003).

104. *See Veasey, supra* note 7, at 693.

105. *Malpiede v. Townson*, 780 A.2d 1075, 1093, 1095 (Del. 2000); *Zim v. VLI Corp.*, 681 A.2d 1050, 1061 (Del. 1996).

106. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii).

107. *See infra* Part II.C.

108. *See Veasey, supra* note 7, at 693.

109. *See Veasey, supra* note 7, at 692.

110. *See Veasey et al., supra* note 1, at 401.

111. *See Allen et al., supra* note 5, at 449–51.

decisionmaking.¹¹² While investors want directors who are diligent and honest,¹¹³ they also want directors who are bold and willing to take business risks.¹¹⁴ To address these shareholder concerns, the Delaware legislature enacted section 102(b)(7).¹¹⁵

B. Section 102(b)(7) Protects Directors from Liability Arising from Breaches of the Duty of Due Care, but Not from Breaches of the Duty of Good Faith

To determine whether section 102(b)(7) protects directors from liability arising from alleged misconduct, courts must discern whether the misconduct amounts to a breach of the duty of due care or a breach of the duty of good faith.¹¹⁶ Section 102(b)(7) expressly states that it offers directors no protection from personal liability arising from acts not in good faith.¹¹⁷ However, Delaware courts interpret section 102(b)(7) to protect directors from personal liability arising from all duty of due care violations.¹¹⁸ Directors breach their duty of due care through negligence or gross negligence.¹¹⁹ The business judgment rule protects directors from liability arising from negligence,¹²⁰ and section 102(b)(7) extends this protection to liability arising from gross negligence.¹²¹ Therefore, if a director can characterize a plaintiff's claim as alleging only a breach of the duty of due care, then the director can invoke section 102(b)(7)¹²² to have the complaint dismissed.¹²³

112. See Veasey, *supra* note 7, at 693–94.

113. Veasey, *supra* note 7, at 694.

114. See Veasey, *supra* note 7, at 684–85 (“Requiring perfect, fail-safe systems can be far more costly than any potential business loss to the stockholders.”).

115. See Veasey, *supra* note 7, at 693.

116. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2003); *Malpiede*, 780 A.2d at 1095.

117. DEL. CODE ANN. tit. 8, § 102(b)(7).

118. See *Malpiede v. Townson*, 780 A.2d 1075, 1093 (Del. 2001); *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061 (Del. 1996).

119. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating that directors receive no business judgment rule protection if they fail to make a conscious decision).

120. See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

121. See *Malpiede*, 780 A.2d at 1094–95 (concluding that section 102(b)(7) protects directors from gross negligence).

122. This assumes that the corporation had amended its certificate of incorporation to include section 102(b)(7).

123. *Malpiede*, 780 A.2d at 1094–95.

C. *Courts Are Divided as to Whether Section 102(b)(7) Protects Directors from Personal Liability Arising from Reckless Conduct*

Delaware courts agree that section 102(b)(7) protects directors from liability arising from breaches of the duty of due care,¹²⁴ and the statute explicitly states that it offers no protection from liability arising from breaches of the duty of good faith.¹²⁵ However, courts have not reached a definitive conclusion as to whether the statute protects directors from liability arising from recklessness.¹²⁶ If courts conclude that recklessness is a breach of the duty of due care, then section 102(b)(7) will protect directors from liability arising from recklessness.¹²⁷ Conversely, if courts conclude that recklessness is a breach of the duty of good faith, then section 102(b)(7) will offer directors no protection.¹²⁸ Thus, the issue is whether recklessness is a breach of the duty of good faith or a breach of the duty of due care.

1. *Delaware Courts Provide Little Guidance on Applying Section 102(b)(7) to Recklessness*

The Delaware State Supreme Court has suggested that section 102(b)(7) will protect directors from liability arising from recklessness.¹²⁹ For example, in *Van Gorkom*, the court implicitly determined that reckless conduct does not breach the duty of good faith.¹³⁰ The court characterized the *Van Gorkom* directors' conduct as reckless,¹³¹ but concluded that there was no evidence that the directors had breached their duty of good faith.¹³² Although decided before the enactment of section 102(b)(7), the *Van Gorkom* court's analysis

124. See, e.g., *id.* at 1093 (concluding that section 102(b)(7) protects directors from gross negligence).

125. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2003).

