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CONSENT, EXIT, AND THE CONTRACT MODEL OF THE CORPORATION — A COMMENTARY ON MARYLAND'S NEW DIRECTOR AND OFFICER LIABILITY LIMITING AND INDEMNIFICATION LEGISLATION

Dennis R. Honabach†

I. INTRODUCTION

On February 18, 1988 the Maryland General Assembly adopted amendments to Maryland's General Corporations Law placing Maryland among the leaders in the ongoing revolution to restate and reformulate the fiduciary duty of corporate officers and directors.¹ The new provisions allow shareholders to "opt out" of the current rules imposing monetary liability on directors and officers in a wide range of cases.² In addition, they authorize the corporation to offer greatly expanded indemnification to officers and directors.³ Because the new provisions enhance the ability of Maryland corporations to shelter their directors and officers from personal liability, they undoubtedly will be warmly received in both the boardroom and the executive suite.⁴

A warm reception by their most obvious beneficiaries, however, does little to answer the important question of whether the new provisions constitute an improvement over the prior corporate governance rules. Some commentators believe they are not. These critics argue that by reducing the role liability rules play in regulating corporate fiduciaries, the new legislation eliminates crucial protection for shareholders.⁵ They condemn the wave of legislation reformulating corporate fiduciary duties, characterizing it as merely another example of the power of corporate directors and officers to extract concessions from state legislatures; as yet

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1. Act of Feb. 18, 1988, ch. 3, 1988 Md. Laws 739. For a general discussion of the new legislation in all states, see Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMP. L. REV. 13 (1988); Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207 (1988).

2. See MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b)(8), 2-405.2 (Supp. 1988).

3. See *Id.* § 2-418 (1985 & Supp. 1988).

4. See Hanks & Scriggins, *Let Stockholders Decide: The Origins of the Maryland Director and Officer Liability Statute of 1988*, 18 U. BALT. L. REV. 235 (1989) (describing response of Maryland chartered publicly-owned corporations to the passage of the new legislation).

5. See Sargent, *Two Cheers for the Maryland Director and Officer Liability Statute*, 18 U. BALT. L. REV. 278 (1989); Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L. J. 919 (1988); see also Zwier, *Is the Maryland Director and Officer Liability Statute Based on a Male-Oriented Ethical Model?*, 18 U. BALT. L. REV. 368 (1989).

“another lap in the race to the bottom.”⁶

The drafters of the new legislation naturally view their efforts quite differently. Though they admit that the new provisions diminish the role liability rules play in structuring the relationship between shareholders and their directors and officers, the drafters do not believe the new provisions unduly favor directors and officers. Instead, as they noted in their report to the Maryland State Bar Association's Section of Corporation, Banking and Business Law,⁷ the drafters believe that several rationales justify the new legislation. They contend that the new provisions are “fair” to corporate directors and officers;⁸ that they promote the economic well-being of the state;⁹ and that they empower shareholders, the owners of a corporation, to privately order their own relations with their directors and officers.¹⁰ The new legislation may lead to increased discretion for directors and officers, the drafters admit, but for good reasons.

This article undertakes a five-part critique of the new legislation. Part II summarizes the new provisions and explains their significance. Part III examines each of the drafters' justifications, concluding that only the shareholder empowerment justification has a serious claim of legitimacy. Part IV analyzes the central portions of the new provisions in light of the empowerment justification. It demonstrates that although the new provisions afford shareholders some power to vary traditional liability rules, they restrict that power in important ways that are inconsistent with the goal of empowering shareholders. Moreover, it demonstrates that the new indemnification provisions inexplicably permit corporate directors to override shareholder intent. Part V concludes that the new provisions cannot be justified by a simple invocation of shareholder empowerment norms.

The inadequacy of the justifications for the new provisions proffered by the drafters, however, does not compel the conclusion that the provisions are inappropriate. Part V considers a different but related defense of the new provisions. Analyzing them in light of the emerging Contract Model of the corporation, it argues that the new provisions may be consistent with at least the “strong” or neo-classical form of that Model,¹¹

6. Hazen, *Corporate Directors' Accountability: The Race to the Bottom - The Second Lap*, 66 N.C.L. REV. 171 (1987); Steinberg, *supra* note 5, at 924.

7. MARYLAND STATE BAR ASS'N SEC. OF CORP., BANKING AND BUS. L., COMM. ON CORP. LAW, SUBCOMM. ON DIRECTOR LIABILITY REP. (Nov. 16, 1987), *reprinted in* 18 U. BAL. L. REV. 254 (1989) (Appendix) [hereinafter DIRECTOR LIABILITY REPORT]; *see also* Hanks & Scriggins, *supra* note 4.

8. DIRECTOR LIABILITY REPORT at 16-17, *reprinted in* 18 U. BAL. L. REV. at 262-63; *see also infra* text accompanying notes 58-69.

9. DIRECTOR LIABILITY REPORT, *supra* note 7, at 17, *reprinted in* 18 U. BAL. L. REV. at 263; *see also infra* text accompanying notes 70-82.

10. DIRECTOR LIABILITY REPORT, *supra* note 7, at 16, *reprinted in* U. BAL. L. REV. at 262; *see also infra* text accompanying notes 83-120.

11. For a description of the “strong” or neoclassical form of the Contract Model, *see infra* note 130.

but only so long as they are applied to "open corporations."¹² Because shareholders of open corporations who oppose the modification of their corporate contract provisions can "exit" by selling their shares, their failure to exit implies consent to the new regime.¹³ Unfortunately, at least from the view point of one who would invoke the Contract Model to justify them, the new provisions, however, do not apply only to open corporations. As Part V demonstrates, indiscriminate application of the new provisions to all Maryland corporations is inconsistent with the Contract Model, for it may work a midstream modification of the fiduciary rules of corporations whose shareholders cannot exit if they object, and who therefore cannot be deemed to have consented to the new provisions merely because they continue to hold their shares. Part VI proposes changes in the structuring of the new provisions which, if adopted, might align them more closely with the requirements of the Contract Model by assuring that they apply only to shareholders who explicitly or implicitly consent to their application.

II. AN OVERVIEW OF THE NEW PROVISIONS

As the Subcommittee recognized, the new provisions may effect a substantial change in the fiduciary rules applicable to corporate directors and officers.¹⁴ That change, however, is likely to be significant only in a limited context. Until quite recently, the directors and officers of Maryland corporations were nominally subject to a duty of loyalty and a duty of care which required essentially that they act (1) in good faith, (2) in the best interest of the corporation, and (3) with the care of an ordinary person under similar circumstances.¹⁵ Because the courts readily employed the Business Judgment Rule¹⁶ to decline review of most manage-

12. For a definition of "open corporation" as used in this article, see *infra* note 170.

13. See *infra* text accompanying notes 171-174.

14. DIRECTOR LIABILITY REPORT, *supra* note 7, at 16-19, reprinted in 18 U. BALT. L. REV. at 262-64.

15. MD. CORPS. & ASS'NS CODE ANN. § 2-405.1(a) (Supp. 1988).

16. The Business Judgment Rule provides that directors and officers of corporations are not liable for the unfavorable outcomes of their decisions so long as they had a rational business purpose for their decisions. Generally, the rule shields both the decision and the decision maker from judicial review so long as the decision maker (1) was not interested in the decision, (2) adequately informed himself to the extent he reasonably believed appropriate, and (3) rationally believed his decision was in the best interest of the corporation. ALI PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (Tent. Draft No. 4, Apr. 12, 1985) [hereinafter ANALYSIS AND RECOMMENDATIONS]. For a discussion of the ALI project, see Special Project: Director and Officer Liability, *The Corporate Governance Debate and The ALI Proposals: Reform or Restatement?*, 40 VAND. L. REV. 693 (1987) [hereinafter Special Project, *Debate*]; see also E. BRODSKY & M. ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES, AND LIABILITIES, ch. 2 (1984 & Supp. 1988); Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979); Special Project: Director and Officer Liability, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605 (1987) [hereinafter Special Project, *Historical Perspective*]; Special Project: Director and Officer Liability, *Recent Develop-*

rial behavior in which no self-dealing was alleged, directors and officers had little real reason to fear that they might actually incur personal liability simply because they might have failed to exercise adequate care. Indeed, they were likely to be held personally liable to the corporation only if they were disloyal¹⁷ or grossly negligent.¹⁸ In that respect, directors and officers fared no better or worse than their counterparts in other states.¹⁹ As one commentator has described it, searching for cases imposing liability on directors and officers for failing to exercise due care has always been much like searching "for a very small number of needles in a very large haystack."²⁰

The comfortableness of Maryland's directors and officers, however, was ended abruptly in the mid-1980's by three related events. First, leading corporate courts suddenly and dramatically expressed both a renewed interest in evaluating the *process* (as opposed to the substance) of the management's decision making, *and* a willingness to impose personal liability on directors and officers if they found that process wanting.²¹ Second, the highly publicized wave of hostile takeovers continued, forcing more and more directors and officers to take action designed to pro-

ments Concerning the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule, 40 VAND. L. REV. 631 (1987) [hereinafter Special Project: Director and Officer Liability, *Recent Developments*]. For a decidedly unflattering view of the Business Judgment Rule, see Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1277 (1984).

17. See, e.g., *Toner v. Baltimore Envelope Co.*, 304 Md. 256, 498 A.2d 642 (1985); *Chesapeake Constr. Co. v. Rodman*, 256 Md. 531, 261 A.2d 156 (1970). See generally Miller, *The Fiduciary Duties of a Corporate Director*, 4 U. BALT. L. REV. 259 (1975).
18. See, e.g., *Devereux v. Berger*, 264 Md. 20, 284 A.2d 605 (1971); *Parish v. Maryland & Va. Milk Producers Ass'n*, 250 Md. 24, 242 A.2d 512 (1968). See generally Miller, *supra* note 17.
19. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) ("[D]irector Liability is predicated upon concepts of gross negligence."). The origins of the gross negligence standard can be traced at least as far back as the decision in *Percy v. Millaudon*, 8 Mart. 68 (La. 1892). For an overview of the negligence standard as applied to corporate fiduciaries, see Special Project, *Historical Perspective*, *supra* note 16, at 614-615.
20. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors & Officers*, 77 YALE L. J. 1078, 1099 (1968); see also Comment, *Director Liability Under the Business Judgment Rule: Fact or Fiction*, 35 SW. L.J. 775 (1981).
21. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). The Delaware Supreme Court presaged its decision in *Van Gorkom* in *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch.), *aff'd per curiam*, 316 A.2d 619 (Del. 1974). In *Gimbel*, however, plaintiff shareholders sought to enjoin a transaction they claimed was the product of hasty decision making, not to impose personal liability. For hostile reactions to *Van Gorkom*, see Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985); Herzel & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Manning, *Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1986). But see Prickett, *An Explanation of Trans Union to "Henny Penny" and Her Friends*, 10 DEL. J. CORP. L. 451 (1985) (arguing *Van Gorkom* was correctly decided).

tect the corporation from unwanted suitors.²² Such action requires directors and officers to make decisions which may significantly affect the corporation's value but which vary from the pattern of "ongoing business decisions" routinely protected by the Business Judgment Rule.²³ Finally, the so-called "liability insurance crisis" forced corporations to pay dramatically higher premiums for directors' and officers' liability insurance (if they were able to purchase it at all).²⁴ The combination of these events apparently so threatened corporate directors that many expressed an unwillingness to serve unless they were assured protection from liability.²⁵ Not surprisingly, corporate leaders clamored for legislative relief. The Maryland General Assembly, like many other state legislatures,²⁶ responded affirmatively.²⁷

The recent amendments to the Maryland General Corporations Law consist of two sets of provisions designed to alleviate the liability fears of directors and officers. The first, which is patterned on a similar provision

22. For an overview of hostile takeover activity and legislative responses, see Romano, *The Future of Hostile Takeovers: Legislative and Public Opinion*, 57 U. CINN. L. REV. 457 (1988).

23. At least one rationale for the Business Judgment Rule is that in appointing directors (and through the directors, the officers), shareholders have expressed confidence in directors' and officers' business acumen, at least as to decisions relating to ongoing business matters. Accordingly, the courts interfere only reluctantly with decision-making by the shareholders' chosen managers, because doing so would require them to second-guess the managers and would involve them in frequent disputes over day-to-day matters. When the decisions before the board involve structural rather than operational matters, however, the courts are less reluctant to intervene. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (board of directors must demonstrate that its response to a hostile bid was reasonable in relation to the threat posed by the bid). The courts appear to recognize that reviewing structural decisions need not involve them in an ongoing review of day-to-day business operations. Moreover, doing so does not require them to displace decision makers chosen by shareholders, because shareholders have not necessarily expressed confidence in management's ability to make structural decisions. See GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 573-580 (1986); Note, *False Halo: The Business Judgment Rule in Corporate Control Transactions*, 66 TEX. L. REV. 843 (1988) [hereinafter Note, *False Halo*].

Other reasons offered in support of the rule include: (1) imposing liability on directors and officers would deter qualified individuals from serving in those positions; (2) shareholders "assume" the risk of poor management; (3) retrospective review may result in the judge or jury mistaking bad luck for bad judgment; and (4) the threat of liability may deter directors and officers from undertaking desirable risks. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 14 (1984).

