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Mark A. Sargent

University of Baltimore School of Law

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TWO CHEERS FOR THE MARYLAND DIRECTOR AND OFFICER LIABILITY STATUTE

Mark A. Sargent†

I. INTRODUCTION

In 1986 the Delaware legislature unveiled a new weapon designed to protect Delaware's dominant position in the market for corporate franchises: a statute authorizing charter provisions that limit or eliminate the personal liability of directors for certain breaches of their fiduciary obligations. Delaware was not the first state to enact new means of protecting corporate managers from liability, but its decision to deploy its own version of this state-of-the-art legal technology signaled its determination to remain the corporate home for thousands of corporations — particularly public corporations — with their principal places of business located elsewhere. Delaware's salvo triggered a multistate "arms race,

† B.A., 1973, Wesleyan University; M.A., 1975, Cornell University; J.D., 1978, Cornell Law School; Professor of Law, University of Maryland School of Law. I would like to thank Dennis Honabach, Cyril Moscow, Arnold Rochvarg and Marc Steinberg for their comments, and Mary Sue Greisman for her research assistance. Apologies to E.M. Forster for the title. E. FORSTER, TWO CHEERS FOR DEMOCRACY (1951).


3. Delaware's impact on the market for corporate franchises has been a matter of in-
as state after state hastened to enact its own version of the Delaware statute or to find even more radical means of protecting corporate man­
gagers from liability to the corporation and its shareholders.\(^4\)

This arms race resulted, of course, from the fear that corporations
organized under the laws of other states would reincorporate in Dela­
ware to take advantage of the increased level of protection provided by
the new law.\(^5\) This phenomenon has been characterized by one commen­
tator as “the race to the bottom — the second lap.”\(^6\) Whether one agrees
with the highly pejorative connotations of that label, it is fair to say that
Delaware has forced the issue, causing many states to respond precip­
itously to a perceived “crisis” in managerial liabilities that is obscure in

\(^4\) For a survey of those legislative responses, see Hanks, Evaluating Recent State Leg­
islation on Director and Officer Liability Limitation and Indemnification, 43 Bus.

\(^5\) See, for example, the comments of two of the drafters of expanded indemnification
provisions under the Wisconsin statute (Wis. STAT. ANN. §§ 180.044, 180.048
(West Supp. 1988))：“The [drafting] committee . . . believes that if Wisconsin does
not act promptly, it risks losing the corporate domiciles, and perhaps the headquar­
ters and executive personnel, of many of its major corporations to states which have
already acted in response to director and officer liability concerns.” Ware & Wil­
liams, Director and Officer Liability, A Concern of Wisconsin Lawyers and Corpora­
tions,Wis. BAR BULL., Dec. 1986, at 9, 12. A proponent of new corporate liability
legislation for Michigan argued that “Michigan does not want corporations leaving
the state and reincorporating in states, like Delaware, with more advantageous lia­
bility, indemnification, and insurance statutes.” Comment, Director Liability: Michi­
gan’s Response to Smith v. Van Gorkom, 33 WAYNE L. REV. 1039, 1065
(1987). The fear that reincorporations might rise in Delaware as a result of the
enactment of its new liability-limiting legislation was not unfounded. See Compa­

nies Gear Up to Take Advantage of Del. Break on Liability, Baltimore Sun, Jan. 16,
1987, at 2F, col. 4 (“[T]he number of businesses newly incorporating in Delaware
has been growing somewhat more quickly than usual since the new law went into
effect.”). Id. at col. 5.

\(^6\) Hazen, Corporate Directors’ Accountability: The Race to the Bottom — The Second
ments, see Steinberg, The Evisceration of the Duty of Care, 42 Sw. L.J. 919
(1988).
its origins and uncertain in its effects. One of the few states where the legislature at least initially resisted this stampede was Maryland.

In the Spring of 1987, a bill intended to limit the liability of the directors of Maryland corporations was introduced in the Maryland legislature. This bill departed substantially from the Delaware model, and soon encountered serious opposition. The fate of this bill would offer an interesting case study in the political economy of corporate legislation, but suffice it to say that the 1987 bill engendered great resistance and died in the House Judiciary Committee.

This result produced chagrin in some Maryland business and legal circles and led to a renewed effort in 1988 to enact corporate liability-limiting legislation. This time the effort succeeded, in part because the 1988 legislation bore a greater resemblance to the well-established

7. See infra text accompanying notes 73-76.
8. Md. Senate Bill No. 223 (1987); Md. House Bill No. 242 (1987); see also Sia, Liability Shield Pushed for Company Directors, Baltimore Sun, Feb. 5, 1987, at 12C, col. 2. The drafters of the bill obviously were worried that the failure to enact some form of liability-limiting legislation would lead to the reincorporation of Maryland corporations in Delaware. See Glasgow, Changes in Liability Laws to Shield Directors Called Critical to Companies, Baltimore Sun, Feb. 11, 1987, at 1G, col. 4. One of the proponents of the bill "said he has made a list of a dozen companies that... have announced their intention to reincorporate in Delaware." Id. at 4G, col. 6.
9. For example, the legislation proposed in the 1987 bill would have created a mandatory limit on liability for directors with no requirement of shareholder approval. The bill also omitted a broad exclusion from coverage of the limitation for duty of loyalty violations. See Md. Senate Bill No. 223 (1987); Md. House Bill No. 242 (1987); cf. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988).
10. See Sia, Judiciary Panel is Skeptical of Liability Package, Baltimore Sun, Feb. 18, 1988, at 11B, col. 5.
14. See Zorzi, Corporate Liability Curb Signed, Baltimore Sun, Feb. 19, 1988, at 1F, col. 6. The legislation enacted was Senate Bill 223 (1987), adding a new MD. CORPS. & ASS'NS CODE ANN. § 2-405.2 (Supp. 1988), and amending MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b), 2-405.1(c), and 2-418(b), (e)(1), (f), (g), (k) (Supp. 1988). This legislation not only created a limitation on liability for corporate managers, it liberalized the Maryland statute's indemnification provisions. This article will not discuss these new indemnification provisions in detail. For more detailed discussion, see Honabach, Consent, Exit, and the Contract Model of the Corporation—A Commentary on Maryland's New Director and Officer Liability Limiting and Indemnification Legislation, 18 U. BALTIMORE L. REV. 310, 328-31 (1989) [hereinafter Honabach, Consent and Exit]. For discussion of Delaware's comparable provisions, see Veasey, Finkelstein & Bigler, Delaware Supports Directors With a Three-Legged Stool of Limited Liability, Indemnification, and Insurance, 42 BUS. LAW. 399, 404-17 (1987).
Delaware model. There are, however, some very important differences between the two pieces of legislation.

New section 2-405.2 of the Corporations and Associations Article of the Maryland Annotated Code resembles section 102(b)(7) of the Delaware General Corporation Law insofar as they are both charter-option statutes that enable the shareholders to adopt charter provisions limiting the personal liability of directors to the corporation or its shareholders. The Maryland statute departs from the Delaware model, however, by authorizing limitations on the liability of officers as well as of directors. More importantly, the Maryland statute does not track the Delaware statute's broad exclusion of breaches of the duty of loyalty from coverage of the liability limitation. The Maryland statute allows the liability limitation to apply to breaches of that duty except in cases of receipt of “an

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15. This section provides that:

(a) Effect of corporate charter — The charter of the corporation may include any provision expanding or limiting the liability of its directors and officers to the corporation or its stockholders for money damages but may not include any provision which restricts or limits the liability of its directors or officers to the corporation or its stockholders:

(1) To the extent that it is proved that the person actually received an improper benefit or profit in money, property, or services, for the amount of the benefit or profit in money, property, or services actually received;

(2) To the extent that a judgment or other final adjudication adverse to the person is entered in a proceeding based on a finding in the proceeding that the person’s action, or failure to act, was the result of active and deliberate dishonesty and was material to the cause of action adjudicated in the proceeding.


Subsection (b) of section 2-405.2 provides further that the section does not apply to actions brought against directors or officers of specified financial institutions. Id. § 2-405.2(b). This provision is obviously a concession to sensitivities born of the recent scandals in Maryland’s savings and loan industry. See Batoff, Maryland’s Savings and Loan Crisis of 1985: The Resulting Legislative Reform, 16 U. Balt. L. Rev. 403 (1987). Subsection (c) of section 2-405.2 provides that “[t]his section may not be construed to affect the liability of a person in any capacity other than the person’s capacity as a director or officer.” Md. Corps. & Ass’ns Code Ann. § 2-405.2(c) (Supp. 1988).

16. Section 102(b)(7) of Title 8 of the Delaware Annotated Code allows shareholders to adopt:

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. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

improper benefit or profit in money, property, or services” 17 or in cases of “active and deliberate dishonesty.” 18 The liability-limiting effect of the Maryland statute is thus broader than that of the Delaware statute insofar as it applies to some breaches of the duty of loyalty as well as to breaches of the duty of care.

The Maryland statute is naturally of interest as a departure in Maryland corporate law, but its significance transcends that narrow concern. Like all of the liability legislation enacted in recent years, it raises important questions about the role of liability rules in corporate governance. 19 Furthermore, the difference between Delaware’s and Maryland’s statutory treatment of duty of loyalty violations requires rethinking the traditional distinction between that duty and the duty of care. Any evaluation of the Maryland statute necessitates consideration of all of these fundamental issues.

This article’s analysis of those issues will lead to the conclusion that the Maryland statute deserves some praise. The statutory authorization of a limitation on liability for breaches of the duty of care is not inimical to shareholder welfare. It actually represents a useful means of aligning the interests of the shareholders and the managers of public corporations. The statute deserves something less than three cheers, however, because its failure to distinguish broadly between the duties of care and loyalty for purposes of the limitation on liability constitutes an unjustifiable repudiation of a well-established and useful distinction.