126. See Veasey et al., *supra* note 1, at 403.

127. See *Malpiede*, 780 A.2d at 1093 (observing that section 102(b)(7) protects directors from personal liability arising from duty of due care claims).

128. See DEL. CODE ANN. tit. 8, § 102(b)(7).

129. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 871, 873 (Del. 1985) (describing the directors' conduct as reckless, but concluding that the conduct breached only the duty of due care, not the duty of good faith).

130. See *id.* at 873.

131. *Id.* at 871 (stating that the lower court erred by finding that the directors had not acted "recklessly or improvidently").

132. *Id.* at 873.

indicates that directors' reckless conduct does not breach their duty of good faith.

Contrary to the *Van Gorkom* court's decision, the *Disney* chancery court suggested that directors' reckless conduct breaches the duty of good faith.¹³³ The *Disney* chancellor avoided the term "reckless" throughout the opinion, but described the directors' conduct with terms synonymous with recklessness.¹³⁴ For example, the chancellor stated that the directors "consciously and intentionally disregarded their responsibilities" and "adopt[ed] a 'we don't care about the risks attitude.'"¹³⁵ The chancellor concluded that section 102(b)(7) provided the directors no protection from liability because their actions breached the duty of good faith.¹³⁶

However, only two years before the *Disney* decision, the Delaware Court of Chancery in *Emerald Partners v. Berlin*¹³⁷ expressly questioned the argument that recklessness breaches the duty of good faith.¹³⁸ In *Emerald Partners*, the plaintiff alleged that the directors recklessly approved a merger.¹³⁹ The plaintiff argued that section 102(b)(7) should not protect the directors from liability because the directors' reckless indifference amounted to a breach of the duty of good faith.¹⁴⁰ However, the chancellor declined to accept this argument and responded that, at best, the plaintiff cited equivocal authority to prove that reckless indifference breaches the duty of good faith.¹⁴¹ The chancellor ultimately concluded that he need not determine whether reckless indifference breaches the duty of good faith because the plaintiff failed to prove that the directors acted recklessly.¹⁴²

133. *See In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 278, 290 (Del. Ch. 2003).

134. *See id.* at 289.

135. *Id.*

136. *See id.* at 289–90.

137. No. CIV.A-9700, 2001 WL 115340 (Del. Ch. Feb. 7, 2001).

138. *See id.* at *26 n.66.

139. *Id.* at **17, 18.

140. *See id.* at *26 n.66.

141. *See id.* at *26.

142. *Id.* at *26 n.66.

2. *Federal Appellate Courts Have Held that Section 102(b)(7) Does Not Protect Directors from Liability Arising from Reckless Conduct*

Given Delaware's significant influence on corporate law throughout the United States,¹⁴³ other jurisdictions have considered recklessness and good faith when interpreting section 102(b)(7) or its local equivalent.¹⁴⁴ For example, in *McCall v. Scott*,¹⁴⁵ the United States Court of Appeals for the Sixth Circuit held that section 102(b)(7)¹⁴⁶ did not protect the *McCall* directors from personal liability arising from reckless conduct.¹⁴⁷ The *McCall* directors allegedly knew that the senior managers' policies encouraged employees to engage in illegal activities, but the directors recklessly failed to address these policies.¹⁴⁸ The court found that the directors' "sustained inattention to their management obligations" and "intentional ignorance of" and "willful blindness" to "red flags" surpassed mere breaches of the duty of due care.¹⁴⁹ The Sixth Circuit concluded that "[u]nder Delaware law, the duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer."¹⁵⁰

The Sixth Circuit's reference to Delaware law on the conscious disregard of directorial duties¹⁵¹ came entirely from a footnote in *Nagy v. Bistricher*.¹⁵² In *Nagy*, the Delaware chancery court discussed whether directors breached their fiduciary duties by merging the corporation with

143. See generally William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 BUS. LAW. 351 (1992) (stating that the Delaware Court of Chancery plays an important part in the United States legal system and that most United States corporations have formed in Delaware because the court has the highest standards of responsibility and excellency).