24. See Hanks, *supra* note 1, at 1208-09; Hanks & Scriggins, *supra* note 4, at 235; see also DIRECTOR LIABILITY REPORT, *supra* note 7, at 3-5, reprinted in 18 U. BALT. L. REV. at 255-56.

25. See DIRECTOR LIABILITY REPORT, *supra* note 7, at 7, reprinted in 18 U. BALT. L. REV. at 257.

26. For a complete listing of the various state acts, see Hanks, *supra* note 1, at 1246-1253.

27. For an extensive review of the legislative history of Maryland's new provisions, see Hanks & Scriggins, *supra* note 4, at 238-45.

in the Delaware code,²⁸ permits shareholders to "opt out" of many of the current rules that impose monetary liability on corporate directors and officers.²⁹ The second liberalizes the rules governing the power of a Maryland corporation to indemnify its directors and officers.³⁰ The drafters apparently assume that shareholders will use the power granted them by the new rules to eliminate liability to the fullest extent permitted by law.³¹

The first set of provisions permits shareholders to adopt a corporate charter provision expanding or limiting the liability of the corporation's directors and officers for money damages in a wide range of cases.³² These provisions, however, do not grant shareholders *carte blanche*. The new provisions prohibit shareholders from limiting directors' or officers' liability to the corporation or its shareholders in any of three situations: when a director or officer has 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;³³ when a director's or officer's action or inaction is the result of active and deliberate dishonesty;³⁴ or when a director's or officer's actions arise out of certain specified banking transactions.³⁵ More importantly, the new provisions do not permit shareholders to modify the director's or officer's underlying duty to the corporation.³⁶ Their duty is still to act in good faith and in the manner of a reasonable person in a like situation under similar circumstances.³⁷ Consequently, a liability-limiting charter provision that is adopted pursuant to the new provisions will have no effect on a director's or officer's liability in equity.³⁸ Moreover, such a provision will not

28. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988). Maryland's "charter option" provision differs significantly in that it applies to officers as well as directors, and does not contain a broad "duty of loyalty" exclusion. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2 (Supp. 1988). For a discussion of Maryland's exclusions, see *infra* text accompanying notes 33-40. For a comparison of the two provisions, see Hanks, *supra* note 1, at 1210-16; Sargent, *supra* note 5, at 280-82.

29. MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b)(8), 2-405.2 (Supp. 1988).

30. *Id.* § 2-418 (Supp. 1988).

31. See, e.g., Hanks, *Forms - Liability of Directors and Officers* (Proposed Article First), reprinted in M. SARGENT, *DIRECTORS AND OFFICERS LIABILITY TODAY* 81 (MICPEL 1988):

To the maximum extent that Maryland law in effect from time to time permits limitation of the liability of directors and officers, no director or officer of the Corporation shall be liable to the Corporation or its stockholders for money damages.

The preliminary corporate reaction to the new provisions supports the drafters' assumption. See Hanks & Scriggins, *supra* note 4.

32. MD. CORPS. & ASS'NS CODE ANN. §§ 2-104(b)(8), 2-405.2 (Supp. 1988).

33. *Id.* § 2-405.2(a)(1).

34. *Id.* § 2-405.2(a)(2).

35. *Id.* §§ 2-405.2(a)(3), 2-405.2(b).

36. Compare *id.* with VA. CODE ANN. § 13.1-609(A)(1985) ("a director shall discharge his duties as a director . . . in accordance with his good faith business judgment of the corporation.").

37. MD. CORPS. & ASS'NS CODE ANN. § 2-405.1 (Supp. 1988).

38. See Hanks & Scriggins, *supra* note 4, at 246.

shield the decision itself from review.³⁹ Notwithstanding shareholder adoption of a liability-limiting charter amendment, a disgruntled shareholder may still petition the courts to have action on the board's decision enjoined or rescinded.⁴⁰

The second set of provisions significantly expands the ability of the corporation to indemnify corporate directors and officers and to advance monies to defer the expenses such individuals incur if they are sued.⁴¹ Modeled on similar provisions in the Delaware General Corporation Law⁴² and the Revised Model Business Corporation Act,⁴³ the new provisions permit a corporation to pay such indemnification unless it is proved that the defendant: (1) acted in bad faith or with active and deliberate dishonesty; (2) actually received an improper personal benefit in money, property, or services; or (3) engaged in criminal behavior with reasonable cause to believe that his act or omission was unlawful.⁴⁴ The new provisions permit indemnification in a derivative action for actual expenses, judgments, penalties, fines, and, most importantly, amounts paid as settlements, so long as the defendant director or officer is not adjudged to be liable to the corporation.⁴⁵ The provisions eliminate the prior rule that a termination of an action by a judgment, order, or settlement creates a presumption that the individual failed to meet the requisite standard of conduct.⁴⁶

The new indemnification provisions also permit the corporation to advance the defendant director reasonable expenses so long as the de-

39. In effect, the new liability limiting provisions strengthen the Business Judgment Rule while leaving the Business Judgment Doctrine untouched. For a discussion of the distinction between the Business Judgment Rule and Business Judgment Doctrine, see Hinsey, *Business Judgement and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609 (1984).
40. See, e.g., *Gimbel v. Signal Companies, Inc.* 316 A.2d 599 (Del. Ch.), *aff'd per curiam*, 316 A.2d 619 (Del. 1974).
41. MD. CORPS. & ASS'NS CODE ANN. § 2-418 (1985 & Supp. 1988). The new provisions are applicable to corporate officers and agents unless otherwise provided in the corporation's charter. *Id.* § 2-418(j)(1) (1985). See generally Scriggins, 1988 Amendments to the Maryland Indemnification Statute, reprinted in M. SARGENT, DIRECTORS AND OFFICERS LIABILITY TODAY (MICPEL 1988).
42. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988). For discussions of Delaware's "charter option" provision, see Katz & Sherpo, *From the Boardroom: Next to Last Word on Endangered Directors*, 87 HARV. BUS. REV. 38 (Jan.-Feb. 1987); Schaffer, *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J.L. & PUB. POL'Y 665 (1987); Veasey, Finkelstein, & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987); Note, *Limiting Directors Duty of Care Liability: An Analysis of Delaware's Charter Option Approach*, 20 J. LAW REF. 543 (1987); Note, *Delaware Amendment Relaxes Directors' Liability*, 44 WASH. & LEE L. REV. 111 (1987).
43. REVISED MODEL BUSINESS CORP. ACT ANN. §§ 8.50 - 8.58 (1985).
44. MD. CORPS. & ASS'NS CODE ANN. § 2-418(b) (Supp. 1988).
45. *Id.* § 2-418(b)(ii).
46. *Id.* § 2-418(b)(3)(i). Compare *id.* with § 2-418(b)(3) (termination by . . . settlement creates a rebuttable presumption that director did not meet the requisite standard).

defendant provides both a statement that he believes in good faith that he has met the standard of conduct required of him, and a written undertaking to repay the amount advanced him should it ultimately be determined that he has not met that standard.⁴⁷ In deciding whether to advance such expenses, the corporation need not determine whether the defendant can satisfy that undertaking should he be called upon to do so.⁴⁸

Finally, the new indemnifications provisions explicitly provide that the corporate statute is not the exclusive source of the corporation's authority to indemnify or advance expenses to defendant directors, officers, and agents.⁴⁹ Expanded indemnification may be authorized by the corporation's charter or bylaws, by shareholders' or directors' resolution, or by agreement.⁵⁰

What effect will the new provisions have on the behavior of the directors and officers of Maryland's corporations? They are unlikely to alter significantly the behavior of directors and officers in ordinary business activities; notwithstanding the recent clamor over liability, directors and officers have little reason to fear liability under the prior rules if they make a poor decision in a matter of routine business.⁵¹ The provisions may have a significant impact, however, on the way directors and officers undertake action in extraordinary transactions (particularly in hostile takeover situations) where personal liability was previously a serious threat.⁵² The natural inclination of directors and officers confronted with a takeover bid is to take measures to ward off the takeover. Under the prior rules, they rightly feared that seemingly hasty action—in particular, action which successfully thwarted the bid or closed off the auction in favor of a white knight—would result in a shareholder derivative suit seeking substantial damages. Under the new provisions, such a suit loses its sting.⁵³ Although the shareholder who successfully challenges the di-

47. *Id.* § 2-418(f)(1).

48. *Id.* § 2-418(f)(2).

49. *Id.* § 2-418(g).

50. *Id.*

51. See *supra* notes 16-20 and accompanying text. The new rules may actually have been formulated to operate as a form of self-insurance. See Sargent, *supra* note 5, at 293. The new rules may reduce the urge of directors to create a "paper trail" to document the reasonableness of the decision-making process. See *id.* at 286; see also Manning, *Reflections and Practical Tips on Life in the Boardroom after Van Gorkom*, 41 BUS. LAW 1 (1985).

52. Steinberg, *Tender Offer Regulation: The Need for Reform*, 23 WAKE FOREST L. REV. 1, 38 (1988); Honabach & Sargent, *Directors' Liability Statutes Placed in Perspective*, NAT'L L.J., July 4, 1988, at 23-24; see also Note, *False Halo*, *supra* note 23 (courts should repudiate application of the Business Judgment Rule in cases testing defensive takeover action by directors).

53. Even if shareholders have not amended the corporation's charter to limit liability, directors and officers are generally assured that they can look to the corporation for an advancement of expenses, and later, for indemnification. See *infra* text accompanying notes 105-120. See generally MD. CORPS. & ASS'NS CODE ANN. § 2-418 (1985 & Supp. 1988).

rectors' and officers' actions eventually might convince the court to order the dismantling of the defensive barricades, directors and officers need not fear personal liability.⁵⁴

III. JUSTIFYING THE NEW PROVISIONS

Because the new provisions will enhance the ability of directors and officers to undertake important and potentially self-serving actions without fear of liability, they are certain to be criticized as a tool intended to permit corporate managers to entrench themselves at the expense of their shareholders. The drafters of the new provisions offer three quite different rationales to support adoption of the new provisions: (1) the new provisions are "fairer" to corporate directors and officers because, if implemented fully by the shareholders, they protect corporate directors and officers from unpredictable, excessive liability;⁵⁵ (2) the new provisions are beneficial to the state because they eliminate an incentive for corporations to abandon Maryland and reincorporate elsewhere;⁵⁶ and (3) the new provisions are desirable because they give shareholders, the owners of the corporation, the power to formulate their own governance rules.⁵⁷ Because similar reasoning is often advanced to support legislation restating the fiduciary rules applicable to corporate directors and officers, it is worthwhile to examine, at least momentarily, each rationale.

A. *The Fairness Justification*

One argument frequently made to justify enactment of provisions like the new Maryland amendments is that they are "fairer" to corporate directors and officers. That argument may be interpreted in either of two ways. One view is that it is unfair to subject corporate directors and officers to unpredictable, excessive liability on the basis of an after-the-fact determination by a judge or jury that the directors and officers employed an inadequate decision-making process or otherwise failed to act with due care.⁵⁸ Such liability, the argument goes, is disproportionate to the rewards directors and officers receive for serving in their official capacities.⁵⁹ In particular, as the drafters of Maryland's new provisions noted, directors of publicly traded corporations often "are outsiders with

54. Moreover, because time is the enemy of the bidder, the directors' and officers' adoption of antitakeover measures may effectively thwart the takeover even though the court ultimately enjoins implementation of those measures.

55. See *infra* text accompanying notes 58-69.

56. See *infra* text accompanying notes 70-82.

57. See *infra* text accompanying notes 83-120.

58. DIRECTOR LIABILITY REPORT, *supra* note 7, at 6, reprinted in 18 U. BALT. L. REV. at 256-57.

59. ANALYSIS AND RECOMMENDATIONS, *supra* note 16, § 7.17, at 31 ("First and most fundamentally, a ceiling [on director and officer liability] is justified on grounds of fairness, because the potential liability . . . would be excessive in relation to the nature of the defendant's culpability and the economic benefits expected from serving the corporation.").

little or no equity investment . . . in the corporation; yet they are charged with protecting the investment of [a large number] of stockholders. . . . Their compensation is insignificant relative to the magnitude of their risks and responsibilities."⁶⁰ Implicit in the argument is the belief that liability for mismanagement—like criminal punishment—should somehow “fit” the act.

The premise of this fairness argument—that liability should be dependent on compensation rather than on harm caused—is flawed. The compensation of a director (or officer) is irrelevant in assessing the fairness of directors' and officers' liability *so long as* the rules for imposing liability are not amended *ex post* to impose personal liability for behavior which before hand was satisfactory.⁶¹ An individual who accepts a corporate position does so knowing both the compensation and the responsibility. If he believes that the threat of liability outweighs the compensation and perquisites of the position, he need only resign. By continuing to serve, he voluntarily subjects himself to the implicit terms of his agreement with the corporation, including the fiduciary rules imposed by the courts. Having freely made the decision to serve, he cannot complain that the threat of liability is onerous or unfair.⁶²

The drafters' concern about the fairness of imposing liability on corporate directors and officers may also be interpreted as concern not for

60. DIRECTOR LIABILITY REPORT, *supra* note 7, at 18-19, *reprinted in* 18 U. BAL. L. REV. at 263-64. In their commentary, the drafters compared the potential liability of directors *qua* directors with the fees they receive for serving. Directors who are also officers, and non-officer directors (to whom the statute also applies) receive considerably greater compensation from the corporation. Nevertheless, their financial interest in the corporation is likely to be considerably less than the amount for which they might be held liable should they be found to have acted negligently in making a corporate decision which later turned bad.