Part II of this article begins the analysis by explaining how the traditional function of the duty of care as an aspirational rather than a liability-generating rule maximizes shareholder welfare, and how that traditional function is reinforced by the new statute’s limitation on liability for breach of the duty of care. The discussion focuses primarily on the duties and liabilities of corporate directors, with particular emphasis

18. Id. § 2-405.2(a)(2). The Maryland statute also contains other specific exclusions from coverage of the liability limitation. For discussion, see Honabach, Consent and Exit, supra note 14, at 315.
II. PROTECTING DIRECTORS AGAINST LIABILITY FOR BREACH OF THE DUTY OF CARE: REINFORCING THE TRADITIONAL APPROACH

A. The Rhetoric of Care and the Realities of Directorial Liability

Corporation statutes typically impose a duty of care upon corporate directors, although they tend not to use that term. Section 8.30(a) of the Revised Model Business Corporation Act, for example, states that a "director shall discharge his duties as a director . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances. . . ."20 Section 2-405.1 of the Maryland Corporation statute is quite similar.21 By defining the directors' obligation to the corporation in terms of a standard of care and phrasing that standard in the language of ordinary negligence, the statutes suggest that directors routinely face personal liability for breach of the duty of care.

The converse, of course, is closer to the truth. Corporate directors do not routinely or even frequently incur personal liability for breach of the duty of care.22 Such liability is, quite simply, very rare.23 As explained below, the courts have used a few substantive doctrines and procedural devices to minimize the risks of liability for breach of the duty of care.

20. 2 MODEL BUSINESS CORP. ACT ANN. § 8.30(a) (3d ed. 1985); see also CAL. CORP. CODE § 309(a) (1977 & West Supp. 1988) ("[W]ith such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.").

21. MD. CORPS. & ASS'NS CODE ANN. § 2-405.1 (1985). This section provides:

(a) In general. — A director shall perform his duties as a director, including his duties as a member of a committee of the board on which he serves:

(1) In good faith;

(2) In a manner he reasonably believes to be in the interest of the corporation; and

(3) With the care that an ordinarily prudent person in a like position would use under similar circumstances.

Id.

22. This point has been made so many times that copious citation is unnecessary. But see Lee, supra note 19, at 239-40.

23. See infra notes 28-29 and accompanying text.
care while preserving the rhetoric of care.24 This apparent tension between the statutory articulation of a standard and the lack of any substantial risk of liability for failing to meet that standard has led some commentators to describe the duty of care as having a "bark worse than its bite,"25 leading a "twilight existence,"26 or, in an oft-quoted phrase, resembling the shearing of the pig: "much squealing, little wool."27

Whether one regards this state of affairs with alarm or approval, it remains indisputable that the corporation statutes' unequivocal proclamation of the duty of care has produced few cases holding directors liable for breach of the duty of care. The short list of such cases compiled by Professor Bishop in 196828 has not been swelled by an influx of new cases,29 despite the growing sensitivity in the last two decades to the general problem of corporate governance and to the special problem of how corporate managers should respond to hostile takeovers.30 The traditional judicial reticence toward duty of care claims persists, and the courts remain reluctant to assign personal liability to directors except in cases where there is at least an undertone of breach of the duty of loyalty.31 This was true even in Smith v. Van Gorkom,32 the now famous

24. See infra notes 45-55 and accompanying text.
25. Lee, supra note 19, at 240.
28. Id. at 1099-1100 (citing New York Credit Men's Adjustment Bureau v. Weiss, 305 N.Y. 1, 110 N.E.2d 397 (1953); Syracuse Television, Inc. v. Channel 9, Syracuse, Inc., 51 Misc. 2d 188, 273 N.Y.S.2d 16 (Sup. Ct. 1966); Clayton v. Farish, 191 Misc. 136, 73 N.Y.S.2d 727 (Sup. Ct. 1947); Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634 (1966)).

Coffee has commented that measuring the importance of the duty of care by listing reported decisions underestimates the role of settlements. Coffee, Litigation and Corporate Governance, supra note 2, at 796. He makes this point in order to emphasize that the duty of care is not a "nullity," and that it has an important "educational and socializing effect." Coffee is surely correct in this estimation of the value of the duty of care, as will be argued below. See infra text accompanying notes 43, 90-91. His observation that there must be some undetermined number of settlements of duty of care claims, however, does not negate the basic point that the duty of care has not been a major liability generating rule. It is merely consistent with his persuasive argument that a largely aspirational or precatory duty of care still has an important "socializing and exhortative impact." Coffee, Litigation and Corporate Governance, supra note 2, at 798.

30. The immense literature on this topic is summarized and evaluated in R. Gilson, The Law and Finance of Corporate Acquisitions 696-815 (1986).
31. This phenomenon has been noted by several commentators. See, e.g., R. Clark, Corporate Law 126 (1986) ("[T]he facts suggest that the directors were actually
case which seemed to some to be such an anomalous threat to the traditional equilibrium.\textsuperscript{33}

The means by which the courts have maintained the traditional equilibrium between the rhetoric of care and limited actual liability are no mystery. A principal means has been the articulation of the standard in relatively forgiving terms.\textsuperscript{34} Statutory provisions such as section 8.30 of the Revised Model Business Corporation Act allow the courts substantial flexibility and opportunity for leniency by defining the standard in terms of an "ordinarily prudent person in a like position under similar circumstances."\textsuperscript{35} The Delaware courts have pushed this tendency even further by defining the standard of care applicable to directors of Delaware corporations in terms of gross negligence.\textsuperscript{36}

The key to the equilibrium, however, has been the business judgment rule.\textsuperscript{37} The precise verbal formulation of that rule varies from ju-

\textsuperscript{32} 488 A.2d 858 (Del. 1985). This decision is also sometimes referred to as the "Trans Union" case, after the corporation involved in the case. The Delaware Supreme Court held the directors of a public corporation liable for approving the acquisition of the corporation, albeit at a price substantially higher than the market price, because they did not adequately consider the possibility of better offers from other bidders. \textit{Id.} at 879-80, 884.

\textsuperscript{33} See, e.g., Fischel, \textit{The Business Judgment Rule and the Trans Union Case}, 40 \textit{Bus. Law.} 1437, 1455 (1985) ("[O]ne of the worst decisions in the history of corporate law. . . "); Veasey & Seitz, \textit{The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project — A Strange Porridge}, 63 \textit{Tex. L. Rev.} 1483 (1985); but see Pickett, \textit{An Explanation of Trans Union to \textquotedblleft Henny-Penny\textquotedblright and Her Friends}, 10 \textit{Del. J. Corp. L.} 451, 452 (1985) (Trans Union was "not only correctly decided, but is a sound precedent, reaffirming the basic obligation of due care owed by corporate directors to stockholders.").

\textsuperscript{34} For a summary of historical and state-to-state variations in the articulation of the standard of care, see Special Project: Director and Officer Liability, \textit{An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule}, 40 \textit{Vand. L. Rev.} 605, 606-13 (1987).

\textsuperscript{35} 2 \textit{Model Business Corp. Act Ann.} § 8.30(a) (3d ed. 1985).

\textsuperscript{36} See Smith \textit{v.} Van Gorkom, 488 A.2d 858, 873 (Del. 1985); Aronson \textit{v.} Lewis, 473 A.2d 805, 812 (Del. 1984).

\textsuperscript{37} For discussion of the business judgment rule, see generally E. Brodsky & M. Adamski, \textit{Law of Corporate Officers and Directors: Rights, Duties and Liabilities} ch. 2 (1984); R. Clark, \textit{Corporate Law} § 3.4 (1986); H. Henn & J. Alexander, \textit{Laws of Corporations and Other Enterprises} § 242 (3d ed. 1983). It is sometimes said that there is a distinction between the "business judgment rule" which shields directors from personal liability, and the "business judgment doctrine" which shields the directors' decision from judicial re-
risdiction to jurisdiction, and there are some substantive differences among the various versions of the rule, but the essence of the rule is clear. The business judgment rule, in effect, protects directors from personal liability for mistakes of business judgment so long as no conflict of interest was present and the director's decision was intended to serve the business purposes of the corporation. The rule thus shields a vast range of directorial decisions from meaningful judicial review and effectively insulates directors from personal liability for breach of the duty of care. The courts' commitment to the business judgment rule over the years has been unbending. Only recently has the enormous pressure of a volatile market for corporate control on traditional canons of corporate governance produced any equivocation, and that equivocation has been modest. Some courts, following Delaware's lead, have attached a "procedural precondition" to the application of the rule, requiring directors to show that they followed appropriate procedures in informing themselves of the merits of the business decision. As a practical matter, this precondition requires directors, particularly those confronting control transactions, to engage in the ritual of consulting lawyers, investment bankers, appraisers and other experts in a deliberate and highly structured manner. The ultimate value of constructing these elegant and expensive paper trails is a matter of dispute, but they have become in many cases an essential first step toward invoking the business judgment rule. Once that rule is successfully invoked, directors can enjoy the traditional level of protection from liability for mistakes in business judgment. In short, recent judi-

view. This distinction is articulated in Hinsey, Business Judgment and the American Law Institute's Corporate Governance Project: the Rule, the Doctrine and the Reality, 52 Geo. Wash. L. Rev. 609 (1984), but has not been developed in the case law. It may be, however, that the enactment of a statutory limit on liability in effect codifies the distinction. See Honabach, All that Glitters, supra note 2, at 467 n.206.