144. See, e.g., *McCall v. Scott*, 239 F.3d 808, 1000–01 (6th Cir. 2001) [hereinafter *McCall I*] (adjudicating corporate liability under section 102(b)(7) for a corporation that had amended its certificate of incorporation to include section 102(b)(7)), amended by 250 F.3d 997 (6th Cir. 2001) [hereinafter *McCall II*].

145. 239 F.3d 808 (6th Cir. 2001), amended by 250 F.3d 997 (6th Cir. 2001).

146. The defendant was incorporated in Delaware and had amended its certificate of incorporation to include section 102(b)(7), which required that the Sixth Circuit apply Delaware law. See *id.* at 1000.

147. *McCall II*, 250 F.3d at 1000–01.

148. *McCall I*, 239 F.3d at 814–15.

149. *McCall II*, 250 F.3d at 1001 (internal quotations omitted).

150. *Id.* (citation omitted).

151. See *id.*

152. 770 A.2d 43 (Del. Ch. 2000).

a second corporation controlled by the directors.¹⁵³ While listing the plaintiff's allegations in the factual background section,¹⁵⁴ the chancellor discussed the relationship between the duty of loyalty and the duty of good faith in a footnote.¹⁵⁵ In the footnote, the chancellor concluded that the duty of good faith is subsumed within the duty of loyalty,¹⁵⁶ and, at best, it is a reminder that "regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes."¹⁵⁷ The chancellor provided no authority for this statement.

Two years after the *McCall* decision, the United States Court of Appeals for the Seventh Circuit, in *In re Abbott Laboratories*,¹⁵⁸ followed *McCall* by concluding that evidence of directors' reckless conduct is sufficient to prove bad faith.¹⁵⁹ The plaintiffs in *Abbott* accused the directors of acting grossly negligent, recklessly, and intentionally when the directors failed to address employee misconduct that led to repeated violations of FDA regulations.¹⁶⁰ The Seventh Circuit quoted nearly every line from the *McCall* decision that discussed Delaware's recklessness standard and concluded that the corporation's section 102(b)(7)-like provision¹⁶¹ did not protect the directors from liability arising from their recklessness.¹⁶² In fact, the Seventh Circuit relied so heavily on the Sixth Circuit's interpretation of Delaware law that it cited to the *McCall* decision even when it relied on the *Nagy* quote that recklessness is sufficient to prove bad faith under Delaware law.¹⁶³

In sum, the extent of section 102(b)(7) protections is still unclear.¹⁶⁴ Courts agree that section 102(b)(7) protects directors from liability for all breaches of the duty of due care¹⁶⁵ and that it offers no protection

153. *Id.* at 46.

154. *Id.* at 49.

155. *Id.* at 49 n.2.

156. *Id.*

157. *Id.*

158. 325 F.3d 795 (7th Cir. 2003).

159. *See id.* at 811.

160. *Id.*

161. The Seventh Circuit was interpreting an Illinois statute, 805 ILL. COMP STAT. 5/8.65, that was modeled after Delaware's section 102(b)(7). *Id.* at 810.

162. *Id.* at 811.

163. *Id.* (citing *McCall II*, 250 F.3d 997, 1001 (6th Cir. 2001), but applying the *Nagy* quote).

164. *See Veasey et al.*, *supra* note 1, at 403.

165. *Malpiede v. Townson*, 780 A.2d 1075, 1093, 1095 (Del. 2000); *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061 (Del. 1996).

from liability for breaches of the duty of good faith.¹⁶⁶ However, courts are divided over whether section 102(b)(7) protects directors from liability arising from recklessness.¹⁶⁷

III. SECTION 102(b)(7) PROTECTS DIRECTORS FROM PERSONAL LIABILITY ARISING FROM RECKLESSNESS

Under Delaware State Supreme Court precedent, section 102(b)(7) should protect directors from personal liability arising from recklessness for two reasons. First, Delaware corporate law includes recklessness within its gross negligence standard.¹⁶⁸ Given that Delaware courts agree that section 102(b)(7) protects directors from liability arising from gross negligence,¹⁶⁹ the statute should accordingly protect directors from liability arising from recklessness, which is a subset of gross negligence.¹⁷⁰ Second, even if recklessness is not a subset of gross negligence, recklessness does not breach the duty of good faith because reckless actors lack a bad faith motive.¹⁷¹ Without this requisite motive, recklessness is not a breach of the duty of good faith,¹⁷² but is instead a breach of the duty of due care.¹⁷³ As a breach of the duty of due care, section 102(b)(7) protects directors from liability arising from recklessness.¹⁷⁴

166. See, e.g., *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003) (stating that section 102(b)(7) does not protect directors from personal liability arising from conduct not undertaken in good faith).