61. Although some commentators believed that *Van Gorkom* represented just such a change in the law, others believe that the decision was consistent with prior law. Compare Fischel, *supra* note 21, with Prickett, *supra* note 21. At least one commentator argues that the *Van Gorkom* court's emphasis on process offers directors and officers enhanced protection. See Sargent, *supra* note 5, at 291-92; see also Christy, *Corporate Mismanagement as Malpractice: A Critical Reanalysis of Corporate Managers' Duties of Care and Loyalty*, 21 HOUS. L. REV. 104 (1984) (courts should review the process by which the defendant director or officer made her decision). *But see* Frug, *supra* note 16 (reliance on process review is inappropriate).

62. A caveat is in order. The statement in the text assumes that a director or officer may resign without incurring a substantial penalty. In some cases that is not true. For example, if a director's or officer's compensation includes a substantial deferred compensation component which she would forfeit should she resign, she may be forced to continue serving in her official capacity even though she no longer desires to do so. Under such circumstances, she may not be deemed to have consented voluntarily to the changing fiduciary rules. Subjecting her to stricter liability rules would be an implicit breach of her agreement with the corporation. See Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 16-24 (1986). So long as exit is possible only at an extreme cost, one's failure to exit may signal either consent or recognition that the costs of exiting exceed the loss imposed by new contract terms. Cf. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 416-18 (1988).

the directors and officers themselves but rather for the corporation's shareholders. The drafters apparently feared that the increasing threat of liability might create a talent drain that eventually would harm the shareholders of Maryland's corporations. The drafters may have believed that reform was necessary to enable shareholders to retain managerial talent.⁶³

The drafters' fear about shareholder welfare may not have been completely warranted for several reasons. First, as noted above, the threat of liability to directors and officers was significant under the prior rules only when they undertook a small (but important) set of decisions.⁶⁴ If, nevertheless, shareholders and managers thought that threat too onerous, they could have devised private arrangements for permitting the directors and officers to act in those situations without risking personal liability. Action by the General Assembly may well have been unnecessary. Second, even if some individuals were unwilling to serve as directors because they perceived an increased risk of liability,⁶⁵ it is not clear that corporations were unable to fill their boards. Nor is there proof that the quality of corporate management would decline if board size were to be reduced.⁶⁶ Anecdotal evidence of "director flight" hardly

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63. The drafters referred repeatedly to their concern that the threat of liability would dissuade would-be directors from serving. See, e.g., DIRECTOR LIABILITY REPORT, *supra* note 7, at 7, reprinted in 18 U. BALT. L. REV. at 257 (Corporations will lose a vital source of independent thought and expertise and the remaining directors will inevitably tend toward caution and conservatism rather than innovation and the taking of sound business risks.); see also ANALYSIS AND RECOMMENDATIONS, *supra* note 16, § 7.17, at 31 (Given the frequently nominal investment of directors in their corporation's stock, a substantial risk of liability might lead risk-adverse directors to opt for more hesitant policies than shareholders desire (particularly to the extent that shareholders hold reasonably diversified portfolios and so are substantially protected from any firm-specific risk)).
64. *But see* Sargent, *supra* note 5, at 294-95 (the perception of increased risk was sufficient to alter directors' and officers' behavior in ways that were injurious to shareholder welfare).
65. See, e.g., Baum & Bryne, *The Job Nobody Wants*, BUS. WK., Sept. 8, 1986, at 56; Mallen & Evan, *Surviving the Directors' and Officers' Liability Crisis: Insurance and the Alternatives*, 12 DEL. J. CORP. L. 439, 443-444 (1987); Selas, *Risky Business: Corporate Directors Bail Out*, 72 A.B.A. J., June 1, 1986, at 24-25; Fowler, *Scarce Corporate Directors*, N.Y. Times, Jan. 7, 1986, at D20.
66. The threat of liability most affected the willingness of outside directors to serve. See Baum & Bryne, *supra* note 65. That development was viewed with alarm by many jurists, practitioners, and theorists who believe that outside directors perform a valuable role in monitoring managerial behavior and injecting "outside" views into the debates about corporate activities. See, e.g., M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 149-170 (1976); Ruder, *Protections for Corporate Shareholders: Are Major Revisions Needed?*, 37 U. MIAMI L. REV. 243, 261 (1988). To the extent that provisions like Maryland's limit the liability of such directors, more outside directors will be willing to serve. A substantial number of the theorists, however, dispute the claim that outside directors are effective agents. See, e.g., Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 617-33 (1981); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1282-84 (1982). To the extent that this latter group of theorists is correct, the movement to limit director liability may represent misguided policy.

justifies a significant revision of fiduciary rules, rules that have evolved over time.⁶⁷

It is even less likely that many corporate officers were deterred from continuing to serve their corporations by the threat of increased personal liability. Given the size of their compensation and their investment of effort and time in acquiring managerial skills (many of which are firm specific),⁶⁸ most officers likely would have found resignation much too expensive a response. Rather than abdicate their posts, they likely would have opted to negotiate increased salaries or perquisites, and would have sought to develop decisionmaking devices that shifted responsibility for crucial structural decisions to outside directors.

Most importantly, if the drafters' frequently expressed concern for fairness reflected their concern for the well-being of shareholders, they presumably would have drafted legislation enabling shareholders to decide whether to reduce fiduciary liability or expand indemnification. Instead, the new provisions only grant shareholders partial flexibility, and, as discussed below, they do not even ensure that shareholders—rather than corporate managers—decide which route to take.⁶⁹

B. *The Protectionism Justification*

At several points in their report, the drafters of the new provisions argue that the new rules are desirable because they benefit the state's economy.⁷⁰ They contend that the new rules will eliminate the eagerness of Maryland corporations to reincorporate elsewhere to take advantage of more lenient liability rules.⁷¹ Moreover, they assert, the new rules will establish Maryland's reputation as a state with a favorable business climate, and will even encourage foreign corporations to reincorporate in Maryland.⁷² The implicit premise of such statements is that Maryland and her citizens profit from having corporations incorporated in the state.

The nexus between the economy of the state and the decision of corporations to incorporate in the state, however, is far from clear. Whether a corporation chooses to incorporate in Maryland or elsewhere does not directly affect that corporation's decision about where to locate its headquarters or plants. By way of example, Delaware is renowned for the number of leading firms incorporated there.⁷³ Yet relatively few of

67. Cf. Baysinger & Butler, *Revolution Versus Evolution in Corporate Law: The ALI's Project and The Independent Director*, 52 GEO. WASH. L. REV. 557, 580-81 (1984).

68. See Carney, *supra* note 62, at 416-18; Coffee, *supra* note 62, at 17-19.

69. See *infra* notes 88-120 and accompanying text.

70. DIRECTOR LIABILITY REPORT, *supra* note 7, at 11, 17, 20, *reprinted in* 18 U. BALT. L. REV. at 259, 263, 264-65.

71. *Id.* at 31, *reprinted in* 18 U. BALT. L. REV. at 271.

72. *Id.*

73. As of December 28, 1984, approximately forty-three percent of the corporations whose shares were listed on the New York Stock Exchange were incorporated in Delaware. See Schaffer, *supra* note 42, at 65.

those corporations have any substantial operational or administrative presence in that state.⁷⁴ Though the drafters were correct to believe that in making "bricks and mortar" decisions, corporations care greatly about a state's "business climate", the "business climate" about which corporations are concerned is primarily a state's education, regulation, and taxation policies, not its corporate code.⁷⁵ Moreover, because a corporation's decision about where to locate a plant has little to do with where it is incorporated, a change in the situs of incorporation of a corporation that has a substantial presence within the state of Maryland is unlikely to decrease the number of plants, jobs, and taxes it provides the state. Most Marylanders would scarcely notice its reincorporation elsewhere.⁷⁶

It would overstate the objection to the drafters' comments to assert that a decision by a Maryland corporation to reincorporate elsewhere would have no direct impact whatsoever on Marylanders. At least two such effects should be identified. First, a decision by a Maryland corporation to reincorporate elsewhere would reduce the revenue that corporation pays the state in organizational fees.⁷⁷ The resulting revenue loss

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74. Less than one percent of the 1400 NYSE and AMEX firms tracked by Standard & Poor's Stock Report were headquartered in Delaware. All of the firms headquartered in Delaware, however, were incorporated there. In contrast, while fewer than one percent of the same sample of corporations were headquartered in Maryland, only slightly more than half were incorporated in the state. Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 27 J. L. & ECON. 179, 186 (1985).
75. See, e.g., Leepson, *Keeping Business at Home*, NATION'S BUSINESS 67 (May, 1987) (emphasizing education, tax assistance, and technical advice as the key factors in promoting economic growth); see also D. OSBORNE, LABORATORIES OF DEMOCRACY 259-88 (1988).
76. The drafters' tendency to mistakenly equate the state of incorporation with the situs of plants echoes a similar error made in the past by courts confronted with shareholder suits seeking to have the courts order the dissolution of a closed corporation on the grounds that its majority shareholders were oppressing the minority shareholders. Equating dissolution with termination of the business, the early courts were reluctant to order dissolution, fearing that doing so might sacrifice the going-concern value of the corporation and might thereby harm the public in the process. See, e.g., *In re Radom & Neidorff*, 307 N.Y. 1, 119 N.E.2d 563 (1954). In reality, dissolution primarily affects the mode of organization, not the business activity of the firm. (That the corporate participants choose to do business as a corporation evidences their belief that the corporate form yielded some advantages. It is possible, therefore, that in marginal cases, denying the participants the corporate form might be sufficient to destroy the residual value of the firm). Shareholders seeking a decree of dissolution rarely actually compel termination of the firm; they seek instead a bargaining chip to be used in determining the price they will receive in return for relinquishing their interests in the corporation. For a complete discussion, see Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977).
77. Maryland imposes a bonus tax on the filing of articles of incorporation which may range from a minimum of \$20 to a maximum of \$390 plus \$20 for each \$1,000,000 in authorized capital stock in excess of \$5,000,000. MD. CORPS. & ASS'NS CODE ANN. § 1-204 (Supp. 1988). In addition, domestic corporations must pay an annual fee of \$40. *Id.* § 1-203(3). Foreign corporations need not pay the bonus tax. They must, however, pay a \$40 annual fee. *Id.* By reincorporating elsewhere, corporate participants subject themselves to a second round of formation and annual fees. See, e.g., DEL. CODE tit. 8, § 391 (1983 & Supp. 1988).

would be devastating to Maryland's fisc if the state depended heavily for its revenue on such franchise taxes. But Maryland does not and, consequently, the fiscal impact on Maryland of the loss of some franchise taxes is not likely to be substantial. Second, an exodus of Maryland corporations would hurt those individuals, including members of the state's corporate bar, who provide Maryland-specific services (such as advice about Maryland corporate and tax law) to Maryland corporations.⁷⁸ Here too, however, it is unclear whether this loss would be significant. The expertise of Maryland's corporate bar, for example, extends to a large number of legal fields such as contract law, employment law, and federal securities law. One would expect few exiting corporations to change counsel for such matters merely because they reincorporated in a neighboring state. Moreover, the overall demand for expertise in Maryland corporate law would be little affected even if a few of Maryland's publicly traded corporations were to depart for greener corporate pastures. The great majority of Maryland corporations are small; they are apt to find the transaction costs of reincorporating elsewhere prohibitive.⁷⁹

Moreover, even if the drafters were correct in believing that reincorporations would adversely affect the economy of the state, they would be hard pressed to rely on that effect alone to justify changing the governance rules applicable to Maryland corporations. To do so would require the drafters to subordinate the interests of shareholders to the interests of other constituencies. Although some academics have long advocated recognition of other interests,⁸⁰ only fourteen states now permit directors to take into account the impact of corporate decisions on nonshareholder groups.⁸¹ Maryland does not; it holds the traditional

78. The phrase "Maryland-specific services" refers to activities, including the giving of advice on Maryland corporate and tax law, which have value only so long as clients are incorporated in the state. At least some commentators have contended that the investment made by the members of Delaware's corporate bar explains that state's popularity as a state of incorporation. Professors Macey and Miller contend, for example, that such state-specific investment is one factor in explaining Delaware's continuing popularity as a state of incorporation. The corporate bar, they argue, essentially "bond" the state's commitment to keeping the Delaware corporate code at the head of the pack. Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporation Law*, 65 TEX. L. REV. 469, 503-506 (1987).