38. Those differences are summarized in Special Project, supra note 34, at 606-13.


40. Id. The principal case so holding is Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985).


42. In the takeover context, however, a target board's defensive actions will be subjected to a "proportionality" test that constitutes an "intermediate" standard of review somewhere between the traditional business judgment approach and a more radical requirement that the board prove the "intrinsic fairness" of its actions. See Gilson & Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Proportionality Review, 44 Bus. Law. 247 (1989). This development in Delaware law is probably of greater significance than Van Gorkom's creation of a procedural precondition to application of the business judgment rule. As explained in the text, that precondition can be satisfied through the implementation of procedures that by now have become routine, albeit expensive. The proportionality test, in contrast, requires the board to prove that its defensive tactics were "reasonable in relation to the threat posed" by a hostile offer. Unocal v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985). This requirement raises serious interpretive problems that render the future course of Delaware law unclear and create substantial uncertainty for those structuring defensive tactics. The development of the proportionality test, therefore, represents a more substantial departure from the tradition of deference to business judgment than does Van Gorkom's procedural precondition. It is unlikely,
cial decisions may have generated new levels of anxiety, but the directors’ duty of care is still largely aspirational or precatory in character and generally does not function as a routine basis for liability. 43

This state of affairs has received its share of criticism. The impact of the business judgment rule on the duty of care has seemed to some to be yet another example of how state corporate law has avoided its obligation to protect shareholders, particularly shareholders in public corporations, from the negligence and ineptitude of corporate directors who do not direct. 44 The flexible and forgiving standard of care, coupled with the barrier posed by the business judgment rule, figure in this perspective as yet more crumbled milestones on the race to the bottom. A closer look, however, leads to the conclusion that these long-standing limitations are actually in the best interests of shareholders.

B. A Defense of the Traditional Limits on Directorial Liability

The legal rules that virtually foreclose personal liability for directorial breach of the duty of care are sometimes justified in terms of the inherent limitations of the courts’ perspective and experience. 45 Judicial reluctance to second-guess business decisions that the judge would not be

43. Characterizing the duty of care as “aspirational” or “precatory” does not mean that the duty is unimportant or that references to it should be eliminated from the corporate codes. Scott has argued that the duty should be abolished. See Scott, supra note 2, at 932-37. Although Scott’s argument that the duty of care should not be a basis for routine negligence liability is sound, Coffee’s argument that some affirmative articulation of the duty is still necessary is also valid. See Coffee, Litigation and Corporate Governance, supra note 2, at 798; see also supra note 29. As Coffee points out, the existence of a statutory limit on liability may strike the balance between the need for an aspirational body of law that communicates appropriate standards of behavior to the relevant audience and the need to avoid exposing “corporate officials to a threat of liability that may either chill the movement toward independent directors or produce excessive risk aversion.” Coffee, Litigation and Corporate Governance, supra note 2, at 799. In addition, breaches of the duty of care can be a basis for injunctive or equitable relief, so the effect of the duty is not entirely aspirational. This fact alone undermines any argument that the duty should be abolished.

44. The classic statement of this position is William O. Douglas’ famous article, Directors Who do Not Direct, 47 HARV. L. REV. 1305 (1934). Among the inheritors of this perspective are Hazen, Schwartz and Steinberg. See Hazen, supra note 6, at 179 (“Because directors manage the shareholders’ investment, they should be accountable for their misdeeds. The age-old analogy of corporate directors to trustees is not misplaced.”); Schwartz, In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley, 71 CORNELL L. REV. 322, 323 (1986) (“Liability rules, enforced by shareholder litigation, are theoretically sound and profoundly affect the conduct of corporate managers. . . . ”); Steinberg, supra note 6, at 923-27 (criticizing the Maryland and Delaware statutes for their “evisceration” of the duty of care).

45. See, e.g., Special Project, supra note 34, at 616 (“[C]ourts have neither the ability nor the desire to substitute their judgment for that of more experienced professionals.”).
competent to make reflects a becoming modesty. Although plausible, this justification does not explain why courts should be unwilling to review managerial decisions when they are regularly willing to second-guess, through reliance on expert testimony, the decisions of physicians, industrial designers and other professionals engaged in complex, technical and sophisticated decision-making. The justification must lie elsewhere.

To a large extent, these liability limiting rules are an expression of the specialization of functions within the nexus of contracts encapsulated in the public corporation. Shareholders are both the residual claimants and the primary risk-bearers within the corporation. Directors of public corporations provide a specialized kind of managerial service which public shareholders are not able to provide. A substantial amount of deference by both shareholders and the courts to the decisions made by directors is thus wholly appropriate. This assumption does not ignore the existence of agency costs or the need for aspirational statements of fiduciary principles as structural elements in the relationship between shareholders and directors of public corporations; it merely suggests that the risk of liability for negligence, as distinct from disloyalty, should not be routine.

Minimization of the directors' risk of personal liability for negligence, furthermore, is actually in the shareholders' interest. Shareholders in public corporations, generally speaking, are willing to accept a certain quantum of firm-specific risk, including the risk that managers' performances will be suboptimal, because their access to the capital markets allows them to diversify their firm-specific risk. From an ex ante perspective, therefore, shareholders would prefer that directors approve at least some relatively risky projects. Directors, on the other hand, tend to be risk averse, since responsibility for the poor outcome of a risky project may be laid at their door, regardless of the reason for the poor outcome, while the net gains of a positive outcome will be appropriated by the residual claimant, the shareholder. This tendency toward risk aversion, which is not in the shareholders' interest, would be exacerbated by legal rules that routinely impose liability for breach of the duty of care. The net effect would be a transfer of risk from more efficient to less efficient risk-bearers.

Rules that reduce directors' potential liability for breach of the duty of care, furthermore, are consistent with rules that facilitate, or at least do not discourage, negligence actions against outside contractors such as

46. The literature on the modern theory of the firm from which this assumption is derived is extensive. For citations to part of that literature, see Honabach, All That Glitters, supra note 2, at 439 n.25.
47. This argument is derived largely from Fischel & Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 CORNELL L. REV. 261, 265-66, 270-74 (1986); see also Coffee, Litigation and Corporate Governance, supra note 2, at 802.
lawyers or investment bankers. Those professionals can absorb the risk of personal liability into their cost of doing business by charging their many clients a price that reflects the risk.\textsuperscript{48} In other words, they can spread their risk of liability. In contrast, directors invest their human capital in only one or a small number of firms, and are thus relatively inefficient cost-avoiders. As such, they are poor candidates for negligence-based personal liability.\textsuperscript{49}

It might be argued that this preoccupation with risk preferences in public corporations ignores the need for negligence-based liability rules as a means of controlling agency costs in a context that discourages monitoring and inhibits coordinated action by shareholders. It might be argued further that negligence-based liability rules are an essential means of enforcing the fiduciary obligations on which shareholders in public corporations must rely if they are to be spared the transactional costs of writing contracts that specify in detail the duties of directors.\textsuperscript{50} It is probably fair to say, however, that such arguments not only ignore or underestimate the threat to shareholder welfare created by exacerbating directorial risk aversion, but also disregard the tendency of market incentives to align the interests of directors and shareholders.\textsuperscript{51} Such market incentives may not be sufficient to control loyalty problems,\textsuperscript{52} but the traditional approach to the duty of care seems consistent with the shareholders' own interests.

In addition, the argument for increasing the risk of directorial liability for violations of the duty of care reflects a misunderstanding of the inherent structural limitations on the ability of outside directors to carry out their monitoring function. Bayless Manning has shown how control by corporate officers over the vast amounts of information generated by a public corporation necessarily limits the directors' ability to perceive, conceptualize and prioritize the wide range of problems facing the corpo-

\textsuperscript{48} See Coffee, \textit{Litigation and Corporate Governance}, supra note 2, at 802-03. The ability of other professionals, such as physicians, to absorb the risk of personal liability into their cost of doing business may be diminishing as the cost of medical malpractice insurance increases. \textit{See Blair \\& Dewar, How to End the Crisis in Medical Malpractice Insurance}, 31 \textit{CHALLENGE} 36, 37 (1988) (survey and discussion of "premium explosion" for Florida physicians). The net result may be a flight from particularly precarious areas of medical practice, a phenomenon perhaps analogous to the flight of outside directors from corporate boards.

\textsuperscript{49} See \textit{Coffee, Litigation and Corporate Governance}, supra note 2, at 802-03; see also Hanks, supra note 4, at 1232-34.


\textsuperscript{52} \textit{See infra} text accompanying notes 92-94.
ration and to take appropriate initiatives. When those inherent informational disadvantages are taken into account, the courts' reluctance to second-guess directors' business decisions, as distinguished from other kinds of decisions, is perhaps more comprehensible.

The traditional approach is not only sound as a matter of policy, it is largely effective in meeting its goal of protecting directors against the routine risk of personal liability for the poor outcomes of their good faith business decisions. If that is the case, it is fair to ask why forty-odd states hastily enacted a profusion of new statutes intended to provide further protection for corporate directors.

C. The "Crisis" in Liability and the Reinforcement of the Traditional Approach

The conventional explanation for the recent spate of liability legislation has been that a "crisis" in directors' liability forced Delaware to enact its version of liability limiting legislation, and that the dynamics of the market for corporate franchises has led many other states either to fall in line behind Delaware or to develop statutes of greater breadth and novelty. The linchpin of that argument, of course, is the assumption


[T]he question of what the board will discuss and act on is typically determined by the management or by the corporation's automatic built-in secular equivalent of an ecclesiastical calendar, that is, shareholders' meeting date, fiscal year, cycle of audit committee meetings, and similar matters... [T]he board itself has little capacity to generate significant proposals, other than generalized suggestions looking toward the establishment of procedures or systems. Almost all of what a board does is made up of matters that are brought to it; matters generated by the board itself are very rare. Typically, boards cannot take, and are not expected to take, initiatives.

Id. at 1484; see also id. at 1485-86 (courts should defer to the board's judgment as to how far to extend the scope of its inquiry into the information available to directors). "No one believes that a director should be able with impunity simply to ignore the work of the board, never doing his homework; but the director's judgment as to the scope of inquiry called for in the circumstances is itself a business judgment of the most basic character." Id. at 1486. For discussions of some of the other consequences of directors' (particularly outside directors') informational disadvantages, see Brudney, The Independent Director — Heavenly City or Potemkin Village?, 95 HARV. L. REV. 597, 633 (1982); Coffee, Beyond the Shut-eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 VA. L. REV. 1099, 1131 (1977).

