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Symposium: Maryland's Director and Officer Liability Statute of 1988 — Introduction to a Symposium

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MARYLAND'S DIRECTOR AND OFFICER LIABILITY STATUTE OF 1988 — INTRODUCTION TO A SYMPOSIUM

Arnold Rochvarg†

In February 1988 Maryland's Governor Schaefer signed emergency legislation permitting a corporation incorporated in Maryland to include in its articles of incorporation a provision eliminating any liability of its directors and officers for money damages to the corporation or its stockholders unless the director or officer received an improper personal benefit or acted with active and deliberate dishonesty. In light of the controversy which surrounds limitation of director and officer liability statutes in general, and the Maryland statute in particular, this issue of the University of Baltimore Law Review contains a symposium on Maryland's Director and Officer Liability Statute of 1988.

The first article, "Let Stockholders Decide: The Origins of the Maryland Director and Officer Liability Statute of 1988" provides a useful introduction to the statute. Written by two practitioners, James J. Hanks, Jr. and Larry P. Scriggins, both members of the Maryland State Bar Association subcommittee which drafted the legislation, the article sets forth the justifications for the statute, its legislative history, and its operation. According to Messrs. Hanks and Scriggins, the justifications for the statute include: (1) a crisis in the availability and cost of director and officer (D&O) liability insurance; an increased willingness of the courts to second-guess business decisions of corporate management; and difficulty in attracting persons to serve on the boards of directors of public corporations because of the fear of liability. The article then re-

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1. Act of Feb. 18, 1988, ch. 3, 1988 Md. Laws 739. Unlike most legislation in Maryland which is signed by the Governor after the legislative session, this legislation was signed during the session and took effect immediately.


5. Id. at 235-37.

6. Id. at 237.
views in detail the legislative history of the statute. In 1987 legislation was proposed by the Bar Association Subcommittee to the Maryland Legislature as a "self executing" as opposed to a "charter option" statute. The original proposal limited liability not only to the corporation and its stockholders, but also to third parties. Its drafters maintained that the proposed legislation would (1) discourage Maryland corporations from reincorporating in other states,7 (2) encourage new incorporations in Maryland,8 and (3) add to the perception that Maryland is a state with a "favorable and responsible business climate."9 Although the Maryland Senate approved the bill, the House of Delegates Judiciary Committee gave it an unfavorable report primarily because it limited third-party actions and because it applied automatically to all Maryland corporations without any shareholder vote. The 1987 bill was subsequently defeated by the full House of Delegates.10

After some public outrage and threats from the expected beneficiaries of the defeated legislation to reincorporate outside of Maryland,11 the Bar Association Subcommittee drafted a new bill and presented it to the legislature. This bill did not automatically apply to all corporations; instead it required shareholder approval. Moreover, it did not limit liability to third parties. The 1988 bill did, however, add officers to the liability limitation, and expanded the range of improper conduct covered by the liability limitation. This 1988 bill won easy approval in both the Senate and House, and was signed by the Governor as emergency legislation on February 18, 1988.

In the final part of their article, Hanks and Scriggins discuss some of the effects of the new statute. They contend that the new statute is not a major expansion of shareholders' authority because sections of the Maryland General Corporation Law already permit shareholders to include provisions in the articles of incorporation regulating the functioning of their corporation.12 They next discuss the very broad range of conduct that can be protected from liability. The Maryland statute offers liability protection from more misconduct than does the comparable Delaware statute.13 For example, directors and officers of Maryland corporations can be absolved from liability even if their behavior constitutes intentional misconduct and self-dealing. Hanks and Scriggins justify the expansiveness of the Maryland statute as part of "the broad right of stockholders to decide for themselves the allocation of the economic risk of directors' or officers' misconduct."14 The broad language of the Mary-

7. Id. at 240.
8. Id.
9. Id.
10. Id. at 242.
11. Id. at 242-43.
12. Id. at 246.
13. Id. at 246-47.
14. Id. at 252.
land statute, they argue, will promote clarity and certainty.\textsuperscript{15}

In conclusion, Hanks and Scriggins maintain that the new statute will encourage competent persons to serve as directors and officers of Maryland corporations, and will keep Maryland corporations from re-incorporating elsewhere.\textsuperscript{16} In addition, the statute will not lead to self-dealing or other misconduct because directors and officers still face liability from lawsuits by third parties, and exposure to lawsuits for equitable relief by the corporation and its stockholders.\textsuperscript{17} In sum, they conclude it is a beneficial statute.