79. See *infra* notes 175-179 and accompanying text.

80. See, e.g., A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 356 (1948).

81. Fourteen states have adopted such statutes: Arizona, ARIZ. REV. STAT. ANN. § 10-1202(A)(Supp. 1987); Idaho, IDAHO CODE § 30-1-35 (Bobbs-Merrill 1980); Illinois, ILL. ANN. STAT. ch. 32, ¶ 8.85 (Smith-Hurd Supp. 1988); Indiana, IND. CODE ANN. § 23-1-35-1(d) (Burns Supp. 1988); Kentucky, KY. REV. STAT. ANN. § 271A.397(4) (Baldwin 1988); Maine, ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1988); Minnesota, MINN. STAT. § 302A.251(5) (Supp. 1988); Missouri, MO. ANN. STAT. § 351.347(4) (Vernon Supp. 1988); Nebraska, NEB. REV. STAT. § 21-2004(15)(a) (Supp. 1987); New Mexico, N.M. STAT. ANN. § 53-11-35(D) (Supp. 1988); New York, N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1988); Ohio, OHIO REV. CODE ANN. § 1701.59(E) (Page Supp. 1988); Pennsylvania, 42 PA. CONS. STAT. ANN. § 8363(b) (Purdon Supp. 1988); and, Wisconsin, WIS. STAT.

view that a corporation should be run for the benefit of its shareholders.⁸² The drafters' repeated expression of concern that shareholders be permitted to fashion their own governance rules belies any argument that the drafters intended a radical restatement of the traditional view.

C. *The Shareholder Empowerment Justification*

Throughout its report the Subcommittee repeatedly returns to one dominant theme: the new provisions are appropriate because they permit shareholders to privately order their own relationships.⁸³ In so doing the drafters squarely ground the new provisions on the central freedom-of-contract principle that holds that individuals who voluntarily commit themselves to a governance scheme tend to maximize their interests, at least over the long run.⁸⁴ The role of the state in such a regime is limited to facilitating the contracting process and to enforcing the resulting agreement. This view rejects outright the argument that the proper role of those who craft corporate codes is to define and impose concepts of procedural and substantive "fairness" on directors, officers, and shareholders.⁸⁵ Instead, the contract principle directs drafters to eliminate the barriers — including mandatory fiduciary rules — which prevent corporate participants from negotiating the governance rules they prefer.

Given the attractiveness of self-governance and the current wave of deregulation, someone unfamiliar with corporate theory would anticipate that the drafters' commitment to empowering shareholders would be received warmly. This is unlikely to be the case for two reasons. First, as discussed below, many corporate theorists discount "shareholder choice" as a meaningful concept with respect to publicly traded corporations.⁸⁶ Second, even if one suspends debate on whether shareholders ever actu-

ANN. § 180.305 (West Supp. 1988). For an exhaustive listing of state director and officer provisions, see Hanks, *supra* note 1, at 1246-53.

For discussion of the wisdom of such "other constituency" provisions, see *id.* at 1227-1230; Mahoney, *New Laws Place Directors in Untenable Position*, NAT'L L.J., July 4, 1988, at 26; Steinberg, *The Pennsylvania Anti-Takeover Legislation*, 12 SEC. REG. L.J. 184 (1984).

82. Presumably the directors and officers of a Maryland corporation may take into account the effect of proposed acts on members of other constituencies, but only in so far as such effects may impact on the long-run profitability of the corporation. Compare *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919) (corporation must be run for the benefit of its shareholders) with *Union Pac. R.R. v. Trustees, Inc.*, 8 Utah 2d 101, 329 P.2d 398 (1958) (charitable contribution upheld on grounds that such action benefits corporation in the long-run).

83. DIRECTOR LIABILITY REPORT, *supra* note 7, at 12, 15, 16, 19, 21, reprinted in 18 U. BALT. L. REV. at 259-60, 262-63, 264, 265.

84. See, e.g., A. KRONMAN & R. POSNER, *THE ECONOMICS OF CONTRACT LAW* 1-2 (1979). For a discussion of the development of the philosophic view that the self-interest of man is a constructive force for collective welfare, see M. MYERS, *THE SOUL OF ECONOMIC MAN* (1983). But see West, *Authority, Autonomy, and Choice: The Role of Consent in the Moral and Political Visions of Franz Kafka and Richard Posner*, 99 HARV. L. REV. 384 (1985).

85. See N. WOLFSON, *THE MODERN CORPORATION* (1984).

86. See *infra* text accompanying notes 121-126.

ally exercise control over their corporation, the new provisions do not grant shareholders such control.⁸⁷ A study of the new provisions calls into question the extent of the drafters' commitment to private ordering by shareholders. Although the new provisions afford shareholders greater control over the structuring of their governance rules, they limit that power in curious ways, and, more importantly, they enable corporate directors to override shareholder decisions in important matters.

IV. THE NEW PROVISIONS AND THE EMPOWERMENT JUSTIFICATION

No drafting effort is perfect. Critics of any piece of legislation can always identify a troublesome word or odd phrase. Even so, the structure of parts of the new provisions appear so inconsistent with the drafters' announced purpose of empowering shareholders to fashion their own governance scheme that it calls into question the drafters' commitment to that goal. The difficulties become apparent when the liability-limiting provisions and the indemnification provisions are considered individually. When considered together, those provisions become even more troublesome.

A. *Shareholder Empowerment and the New Liability Provisions*

On first reading, the new liability-limiting provisions appear to be consistent with the empowerment justification. New section 2-405.2 is relatively uncomplicated.⁸⁸ The drafters, eschewing the mandatory pattern of change adopted by states like Virginia⁸⁹ and Indiana,⁹⁰ crafted the liability-limiting provisions as a charter option provision that permits shareholders to amend their corporate charter to modify the liability rules applicable to corporate directors and officers. If, for any reason, the shareholders do not act, the prior rules governing liability continue in effect. Conversely, if shareholders choose to amend the prior rules, they have considerable discretion. They may eliminate director and officer monetary liability almost entirely. Or, if they wish, they may fashion a somewhat less radical revision of the existing rules. In theory, they might

87. See *infra* text accompanying notes 88-120.

88. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2 (Supp. 1988); see also *id.* § 2-104(b)(8) (authorizing the inclusion of a liability limiting provision in the corporate charter).

89. VA. CODE ANN. § 13.1-690 (1989) (restating the duty of a director to require him "to discharge his duties . . . in accordance with his good faith business judgment"); *id.* § 13.1-692.1(A)(1),(2) (capping director and officer liability at the greater of \$100,000 or twelve months' cash compensation). For a complete discussion of the Virginia act, see Honabach, *All That Glitters: A Critique of the Revised Virginia Stock Corporation Act*, 12 J. CORP. L. 433, 463-480 (1987).

90. IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1988) (directors not liable absent willful misconduct or recklessness). For a discussion of the Indiana statute and a comparison to its Delaware counterpart, see Note, *Statutory and Non-Statutory Responses to the Director and Officer Liability Crisis*, 63 IND. L.J. 181 (1987).

even up the ante,⁹¹ exposing directors and officers to the type of strict, insurance-like liability that the courts have never deemed appropriate.⁹² The important point is that under the new provisions a corporation's shareholders, not the drafters of the new provisions, choose whether to modify the liability rules applicable to their directors and officers.⁹³

Although critics are likely to claim that section 2-405.2 goes too far in permitting shareholders to eliminate the traditional duty of care,⁹⁴ the difficulty with it, at least from the empowerment justification, is its limited scope. Section 2-405.2(a) does not permit shareholders to eliminate the personal liability of a director or officer who does not act in good faith or who receives an improper personal benefit.⁹⁵ Although shareholders might rarely wish to eliminate liability entirely in such cases, they might well decide that litigating all claims alleging such behavior is too expensive. To conserve resources, shareholders might prefer to set a minimum threshold level of personal gain which the director or officer must realize before the behavior becomes actionable.⁹⁶ Alternatively, they might adopt a system of nonjudicial claim resolution.⁹⁷ Some shareholders might even choose to eschew regulation and rely entirely on portfolio diversification.⁹⁸ If section 2-405.2(a) were to be completely consistent with the empowerment justification, it would leave such matters for decision by the shareholders, not the General Assembly.⁹⁹

91. Compare MD. CORPS. & ASS'NS CODE ANN. § 2-405.2 (Supp. 1988) (shareholders may adopt "provision *expanding or limiting* the liability . . .") with DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1988) (shareholders may adopt a "provision *eliminating or limiting* the personal liability . . .") (emphasis added).

92. See Hanks & Scriggins, *supra* note 4, at 247. To be sure, the drafters hardly expect shareholders to actually expand liability, but they permit shareholders to do so. *But cf. infra* text accompanying notes 105-120 (the new indemnification provisions ultimately rest power in the hands of the board of directors, not shareholders).

93. See *supra* note 83.

94. See, e.g., Steinberg, *supra* note 5, at 927-29.

95. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a)(1)-(3) (Supp. 1988).

96. The determination of the compensation paid by the corporation to directors and officers presents a classic instance of self-dealing. Yet, as a general rule, such amounts are determined by the board of directors. See REVISED MODEL BUSINESS CORPORATION ACT § 8.11 (1984). Generally, courts will not interfere with the determination of compensation set by the board so long as it is reasonable. See H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* 663-671 (3d ed. 1983).

97. For example, shareholders might agree to submit allegations of self-dealing to mediation or arbitration. Many firms probably handle small "breach of loyalty" claims by simply dismissing the employee in question. Presumably, the severance benefits such an employee demands and receives are affected by the nature of the dismissal.

98. Easterbrook & Fischel, *Corporate Control Transactions*, 91 *YALE L.J.* 698, 711-714 (1982); see also *infra* note 171. For a general discussion of portfolio theory, see E. ELTON & M. GRUBER, *MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS* (3d ed. 1987); R. HAGIN, *MODERN PORTFOLIO THEORY* (1979); see also Gilson & Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 *STAN. L. REV.* 313 (1985).

99. At first glance, the argument in the text may appear to be an extreme example of academic insistence that the drafters of the new provisions be consistent regardless of the likelihood that shareholders might actually notice the missing power, let alone employ it. After all, one might argue, it is unlikely that any corporation's

Perhaps more troubling is that section 2-405.2(a) only empowers shareholders to address the issue of personal liability of directors and officers for monetary damages. It does not permit them to restate the standard of conduct entirely.¹⁰⁰ No matter what action shareholders take, a disgruntled shareholder may still sue to set aside a proposed corporate action on the grounds that the directors or officers failed to exercise due care.¹⁰¹ Although the board of directors might form a litigation committee and the committee, after due consideration, might properly dismiss the claim,¹⁰² the litigation will necessarily impose costs on the corporation. Unscrupulous shareholders may still file strike suits to extract concessions. Therefore, despite their having implemented the new provisions, shareholders as a group must continue to bear both the direct costs of litigation *and* the opportunity costs that occur when the threat of personal liability for self-dealing and the annoyance of time consuming litigation deters managers from engaging in desirable risk taking.¹⁰³ Had

shareholders would ever avail themselves of the power to permit directors or officers to engage in self-dealing. Yet shareholders (and courts attempting to determine what shareholders might do if asked) already permit self-dealing in some instances. Consider, for example, the problem of usurpation of corporate opportunities. In determining what is and what is not a corporate opportunity, the courts seek to examine the reasonable expectations of the parties. *See, e.g., Burg v. Horn*, 380 F.2d 897 (2d Cir. 1967) (one family of shareholders did not usurp a corporate opportunity of a real estate development corporation by purchasing and developing other real estate); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (parent corporation did not usurp opportunity of subsidiary in not permitting subsidiary to participate in development of oil fields located other than in Venezuela). To the extent that the courts defer to the *ex ante* expectations of the shareholders, they implicitly recognize the power of shareholders to vary the scope of a fiduciary's duty of loyalty by agreement.

Nevertheless, in practice the "good faith"-loyalty restriction of section 2-405.2(a) is unlikely to affect shareholders adversely to any significant degree. *Accord Hanks & Scriggins, supra* note 4, at 247-48. Perhaps the drafters elected to exclude such behavior from the scope of the section as a matter of practical politics. The harm of their doing so will likely be small. Even those theorists who advocate making the entire menu of fiduciary duties elective generally recognize that "loyalty" issues present problems different from those presented by "care" issues. *See, e.g., Sargent, supra* note 5, at 295-302; Scott, *The Role of Perceptions in Policy Analysis in Law: A Response to Fischel and Bradley*, 71 CORNELL L. REV. 299 (1986).