54. For an impassioned argument that the peculiar nature of the board's exercise of business judgment makes judicial intervention wholly inappropriate, see Manning, supra note 53, at 1490-91.

55. For a count current as of the spring of 1988, see Hanks, supra note 4, at 1246-53.


57. See Hazen, supra note 6, at 171-72; Schaffer, supra note 19, at 675-77. The degree of sensitivity to the risk of reincorporation in Delaware or other states may vary from state to state, but it seems to have been particularly acute in Maryland at the time the Maryland legislation was passed. The drafters of the legislation warned that
that there is some kind of "crisis" in directors' liability, caused primarily by a judicial erosion of the business judgment rule and other legal limits on directorial liability, which led to a sharp decline in the availability and affordability of directors and officers (D&O) insurance.

Much ink has been spilled on this question, so it seems self-indulgent to spill more. A few observations are worth making, however, since they may cast some doubt on the reality of the "crisis." First, the recent trajectory of the business judgment rule has been in the ascendant, not the descendant. Although the "procedural precondition" required by Delaware and other jurisdictions appears to limit the rule, it in fact protects the rule. Once the board of directors establishes that it has adequately informed itself of the merits of the decision at hand, the board may proceed to a decision with confidence that its decision will be sheltered from judicial scrutiny. Compliance with the procedural precondition is feasible, although it is time consuming, expensive and somewhat uncertain in its requirements. The specter of judicial second-guessing of the adequacy of the board's review procedures may be disquieting to individual directors, but it is a risk that can be handled by well-advised boards. The judicial camel's nose may be under the tent, but the rest of the beast is still outside. In addition, the apparent tempering of the full rigor of the rule through attachment of a procedural precondition tends to deflate more radical challenges to the fairness of the rule.

Second, those decisions sometimes cited as evidence of the erosion of the rule actually represent no such thing. In fact, these cases may simply be new examples of the courts' long-standing tendency to find breaches of the duty of care only when there is a duty of loyalty subtext or undertone. Even Van Gorkom, regarded by some as the most alarming of such decisions, is actually not so troubling when analyzed in those terms. For example, the Van Gorkom court may have suspected that the chief executive officer had rammed approval of the proposed acquisition

failure to enact the legislation "is likely to result in . . . the reincorporation of many Maryland corporations in other states, thus injuring the state's efforts to be perceived as a favorable business climate. . . ." Maryland State Bar Ass'n, Sec. of Corp., Banking and Bus. L., Comm. on Corp. Laws, Subcomm. on Director Liability Rep. 17 (Nov. 16, 1987), reprinted in 18 U. Balt. L. Rev. 254, 263 (1989) [hereinafter Director Liability Report]. The sensitivity to the risk may be less in major jurisdictions such as California, Illinois or Michigan than in a smaller state such as Maryland with fewer corporate headquarters within its borders.

58. See supra note 19.
59. See supra text accompanying notes 39-42.
60. This proposition is, of course, subject to debate. It can be argued that the court's willingness to scrutinize decisional procedures is an unjustifiable attempt to second-guess highly complex, indeterminate decisions, and that the court's intrusion has generated a profound and disquieting sense of uncertainty. The prevalence of this sentiment among corporate managers and their counsel was surely germane to the proliferation of liability-limiting statutes. Whether their concern is overwrought or justifiable remains to be seen.
61. See supra note 33.
through the board because he preferred a quick and lucrative sale of his own shares to a lengthier, more complex, and perhaps riskier management-led leveraged buy-out that might have produced a better price for the other shareholders. Furthermore, the entire board may have appeared to the court to have been tainted by the CEO's conflict of interest. Recognition of the existence of this subtext in Van Gorkom does not require a concession that the case was correctly decided, or even a complete recharacterization of Van Gorkom as a duty of loyalty case. It merely suggests the possibility that the court's decision to hold the directors personally liable for breach of fiduciary obligation was influenced by a perception that more was at issue than gross negligence, and that the court's willingness to find a breach of the duty of care was determined not by a revolutionary change in attitude but by the faint aroma of disloyalty.

Similarly, in Unocal v. Mesa Petroleum Co., Moran v. Household International, Inc. and Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., the Delaware courts' redefinition of the business judgment rule's applicability to target board defensive tactics does not represent a repudiation of the traditional approach to the duty of care. The courts' requirement that the board prove that a proposed takeover constitutes a threat to the corporation and that the board's defensive tactics were a reasonable response to that threat is merely a belated recognition of the inherent conflict of interest imposed on directors by hostile takeover bids. The Delaware courts' willingness to modify the business judgment rule in that context is thus wholly appropriate, and does not undermine the basic function of the rule. It is worth noting, furthermore, that the Delaware courts' refinement of the basic business judgment rule represents a cautious, conservative approach to the problems of defensive tactics that falls far short of more radical suggestions for restraining opportunistic behavior by target boards.

62. This course of events is laid out in Smith v. Van Gorkom, 488 A.2d 858, 866-70 (Del. 1985).
63. Several different interpretations of Van Gorkom have surfaced. For a summary, see Special Project: Director and Officer Liability, Recent Developments Concerning the Duty of Care, the Duty of Loyalty and the Business Judgment Rule, 40 Vand. L. Rev. 631, 638-44 (1987).
64. 493 A.2d 946 (Del. 1985).
65. 500 A.2d 1346 (Del. 1985).
67. Unocal, 493 A.2d at 955; Moran, 500 A.2d at 1355-56; Revlon, 506 A.2d at 180. For a detailed discussion and critique of these cases in light of this fundamental dilemma, see R. Gilson & R. Kraakman, 1988 Supplement to The Law and Finance of Corporate Acquisitions 155-97 (1988); Johnson & Siegel, Corporate Mergers, Redefining the Role of Target Directors, 136 U. Pa. L. Rev. 315, 332-37 (1987).
68. See, e.g., Bebchuk, The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028 (1982) (generally supports a rule of passivity, but would allow target managers to seek out competing bidders); Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982) (rejects argument that
If in fact the current trend in the case law does not represent a substantial departure from the traditional approach to directorial liability for breach of the duty of care, then what accounts for the flood of law-making? An easy way to answer this question is simply to point to the very real increase since 1986 in the cost of D & O insurance, a decrease in the availability of such insurance, and some degree of flight by directors and potential directors from the boards of public corporations.69 The new director and officer liability laws thus can be understood as an attempt to reduce insurers' risks and to lure them back into the business of providing relatively affordable D & O insurance. Alternatively, these statutes can be regarded as attempts to fill the gaps left by insurance that is either unavailable or prohibitively expensive.

This answer is too easy, however, because it fails to account for the considerable uncertainty about whether directorial flight in response to insurance problems is really serious and widespread. Anecdotal evidence and some informal surveying exists,70 but the comprehensive data is not really available. More importantly, this "explanation" does not explain why the cost of D & O insurance has risen so dramatically when the net effect of recent case law is a reaffirmation and reinforcement of the traditional approach to directorial liability.71 It has been argued that the insurance industry's behavior may have more to do with compensating for past failures in the marketing and pricing of D & O insurance than with any real perception of failure on the part of existing liability rules.72 It also may be argued that the problem of directorial liability is simply part of a general crisis in liability insurance and presents no unique characteristics.73 Both of those arguments may be true, although the case has not...


70. See, e.g., Baum, supra note 69, at 56-57 (listing the numbers of resignations since 1984 from the boards of ten corporations); Hilder, Risky Business: Corporate Directors Bail Out, A.B.A. J., June 1986, at 24 (describing similar results of a study of board recruiting); Hot Seats, supra note 69, at 1.

71. See supra text accompanying notes 57-68.

72. For a critical discussion of the perception of "crisis," see Lee, supra note 19, at 252-56.

been proven for either of them.\textsuperscript{74}

The real reason for the flood of liability-limiting statutes can be stated in a single word: uncertainty. It is easy to sit back with three or four years' worth of perspective on cases like \textit{Van Gorkom} and conclude that after all is said and done, nothing has changed very much, and that directors still face very little risk of personal liability. It was quite another matter, circa 1986, to have to write D & O insurance policies or to advise boards of directors in light of decisions that appeared to erode fundamental tenets and to increase the risk that duty of care claims would go to the jury. In other words, it may be correct to conclude that the legal significance of \textit{Van Gorkom} and the other cases was less than first appeared, but that conclusion is almost irrelevant. The rapid, ad hoc judicial process by which the law moved from one point to another was the source of the problem because it led to the realization on the part of corporate counsel and insurance carriers that the courts could force further changes if they so desired. The ancient monolith had developed a crack, and the future appeared very unpredictable indeed. The mere appearance of unpredictability may have been enough to discourage the D & O insurance carriers;\textsuperscript{75} it was more than enough to spur to action the corporate counsel who were to draft the new liability-limiting statutes.\textsuperscript{76}