The second article, written by Professor Mark Sargent and entitled "Two Cheers for the Maryland Director and Officer Liability Statute," both praises and criticizes the statute. Professor Sargent believes that a statute which permits shareholders to limit liability for directors' or officers' breach of duty of care is a useful means of aligning the interests of shareholders and managers in public corporations. He is troubled, however, because the statute permits the corporation to limit liability for breaches of duty of loyalty.

Sargent reminds us that despite some rhetoric to the contrary, the imposition of money damages for breaches of duty of care is very rare, and the courts' commitment to the business judgment rule has been "un-bending."\textsuperscript{18} He believes this is the proper position for the courts. The unwillingness of courts to review business decisions is an "expression of the specialization of functions within the nexus of contracts encapsulated in the public corporation."\textsuperscript{19} Moreover, minimization of personal liability of directors for business decisions actually benefits shareholders because directors will not become excessively risk averse if they are protected from liability.\textsuperscript{20} Sargent argues that the courts' reluctance to impose personal liability for breach of duty of care is further justified by the fact that, unlike other professionals, directors cannot absorb the risk of personal liability into the cost of doing business by charging clients a price that reflects the risk.\textsuperscript{21}

Professor Sargent asks, however, why liability limitation statutes such as Maryland's are needed if courts are so reluctant to impose personal liability on directors for breaches of duty of care? Although one explanation is that these statutes exist because of a decline in the availability and affordability of D&O insurance, Sargent questions the existence of any fundamental change in the law of director liability that would justify any radical change in the cost or availability of D&O insur-

\begin{footnotes}
\item[15] Id. at 240.
\item[16] Id. at 252.
\item[17] Id.
\item[19] Id. at 288.
\item[20] Id.
\item[21] Id. at 289.
\end{footnotes}
Unlike other commentators, Sargent does not go so far as to argue that director and officer liability limitation statutes are really insurance industry protection statutes. He believes instead that the ultimate motivation for the enactment of such statutes is a general sense of uncertainty about the direction of the law among corporate management, their counsel and their insurers. The Maryland statute mitigates that uncertainty and helps ensure that the risk of liability for breaches of duty of care will continue to be insignificant. The Maryland statute is therefore worthy of some praise.

On the other hand, as Sargent points out, the Maryland statute differs from its Delaware counterpart by permitting limitation of liability for breaches of duty of loyalty. Although some have suggested that the distinction between duty of care and duty of loyalty is not a useful one, Sargent disagrees. He believes that judicial monitoring of duty of loyalty violations can be effective (as opposed to judicial monitoring of duty of care) because courts are capable of deciding issues of fairness and honesty, and because duty of loyalty cases often involve concealment of crucial facts. Because the Maryland statute treats duty of care and duty of loyalty identically, i.e., it permits the limitation of liability for breaches of both duties, Sargent concludes that the Maryland statute is "misguided" and finds the Delaware statute preferable.

Finally, Sargent discusses the implications of the statute for closely held corporations. He concludes that a statute limiting liability for breaches of duty of care in a closely held corporation is "largely innocuous." Loyalty issues, however, are important in close corporations. Eliminating liability for breaches of duty of loyalty in a closely held corporation therefore is undesirable. In sum, Sargent's review of the Maryland statute is a mixture of praise and criticism.