167. Compare *Zirn*, 681 A.2d at 1061–62 (Del. 1996), and *Smith v. Van Gorkom*, 488 A.2d 858, 871, 873 (Del. 1985), with *Disney*, 825 A.2d at 286.

168. See *Tomczak v. Morton Thiokol, Inc.*, No. CIV.A-7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990).

169. See, e.g., *Malpiede*, 780 A.2d at 1089–90 (stating that section 102(b)(7) protects directors from liability even if the complaint is construed to allege gross negligence).

170. See, e.g., *Tomczak*, 1990 WL 42607, at *12 (stating that gross negligence includes recklessness).

171. See, e.g., *Cort'l Ins. Co. v. Dooley*, No. CIV.A.02C-07-065JOH, 2003 WL 1903771, at *6 (Del. Super. Ct. Feb. 4, 2003) (applying the definition of recklessness from DEL. P.J.I. CIV. § 5.9, which defines “recklessness” as the “knowing disregard of a substantial and unjustifiable risk”).

172. Also, it does not implicate the duty of loyalty. See *supra* Part I.B.

173. If it does not fall under the duties of loyalty or good faith, the only remaining option is the duty of due care. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (discussing the three components of fiduciary duty: duty of loyalty, duty of care, and duty of good faith).

174. See, e.g., *Malpiede*, 780 A.2d at 1092–93 (noting that section 102(b)(7) protects directors from liability arising from all breaches of the duty of due care).

A. *Section 102(b)(7) Protects Directors from Liability Arising from Reckless Conduct Because Corporate Recklessness Is a Subset of Gross Negligence*

Section 102(b)(7) protects directors from liability arising from recklessness because corporate recklessness is a subset of gross negligence.¹⁷⁵ As stated by the *Tomczak* court and acknowledged by Delaware chancellors and treatises, corporate gross negligence includes reckless indifference.¹⁷⁶ Therefore, corporate recklessness is a part of the larger classification of grossly negligent conduct. Because section 102(b)(7) protects directors from liability arising from gross negligence,¹⁷⁷ it should also protect them from liability arising from a subset of gross negligence—recklessness.

In *Van Gorkom*, the Delaware State Supreme Court suggested that recklessness is a subset of gross negligence.¹⁷⁸ The *Van Gorkom* court imposed liability on directors for conduct that the court classified as reckless.¹⁷⁹ Although the court described the directors' conduct as reckless, it ultimately concluded that this reckless conduct did not constitute bad faith.¹⁸⁰ Instead, the court held that the directors' misconduct amounted to gross negligence, which breached the directors' duty of due care.¹⁸¹

Accordingly, because recklessness is a subset of gross negligence,¹⁸² section 102(b)(7) protects directors from personal liability arising from

175. See, e.g., *Tomczak*, 1990 WL 42607, at *12 (noting that in the corporate context, gross negligence means recklessness) (quoting *Allaun v. Consol. Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929)); *Rabkin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 970 (Del. Ch. 1986) (same); see also *WARD ET AL.*, *supra* note 68, § 141.2 (same); *Allen et al.*, *supra* note 5, at 453 (same).

176. See *Tomczak*, 1990 WL 42607, at *12 (quoting *Allaun*, 147 A. at 261); *Rabkin*, 547 A.2d at 970; *WARD ET AL.*, *supra* note 68, § 141.2; *Allen et al.*, *supra* note 5, at 453.

177. See *Malpiede*, 780 A.2d at 1092–93 (noting that section 102(b)(7) protects directors from personal liability arising from gross negligence).

178. See *Smith v. Van Gorkom*, 488 A.2d 858, 871 (Del. 1985) (stating that the lower court erred in finding that grossly negligent directors had not acted “recklessly or improvidently”).