This general sense of uncertainty, furthermore, was compounded by the continuing volatility of the market for corporate control. The rapid proliferation of hostile control transactions in the last fifteen or twenty years\textsuperscript{77} has not only raised fundamental questions about the direction of the American economy, but has called into question our most basic assumptions about corporate governance.\textsuperscript{78} The debate over these assumptions is not merely a matter of academic interest. It has a direct and sometimes daily impact on the lives of corporate managers, who are now

\begin{itemize}
\item \textsuperscript{74} For a critique of the "conspiracy theory" explanation of the general liability insurance crisis, see Abraham, \textit{supra} note 73, at 401-04.
\item \textsuperscript{75} For discussion of the impact of legal unpredictability on the general liability insurance crisis, see \textit{id.} at 404-09.
\item \textsuperscript{76} One of the drafters of the Maryland statute has stated that as a result of \textit{Van Gorkom} and other cases, "the predictability on which directors and D & O insurance carriers have for so long relied" has "evaporated." Hanks, \textit{supra} note 4, at 1209.
\item \textsuperscript{77} For an analysis of merger trends, see D. \textit{Ravenscraft} & F. \textit{Scherer}, \textit{Mergers, Sell-offs & Economic Efficiency} 20-55 (1987).
\item \textsuperscript{78} This development has also infused new life into the study of corporate law. Twenty-six years ago Bayless Manning described the state corporation statutes as "towering skyscrapers of rusted girders, internally welded together and containing nothing but wind," and concluded that "[i]f those of us in academic life who have specialized in corporate law face technological unemployment, or at least substantial retooling." Manning, \textit{The Shareholder's Appraisal Remedy: An Essay for Frank Coker}, 72 \textit{Yale L.J.} 223, 245 n.37 (1962). In contrast to Manning's stark image and gloomy prediction, corporation law today is an extraordinarily vital area of inquiry. The combined impact of an explosive market for corporate control and the development of new analytical tools has forced rethinking of old shibboleths and given students of corporate law too much to do, rather than too little.
\end{itemize}
required to make extremely important and complex decisions about the futures of their corporations under circumstances that give them little time, almost no margin for error, and the certainty of being sued. It is by no means surprising, therefore, that corporate directors and their attorneys have looked for some kind of additional help from the state legislatures, especially when decisions like *Van Gorkom* and the Delaware trilogy at least seemed to undermine traditional legal protections.

Thus, it almost does not matter whether the courts really have compromised the business judgment rule. The feeling of vulnerability was enough to have provided the impetus for legislation. It is also enough, perhaps, to justify those aspects of the legislation that are intended to reinforce the traditional means of protecting directors from liability for breach of the duty of care. In particular, the Maryland legislation's authorization of a limitation on directorial liability for breaches of the duty of care is an effective means of bolstering the state's traditional approach. The new statute helps ensure that the corporate law will perform its long-standing function of aligning the risk preferences of directors and shareholders of public corporations through reducing the risk of personal liability for negligence. The Maryland statute deserves at least two cheers for accomplishing that. Others aspects of this legislation, however, are more problematic.

III. THE CONTINUING VALIDITY OF THE DISTINCTION BETWEEN THE DUTIES OF CARE AND LOYALTY AND ITS IMPLICATIONS FOR THE MARYLAND STATUTE

As explained above, section 102(b)(7) of the Delaware General Corporation Law is similar to the Maryland statute insofar as they both use a charter-option approach that enables shareholders to approve charter provisions limiting the liability of the directors of the corporation. In other important respects, however, the two provisions differ substantially.

The Maryland statute, for example, differs from the Delaware statute by permitting limitation of the liability of officers as well as directors. Most significantly, however, the Maryland statute lacks the Delaware statute's broad prohibition of any limitation on liability "[f]or

79. There is no small irony in the fact that the Trans Union directors rested their decision to accept the proposed acquisition in part on an attorney's advice that they might be sued if they rejected the proposal. Smith v. Van Gorkom, 488 A.2d 858, 868 (Del. 1985).
80. See supra notes 64-67 and accompanying text.
82. See supra text accompanying notes 15-18.
83. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988).
any breach of the director’s duty of loyalty to the corporation. . . .”84
Maryland section 2-405.2(a)(1)-(2) merely prohibits liability limitations:

(1) To the extent that it is proved that the person actually received an improper benefit or profit in money, property, or services, for the amount of the benefit or profit in money, property, or services actually received;
(2) To the extent that a judgment or other final adjudication adverse to the person is entered in a proceeding based on a finding in the proceeding that the person’s action, or failure to act, was the result of active and deliberate dishonesty and was material to the cause of action adjudicated in the proceeding. . . .85

Although there may be some debate about the precise scope of these exclusions, they are obviously much narrower than Delaware’s broad exclusion of breaches of the duty of loyalty from the benefit of a cap on liability.

The significance of this difference between the Maryland and Delaware statutes should not be underestimated. The drafters of the Maryland provision obviously intended to reduce the risk of liability from a wider range of managerial misbehavior than was covered by the Delaware statute. More specifically, the rejection of a general reference to the duty of loyalty, in favor of a specific and exclusive reference to two of the most egregious means of breaching that duty, substantially reduced the possibility that ingenious counsel and compliant judges might succeed in recharacterizing care claims as loyalty claims in order to circumvent the liability cap.86 The Maryland statute reflects the conclusion that the goal of protecting managers from substantial risks of personal liability would be seriously undermined by a broad distinction between the duties of care and loyalty. Even more fundamentally, it seems to embody a belief that there is no meaningful difference between the two duties. Any attempt to compare the merits of the Delaware and Maryland statutes, therefore, should begin with an analysis of the distinction between those two duties.

Perhaps the sharpest critics of the traditional distinction between

85. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a)(1)-(2) (Supp. 1988). For references to other state statutes omitting a broad duty of loyalty exception, see Hanks, supra note 4, at 1213-15.
86. One of the drafters of the Maryland statute has expressly stated this concern. After critically describing the Delaware statute’s duty of loyalty exclusion, Hanks predicted that “[i]t will not be surprising . . . if stockholders of Delaware corporations that have adopted exculpatory charter provisions begin alleging violations of the duty of loyalty for acts or omissions that until now would have supported a claim for breach of the duty of care.” Hanks, supra note 4, at 1212. This is not a trivial concern. If this article’s analysis of the duty of loyalty undertones in Van Gorkom is correct, then the distinction between the two duties may be so elusive that it justifies the Maryland statute’s different approach. See supra text accompanying notes 61-63. It will be argued below, however, that the distinction between the two duties is real and useful, and that there are disadvantages to abandoning the broad distinction between the two. See infra text accompanying notes 89-103.
the duties of care and loyalty are Professors Fischel and Bradley. They have argued that:

[T]he distinction between the duty of care and the duty of loyalty is not at all clear. For example, there is no difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty). Both are examples of agency costs (conflicts of interest in an economic sense) that reduce shareholders' wealth.\(^{87}\)

This position has the charm of any counterintuitive assault on the conventional wisdom. It also has a sound basis in economic theory, insofar as both types of violation do represent agency costs — decisions by the managers to maximize their own utility rather than that of the shareholders.\(^{88}\) Fischel and Bradley's position also demonstrates the conceptual weakness of the legal distinction between care and loyalty as applied to the problem of shirking. Acceptance of their position, furthermore, would appear to lead almost inescapably to the conclusion that any limitations on liability should extend to loyalty as well as care violations. Their position thus has great conceptual force, since it links care and loyalty violations under the common rubric of agency costs and asks why there should be two different sets of liability rules for what is essentially the same problem. There are several answers to that question and they suggest that the conventional wisdom may be more resilient than Fischel and Bradley would concede.

First, some deference should be given to the fact that for a very long time the courts have found the care/loyalty distinction a useful means of determining when they should intervene in private economic decision-making and when they should not. Fischel and Bradley's analysis of the ambiguous boundary situation of shirking suggests that this distinction is not absolutely coherent, but it has at least seemed to many decision-makers to be a relatively principled means of sorting out difficult cases.\(^{89}\) Of

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\(^{87}\) Fischel & Bradley, supra note 47, at 291; see also Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics, 71 CORNELL L. REV. 357, 368-69, 371 (1986) (comments of Fischel) [hereinafter Proceedings]. Other commentators have made the same argument. See, e.g., Honabach, All That Glitters, supra note 2, at 475 (“As the contract theory makes clear, there is little or no difference between many allegations of a failure to exercise due care and allegations of self-dealing.”).

\(^{88}\) For a fundamental discussion of the problem of agency costs in business organizations, see Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976). For very useful illustrations of how these costs originate and how they may be handled, see W. Klein & J. Coffee, supra note 31, at 8-42.

\(^{89}\) Goetz has made a similar point about the usefulness of the care/loyalty distinction for the planning function. Goetz, A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven, 71 CORNELL L. REV. 344, 350 (1986) (“The legal sys-
course, it may be argued that these decision-makers were simply wrong, but that point remains to be proven. There is something to be said for so functional a legal distinction, and it should not be junked lightly.

Second, the law's function of setting normative standards of behavior may be undermined by a refusal to distinguish between care and loyalty for purposes of liability. The argument made above that the duty of care should be largely aspirational in character seems to go against the grain, despite the very good arguments in favor of such a position. The rhetoric of care is simply less persuasive when it is not attached to a risk of liability. It may make sense to accept that consequence, as this article has argued, but the law should be cautious in pushing much farther. In particular, any characterization of the duty of loyalty as largely aspirational cuts even more violently against the grain, despite the conceptual similarity of the two duties. Collapsing the distinction between the duty of care and loyalty and creating a common set of liability rules that renders both duties essentially hortatory may go too far in diminishing the law's function of setting and reinforcing norms of behavior through the combined effects of exhortation and liability.

Finally, Fischel and Bradley's argument that the same liability rules should apply to care and loyalty violations ignores the possibility that markets and courts may operate more effectively with respect to one violation than to the other. For example, the courts' traditional reluctance to second-guess business decisions does not leave shareholders to the mercies of negligent or incompetent managers. At least in public corporations, the markets for managerial services and the market for corporate control monitor managerial performance and impose their own sanctions. Judicial monitoring by means of derivative suits probably does not work as well. With respect to duty of loyalty violations, however, judicial monitoring is both more effective and more needed. It is more effective because courts are more likely to be comfortable with the fairness or honesty considerations central to loyalty cases than with the business or investment considerations essential to duty of care cases. It is

90. See supra text accompanying notes 45-55.
91. See supra notes 29, 43.
93. Scott argues that courts are more comfortable with close scrutiny of loyalty claims because "[t]he analysis is far more simple and reliable than in a duty of care case where the court must assess the interaction of a multitude of factors in a business disaster." Scott, The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley, 71 CORNELL L. REV. 299, 308 (1986).
more needed because loyalty cases, as Professor Scott has pointed out, often involve concealment of the crucial facts. Market monitoring does not work as effectively in such contexts, and the facts will be ferreted out only if shareholders — or their attorneys — have an incentive to look for them. Liability rules that permit a higher level of judicial scrutiny and a greater likelihood of managerial liability provide such an incentive. In short, reliance on market monitoring may make sense with respect to the duty of care; reliance on judicial intervention may do so with respect to the duty of loyalty.