100. MD. CORPS. & ASS'NS CODE ANN. § 2-405.2(a) (Supp. 1988); *see also* DIRECTOR LIABILITY REPORT, *supra* note 7, at 16, *reprinted in* 18 U. BALT. L. REV. at 263.
101. That the shareholder will not be permitted to recover damages, however, will likely undercut his incentive (and that of his attorney) to pursue the action.
102. *See, e.g., Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994 (1979) (judicial review limited to the adequacy of the procedures employed and the independence of the directors who decided to dismiss); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (same as in *Auerbach* except that in "demand excused" cases, the court may also review the sufficiency of the reasons advanced to support dismissal). *But see Miller v. Register & Tribune Syndicate*, 336 N.W.2d 709 (Iowa 1983) (neither board nor special committee can dismiss action when a majority of board are defendants).
103. For example, section 2-405.2(a) permits disgruntled shareholders to brand a particular decision as the product of a careless, unprofessional decision-making process. One can anticipate that directors, although shielded from personal liability, will

the drafters of section 2-405.2(a) attempted to employ the full measure of the empowerment justification, they would have permitted shareholders to shield the directors' and officers' decisions as well as the directors and officers themselves.¹⁰⁴

B. Shareholder Empowerment and the New Indemnification Provisions

The new indemnification provisions of section 2-418 create even greater problems for one who would attempt to employ the empowerment justification to support the recent amendments to the Maryland code.¹⁰⁵ At first glance, the new indemnification provisions appear to be consistent with the goal of permitting corporate participants to determine the role that the threat of personal liability is to play in regulating directors' and officers' behavior. Affording such participants greatly expanded discretion, section 2-418(b)(1) provides that:

A corporation *may* indemnify any director (and officers and corporate agents). . . unless it is proved that (i) the act or omission of the director was material to the cause adjudicated. . . ; and (1) Was committed in bad faith; or (2) Was the result of active and deliberate dishonesty; or (ii) The director actually received an improper benefit in money, property, or services; or (iii) In the case of any criminal proceeding, the director had reasonable cause to believe that the act or omission was unlawful.¹⁰⁶

The corporation may indemnify its directors in any other action so long as they are not adjudged liable to the corporation.¹⁰⁷

A closer reading, however, reveals that these expanded indemnification provisions are not entirely consistent with the principle that *shareholders* be permitted to determine their own fiduciary rules. First, note that the new indemnification provisions apply to all Maryland corporations without regard to shareholder action. Unlike with the new liability rules, shareholders need not act to "opt into" the new indemnification

continue to engage in an elaborate, costly "papering" process to ward off *Van Gorkum*-type claims for personal and reputational reasons. Moreover, because many Maryland corporations may have taken advantage of the invitation of section 2-406 to eliminate the right of shareholder to remove a director without cause, a shareholder might litigate "care" claims to establish sufficient cause for removal. MD. CORPS. & ASS'NS CODE ANN. § 2-406 (1985). The exact meaning of "cause" is unclear, but arguably a director's breach of her duty of care constitutes "cause." See generally Travers, *Removal of the Corporate Director During His Term of Office*, 53 IOWA L. REV. 389, 412-14 (1967).

104. Accord Butler & Ribstein, *Free at Last? The Contractual Theory of the Corporation and The New Maryland Officer-Director Liability Provisions*, 18 U. Balt. L. Rev. 352 (1989). Given the response of critics like Hazen, *supra* note 6, and Steinberg, *supra* note 5, the drafters no doubt will be bemused to find themselves criticized for not having gone far enough!

105. MD. CORPS. & ASS'NS CODE ANN. § 2-418 (Supp. 1988).

106. *Id.* at § 2-418(b)(1) (emphasis added).

107. *Id.* at § 2-418(b)(2)(ii).

regime. The new rules supplant the old ones automatically. No shareholder action is required. Moreover, although the new rules are merely enabling, they are crafted so that the board of directors (or a special legal counsel selected by the directors), *not* shareholders, will usually determine whether the corporation will indemnify a defendant director, officer, or corporate agent.¹⁰⁸ To be sure, the drafters' decision to permit the board to decide initially would ordinarily be desirable, as the board can act more swiftly and at considerably lower cost. Even if shareholders believe that indemnification is inappropriate in a particular case, they cannot veto a decision of the board to pay it. Nor can they adopt a charter provision vesting in themselves the sole power to decide indemnification issues. At best, shareholders can pass a precatory resolution advising the board how they would vote and threatening removal if the board does not concur.¹⁰⁹

The dominant role played by the board of directors in determining whether to indemnify is particularly important given the interplay between the new indemnification provisions and the provisions relating to director and officer liability. As written, the new provisions permit the board to achieve on a case-by-case basis essentially the same result that shareholders might have achieved by approving a charter provision limiting liability *even if the shareholders have expressly rejected such an amendment*.¹¹⁰

The only check on the board's ability to indemnify is section 2-418(b)(2)(ii), which prohibits indemnification if the defendant is adjudged liable to the corporation.¹¹¹ That limitation, however, is incomplete for two reasons. First, it applies only to derivative actions; it is inapplicable to direct shareholder actions.¹¹² Second, even in a derivative action, the section 2-418(b)(2)(ii) limitation is triggered only if the direc-

108. *Id.* at § 2-418(e)(2) (1985). To be sure, the drafters' decision to permit the board to decide initially would ordinarily be desirable, as the board can act more swiftly and at considerably lower cost.

109. *Cf. Auer v. Dressel*, 306 N.Y. 427, 118 N.E. 2d 590 (1954). The SEC's proxy rules also permit shareholders to use management's proxy to make precatory motions. 17 C.F.R. § 240.14a-8(c)(1) (1988). Shareholders, however, may not use those rules to wage an election contest, nor may they make proposal related to matters of ordinary business operations, *id.* § 240.14a-8(c)(7),(8). Even if shareholders succeed in threatening management, the efficacy of precatory shareholder proposals and the desirability of Rule 14a-8 are both questionable. *See, e.g., Dent, SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y. L. REV. 1 (1985); Liebler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984). *But see* Ryan, *Rule 14a-8, Institutional Shareholder Proposals and Corporate Democracy*, 23 GA. L. REV. 97 (1988) (the rule plays an important role in corporate governance, particularly in light of the increased activism of institutional shareholders).

110. For example, assume that the shareholders have expressly rejected a liability-limiting charter provision. Nevertheless, the board may approve indemnification against liability stemming from those very acts so long as the defendant is not adjudged to have been liable to the corporation. It is safe to assume that most defendants will prefer to settle.

111. MD. CORPS. & ASS'NS CODE ANN. § 2-418(b)(2)(ii) (Supp. 1988).

112. Thus, even though the shareholders refuse to limit the monetary liability of direc-

tor is *adjudged* to be liable.¹¹³ It does not apply if the corporation and the defendant agree to settle the action, a decision generally made on behalf of the corporation by the board itself. Thus, so long as it is still able to settle the lawsuit, the board may authorize expanded indemnification, thereby effectively imposing the new restricted liability standard, albeit on a case-by-case basis. Moreover, the board can apply the new standard retroactively. Should a director confront potential liability at some future date for actions or omissions that occurred after the effective date of the act, the board in the exercise of its business judgment may approve settlement *and* indemnification as if the shareholders had adopted a liability-limiting charter amendment on the earliest date possible.¹¹⁴

Section 2-418(g) is similarly partially inconsistent with the empowerment justification.¹¹⁵ It does empower shareholders to *expand* the indemnification rights granted by the statute.¹¹⁶ It nevertheless does not permit shareholders to *contract* the scope of indemnification. More importantly, it permits *directors* to expand indemnification rights without the approval of shareholders—for example, by amending the corporation's bylaws. Though directors cannot adopt bylaws unless granted the power to do so by the shareholders,¹¹⁷ it is usual for corporate bylaws to contain boilerplate language which enables directors to amend existing bylaws.¹¹⁸ Moreover, even if shareholders have reserved the power to adopt bylaws, their directors may still expand the availability of indemnification by adopting a board resolution or by approving an employment contract that authorizes expanded indemnification.¹¹⁹

In sum, both the new liability limiting provision and the new indemnification provisions are at best only partially consistent with drafters' announced purpose of amending the Maryland corporate code to empower the shareholders of Maryland corporations to privately order their own governance relations.¹²⁰ The liability limiting provisions afford

tors and officers in a shareholder action, the directors may accomplish essentially the same thing *ex post* by authorizing indemnification.

113. MD. CORPS. & ASS'NS CODE ANN. § 2-418(b)(2)(ii) (Supp. 1988).

114. Act of Feb. 18, 1988, ch. 3, § 2, 1988 Md. Laws 743.

115. MD. CORPS. & ASS'NS CODE ANN. § 2-418(g) (Supp. 1988).

116. Although the act suggests that shareholders' power is unlimited, it may be circumscribed by public policy. Consider, for example, a case in which a dissenting shareholder challenges shareholder adoption of a charter provision providing indemnification for directors who have acted in bad faith. Though on its terms, Section 2-418(g) seemingly authorizes such a provision, the prohibition of section 2-418 (b)(1) would arguably override it. Just as it seems inappropriate from the standpoint of the Contract Model to limit the ability of the shareholders to eliminate liability in such a case, it is inappropriate (although consistent) to deny them the power to indemnify.

117. MD. CORPS. & ASS'NS CODE ANN. § 2-109(b) (1985).

118. Cf. 2 R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS Form 1.17, Art. VI § 6.7 (1986).

119. MD. CORPS. & ASS'NS CODE ANN. § 2-418(g) (Supp. 1988).

120. The drafters, aware that the new indemnification rules afforded directors expanded

shareholders only limited freedom to restructure the fiduciary duties of their directors and officers. Likewise, the indemnification provisions permit shareholders the limited right to expand protection; they do not allow shareholders to contract that protection. Finally, the indemnification provisions inappropriately empower directors to alter liability rules *sub silentio* by permitting them to administer the liberalized indemnification procedure. In fact, the board might employ the indemnification procedure so as to circumvent a shareholder decision not to limit liability. Such failings are inconsistent with the principle that shareholders, not lawmakers or corporate fiduciaries, should fashion the governance rules applicable to Maryland's corporations.

V. THE NEW MARYLAND PROVISIONS AND THE CONTRACT MODEL OF THE CORPORATION

Although the inconsistencies between the language of the new provisions and the drafters' avowed goals undercut the drafters' reliance on the shareholder empowerment rationale for the new provisions, those inconsistencies may ultimately matter little in determining whether the provisions can be justified. Critics of the new provisions are likely to come from either of two camps, neither of whom will find the inconsistencies central to their critique of the new legislation. One group will contend that shareholders, at least those of the publicly traded corporations for whom the provisions were drafted, have no real say in the governance of their corporations. Such scholars, the traditionalists, would probably find the new provisions equally objectionable if they were drafted so as to lodge power formally in the hands of shareholders. In contrast, the new school of corporate theorists, the contractarians, be-

indemnification rights and empowered directors to adopt even more expansive protection, offered several explanations. First, they noted that the new provisions encouraged settlement of derivative actions, contending that "settlements are to be encouraged as a means of terminating litigation, and it is against public policy to discourage settlements by providing that corporate officers and directors may lose their indemnification unless they pursue all litigation to its ultimate conclusion." DIRECTOR LIABILITY REPORT, *supra* note 7, at 25, reprinted in 18 U. BALT. L. REV. at 267 (emphasis added). The drafters did not explain, however, why they choose to impose *their* judgment on public policy rather than to leave the matter to shareholders. Their failure to explain is crucial given that the cardinal principle of the empowerment justification is that in matters of internal governance, lawmakers should not impose their own views of "public policy" upon shareholders.

The subcommittee also attempted to support its proposed indemnification rules by noting that the new provisions would "allow Maryland corporations the same flexibility in administering these matters as Delaware corporations." *Id.* at 31, reprinted in 18 U. BALT. L. REV. at 271. While consistent with the policy of emulating Delaware (and thus perhaps eliminating one incentive a corporation might have for reincorporating in Delaware), that explanation again is patently inconsistent with the principle that shareholders should determine which governance rules they prefer. Moreover, as noted earlier, the new Maryland rules are far more expansive than Delaware's. Whether good, bad, or indifferent, the new Maryland provisions clearly "out-Delaware" Delaware.

lieve that shareholders can fend for themselves. They may find portions of the new rules—despite their curious drafting — acceptable when applied to shareholders of some Maryland corporations. On the other hand, they will find some portions unacceptable and will question the propriety of imposing any of the new legislation on the shareholders of certain other corporations.

While accepting the belief that shareholders “own” the corporation, traditionalists have long derided attempts to apply the rhetoric of shareholder choice to matters of corporate governance.¹²¹ Analogizing the relationship between shareholders and corporate directors and officers to that between trust beneficiaries and trustees,¹²² traditionalists contend that corporate managers, like their trustee counterparts, actually establish and implement all corporate policies.¹²³ Formal organizational rules placing shareholders at the base of the corporate power pyramid matter little, because management’s control of the proxy machinery enables it to maintain control and dictate corporate action.¹²⁴ Shareholder action or inaction, traditionalists argue, is not an expression of shareholder will; it merely echoes the interests of those corporate managers who control the medium of shareholder expression.¹²⁵ The appearance that shareholders determine corporate policy and practice, traditionalists maintain, is nothing more than a clever illusion.¹²⁶

Because scholars of the traditional school believe that management, not shareholders, controls corporations, they dismiss claims that charac-

121. See, e.g., Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985).

122. See, e.g., D. BAYNE, *THE PHILOSOPHY OF CORPORATE CONTROL—A TREATISE ON THE LAW OF FIDUCIARY DUTY* (1986). The “Trust Model” of the corporation was popularized by A. BERLE & G. MEANS, *supra* note 80, in which they argued that the management of corporate assets had become separated from ownership. They advanced the theory that managers exercised relatively unrestrained authority over corporate assets. Contract theorists have roundly criticized the Berle-Means theory. See, e.g., R. WINTERS, *GOVERNMENT AND THE CORPORATION* (1978).