179. See *id.*

180. See *id.* at 873.

181. See *id.*

182. See, e.g., *Tomczak v. Morton Thiokol, Inc.*, No. CIV.A-7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (noting that in the corporate context, gross negligence means recklessness); *Rabkin v. Philip A. Hunt Chem. Corp.*, 547 A.2d 963, 970 (Del. Ch. 1986) (noting that gross negligence means recklessness in Delaware corporate law); see also *WARD ET AL.*, *supra* note 68, § 141.2.2.4 (same); *Allen et al.*, *supra* note 5, at 453 (same).

recklessness.¹⁸³ The Delaware State Supreme Court has consistently held that section 102(b)(7) protects directors from liability arising from their own gross negligence.¹⁸⁴ Grossly negligent conduct does not breach the duty of good faith; rather, it breaches the duty of due care.¹⁸⁵ Therefore, once directors establish that the plaintiff's recklessness claim amounts only to a breach of the duty of due care, the directors may invoke section 102(b)(7) to have the court summarily dismiss the claim.¹⁸⁶

B. Even if Recklessness Is Not a Subset of Gross Negligence, Section 102(b)(7) Protects Directors from Liability Arising from Recklessness Because Reckless Directors Lack a Bad Faith Motive

Even if recklessness is not a subset of gross negligence, section 102(b)(7) protects directors from liability arising from recklessness. The Delaware State Supreme Court requires proof of an illicit motive or bad faith state of mind to establish that conduct was carried out in bad faith.¹⁸⁷ Because recklessness describes only conduct that lacks intent to cause harm,¹⁸⁸ reckless directors lack the illicit motive or bad faith state of mind intrinsic to bad faith conduct.¹⁸⁹ Without this requisite state of mind, reckless directors do not breach the duty of good faith, but instead breach only the duty of due care.¹⁹⁰ Because recklessness is a breach of the duty of due care, section 102(b)(7) protects directors from personal liability arising from their recklessness.¹⁹¹

183. See *Malpiede v. Townson*, 780 A.2d 1075, 1092–93 (Del. 2000) (noting that section 102(b)(7) protects directors from personal liability arising from gross negligence).

184. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) (stating that Delaware courts have consistently held that section 102(b)(7) protects directors from liability arising from all duty of due care violations); *Malpiede*, 780 A.2d at 1092–93 (noting that section 102(b)(7) protects directors from personal liability arising from gross negligence).

185. See, e.g., *Van Gorkom*, 488 A.2d at 873–74 (concluding that the directors acted with gross negligence but in good faith).

186. See *Malpiede*, 780 A.2d at 1092–93.

187. See *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 (Del. 1993).

188. See *supra* Part I.C.3.

189. See *Desert Equities*, 624 A.2d at 1208.

190. See *id.*

191. *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) (stating that section 102(b)(7) protects directors from liability arising from all duty of due care violations).

1. *A Breach of the Duty of Good Faith Requires a Bad Faith Motive*

The Delaware State Supreme Court requires that defendants have a bad faith motive or illicit intent to breach the duty of good faith.¹⁹² For example, the *Desert Equities* court, focusing on the defendants' subjective intent, stated that the plaintiff's allegations of bad faith relied upon the defendants' "tortious state of mind."¹⁹³ The court further explained that bad faith "implies the conscious doing of a wrong because of *dishonest purpose or moral obliquity*; . . . it contemplates a *state of mind affirmatively operating with furtive design or ill will*."¹⁹⁴ This discussion of bad faith demonstrates that defendants must have a bad faith motive or illicit state of mind to establish that the defendants engaged in bad faith conduct.¹⁹⁵

As in *Desert Equities*, the Delaware State Supreme Court in *Zirn* evaluated the directors' motives to determine whether they acted in bad faith.¹⁹⁶ The court held that the directors had not breached their duty of good faith because the directors had no "pecuniary *motive*" or any "other plausible *motive for deceiving* the stockholders."¹⁹⁷ Therefore, the court acknowledged that directors must have an illicit motive for their conduct to amount to a breach of the duty of good faith.¹⁹⁸

Additionally, *Van Gorkom* demonstrates that the Delaware State Supreme Court will not find a breach of the duty of good faith without proof that directors acted with a bad faith motive.¹⁹⁹ The *Van Gorkom* court stated that it need not evaluate the directors' motives because there was no proof or allegation that the directors acted in bad faith.²⁰⁰ The

192. See, e.g., *Desert Equities*, 624 A.2d at 1208 (stating that a claim of bad faith relies upon a person's state of mind).