In his article, "Consent, Exit, and the Contract Model of the Corporation," Professor Dennis R. Honabach also gives the new legislation a mixed review. After reviewing various aspects of the statute, and pointing out that the statute will have no effect on a disgruntled shareholder who petitions a court to enjoin or rescind a board's decision, Honabach criticizes the drafters' justifications for the Maryland statute and finds all

22. Id. at 290-95.
23. Id.
24. Id. at 294.
26. Sargent, supra note 18, at 298.
27. Id. at 299.
28. Id.
29. Id. at 306.
30. Id. at 307.
of them flawed. He argues that although the compensation paid to directors and officers is insignificant relative to their risks, responsibilities, and potential liability, the amount of compensation is irrelevant and the imposition of liability is fair so long as they understand the risks involved before assuming the job.\textsuperscript{32} In response to the argument that absent a liability limitation statute fewer persons will be willing to serve on boards of directors, Honabach maintains that private agreements can offer sufficient protection, and, moreover, that there is no proof of a "talent" shortage.\textsuperscript{33} He disputes the argument that the statute will aid the economy of Maryland by reducing the incentive for Maryland corporations to reincorporate elsewhere, arguing that no nexus exists between the soundness of a state's economy and the number of corporations incorporated there.\textsuperscript{34} Moreover, because most Maryland corporations are small, local businesses, it is very unlikely that they would reincorporate elsewhere. Finally, Honabach questions the rationale that the new statute can be justified as empowering shareholders to fashion their own governance rules.\textsuperscript{35} For example, the new provisions do not in all instances permit the elimination of personal liability of directors and officers for money damages to the corporation and its stockholders, nor does it permit elimination of lawsuits seeking equitable relief. In sum, Honabach concludes that the Maryland statute cannot be supported by the reasons offered by its drafters.

Honabach does however, believe that in some aspects, the new statute can be supported by the contract theory of corporations. The contract theory views the corporation as a nexus of contracts.\textsuperscript{36} Where one of the parties to such contracts — shareholders — are for the most part capable of protecting their own interests. Under the contract theory, corporate governance rules are best determined not by legislatively or judicially imposed rules but through the private bargaining process among the corporate participants.\textsuperscript{37} Furthermore, because governance rules are public information, the price of a share of stock will reflect all information about the corporation, including its governance rules.\textsuperscript{38} In most instances, shareholders displeased with the rules adopted can sell their shares and invest in corporations with different rules. Therefore, a shareholder who retains his stock or purchases stock can be deemed to consent to whatever rules the state or the other shareholders adopt.

Even under the contract theory, Honabach sees problems with the Maryland statute because the Maryland statute applies to shareholders who cannot be deemed to have consented to its provisions.\textsuperscript{39} Although

\begin{thebibliography}{99}
\bibitem{32} Id. at 319.
\bibitem{33} Id.
\bibitem{34} Id. at 321-24.
\bibitem{35} Id. at 324-28.
\bibitem{36} Id. at 333.
\bibitem{37} Id. at 334.
\bibitem{38} Id.
\bibitem{39} Id. at 337.
\end{thebibliography}
sometimes a shareholder will be deemed to have consented to the governance rules through his purchase or retention of stock, Honabach maintains that a shareholder cannot be deemed to have consented to certain fundamental unforeseeable changes in the governance rules such as the elimination of liability for breach of duty of care and duty of loyalty. Moreover, a shareholder who continues to hold his shares can be deemed to consent only if he could otherwise sell his shares. But this is not true with respect to shareholders in closely held corporations. Thus, even under the contract theory of corporations, the statute should not be applied to closely held corporations. Honabach suggests that the statute be amended so that it applies only to shareholders who consent to the new governance rules. He suggests that one solution would be to grant the appraisal remedy to those dissenting shareholders whose corporations adopt a liability limitation provision pursuant to the statute.

In their article “Free at Last? The Contractual Theory of the Corporation and the New Maryland Officer-Director Liability Provisions,” Professors Henry N. Butler and Larry E. Ribstein also discuss the contract theory of corporations under the Maryland statute and, although they too express reservations about it under the contract theory, they believe that granting more contractual freedom to corporate participants will help solve the director liability problem. They therefore suggest that legislatures fully adopt the contract theory of corporations and give free rein to private parties to draft managerial contracts. The costs of judicially enforced fiduciary duties may far exceed the benefits of controlling managerial misconduct and, thus, it may make more economic sense for shareholders to contract away completely the right to sue directors for breaches of fiduciary duty. Moreover, judicially imposed governance rules may cause management to act more conservatively than shareholders desire. Judicial second-guessing of corporate decisions also creates significant error cost. In any event, according to Butler and Ribstein, the proper remedy is for the parties themselves to privately fashion their own rules. The fact that the parties bear the costs themselves creates the greatest incentive to adopt efficient rules. Private ordering, not mandatory legal rules, Butler and Ribstein maintain, leads to optimal corporate arrangements.