Insofar as the Maryland statute tends to collapse the distinction between the duties of care and loyalty for purposes of liability, it adopts a misguided and potentially harmful position. This is the net result of deviating from the Delaware statute’s broad exception for breaches of the duty of loyalty. Maryland’s carve-outs from coverage of the liability cap would seem to apply only to the most blatant forms of loyalty violations: embezzlement, graft, egregious self-dealing and one-shot frauds. They would not appear to apply to the subtler questions created by corporate opportunity cases, cases involving breaches of the duty of impartial treatment of different classes of shareholders or to cases involving cor-

94. *Id.* One of the reporters for the ALI project reiterated this point in rejecting Fischel and Bradley's attempt to collapse the care/loyalty distinction. Referring to Fischel and Bradley’s discussion of the boundary situation of shirking, the reporter stated: Even if a legal deterrent were lacking, market and social forces seem more likely to be able to deal with the official who is merely lazy than with the one who is dishonest or self-regarding. In contrast, it cannot be assumed that market forces are adequate to penalize duty of loyalty violations, particularly when opportunities for large ‘one shot’ gains arise. *Analysis and Recommendations, supra* note 2, § 7.16, at 220-21.

95. For example, does the usurpation of a corporate opportunity necessarily mean that a director or officer has “actually received an improper benefit or profit in money, property or services,” or that his act was the result of “active and deliberate dishonesty”? See *MD. CORPS. & ASS'NS CODE ANN.* § 2-405.2(a)(1)-(2) (Supp. 1988). Does the benefit derived from the opportunity itself constitute the requisite “improper benefit”? For an example of an application of the corporate opportunity doctrine under Maryland law, see *Maryland Metals v. Metzner,* 282 Md. 31, 382 A.2d 564 (1978). What about corporate opportunity problems created by interlocking directorates in parent-subsidiary relationships? Does the misallocation of corporate opportunities as a means of freezing out minority shareholders of the subsidiary corporation constitute an “improper benefit” to the directors of the subsidiary? The leading case on this general problem is *Sinclair Oil Corp. v. Levien,* 280 A.2d 717 (Del. 1971).

The report of the Maryland State Bar Association Committee that drafted the legislation explains that the “improper benefit” concept was “limit[ed] to . . . benefits actually received in the form of money, property or services in order to eliminate any argument that such ambiguous items as business goodwill or social ingratiation may constitute a benefit to a director or officer.” *Director Liability Report, supra* note 57, at 18, reprinted in 18 U. BALTIMORE L. REV. at 263. It is by no means clear why such “ambiguous items” should be eliminated from the concept of “improper benefit”, because they might be quite valuable to the recipient. It is also not clear what other “ambiguous items” are eliminated by the narrow phrasing of the statute.

96. For examples of allegations of breach of the duty of impartiality, see *Speed v. Trans-
porate control transactions in which some kind of conflict of interest is alleged. 97 If it is argued that the Maryland statute's carve-outs do apply to such violations, then it must be asked why the drafters chose to state narrow exceptions to the coverage of the liability limitation rather than to use Delaware's broad exclusion. 98

The drafters' decision thus diminishes the value of the traditional distinction between care and loyalty, undermines the normative function of the corporate law, and disrupts a rational allocation of monitoring responsibilities between courts and markets. The Delaware approach to coverage of the liability limitation is thus preferable. 99

america Corp., 235 F.2d 369 (3d Cir. 1956); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947). This duty may be asserted more frequently in control transactions as a result of Delaware's adoption of broad duty of loyalty exclusions. For an example of the Delaware courts' analysis of this issue, see Jedwab v. MGM Grand Hotels, 509 A.2d 584, 591 (Del. Ch. 1986) (claim that it was a breach of the duty of loyalty for directors in a control transaction to "unfairly favor one class of stock over another").

97. The line between the duties of care and loyalty in control transactions, and particularly in hostile takeovers, needs sharper definition in light of the target management's inherent conflict of interest. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), the court described the same conduct as violating the duty of loyalty in one part of the opinion and violating the duty of care in another. Id. at 182, 185 (describing an auction-ending lock-up option first as violation of the duty of loyalty and then as a violation of the duty of care).

98. Perhaps the best explanation of the Maryland approach to this question is that the statute attempts to replicate the protection that would be provided by a D & O liability insurance policy, which is now theoretically unavailable or too costly. As the drafters explained, "[t]he exception for 'active and deliberate dishonesty' is based upon a similar exclusion appearing in virtually every directors and officers liability insurance policy . . . ." DIRECTOR LIABILITY REPORT, supra note 57, at 18, reprinted in 18 U. BALT. L. REV. at 263.

99. Butler and Ribstein have argued that it is irrelevant whether the care/loyalty distinction is meaningful (which they doubt), because shareholders should be free to contract around loyalty obligations as well as care obligations. The only problem with the Maryland statute, they conclude, is not that it abandons this distinction, but that it does not go far enough in facilitating shareholder choice. Butler & Ribstein, Free at Last? The Contractual Theory of the Corporation and the New Maryland Officer-Director Liability Provision, 18 U. BALT. L. REV. 352, 360-64 (1989). They argue further that a "limitation on the shareholders' power to contract can be logically justified only by imperfections in the market's ability to constrain inefficient contract terms. The efficiency of the securities markets makes any such justification quite doubtful in this context." Id. at 362. Butler's and Ribstein's faith in the efficient capital market hypothesis is not entirely misplaced, but they are far too sanguine about its implications for legal policy. There is an active debate over whether the market's efficiency is so complete as to justify the wholesale repudiation of traditional legal restraints on private bargaining. See, e.g., Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717, 719 n.10 (1984) ("[D]istinctions should be drawn in terms of the degree to which the [Efficient Capital Markets Hypothesis] is used as a justification for deregulation — particularly since very little evidence exists with respect to any market other than the New York Stock Exchange."); Gordon & Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. REV. 761, 796-837 (1985) ("In our world, which may be only 'close' to the best of all possible worlds, the insights provided by theories of financial markets require patient cultivation before legal policy flowers."); Wang, Some Arguments That the Stock Market is Not Efficient, 19
The Delaware approach, however, is not without its costs, as the drafters of the Maryland statute undoubtedly realized.\textsuperscript{100} As explained above, a broad exception for duty of loyalty cases will undoubtedly lead to attempts to recharacterize care claims as loyalty claims.\textsuperscript{101} This is

\begin{quote}
U.C. DAVIS L. REV. 341, 394-402 (1986) ("Many legal commentators have assumed that the stock market is efficient. These commentators should recognize that the validity of this hypothesis is questionable."); Burgman & Cox, Corporate Directors, Corporate Realities, and Deliberative Process: An Analysis of the Trans Union Case, 11 J. Corp. L. 311, 354-69 (1986) (critique of the neoclassical model's claims of the adequacy of market mechanisms).
\end{quote}

The possibility that there are in fact "imperfections in the market's ability to constrain inefficient contract terms," to use Butler and Ribstein's language, thus requires some qualification of any assumption that shareholder choice should be given free rein, with mandatory rules entirely (or largely) eschewed. The possibility should also cast some doubt upon the assumption that shareholders should be permitted to opt out of liability for breach of the duty of loyalty. Butler and Ribstein apparently reject the notion that this uncertainty over the relative efficiency of the market would require any qualification of their conclusions, but it should at least be recognized that the matter is highly debatable. Given the uncertainty, changes in legal policy dependent upon a faith in market efficiency should be cautious and incremental. Permitting shareholders to opt out of loyalty obligations cannot be characterized as a modest change, but attempting to reinforce the traditional approach to liability for breach of the duty of care can. Preservation of the traditional distinction between loyalty and care thus seems to be the correct approach.

Furthermore, Butler and Ribstein's highly optimistic assessment of the value of facilitating shareholder choice should be read in light of the ongoing debate over the nature and extent of the constraints upon shareholder choice as a value-maximizing ordering mechanism. See, e.g., Gordon, Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 CALIF. L. REV. 1, 39-60 (1988) (discussion of the collective action and strategic choice problems in dual class recapitalizations); see also Coffee, No Exit? Opting Out. The Contractual Theory of the Corporation, and the Special Case of Remedies, 53 BROOKLYN L. REV. 919 (1988).

With respect to the meaningfulness of the underlying distinction between the duties of care and loyalty, Butler and Ribstein reiterate the analysis put forward by Fischel & Bradley, \textit{supra} note 47. Butler & Ribstein, \textit{supra}, at 361-62. This analysis is at least subject to the criticisms outlined above. See \textit{supra} text accompanying notes 89-94. It is also subject to those suggested by Goetz and Scott, and by the Reporter for the ALI Corporate Governance Project. See Goetz, \textit{supra} note 89, at 350; Scott, \textit{supra} note 93, at 308; \textit{Analysis and Recommendations, supra} note 2, at 220-21. For a perceptive discussion of these issues that criticizes some of the more extreme manifestations of contractarian ideology, see Branson, Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors, 57 FORDHAM L. REV. 375, 394-400 (1988). Branson is particularly disturbed by the use of contractarian arguments to justify liability-limiting statutes whose opt-out provisions will tend to erode the duty of loyalty. He concludes that a "relatively stringent and rigid common law duty of loyalty should be maintained as the bedrock beneath and the brackets around the movement toward private ordering in the affairs of American business corporations." \textit{Id.} at 402.