193. *Id.*

194. *Id.* (emphasis added).

195. The Delaware Chancery Court recently quoted *Desert Equities* while considering whether directors breached the duty of good faith in the section 102(b)(7) context. *McGowan v. Ferro*, No. CIV.A-18672, 2004 WL 2340041, at *15-16 (Del. Ch. Oct. 8, 2004). Other lower courts in Delaware have also applied *Desert Equities*'s discussion of bad faith to other situations. For example, a Delaware superior court applied the *Desert Equities* bad faith definition to the insurance realm. *Stuart v. Blue Cross & Blue Shield of Del., Inc.*, No. CIV.A.92C-03-018, 1994 WL 89795, at *3 (Del. Super. Ct. Feb. 7, 1994).

196. See *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061-62 (Del. 1996).

197. *Id.* (emphasis added).

198. See *id.*

199. See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

200. See *id.*

court suggested that, had the plaintiff alleged bad faith conduct, the court would be required to evaluate the directors' motives.²⁰¹ Therefore, to breach the duty of good faith, directors must have a bad faith motive.²⁰²

2. *Recklessness Lacks a Bad Faith Motive and Therefore Falls Within the Protections of Section 102(b)(7) as a Breach of the Duty of Due Care*

Recklessness, by definition, is conduct without a bad faith motive.²⁰³ Reckless directors might be conscious of and indifferent to the fact that their conduct could cause harm, but they do not *intend* to cause the harm.²⁰⁴ A director with a bad faith motive, on the other hand, *intends* to cause harm.²⁰⁵ Instead of acting with indifference as to whether a negative result materializes, directors who act in bad faith intend to bring about the resulting harm.²⁰⁶ Therefore, reckless directors do not have a bad faith motive.

Without the requisite bad faith motive, recklessness falls within the protections of section 102(b)(7) as a breach of the duty of due care. Reckless directors do not breach the duty of good faith because they have no bad faith motive.²⁰⁷ Unless directors have a conflict of interest with the corporation or its shareholders, the directors do not breach the duty of loyalty.²⁰⁸ Therefore, the only fiduciary duty that a reckless director breaches is the duty of due care.²⁰⁹ Because recklessness is a breach of the duty of due care, section 102(b)(7) protects directors from personal liability arising from recklessness.²¹⁰

201. *See id.*

202. *See id.*; *see also Zirn*, 681 A.2d at 1061–62 (stating that the directors acted in good faith because they lacked any motive to deceive or harm the corporation or its shareholders).

203. *See, e.g., Cont'l Ins. Co. v. Dooley*, No. CIV.A.02C-07-065JOH, 2003 WL 1903771, at *6 (Del. Super. Ct. Feb. 4, 2003) (applying the definition of recklessness from DEL. P.J.I. CIV. § 5.9, which defines “recklessness” as the “knowing disregard of a substantial and unjustifiable risk”).

204. *See id.*

205. *See Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 (Del. 1993); *see also McGowan v. Ferro*, No. CIV.A-18672, 2004 WL 2340041, at *15–16 (Del. Ch. Oct. 8, 2004) (concluding that bad faith depends upon a defendant's ill will state of mind) (quoting *Desert Equities*, 624 A.2d at 1208 n.16).

206. *See Desert Equities*, 624 A.2d at 1208.

207. *See id.*

208. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

209. *See id.* (discussing the triad of fiduciary duties).

210. *See, e.g., Malpiede v. Townson*, 780 A.2d 1075, 1093–94 (Del. 2000) (noting that section 102(b)(7) protects directors from personal liability arising from all breaches of the duty of due care).