Butler and Ribstein praise the statute for permitting shareholders to

40. Id. at 339-40.
41. Id. at 344.
42. Id. at 346-51.
44. Id.
45. Id. at 358.
46. Id. at 356.
47. Id. at 357.
48. Id. at 358.
limit liability for breaches of duty of loyalty as well as breaches of duty of care. They criticize the statute, however, for denying shareholders the right to limit liability for acts involving improper personal benefit or acts which constitute active and deliberate dishonesty. These exceptions are criticized not only because they create ambiguities in the statute, but also because shareholders should be given the option to contract away all liability of directors and officers to them if the shareholders so choose. Butler and Ribstein are also troubled that the statute only applies to lawsuits seeking money damages, but not equitable relief. They believe that shareholders should be permitted to waive equitable claims as well. To the extent the statute permits private ordering of rights, it is desirable; however Butler and Ribstein conclude that the Maryland statute falls short of completely permitting private ordering of such rights.

To the extent the Maryland statute is consistent with the contract theory of corporations, it is criticized by Professor Zwier in his article “Is the Maryland Director-Officer Liability Statute Based on a Male-Oriented Ethical Model?”, Zwier prefers the trust theory of corporations — where managers have an obligation to act selflessly for the benefit of others, especially those less able to protect themselves. Rather than the self-interested, adversarial bargaining process which is the crux of the contract theory, the trust theory is based on the premise that the parties are not adversarial, but seek to help each other. Zwier argues that the contract theory is not appropriate to corporate governance rules because it presumes relationships of roughly equal power between persons who are fully informed and aware of all possible risks at the beginning of the relationship. In the corporate setting, however, Zwier believes that management is in a far superior position because it controls access to information and the day-to-day operations of the corporation. The typical shareholder is a passive shareholder and depends on management much like a child depends on a parent. Therefore, a model emphasizing care and loyalty, rather than private bargaining, is appropriate. According to Zweir, the Maryland statute’s elimination of the duty of care and duty of loyalty will be detrimental to shareholders, especially those with little business experience and those occupying minority positions in closely held corporations. By validating an adversarial relationship between management and shareholders, the statute will also have a negative impact on the working atmosphere for management. Insofar as the

49. Id. at 362.
50. Id. at 363.
51. Id. at 363-64.
52. Zwier, Is the Maryland Director and Officer Liability Statute Based on a Male-Oriented Ethical Model?, 18 U. BALT. L. REV. 368, 369 (1989).
53. Id. at 370.
54. Id. at 372.
55. Id. at 370.
56. Id. at 379.
57. Id.
Maryland statute reflects a contract rather than a trust theory of corporations, Zwier concludes it is undesirable.

The final article in the Symposium, "Nonprofit Corporations and Maryland's Director and Officer Liability Statute: A Study of the Mechanics of Maryland's Statutory Corporate Law," is a student comment on the application of the new liability limitation statute to nonprofit corporations. After analyzing certain ambiguities and uncertainties in the statute's language and legislative history, the comment concludes that although the statute applies to nonprofit corporations, its application to those corporations may not be desirable because of the incompatibility of the contract theory with nonprofit corporations. The comment suggests that the legislature should amend the statute so that it does not apply to nonprofit corporations.

* * * *

This Symposium provides a careful and critical analysis of the Maryland Director and Officer Liability Statute of 1988. Only the drafters of the legislation indicate unqualified support for it. Each of the other authors express reservations.

Certain issues seem especially troublesome. Legislation aimed at encouraging qualified persons to serve on boards of directors and aimed at encouraging aggressive business decisions is laudable. The Maryland statute, however, does not entirely accomplish these goals; instead it leaves directors and officers exposed to lawsuits from third parties and still permits shareholder actions for equitable relief. Although the payment of money damages in most cases can be eliminated by a provision in the articles of incorporation, the expense, loss of time and possible damage to reputation which may result from third party actions or injunctive actions will still act as a deterrent to service by some qualified persons. If it is true as the statute's defenders suggest that the new statute will not alter management decisionmaking and behavior, it is unclear whether the statute serves any useful purpose.