\textsuperscript{100} See Hanks, \textit{supra} note 4, at 1212-13.

101. \textit{See supra} text accompanying note 86. Some also may be troubled by the fact that the Delaware corporation statute does not use the term "duty of loyalty" at any point. The lack of any specific statutory reference to such a crucial term might exacerbate the risk that the liability limitation will be undermined by a judicial conflation of "care" and "loyalty." The lack of a statutory reference of the duty of loyalty, however, is probably immaterial, because the courts would have to work out the meaning of the term and its relation to the duty of care in any event.
particularly true in the context of control transactions where the omnipresent taint of managerial conflict of interest obscures the line between care and loyalty. The Delaware statute may eventually produce a more encompassing judicial definition of the duty of loyalty and its attendant liabilities than is known today. This possibility must have been quite troublesome to the drafters of the Maryland statute, since the fear of liability arising from control transactions was undoubtedly one of the primary motivations for enacting this type of legislation. 102

The possibility that all this might happen, however, does not diminish the validity of the Delaware approach. The ultimate result of such redirected litigation would be closer attention to, and more sophisticated analysis of, the distinction between these two fundamental aspects of fiduciary duty. Furthermore, a heightened tendency to analyze managerial behavior in control transactions in loyalty terms would arguably be more appropriate than the current tendency to analyze that behavior under a modified version of the business judgment rule. 103 The Delaware approach may perpetuate some of the uncertainty about managerial liability that has helped generate the current “crisis,” but the degree of that uncertainty is not clear, and the costs of abandoning the traditional distinction reflected in the Delaware statute are.

IV. OF OFFICERS AND CLOSE CORPORATIONS

Part III has argued that a weakness in the Maryland statute is its treatment of liability for breach of the duty of loyalty. Other aspects of the statute are also questionable, although ultimately not as troubling as the statute's treatment of the duty of loyalty.

A. Should Officers Have the Benefit of a Liability-Limiting Charter Provision?

As explained above, the Maryland statute differs from its Delaware counterpart by permitting shareholders to limit the liability of officers as well as directors. 104 Is this a distinction without an important difference, or is it an unwarranted extension of liability limitations?

This question is difficult to answer because relatively little attention has been paid to the differences between the fiduciary duties of directors and officers. More attention has been paid to differences in the obligations of inside and outside directors. 105 Those cases that have addressed the question have tended to content themselves with observing that the officers' higher degree of involvement in the business requires holding

102. See DIRECTOR LIABILITY REPORT, supra note 57, at 5, reprinted in 18 U. BALT. L. REV. at 256.
103. For critiques of that approach, see R. GILSON & R. KRAAKMAN, supra note 67, at 155-97; Johnson & Siegel, supra note 67, at 332-37.
104. See supra text accompanying notes 16-18.
105. See Special Project, supra note 34, at 620.
them to a higher degree of care. A possible analogue is the securities law principle that some officers, by virtue of their position, must show a higher degree of due diligence in order to escape liability under section 11 of the Securities Act of 1933. This merely suggests, however, that persons with a higher degree of involvement and control — whether they be officers or inside directors — may be subjected to some heightened scrutiny when breaches of the duty of care are alleged.

Another possible distinction may flow from the difference in officers' and directors' functions. It is by now commonplace to say that the board's primary function is that of monitoring management. A breach of the directors' duty of care is perhaps most likely to arise when the board somehow fails to meet its responsibility to monitor the officers' behavior. This distinction simply establishes, however, that officers and directors have to do different things in order to satisfy their fiduciary duty. It does not suggest that there is some fundamental difference in the nature of that duty, or that a limitation on liability is appropriate for one group but not the other.

To determine whether a limitation on liability is appropriate for officers, it is necessary to reexamine the reasons why such a limitation is appropriate for directors, particularly outside directors. At first glance, at least one of the justifications for a liability-limiting rule does not seem to apply to officers. The directors' inherent informational disadvantages, which limit their ability to make decisions in a manner that a more rigorous application of the standard of care might require, result largely from the officers' control over the flow of information generated by the corporation. Officers, of course, do not suffer from such informational disadvantages. This rationale for a liability-limiting rule thus does not apply to them.

On the other hand, the other rationales do apply. The discussion above of the role of liability-limiting rules in aligning the risk preferences of directors and shareholders is equally applicable to officers. In fact, it makes more sense to talk about aligning the risk preferences of managers and shareholders, regardless of whether the managers are officers or directors. It also makes sense to align the fates of directors and officers.

106. See id. at 619 n.85.
108. See Special Project, supra note 34, at 619.
110. See W. KLEIN & J. COFFEE, supra note 31, at 149.
111. See supra text accompanying notes 53-54.
112. See supra text accompanying notes 45-52.
for purposes of liability, since they are equally subject to the disciplinary effect of market mechanisms. 113 To the extent that those mechanisms render negligence-based liability rules superfluous with respect to directors, they also do so with respect to officers. In addition, officers, like directors, lack the ability to diversify the risk of negligence liability since their human capital is even more clearly invested in a one-asset portfolio. 114 They are thus also relatively inefficient cost-avoiders.

On balance, therefore, the Maryland statute’s extension of its authorized liability limitations to officers and directors is justifiable. It also eliminates a disturbing anomaly. A statute that applies only to directors creates the possibility that directors who are also officers may face personal liability for their actions as officers, but not as directors. 115 This would mean that only outside directors, as a practical matter, would benefit from the statutory limitation on liability. If the sole purpose of the statute were to stanch the outflow of outside directors from corporate boards, this difference in treatment would be justifiable. 116 This article has argued, however, that there are other more fundamental justifications for liability limitations, at least with respect to the duty of care. In addition, a statute that does not extend protection to officers may pose intractable problems for courts called upon to distinguish acts done in official capacities from those done in directorial capacities. The net result might be that only outside directors would have the benefit of the liability limitation. This result seems inconsistent with the goals of liability-limiting legislation, and is best avoided through a statutory solution like Maryland’s.

B. Liability Rules and Liability Limits in Close Corporations

This article has argued not only that a limitation on directors’ and officers’ liability for breach of the duty of care (although not the duty of loyalty) is not dangerous to shareholders of public corporations, but also that it is a useful means of aligning the interests of managers and shareholders. 117 This argument leads to the conclusion that some reduction of the role of liability rules in the governance of public corporations is justifiable. This conclusion ultimately depends on certain basic assumptions about the division of functions within public corporations, the need to

113. See supra note 92.
114. See supra text accompanying notes 48-49.
115. See Honabach, All That Glitters, supra note 2, at 470-71 (treating Van Gorkom as applying only to officers).
116. See supra text accompanying note 69. While this may not be the sole purpose of the Maryland statute, it surely was a purpose and one that can be applauded. Outside directors have become a crucial part of corporate governance, and their continued involvement should be encouraged. The drafters of the Maryland statute, furthermore, clearly intended the statute to address the problem of flight by outside directors. See Director Liability Report, supra note 57, at 7, reprinted in 18 U. Balt. L. Rev. at 257 (decrying the loss of outside directors as a result of the liability crisis).
117. See supra text accompanying notes 45-55.
align shareholders’ and managers’ risk preferences, and the relative efficiency of market monitoring mechanisms as means of controlling some agency costs. 118

Can the same conclusion be reached when the nature of the corporate organization is different? In a close corporation, the economic functions of managers and shareholders typically are not separate, since the managers are usually the largest residual claimants. 119 Accordingly, there is less need to monitor the managers’ performance, since managers and shareholders tend to be the same people. This is fortunate, because markets cannot serve as monitoring mechanisms when there is no public market for the close corporation’s securities and when the corporation’s managers do not compete in either intra-firm or external markets for managerial services. 120 The central dilemma of close corporation governance thus is not how to monitor managers’ performance of their specialized economic functions, but how to constrain opportunistic behavior by manager/shareholders who use majority positions to appropriate disproportionate shares of the corporation’s income. 121 The dilemma of minority shareholders faced with such opportunistic behavior is exacerbated by the lack of any meaningful market exit from the relationship. 122

The mere existence of these substantial differences suggests that one cannot simply assume that conclusions about the desirability of liability-limiting provisions apply with equal strength to public and close corporations. On the other hand, one also cannot assume that such provisions would be useless or dangerous in the close corporation context. Their function may simply be different.

The difference in function may derive from the differing roles of liability rules in each context. In public corporations, liability rules may be useful as monitoring mechanisms that help control the agency costs generated by the specialization of functions. The only question is whether they are effective monitoring mechanisms with respect to all types of

118. See supra text accompanying notes 45-81.
119. Easterbrook & Fischel, Close Corporations, supra note 50, at 273. The gross distinction between “public” and “close” corporations is used with full awareness that the dichotomy between the two tends to be overstated, and that there are many hybrids that share characteristics of both ideal types. See W. Klein & J. Coffee, supra note 31, at 107 (“Most corporations are neither public, in the way General Motors is, nor closely held, as a family corporation is.”). The distinction still does have some explanatory power, however, as it reflects a perhaps more fundamental distinction between “owner controlled” and “manager controlled” firms. See id. Emphasizing the distinction between owner control and manager control reinforces the need to reexamine the role of liability rules and liability limits in the two types of organizations. For discussion of the effects of liability limits in hybrid forms, see Honabach, All That Glitters, supra note 2, at 438 n.18; Honabach, Consent and Exit, supra note 14, at 342 & n.170.
120. For discussion of these markets as monitoring mechanisms, see the authorities cited supra note 92.
121. Easterbrook & Fischel, Close Corporations, supra note 50, at 278-79.
122. For discussion of the “exit” problems of shareholders in close corporations, see Honabach, Consent and Exit, supra note 14, at 344.
agency cost. As argued above, it may be that they perform that function well with respect to duty of loyalty problems but not duty of care problems. A statutory provision limiting liabilities for breach of the duty of care, but not the duty of loyalty, thus makes sense for public corporations.