123. M. EISENBERG, *THE STRUCTURE OF THE CORPORATION - A LEGAL ANALYSIS* (1976).

124. *Id.*

125. Traditionalists deny the validity even of explicit shareholder approval. For example, in reviewing the recent directors’ and officers’ liability-limiting legislation, Professor Steinberg argues:

Although this argument (that shareholders who vote for a charter amendment have consented) has certain appeal, its validity rings hollow in light of the realities of the corporate governance process. Meaningful shareholder consent in this context is an illusion given management’s control of the proxy machinery process, the strong inclination of institutional investors to vote with management, and the typical individual shareholders’ ignorance of corporate charter provisions.

Steinberg, *supra* note 5, at 927. Characterizing the resulting arrangements as adhesion contracts, Steinberg concludes that they lack validity. *Id.*

126. Schwartz, *Shareholder Democracy: A Reality or Chimera?*, 25 CALIF. MGMT. REV. 53, 54 (1983) (“[The notion of shareholder democracy] engenders illusions of shareholder power while discouraging alternative constraints. These illusions are dangerous; they are the laetrile to the problem of corporate accountability.”).

terize "corporate reforms" as attempts to empower shareholders. They view "reforms" like Maryland's as little more than transparent attempts by state legislatures to attract corporations, and the incorporation and franchise fees they bring, by catering to the managers' appetite for power.¹²⁷ Given that perspective, traditionalists are certain to view the new amendments to Maryland's code as a pernicious loosening of the already weak restraints on self-serving behavior by corporate directors and officers.¹²⁸ Such legislation, traditionalists will conclude, leads not to improved corporate governance but rather to an escalation of the "race to the bottom."¹²⁹

In contrast, the contractarians¹³⁰ believe that shareholders by and

127. Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L.J. 663 (1974); Hazen, *supra* note 6; Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976).

128. See, e.g., Steinberg, *supra* note 5, at 928.

129. See Hazen, *supra* note 6, at 179-82.

130. The "Contract Model" of the corporation has given rise to an outpouring of writings. The leading figure in the development of the model is Dean Henry Manne. See, e.g., Manne, *Some Theoretical Aspects of Share Voting, An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427 (1964) [hereinafter *Share Voting*]; Manne, *Mergers and the Market for Control*, 73 J.P. E. 110 (1965) [hereinafter *Market for Control*]; Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967) [hereinafter *Two Systems*]. For a representative sample of other writings, see Baysinger & Butler, *Revolution Versus Evolution*, *supra* note 67; Baysinger & Butler, *The Role of Corporate Law*, *supra* note 74; Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365 (1988); Butler & Ribstein, *supra* note 104; Carney, *supra* note 62; Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984); Easterbrook & Fischel, *supra* note 98; Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986); Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982); Honabach, *supra* note 89; Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987); Scott, *Corporation Law & the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983).

Recently, the adherents of the contract model have begun to divide into two groups: those who apply a "strong form" model of the corporate contract, see, e.g., the writings of Butler, Easterbrook, Fischel, and Ribstein noted above; and those who have begun to develop a "weak form" or "consensualist" model of the corporate contract. See, e.g., Coffee, *supra* note 62; Coffee, *No Exit? Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919 (1988) [hereinafter *No Exit*].

The "strong form" contractarians apply a more or less rigorous neo-classical version of contractual theory focusing primarily on the formation of the contract and the determination of its terms. The "weak form" contractarians, on the other hand, have begun to challenge that emphasis, contending that contract law is a much more richly textured set of principles than that employed by the "strong form" contractarians. The "weak form" contractarians argue that contractarians need to acknowledge that classical contract law gave way to doctrines recognizing the need for judicial intervention to prevent, among other things, post-formation opportunistic behavior. Coffee, *No Exit*, *supra*, at 939; cf. Aivazian, Trebilcock &

large are fully capable of protecting their own interests. These scholars view the corporation as a nexus of contracts through which corporate participants, including both managers and shareholders, interact.¹³¹ Contractarians argue that because each party to the corporate "contract" seeks to maximize his own interests, conflicts of interest are inevitable. The costs of such conflicts—the agency costs—include the direct and indirect costs of monitoring the behavior of others, the costs incurred by managers to bond their performance, and the costs of opportunities managers forego because of overly stringent liability rules.¹³² Rejecting the traditionalist's claim that these costs are best minimized by judicially enforced fiduciary rules, contractarians contend that corporate participants, foreseeing the inevitability of such conflicts, will fashion their own efficient governance techniques. They assert that corporate participants need not rely solely on legislators or the courts for protection from overreaching by their fellow participants.

Contractarians believe that the error of traditional scholars in viewing shareholders as helpless can be attributed to the traditionalists' almost exclusive focus on the role played by the formal rules of corporate governance.¹³³ Contractarians argue that parties to the corporate contract rely on a mixture of "voice" rules and "exit" techniques to minimize agency costs.¹³⁴ Voice rules encompass the formal procedural rules of the corporation that permit corporate parties to participate directly in the governance of the corporation. Quorum and voting rules are examples. Contractarians view the governance rules embedded in the corporate code—including the fiduciary duty rules that traditionalists prize—as nothing more than a set of default voice rules which apply absent ex-

Penny, *The Law of Contract Modification: The Uncertain Quest for a Bench Mark of Enforceability*, 22 OSGOODE HALL L. J. 173 (1984) (some contract doctrines are intended to prevent opportunistic modifications of contracts); Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981). It is unclear at this juncture whether the development of the "weak form" of the contract model represents the evolution of the model, a heresy, or, as Grant Gilmore suggested, the inevitable germination of the self-destructive seeds inherent in all conceptual systems. See G. GILMORE, *THE DEATH OF CONTRACTS* (1974).

131. See generally *supra* note 130. See also Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1986); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structures*, 3 *J. FIN. ECON.* 305 (1976); Williamson, *The Modern Corporation: Origins, Evolutions, Attributes*, 19 *J. ECON. LIT.* 1197 (1984). Not all commentators find the contract model useful. See, e.g., Brudney, *supra* note 121.
132. Fama, *Agency Problems and the Theory of the Firm*, 88 *J.P. E.* 660 (1980). For a general discussion of "agency costs," see W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE* 157-58 (2d ed. 1986).
133. See, e.g., Manne, *Two Systems*, *supra* note 130, at 273.
134. For a full discussion of the terminology of exit and voice, see A. O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* (1970). The seminal article applying such analysis to the corporate field is Dean Manne's *Market for Control*, *supra* note 130; see also R. WINTERS, *GOVERNMENT AND THE CORPORATION* 17-18 (1978); Easterbrook, *Theories and Evidence*, *supra* note 130, at 553-557; Jensen & Ruback, *The Market for Control: The Scientific Evidence*, 11 *J. FIN. ECON.* 5 (1983).

press alteration by the parties.¹³⁵

Because exercising voice rules is expensive, contractarians emphasize, most shareholders do not employ voice techniques as their primary check on agency costs; instead, they resort to "exit" techniques.¹³⁶ Exit techniques are essentially market strategies by which a member of any organization registers her dissatisfaction with an organization by leaving. For example, a corporate shareholder who becomes unhappy with the performance of her directors and officers often expresses her dissatisfaction by selling her shares.¹³⁷ Contractarians believe that exiting exerts an indirect but powerful discipline on corporate directors and officers. Arguing that because the market for corporate shares is informationally efficient, *i.e.*, the price of a security at any given time accurately impounds all publicly available information about corporate performance, including managerial performance,¹³⁸ contractarians maintain that deficient managerial behavior will trigger a decline in the market price of the corporation's securities. Unless management corrects its performance, the price of the corporation's securities will continue to fall until it becomes worthwhile for some investor to acquire control of the corporation, oust the incumbent managers, and alter management behavior.¹³⁹ Con-

135. R. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 369-72 (3d ed. 1986); Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985) [hereinafter *Antitakeover Amendments*]; Fischel, *supra* note 130; Manne, *Share Voting*, *supra* note 130.

136. *See, e.g.*, Manne, *Market for Control*, *supra* note 130.

137. Such exit is generally referred to as the "Wall Street Rule." W. KLEIN & J. COFFEE, *supra* note 132, at 161. If a sufficient number of the participants of any group exits (or makes credible threats to exit), they may force a modification of the policies of the organization, because the incumbent managers either will change or will be replaced to end the exodus. If the exodus continues unabated, the identity of the organization will be mutated to reflect the remaining membership. A.O. HIRSCHMAN, *supra* note 134.

138. The statement in the text is a statement of the "semi-strong" form of the Efficient Capital Market Hypothesis (ECMH). The ECMH maintains that security prices at any time fully reflect all publicly available information, *i.e.*, profitable trading strategies or arbitrage opportunities are not possible. The ECMH is presented in three forms: (1) the weak form which simply maintains that histories of securities prices could not reveal profitable trading opportunities; (2) the semi-strong form which, as stated above, maintains that securities prices reflect all *publicly* available information; and (3) the strong form which maintains that prices reflect all information whether public or private. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 374-381 (1984); Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554-565 (1984). Contractarians generally take the ECMH as a given. *See, e.g.*, Butler & Ribstein, *supra* note 104, at 353-60. *But compare* Wang, *Some Arguments That the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986) (the capital market may not be "information-arbitrage" efficient and, in any event, may not be "fundamental-valuation" efficient) *with* Dennis, *Valuing the Firm and The Development of Delaware Corporate Law*, 17 RUTGERS L.J. 1, 9-13 (1985) (the market is efficient in both senses).

139. *See generally* Manne, *Two Systems*, *supra* note 130. Of course, within limits managers can usurp wealth without fear of reprisal because the costs to shareholders of effective monitoring exceed the benefits shareholders derive from monitoring. Pre-

tractarians believe that the threat of such a takeover deters incumbent managers from shirking and engaging in other forms of mismanagement as effectively as (and generally at a lower cost than) a threatened proxy fight or a suit alleging breaches of management's fiduciary duties.¹⁴⁰ Moreover, because the prerequisite of market discipline—an active market for the corporation's shares—exists as a by-product of securities trading, shareholders (at least those who hold shares in publicly traded corporations) find exiting to be relatively inexpensive. Consequently, contractarians believe, shareholders resort to voice rules to correct managerial performance only in extreme or unusual cases.¹⁴¹

Because they believe that the corporate governance is an evolving, self-checking process, contractarians—at least members of the “strong model” school¹⁴²—tend to perceive rule changes like those adopted in Maryland as part of an ongoing “climb to the top.”¹⁴³ Over time, they assert, governance rules tend to come to resemble each other because corporate participants copy the more efficient governance rules engineered by others. Though changing conditions ensure that corporation codes will continue to evolve, contractarians believe that at any given moment there exists a general equilibrium between liberal codes and strict codes.¹⁴⁴ Because shareholders — again at least those of relatively

sumably most managers already will have extracted such benefits up to the point where the costs to shareholders of additional monitoring equal the benefits to shareholders of additional monitoring. Scholarship on the subject appears to assume that managers will “consume” whatever amounts they appropriate. Recently, however, it has become evident that managers instead may “invest” all or part of such amounts in “rent-seeking” activity. That is, they may lobby the state legislature for firm-specific anti-takeover legislation. If successful in securing passage of such legislation, they may realize enhanced gains in future periods because the legislation shelters them somewhat more from the disciplinary effects of the market for control. See generally Butler, *Corporation Specific Statutes*, *supra* note 130.

140. Manne, *Market for Control*, *supra* note 130, at 114-15.

141. The market for corporate control is not the sole market-derived source of managerial discipline. Other market-based restraints include the market for capital, the product market, and the market for managers. See Easterbrook, *Theories and Evidence*, *supra* note 130.

142. For a discussion of “strong” and “weak” schools of contractarians, see *supra* note 130. Throughout the remainder of this article, the term *contractarians* will be used to refer to those scholars who employ the “strong form” of the model; the term *consensualists* will be used to refer to those scholars who employ the “weak form” of the model.

143. Baysinger & Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431 (1985); Fischel, *The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law*, 76 N.W. U.L. REV. 913 (1982).

144. Baysinger and Butler, *supra* note 143, at 456-62. A “strict statute” relies heavily on non-market oversight. Corporate participants are given little discretion to vary the corporate rules. “Liberal” statutes, on the other hand, afford the participants considerable discretion with which to fashion governance rules. In theory, corporate participants may find “strict” statutes beneficial because they enable participants to “bond” their performance of desirable behavior. But see Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1 (1988) (state corporate codes are ineffective as bonding vehicles because

large corporations — can choose to incorporate wherever they wish without affecting the location of their business activities, they can choose from a wide variety of codes in selecting their governance regime.¹⁴⁵ They need subject themselves to a particular state's corporate code only so long as that code meets their requirements. If another state offers a superior statutory product, they reincorporate there. So long as shareholders can freely choose which corporate code will govern their affairs, they are helped, not hurt, by the competition among states.¹⁴⁶

The Contract Model provides persuasive, if controversial,¹⁴⁷ support for the drafters' assertion that shareholders should be empowered to formulate their own governance schemes. The drafters of the new provisions, however, can invoke that model only so long as the new provisions are not imposed on unwilling shareholders. The principle that underlies the Contract Model—voluntary exchanges are *pareto superior* moves,¹⁴⁸ at least as between the contracting parties—requires that changes in the “contracts” of existing corporations not be made without the explicit or implicit consent of corporate participants.¹⁴⁹ Unfortunately, the drafters

participants can secure ameliorating changes in the statute or may reincorporate elsewhere).