One impetus to the legislation was the large increases in premiums for D&O insurance. It is far from clear, however, whether these increases were justified, and whether the statute will lead to a rollback of premiums. Very few cases seeking money damages from directors or officers are successful. Unlike, for example, medical malpractice insurance where the insurance industry can point to recent large jury verdicts against insureds as a justification for increased premiums, there has not

59. Id. at 399-400.
60. Hanks & Scriggins, supra note 4, at 237.
61. Id. at 252.
62. Id. at 236-37.
been a similar experience with D&O insurance. The problem may be with the insurance industry, not with the corporate governance rules.

Concern is also caused by the statute’s exceptions denying to the corporation the ability to limit liability if a director or officer received an improper personal benefit, and if a director or officer acted with active and deliberate dishonesty. The vagueness and ambiguity of these two exceptions will likely give rise to much litigation. Eschewing the exceptions and language of the Delaware statute in Maryland’s attempt to “out-Delaware Delaware” deprives corporate counsel and Maryland courts from reliance on what will most likely be the largest body of case law on this issue, i.e., Delaware’s.63

Although it is difficult to argue with the proposition that individuals should be able to bargain for the terms of their own relationships, it is not certain that this Maryland statute expands the ability of shareholders and management to define their relationship beyond what the Maryland statute provided before the new legislation.64 Even before this new statute, courts had not interfered in corporate matters in circumstances where the parties had defined their own rights and liabilities. Nor did the courts suggest any interest in doing so in the future.

Much was made in the Maryland legislature about the undesirability of a self-executing statute. The original 1987 legislation which was self-executing was defeated. Most commentators believe, however, that it makes no difference whether a limitation of liability statute is self-executing or not because shareholders, when given the choice, overwhelmingly approve limitation of liability provisions because they invariably approve almost all proposals requested by management.65 The legislative battle over the self-executing nature of the 1987 proposal, therefore, was most likely irrelevant in terms of affording shareholders additional protection.

It should be remembered that liability limitation statutes are enacted not by persons who have decided to adopt a particular economic or ethical model, but rather by legislators and governors who are, above all else, politicians. Therefore Maryland’s liability limitation statute should also be looked at from a political policy making point of view. Under this approach, certain issues create interest. What is the proper reaction of a legislature to threats by prominent local businesses to reincorporate in other states, especially when considering that a business’ place of incorporation, although perhaps having an impact on certain special interest

63. The desirability of being able to rely on precedents from other states with comparable statutes was acknowledged by the drafters of the original legislation in 1987. Id. at 237-38. Curiously, the states that the drafters looked to for guidance were Louisiana and Indiana. Id.
64. Hanks & Scruggins, supra note 4, at 246.
65. Honabach, supra note 36, at 331-32. There has been a slight trend away from shareholder passivity by institutional investors, however, when asked to approve certain anti-takeover defenses suggested by management.
groups within that state,\textsuperscript{66} has a minimal impact on the general condition of the state's economy? What quantum and quality of evidence should the legislature require in deciding whether a director and officer liability "crisis" exists? If no crisis exists, why has this been used as a justification for the statute? What was the "emergency" that convinced the legislature and the Governor that unlike most legislation, this legislation should take effect immediately?\textsuperscript{67}

This legislation also presents the interesting question of the proper role of local bar associations in promoting legislation. Is there any way to determine whether bar association subcommittees are acting as advocates of the public interest or as advocates of the interests of particular clients? Should full disclosure of client lists be required of those who serve on such bar association subcommittees?

The Maryland Director and Officer Liability Statute of 1988 was portrayed to the legislature and the public as crucial to the economic well-being of the state. There is some question whether this is true. Perhaps the Maryland liability limitation statute can be best understood as a symbol that Maryland will cooperate with business and its advocates so that jobs are kept in Maryland. Even though the liability limitation statute itself may not have a direct impact on jobs in Maryland, the symbolic value it carries may bear an indirect impact. Viewed from this perspective, the gesture of enacting this statute may be more important than its actual operation.