In close corporations, the lack of specialization and the intermingling of economic functions mitigate monitoring problems, but increase the risk of opportunistic behavior. Liability rules with respect to the duty of care thus do not really perform a monitoring function in close corporations. The real problem in close corporations is typically one of loyalty, arising when one group of shareholders decides to oppress the other. Whether one defines the focus of loyalty as the corporation or the other shareholders, liability rules applicable to loyalty violations may play some role in constraining such behavior.

A provision that would limit the liability of managers of close corporations for breach of the duty of care is thus largely innocuous, not because it serves the shareholders' interests, but because it would be mostly irrelevant to those shareholders' real concerns. They are by-and-large not preoccupied with monitoring shirking or negligence on the part of managers, but with freeze-outs or deadlocks engineered by overreaching majorities. Eliminating liability for breaches of the duty of loyalty,

123. See supra text accompanying notes 45-81.
124. The leading case characterizing shareholders as fiduciaries of each other is Donahue v. Rodd Electertype Co., 367 Mass. 578, 328 N.E.2d 505, 512-18 (1975). This analysis largely depended on an analogy of shareholders in close corporations to partners. Id. at 586-87, 328 N.E.2d at 512-13. The analogy has been criticized as not representing the parties' real intentions and as reflecting a misunderstanding of the different forms of business organization. Easterbrook & Fischel, Close Corporations, supra note 50, at 297-300 ("[T]he assumption that participants in closely held corporations want to be governed by partnership law is itself questionable."); Hillman, The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations, 67 MINN. L. REV. 1, 87 (1982) ("There are also structural differences between the two forms of organization which make a close corporation something more than a partnership in a corporate shell.").

The Court of Appeals of Maryland has acknowledged that majority shareholders in some circumstances owe a fiduciary obligation to minority shareholders, but has expressed some skepticism about Donahue's analogy of close corporations to partnerships. See Toner v. Baltimore Envelope Co., 304 Md. 256, 267, 498 A.2d 642, 647, 653-54 (1985).

125. This is not to suggest that there are no duty-of-care problems in close corporations. There is in fact a subgenre of care problems almost peculiar to close corporations — that of the totally inattentive director, who may be a spouse or relative serving as an accommodation to a principal shareholder. The classic case in this line is Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981). See supra note 31; see also Minton v. Cavaney, 56 Cal. 2d 576, 80, 364 P.2d 473, 475, 15 Cal. Rptr. 641, 643 (1961) (immaterial for liability purposes that director accepted office as an "accommodation"). Duty-of-care cases in close corporations, however, tend to be less frequent than the great number of cases involving freeze-outs and other forms of opportunistic behavior. Thus while the duty of care plays an important exhortative function in close corporations as well as public corporations, it is a relatively unimportant source of litigation. In contrast, the loyalty problems generated by freeze-
however, may remove one of the few available constraints on such behav­
or, and thus may be undesirable. Consequently, the Maryland statute’s
failure to include a broad duty of loyalty exclusion may be more prob­
lematic in the close corporate context than in the context of public
corporations.

Before settling for that conclusion, however, one should take into
account the charter-option aspect of the Maryland statute. This article
has not yet addressed that issue, because with respect to public corpora­
tions the existence of the option is largely meaningless.\textsuperscript{126} Information,
coordination and free-riding problems make it virtually impossible for
shareholders to resist management requests for liability-limiting charter
amendments.\textsuperscript{127} The transactional costs of resistance are simply too
high. As far as shareholders of public corporations are concerned, the
statute might as well be mandatory in operation.\textsuperscript{128}

In close corporations, however, the existence of an option may be
significant. Shareholders in such corporations are likely to be able to
negotiate agreements that reflect the desired allocation of control, risk
and return.\textsuperscript{129} Real bargaining is at least possible when the number of
shareholders are few and each is able to reap the benefits of his or her
own participation in the bargaining process.

The agreements among those participating in the bargaining may
take several forms. There are, for example, highly specific agreements
such as employment contracts, buy-sell agreements triggered by death or
retirement, or restrictions on transferability of the shares that define with

\textsuperscript{126} For a thorough critique of a claim by the drafters of the Maryland statute that the
charter-option provision “enhances the role of stockholders in corporate govern­
ance.” \textit{DIRECTOR LIABILITY REPORT, supra note 57, at 21, reprinted in 18 U.
BALT. L. REV. at 265; see Honabach, Consent and Exit, supra note 14, at 324-331.

\textsuperscript{127} For a reference to the “hundreds” of other corporations already incorporated in
Delaware that have amended or proposed charter amendments adding exculpatory
provisions, see Hanks, supra note 4, at 1216 n.32. Such charter amendments are so
routinely approved that the New York Stock Exchange has adopted an informal
position allowing brokers to act without instruction from the shareholders in voting
proxies in favor of such amendments, so long as there is no litigation pending
against the directors. Telephone conversation with Nora Sisk, New York Stock Ex­
change (December 6, 1988).

\textsuperscript{128} The liability legislation proposed in 1987 was intended to be mandatory in operation
and not a charter option. \textit{See supra note 9; DIRECTOR LIABILITY REPORT, supra
note 57, at 2, reprinted in 18 U. BALT. L. REV. at 254. The charter-option feature
may have been added in 1988 to make the new bill more palatable to the legislature.
The distinction certainly received great emphasis from the drafters. See DIRECTOR
LIABILITY REPORT, supra note 57, at 2, 11, 16, 21, reprinted in 18 U. BALT. L.
REV. at 254, 259, 262, 265.

\textsuperscript{129} For further discussion of these issues, see Honabach, Consent and Exit, supra note
14, at 344-46. This discussion of the use of exculpatory provisions in close corpora­
tions benefited particularly from the comments and suggestions of Cyril Moscow.
precision the central elements of the parties' relationship. Because the
cost of writing such agreements precludes complete specificity, the par-
ties usually agree to be bound by at least some of the provisions of the
applicable state corporation statute. For instance, the parties may, in
effect, agree to rely on statutorily-created fiduciary duties as an implied
standard term of their contract in lieu of specifying in greater detail the
exact nature of each other's obligations. Their ability to rely on such
"off-the-rack" rules allows them to reduce the transactional costs of de-
fining their relationship.

A statutory provision that permits shareholders to choose the extent
to which fiduciary obligations can be enforced through suits for liability
simply gives the parties another option. The parties thus can choose to
either: (i) write highly specific contracts defining in detail all of the par-
ties' obligations and the sanctions for violating them; (ii) minimize con-
tract-writing and rely on statutory fiduciary obligations and liability rules
as implied standard terms; or (iii) adopt an intermediate position that
implicitly relies on fiduciary obligations but not on liability rules for en-
forcing them. If shareholders in close corporations are in fact able to
bargain effectively over these options, then there is no reason not to allow
them the third option, even if that would permit them to impose limita-
tions on liability for breach of the duty of loyalty. Evaluation of the
parties' ability to bargain effectively, however, should give due weight to
the great problem of transition in ownership in close corporations. The
initial period of bargaining among the founders of the business may re-
fect relatively equal amounts of information, economic leverage and so-
plication, and hence may be a context in which the adoption of broad
exculpatory provisions is appropriate. The net effect of such provisions
on the founders while they are still involved in the business may be mini-
mal. When stock ownership has passed to a spouse or other heirs, how-
ever, liability-limiting provisions may exacerbate the risk of deadlock or
freeze-out. This kind of risk can be reduced through careful planning for
such transitional situations, but the availability of the charter-option may
lead to the routine use of liability limitations in situations where they are
not appropriate.

Much depends, therefore, on the proper estimation of the parties' abil-
ity to bargain in close corporations. This issue is a matter of great
debate. 130 Suffice it to say that if the ultimate conclusion on the bargain-
ing issue is relatively positive, then probably little purpose is served by
constraining the parties' ability to use a charter-option provision that
limits personal liability for breaches of fiduciary duty. There may be

130. Compare O'Neal, Close Corporations: Existing Legislation and Recommended Re-
form, 33 Bus. LAW. 873, 881 (1977) ("statutory protection is needed for minority
shareholders who fail to bargain for and obtain protective contractual arrange-
ments") with Easterbrook & Fischel, Close Corporations, supra note 50, at 284 ("The
extent to which minority shareholders are ignorant of problems they might face and
thus fail to protect themselves is impossible to tell.").
some risk, however, that the presence of broad exculpatory provisions in transitional situations may exacerbate freeze-out problems.

V. CONCLUSION

When one is asked to comment upon new legislation, the irresistible temptation is to criticize, and to insist that the drafters should have been more sensitive to the concerns raised by the critic. This article certainly contains its fair share of criticism and second-guessing, but it also contains a fair amount of praise, as its title suggests. The authorization of a limit on liability for breach of the duty of care has been described as a sensible reinforcement of the traditional approach to that duty. Similarly, the Maryland statute's extension of that protection to officers as well as directors has been described as justifiable and useful.

It is fair to conclude, therefore, that the Maryland statute's approach to the duty of care makes a positive contribution to the governance of public corporations. The approach to the duty of loyalty, however, is less positive. This is not to suggest that the drafters intended to undermine the duty of loyalty, or that they wished to enable corporate managers to abuse their office with impunity. The statute's duty of loyalty problem is rather an example of the law of unintended consequences. The drafters intended to mitigate the consequences of sharply increased costs of D & O liability insurance, but they accomplished that goal through excessively broad means that have created needless uncertainty about the nature and effects of the duty of loyalty.

The ultimate significance of that uncertainty will depend upon how the courts interpret the different loyalty exclusions under the Maryland and Delaware statutes, so it is perhaps too early to enter a final verdict on the Maryland legislation. In the meantime, a third cheer for the Maryland director and officer liability statute must be postponed.