3. *The Disney, McCall, and Abbott Courts Erroneously Held that Directorial Recklessness Breaches the Duty of Good Faith*

The *Disney* chancellor ignored binding Delaware State Supreme Court precedent by holding that reckless conduct breaches a director's duty of good faith.²¹¹ The *Disney* chancellor's description of how the *Disney* directors abrogated their oversight responsibility is substantially similar to the Delaware State Supreme Court's description of the *Van Gorkom* directors' conduct.²¹² Directors from both cases relied almost entirely on the CEO's recommendation;²¹³ they made their decisions with little or no deliberation or factual information;²¹⁴ and they failed to satisfy their oversight roles by questioning or even evaluating a material corporate decision.²¹⁵ Despite the substantially similar directorial conduct, the Delaware State Supreme Court stated that there was no proof or allegations of a breach of the duty of good faith in *Van Gorkom*,²¹⁶ whereas the *Disney* chancellor opined that the *Disney* directors' conduct amounted to a breach of the duty of good faith.²¹⁷ Although the *Van Gorkom* decision set binding precedent, the *Disney* chancellor failed to distinguish the two cases or even mention *Van Gorkom*.²¹⁸

In addition to omitting any reference to *Van Gorkom*, the *Disney* chancellor also failed to discuss the Delaware State Supreme Court's other binding precedent established in *Desert Equities* and *Zirn*.²¹⁹ The *Desert Equities* court stated that a plaintiff cannot establish bad faith conduct without proving that the defendant had a dishonest purpose or ill will state of mind.²²⁰ The *Disney* chancellor did not evaluate the

211. See generally *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) (failing to discuss *Van Gorkom*).

212. Compare *Van Gorkom*, 488 A.2d 858, 869, 874 (Del. 1985), with *Disney*, 825 A.2d at 281–82, 287.

213. Compare *Van Gorkom*, 488 A.2d at 869, 893, with *Disney*, 825 A.2d at 281, 287.

214. Compare *Van Gorkom*, 488 A.2d at 874, with *Disney*, 825 A.2d at 281, 287.

215. Compare *Van Gorkom*, 488 A.2d at 869–70, with *Disney*, 825 A.2d at 281–82.

216. See *Van Gorkom*, 488 A.2d at 873 (finding no proof of bad faith conduct).

217. *Disney*, 825 A.2d at 286 (“A fair reading of the new complaint, in my opinion, gives rise to a reason to doubt whether the board's actions were taken honestly and in good faith . . .”).

218. See generally *id.* (failing to mention *Van Gorkom*).

219. See generally *id.* (failing to mention *Desert Equities* and *Zirn*).

220. See *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 (Del. 1993).

directors' state of mind or distinguish *Disney* from *Desert Equities*.²²¹ Moreover, the *Zirn* court stated that directors who act in bad faith have a pecuniary motive or some other motive for deceiving the shareholders.²²² Again, the *Disney* chancellor failed to evaluate the *Disney* directors' motives and failed to distinguish *Zirn*.²²³

Like the *Disney* chancellor, the Sixth Circuit in *McCall* and the Seventh Circuit in *Abbott* erroneously found reckless conduct sufficient to prove a breach of the duty of good faith.²²⁴ The *McCall* court cited the *Nagy* decision to support its basic premise that “[u]nder Delaware law, the duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer.”²²⁵

However, the Sixth Circuit's reliance on this *Nagy* quote suffers from four flaws. First, the quote is from a footnote in the factual background section of a chancery court opinion.²²⁶ If Delaware courts had accepted this legal concept, the concept would appear as a holding or at least as a finding in the legal discussion section of other courts' opinions. Second, the *Nagy* chancellor cited no authority to support his conclusion.²²⁷ Third, no Delaware court has cited *Nagy* for the proposition that directors' conscious disregard of their corporate duties breached the duty of good faith even though Delaware courts have faced this issue many times since *Nagy*.²²⁸ Fourth, the *Nagy* chancellor made this comment while explaining that the duty of good faith has no legal significance independent of the duty of loyalty.²²⁹ Because the *Abbott* court relied exclusively on *McCall* to conclude that recklessness breaches the duty of

221. See generally *Disney*, 825 A.2d 275 (failing to mention *Desert Equities* or evaluate the directors' state of mind).