145. For a discussion of the reincorporation literature, see Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985) [hereinafter *Law as a Product*].

146. Baysinger & Butler, *supra* note 74, at 191; Fischel, *supra* note 143, at 921-22.

147. The controversy over the contract model can be broken down into several disputes. First, as noted above, even within the contractarian camp some theorists employ the “strong form” of the model (the contractarians); others employ the “weak form” (the consensualists). The former generally see no place for mandatory rules; the latter view some mandatory rules as necessary. Their difference centers on the question of whether shareholders can sufficiently overcome the collective-action/freerider problems that may compel shareholders to make suboptimal decisions. The dispute about whether or not shareholders can do so bedevils attempts to imply consent. For a general description of those problems by leading theorists who may or may not be consensualists, see R. CLARK, *CORPORATE LAW* 389-400 (1986); Gordon, *supra* note 144, at 42-60.

A second dispute centers on the more general question of whether the capital market accurately prices changes in governance rules. While many contractarians posit that the efficiency of the capital market is an uncontested fact, other commentators argue that the market may be too blunt a tool to reflect accurately the desirability of various governance schemes. Compare Butler & Ribstein, *supra* note 104, at 353-60 with Fox, *The Role of the Market Model in Corporate Law Analysis: A Comment on Weiss and White*, 76 CALIF. L. REV. 1015 (1988). Finally, as noted earlier, still other scholars reject the Contract Model entirely, employing instead the traditional Berle-Means approach, see, e.g., Steinberg, *supra* note 5; or proffering a wholly different conceptual lens, see Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 MICH. J.L. REF. 19 (1988) (developing a “Power Model” of the corporation).

148. A *pareto superior* move is commonly defined as “one that makes at least one person better off and no one worse off.” R. POSNER, *ECONOMIC ANALYSIS OF LAW* 12 (3d ed. 1986). Voluntary transactions are thought to be *pareto superior*, at least as between the parties, because the parties freely consent to the exchange.

149. Of course, to the extent that the drafters hoped to make the Maryland code attractive to corporations, they will find little solace in having met the requirements of the model by including provisions which the shareholders of Maryland's publicly traded

did not craft the new provisions in a fashion which ensures that the new governance scheme is applicable only to shareholders who consent to the alteration of their contract.¹⁵⁰

In some instances ascertaining consent presents no problems. For example, individuals who purchased their shares knowing of when the applicability of the new provisions became effective may be deemed to have consented implicitly to at least some applications of those provisions.¹⁵¹ Even individual shareholders who purchased their shares unaware of the new rules should generally be deemed to have consented to their application, because the price they paid for their shares will have reflected the impact of the new rules.¹⁵²

The major difficulty in ascertaining consent, even for the most staunch contractarian, arises in applying the new provisions to those individuals who purchased their shares prior to the enactment of the new provisions. Can shareholders who purchased their shares before the new rules were enacted and who did not vote for their implementation nevertheless be deemed to have consented to their application? Two types of arguments can be advanced to support the claim that they have. The first argument is that shareholders consent to all future changes in the governance rules so long as such changes are made in accordance with the applicable statutory procedure. Such an argument—an “entrance” argument—might be grounded on the claim that because the Maryland corporate code contains a “reserved powers” provision,¹⁵³ all corporate participants agree *ex ante* to whatever rule changes the Maryland General Assembly approves. The entrance argument might be extended further to include any changes approved by corporate participants pursuant to code provisions permitting such changes, again on the theory that shareholders have delegated unrestricted decision making authority to a designated subset of the shareholder group.¹⁵⁴

The second type of argument for inferring consent, an exit argument, focuses on a shareholder’s response to the passage of new provisions. According to such an argument, a shareholder who does not sell

corporations find so unsatisfactory that they cause their corporations to reincorporate elsewhere to avoid the application of those provisions.

150. Those failings, unfortunately, are likely to provide a basis for critics to argue that the new provisions were drafted with the interests of management, not shareholders, in mind.
151. Thus, if a corporation includes liability limiting provisions in its initial charter, all shareholders of the corporation would be deemed to have consented to those provisions. Similarly, shareholders who purchase the corporation’s shares after it has amended its charter to include the provisions would be deemed to have consented to them. In the case of such midstream amendments, however, it is likely to be impracticable—at least for publicly traded corporations—to track when individual shareholders purchased their shares.
152. See Dennis, *supra* note 138. It seems appropriate to charge share buyers with the duty to acquire knowledge about the governance rules applicable to the corporation into which they are buying.
153. MD. CORPS. & ASS’NS CODE ANN. § 1-1029(e)(1988).
154. See, e.g., Butler & Ribstein, *supra* note 104, at 359-60.

her shares (*i.e.*, does not exit) when confronted with the new provisions may be deemed to have implicitly consented to the new governance rules, whatever their source.¹⁵⁵ In effect, she is treated as if she had sold her shares and then repurchased them subject to the new provisions.¹⁵⁶ As noted earlier, exit arguments play a central role in most versions of the contract model.¹⁵⁷

Although entrance arguments have a superficial appeal, they cannot be advanced without eroding the validity of the shareholder consent argument. The normative appeal of the contract model of the corporation rests upon the claim that shareholders, *as individuals*, have chosen to enter into a corporate "contract" they believe to be beneficial. But if the resulting "contract" may be altered by the General Assembly whenever it believes different rules would be appropriate, the "contract" amounts to nothing more than an agreement to do business on whatever terms the state imposes.¹⁵⁸ Likewise, the concept of contract becomes meaningless if shareholders are to be deemed to have relinquished unconstrained power to a supermajority of shareholders to restructure governance rules. The power of the Contract Model depends upon the ability of parties to bargain explicitly or implicitly for the terms that best suit them. Designating an entirely open-ended arrangement a "contract" blurs completely the distinction between a regulatory system of oversight and the contract system. Using contract language to describe such a relationship is a mere rhetorical flourish.

It is important to note that in dismissing a universal, "anything

155. Butler and Ribstein distinguish between state-decreed changes in the corporate contract and changes decreed by shareholders. They decry the former, suggesting that such changes may even be unconstitutional. They generally approve of the latter, arguing that the initial contract among shareholders explicitly permits such modification. See Butler & Ribstein, *supra* note 104, at 359-60; see also Butler & Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CINN. L. REV. 611, 631-637 (1988) [hereinafter *The Contract Clause*].

Their belief that all shareholder-decreed modifications are acceptable rests upon the assumption that shareholders *ex ante* have consented to any and all changes their fellow shareholders might make. It seems more probable, however, that their initial consent applies only to a set of changes falling within some range of permissible options. That is, in permitting her fellow shareholders to alter the corporate contract, a shareholder probably assumed that their exercise of that power was constrained by notions of "good faith" and "fiduciary duty." Butler & Ribstein themselves appear to recognize some restraints. Butler & Ribstein, *The Contract Clause*, *supra*. The difficult task, of course, is determining which shareholder-decreed changes are permissible and which are not. See *infra* notes 161-168 and accompanying text.

156. For discussion of similar reasoning in the field of corporate taxation, see BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 11.05 (5th ed. 1987).

157. See *supra* notes 136-141 and accompanying text.

158. If the corporate contract can be varied unilaterally by the state, the contract model would differ little from the concession model it replaces. For discussions of the "concession model," see LATTIN ON CORPORATIONS 170-79 (1971); Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327 (1979).

goes" entrance argument, one need not resort exclusively to exit arguments, or, in the alternative, return to the "vested rights" regime which required unanimous explicit shareholder approval of any changes in the corporate contract.¹⁵⁹ To the contrary, shareholders realize that a fully specified contract is impossible;¹⁶⁰ they appreciate that organizational rules, including governance terms, must be modified over time to reflect changing conditions. And they recognize that if explicit, unanimous shareholder approval were required for every change, individual shareholders might opportunistically threaten to veto a necessary change in order to secure a bribe. Shareholders appreciate that the state or a designated group of shareholders must be permitted to impose ordinary changes without the consent of every shareholder. Conversely, shareholders can properly insist under the contract model that fundamental changes be made only with individualized consent.

Distinguishing between those changes which are deemed to be "fundamental" (and hence variable only with the consent of all parties) and those deemed to be "ordinary" (and thus variable despite the dissent of some shareholders) is a formidable task. To apply an entrance argument, one must distinguish between changes on the basis of their foreseeability at the time the holder of the shares purchased her shares.¹⁶¹ For purposes of this article, "ordinary" changes are those which were foreseeable at the time the particular shareholder purchased her shares; "fundamental" changes are those which were not foreseeable at that time. Because the price a shareholder pays for her shares reflects reasonably foreseeable events—including potential future changes in governance rules¹⁶²—a shareholder may be deemed to have consented implicitly to ordinary changes *ex ante* when she purchased her shares. It makes no difference whether the change was made by the state or her fellow shareholders. Conversely, if the change were so radical that it was not reasonably foreseeable at the time the shareholder purchased her shares, the price she paid would not have reflected an appropriate discount for the possibility of that change. Any discount would simply have reflected the general

159. See generally Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69 (1980).

160. A "fully specified contract" or a "fully contingent contract" is one that provides terms for governing relations in any possible future event. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 27 (1983); O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 66-69 (1975). Such contracts are not possible. For a thorough discussion of strategies one might employ to address the problems of incomplete contracts, see Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981).

161. The choice of the "fundamental" and "ordinary" terminology may seem at first unfortunate given the difficulty the courts and commentators have faced in attempting to distinguish between ordinary corporate decisions requiring only the approval of the board of directors and fundamental (or extraordinary) transactions requiring both director and shareholder approval. See generally GILSON, *supra* note 23, at 557-580. In fact, however, the choice is appropriate because the question is similar both as to its substance and its intractability.

162. See *supra* notes 138-39 and accompanying text.

uncertainty inherent in holding corporate shares.¹⁶³ A shareholder cannot be deemed to have consented to such fundamental changes. Again, it matters not a whit whether the change is imposed by the state or by fellow shareholders.

Of course, determining whether a change was reasonably foreseeable is no easy feat. Crude rules of thumb are possible, but not particularly helpful. For example, a few changes, like an increase or decrease in board size, seem easy to classify as "foreseeable" because they are both explicitly authorized by the corporate code and are common.¹⁶⁴ Most changes, however, are much more difficult to classify. For example, some changes not now permitted by the Maryland General Corporations Law, such as reducing the required shareholder vote on fundamental transactions from two-thirds to a bare majority, nevertheless might be objectively foreseeable because the trend toward requiring only a simple majority approval is well established.¹⁶⁵ On the other hand, some changes appear to be so radical that no one would contend that they were reasonably foreseeable when the shareholder purchased her shares. For example, it would be difficult to argue that a shareholder who purchased her shares prior to 1986 foresaw (or, more precisely, that the market foresaw and, therefore, priced) the possibility that the General Assembly would abolish or permit shareholders to abolish the monetary liability of directors and officers in "due care" cases.¹⁶⁶ Before that date, no state had ever done so.¹⁶⁷ The difficulty, if not impossibility, of determining at what date the modification of the fiduciary duty rules applicable to

163. That is, whenever an individual purchases an asset, she must discount its value to reflect the possibility that unforeseen events, including a change in legal rules, will deprive her of its value. She cannot, however, be deemed to have consented to the possibility merely because in some general sense she has taken into account the possibility of a cataclysmic event, lest she be deemed to have consented to all future events.

164. See, e.g., MD. CORPS & ASS'NS CODE ANN. § 2-402 (c) (1985 & Supp. 1988); REVISED MODEL BUSINESS CORP. ACT § 8:03 (1984).

165. See, e.g., REVISED MODEL BUSINESS CORP. ACT §§ 7.25(c), 10.03(e)(2) (1984). Thirty-two jurisdictions require approval of an amendment by only a simple majority of the shares entitled to vote. Twenty jurisdictions require a two-thirds vote, at least in some instances. See generally MODEL BUSINESS CORP. ACT ANN. 1174 (3d ed. Supp. 1988).

166. If anything, the Delaware Supreme Court's decision in *Van Gorkom* might well have caused would-be shareholders to anticipate even stricter application of the traditional fiduciary duties. For discussions of *Van Gorkom* and reactions thereto, see *supra* note 21 and accompanying text.

167. Even then, Delaware's path-breaking legislation was far more limited than the new Maryland rules. It applies only to directors and preserves the traditional loyalty rules. See *supra* note 28. For a discussion of the significance of protecting directors but not officers, see Honabach, *supra* note 89, at 470-474 (1987).

Even now it might require too much speculation on the part of a purchaser to discount share prices appropriately. Recent purchasers of shares of Maryland corporations are not likely to have discounted consciously the price they paid to reflect the recent revisions in the statute. If anything, the Maryland General Assembly's 1987 rejection of proposed modifications might well have been misinterpreted as signaling Maryland's willingness to retain the traditional fiduciary rules.