222. See *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061–62 (Del. 1996).

223. See generally *Disney*, 825 A.2d 275 (failing to mention *Zirn* or evaluate the directors' motives).

224. See *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795, 811 (7th Cir. 2003); *McCall II*, 250 F.3d 997, 1001 (6th Cir. 2001).

225. *McCall II*, 250 F.3d at 1001.

226. See *Nagy v. Bistricher*, 770 A.2d 43, 48–49 (Del. Ch. 2000).

227. See *id.*

228. For example, *Disney* involved the same issue as addressed in the *Nagy* footnote, namely whether recklessness is sufficient to breach the duty of good faith, but the *Disney* chancellor did not cite to *Nagy*. See generally *Disney*, 825 A.2d 275.

229. *Nagy*, 770 A.2d at 49 n.2 (concluding that the duty of good faith is not independent from the duty of loyalty); see also *supra* Part II.C (discussing lack of consensus about whether section 102(b)(7) protects directors from personal liability arising from reckless conduct).

good faith *under Delaware jurisprudence*,²³⁰ the *Abbott* decision suffers from the same flaws as the *McCall* decision. Accordingly, the Sixth and Seventh Circuits erroneously interpreted Delaware law to hold that reckless conduct is sufficient to prove a breach of the duty of good faith.

Therefore, those courts that held that recklessness breaches the duty of good faith erred. The courts ignored binding Delaware precedent and misinterpreted Delaware law. Instead, they should have concluded that reckless conduct does not breach the duty of good faith because reckless directors do not intend to cause harm.

In sum, section 102(b)(7) protects directors from personal liability arising from recklessness because recklessness is a breach of the duty of due care instead of a breach of the duty of good faith. The Delaware State Supreme Court has clearly required a bad faith state of mind to establish that directors acted in bad faith.²³¹ Because reckless directors, by definition, lack a bad faith state of mind,²³² they do not act in bad faith. Therefore, recklessness does not breach the duty of good faith, but instead breaches only the duty of due care. As such, section 102(b)(7) protects directors from personal liability arising from recklessness.²³³

IV. CONCLUSION

Currently, confusion exists over whether section 102(b)(7) protects directors from personal liability arising from their own reckless conduct. When addressing this issue, the Delaware State Supreme Court should resolve the confusion by concluding that section 102(b)(7) protects directors from personal liability arising from recklessness for two reasons. First, recklessness is merely a subset of gross negligence in Delaware corporate jurisprudence. Because section 102(b)(7) unambiguously protects directors from personal liability arising from gross negligence, it concomitantly protects directors from liability arising from recklessness, which is a subset of gross negligence. Second,

230. See *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795, 811 (7th Cir. 2003) (relying solely on *McCall II* to reach the holding that recklessness breaches the duty of good faith).

231. See, e.g., *Zirn v. VLI Corp.*, 681 A.2d 1050, 1061–62 (Del. 1996) (stating that the directors acted in good faith because they lacked any motive to deceive or harm the corporation or its shareholders); *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 (Del. 1993) (stating that a claim of bad faith relies upon a person's state of mind).

232. See DEL. P.J.I. CIV. § 5.9; see also *Cont'l Ins. Co. v. Dooley*, No. CIV.A.02C-07-065JOH, 2003 WL 1903771, at *6 (Del. Super. Ct. Feb. 4, 2003) (applying the recklessness definition from DEL. P.J.I. CIV. § 5.9).

233. See *Malpiede v. Townson*, 780 A.2d 1075, 1093–94 (Del. 2000).

the Delaware State Supreme Court requires proof of an illicit motive or bad faith state of mind before concluding that conduct was carried out in bad faith. Because recklessness describes only conduct with no intent to cause harm, reckless directors lack the illicit motive or bad faith state of mind intrinsic to bad faith conduct. Therefore, the Delaware State Supreme Court should remain consistent with Delaware precedent by holding that section 102(b)(7) protects directors from personal liability arising from their own recklessness.

Protecting directors from personal liability arising from their recklessness may seem counterintuitive. However, it is important to remember that section 102(b)(7) protects directors only if shareholders first vote to amend the corporation's certificate of incorporation to include that protection. Further, the Delaware General Assembly specifically acted to provide this protection to directors where shareholders consent. If the General Assembly believes that the statute produces inequities, it can amend or repeal the statute at any time.