Maryland corporations became sufficiently foreseeable to be reflected in the discounted price of a corporation's shares evidences the impracticability of using "entrance" theories to infer consent to all but the most uncontroversial changes.¹⁶⁸

Though entrance theories of consent are inadequate for determining whether to infer shareholder consent to the adoption of the new Maryland provisions, the drafters' might still draw support from the strong form of the Contract Model if the decision of current shareholders not to exit can be deemed to supply the necessary consent.¹⁶⁹ As a first step in determining whether to infer consent from a shareholder's decision to hold her shares, it is useful to divide corporations roughly into two groups: "open corporations" and "closed corporations." As used in the remainder of this article, an "open corporation" is one whose shares are publicly traded and in which no single shareholder (or group of shareholders) owns absolute control. The category of "closed corporations" includes all others.¹⁷⁰

Contractarians believe that because shareholders of an open corporation can exit through the public market at a relatively trivial cost, their decision to hold rather than sell in the face of changing governance rules implies consent. For example, if a shareholder of an open corporation believes his fellow shareholders have erred in eliminating the personal liability of corporate directors and officers, he can sell his shares and invest elsewhere. Though the price he receives will impound the effect of the liability-limiting charter amendment, the shareholder should lose little, particularly if he has appropriately diversified his portfolio.¹⁷¹ The

168. There are other problems with using "entrance" arguments to determine consent. For example, such an approach would require corporations to keep track of both the identity of their shareholders and also the dates on which they purchased their shares. Depending upon the facts, individuals who purchased their shares on different dates might be deemed to have consented with respect to later purchases but not earlier ones.

169. As previously discussed, theorists of one branch of the Contract Model, the consensualists, view post-formation modifications of the corporate charter as particularly vulnerable points for opportunistic behavior by some corporate participants. See *supra* note 130.

170. As used in this article, the phrase "closed corporations" includes those corporations which are publicly traded but in which a single shareholder or group owns absolute control ("nonopen publicly traded corporations"); corporations which are not publicly traded corporations but which have many passive investors ("nonpublicly traded corporations"); and, corporations which are not publicly traded but in which all participants are active players in determining corporate policy ("closely-held corporations").

It is important to distinguish between a "closed corporation" as that term is used here and a statutory "close corporation" formed under the Maryland General Corporation Act. MD. CORPS. & ASS'NS CODE ANN. §§ 4-101 to -603 (1985 & Supp. 1988). The latter is one of a subset of corporations whose shareholders have unanimously elected to be governed by the special provisions of Maryland's close corporation act. *Id.* § 4-101(b). In theory, any corporation can be a close corporation. In practice, only small corporations with a few shareholders elect close corporation status.

171. Portfolio theory divides the risks to which all investments are subject into two cate-

discipline of the market creates a floor below which the market price is unlikely to fall, because directors and officers who consider imposing a liability limitation over the objection of the majority of their shareholders realize that the price of the corporation's securities would decline if they did so. If that decline were significant (as it would be if adoption of the provision significantly injured shareholders), it would trigger a hostile takeover by an investor who would dismiss the current directors and officers and reimpose the old rules.¹⁷² Recognizing that possibility *ex ante*, directors and officers are unlikely to modify governance rules radically without first securing a strong expression of approval from current shareholders. Shareholders in most open corporations can even circumvent

gories: (1) systematic risk; and (2) unsystematic risk. Systematic risk is the risk of holding any asset. For example, the risk of a dramatic increase or decrease in the inflation rate affects to some extent the value of all assets. An investor cannot eliminate systematic risk by diversification or by any other means, although he can select among investments that are more or less sensitive to broad moves in the economy.

Unsystematic risk, on the other hand, is the risk associated with holding a particular asset. Examples include the risk of a company labor dispute and the risk of new invention that eliminates the market for the company's product. An investor can largely wash away such unsystematic risk by diversifying his investment portfolio. By broadly mixing holdings in various assets, an investor can virtually assure that any significant decrease in the value of one investment is "washed out" by an offsetting gain in another. Assume, for example, the existence of an economy consisting of two products, guns and butter, which their manufacturers can produce with equal profitability. Assume further that at any given time consumer demand for one product will be 1, and for the other, 0. Finally, assume that in either case, the value for each good is equal. An individual holding only shares in one or the other will either profit or suffer complete losses if his particular corporation succeeds or fails. A shareholder holding an evenly split portfolio, however, will profit regardless of which particular firm prospers. Because he can eliminate unsystematic risk through diversification, an investor cannot expect other participants in the venture to compensate him for bearing that risk. He will find that the price of securities in a "thick" market will reflect only the systematic risk associated with holding that security.

Because an amendment to the articles of any particular corporation should affect only the income stream available to shareholders of that corporation, the amendment would affect the price of the securities of only that corporation. A shareholder who has diversified his portfolio, therefore, should find that only a portion of his shares experience any value shift. Moreover, if the amendment increases the ability of his managers to engage in opportunistic behavior, investors may find that the value of the shares of the other corporations which are part of his portfolio will increase (at least if the managers of those firms can credibly bond their promise not to adopt a similar amendment sometime in the future). It is unlikely that the gains will offset losses perfectly, but any loss the shareholder incurs will have been minimized by holding a diversified portfolio.

For a general discussion of portfolio theory, see SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* (1980); see also E. ELTON & M. GRUBER, *supra* note 98; R. HAGIN, *supra* note 98.

172. Of course, if in increasing the discretion of the managers, the charter amendment sheltered them from the discipline of the market for control, the decline in the value of the shares could be substantial without triggering a takeover. There is no evidence, however, that charter amendments that permit shareholders to shield fiduciaries from personal liability for breaches of their duty of care significantly impair the operation of the market for control.

mandatory rules like the new indemnification provisions. Because of their size, open corporations tend to operate in many states; they generally have no special attachment to being incorporated in any particular one. For such corporations, the costs of reincorporating are apt to be relatively small.¹⁷³ If the state of incorporation were to impose mandatory rules that were injurious, shareholders and managers would often find reincorporating elsewhere an inexpensive, curative option.

In short, some contractarians believe that the shareholders of Maryland's open corporations can protect themselves from suboptimal governance rules by employing some form of exit.¹⁷⁴ They would argue that, as a result, the shareholders of those corporations who do not exit, or cause their corporation to exit, should be deemed to have consented to the new provisions. Accordingly, to the extent that the new provisions are applied only to Maryland's open corporations, contractarians are apt to support them.

On the other hand, contractarians should find the application of the new provisions to Maryland's closed corporations indefensible.¹⁷⁵ In the case of closed corporations, one cannot easily infer consent from a shareholder's decision to hold rather than sell his shares. Exiting is relatively more expensive for shareholders of a closed corporation; they may be locked in even though they oppose the new governance arrangements. Shareholders in corporations whose shares are not publicly traded cannot simply sell their shares, because there is no market for them (except for the offer of their fellow shareholders to purchase their shares as a "courtesy"—often at a substantial discount). Unlike his counterpart in an open corporation, a shareholder of a closed corporation who disagrees with a proposed change may have little choice but to continue to hold his shares.¹⁷⁶

173. See Romano, *Law as a Product*, *supra* note 145, at 248-49.

174. Cf. Baysinger & Butler, *Antitakeover Amendment*, *supra* note 135.

175. It is important that the Reader recall that the term "closed corporation" as used herein does not refer only to the traditional small, entrepreneur-dominated firm. For a definition of a "closed corporation" as that term is used in this article, see *supra* note 170.

176. Some contractarians argue that just the opposite may be true. Because shareholders in closely-held corporations are so vulnerable, Easterbrook and Fischel maintain, they readily appreciate the need for planning. Moreover, because they are relatively few in number and tend to be active in the corporation (at least initially), they can and do draft relatively detailed governance provisions. Such provisions take two forms. First, the charters of closely-held corporations often vary the normal voice rules to require a supermajority or unanimous vote at both the board and shareholder levels. Shareholders of Maryland corporations can elect "close corporation" status, which automatically imposes a unanimity requirement for most fundamental transactions. MD. CORPS. & ASS'NS CODE ANN. § 4-501 (1985). Shareholders in closely-held corporations also frequently create an internal market for their shares by adopting deadlock and shareholder provisions requiring the corporation or its shareholders to purchase the shares of a dissident party at a price designed to approximate fair market value. Finally, a shareholder in a closely-held corporation can often successfully petition the courts to dissolve the corporation if their fellow shareholders abuse their power. See generally Easterbrook & Fischel, *supra* note 98.

Even when some market for his shares exists, a shareholder of a closed corporation cannot always avoid the impact of the new provisions cheaply. If, for example, the new rules favor the controlling shareholders, a dissenting shareholder, like his open corporation counterpart, can sell, if at all, only at price reflecting the new, presumably overreaching, provisions. Unlike his counterpart in an open corporation, however, he cannot rely on the possibility of a takeover to shore up the price he receives. Because no buyer can displace the incumbent control group and reap gain from reinstating the prior rules, the controlling group need not be timid in drafting overreaching charter provisions.¹⁷⁷

Finally, unlike their counterparts in open corporations, shareholders of some closed corporations may find that they must bear the costs of mandatory rules even though they are unanimous in finding the new provisions objectionable.¹⁷⁸ The local nature of their corporation's business and the prospect of paying franchise taxes to two states may render reincorporation elsewhere impracticable.¹⁷⁹ With reincorporation no longer an option, the shareholders of a closed corporation effectively have no choice but to tolerate the new provisions—an ironic twist given

177. A controlling shareholder can be expected to impose rules which decrease the value of the corporation as a whole so long as the amount he personally gains from the redistributive effects of the rule exceed his pro-rata share of the loss suffered by the corporation. Such "redistribution" schemes are the basis of loyalty cases. Shareholders have traditionally relied on the courts rather than the market to protect them from such self-serving behavior by controlling shareholders. See, e.g., MD. CORPS & ASS'NS CODE ANN. § 3-413(b)(2) (1985) (empowering courts to order involuntary dissolution of a corporation if a shareholder demonstrates that those in control of the corporation are oppressing shareholders).

In addition, a controlling shareholder/manager may find his discretion to act opportunistically checked by the market for investment capital. If, for example, he anticipates attempting to raise additional capital by selling more shares, he may find that the adverse effect to his reputation of excessive self-dealing increases the costs of additional capital to the point at which the self-dealing behavior becomes unprofitable.

For a criticism of the new Maryland provisions on the grounds that they inappropriately undercut the rigor of the duty of loyalty, see Sargent, *supra* note 5, at 295-302; see also Zwier, *supra* note 5, at 375-77 (the new provisions inappropriately substitute an "arm's-length" flavor to corporate governance issues in place of the trust relation embodied in traditional loyalty rules).

178. Of course, corporate participants do not always find mandatory rules objectionable. They may value such rules because they act as a bonding device to assure investors that no shareholder, or group of shareholders, can act opportunistically at a later date by imposing wealth-shifting rules. *But see* Gordon, *supra* note 144 (state codes are ineffective bonding devices).

179. For example, shareholders of a relatively moderate-sized corporation might prefer the previous, less permissive indemnification rules. Yet the new indemnification provisions do not permit shareholders to opt back into those rules. Even if they could reincorporate in a state that permitted them that option, they would be required to pay a second round of organizational taxes as well as the usual Maryland fees as a cost of doing business within the state. See *supra* note 77. They would also be subject to multiple corporation and taxation filings as well. In many cases, the additional costs would be likely to exceed the benefits they derive from the preferred indemnification rules.

that the drafters nominally proposed to empower shareholders to fashion their own rules.

In short, in contrast to shareholders of open corporations, shareholders of closed corporations cannot exit easily at either the individual or the group level. Thus a contractarian cannot confidently infer consent from their decision to hold their shares.¹⁸⁰ For that reason, a contractarian could not support the new provisions to the extent that they apply to closed corporations.

VI. CRAFTING THE NEW PROVISIONS IN LIGHT OF THE CONTRACT MODEL

If the drafters of the new rules wish to draw upon the Contract Model to support their efforts, they must amend the new provisions to ensure that they apply only to shareholders who explicitly or implicitly consent to whatever modification the provisions may make to their existing corporate contracts. Shareholders of open corporations present no problems; as noted above they may exit if they dissent.¹⁸¹ Shareholders of closed corporations, however, present a problem precisely because they cannot exit easily. To make certain that the new provisions are not imposed on unwilling shareholders in closed corporations, the drafters must refashion the new rules to provide an opportunity for exit to shareholders of closed corporations or, alternatively, the drafters must limit the application of the new provisions to open corporations only.

One tack the drafters might take to resolve the consent problem is to provide dissenting shareholders in closed corporations with a method of exit by borrowing the concept of dissenters' rights from the laws governing fundamental transactions.¹⁸² Recognizing, perhaps intuitively, the importance of providing a method of exit to shareholders who disagree with fundamental changes in their corporations, legislators in all states, including Maryland,¹⁸³ provide protections to shareholders who object to certain proposed transactions. Dissenters' rights permit such shareholders to force the corporation to purchase their shares at their

180. Of course, shareholders in such corporations do not leave themselves completely vulnerable to shirking and self-serving behavior by their fellow participants. As the cost of exit rises, shareholders turn more to voice-based rules for protection. Such voice-based rules will be found in employment contracts, shareholder agreements, and the corporate code. In nonpublicly traded corporations with many passive investors, one would expect to find more reliance on the standard form rules of the corporate code than one would find in closely held corporations. As reliance on the default rules of the corporate code increases, changes in such rules, like those brought about by the new Maryland provisions, become particularly important.

181. See *supra* text accompanying notes 171-174.

182. For discussions of "dissenters' rights", see generally Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B.F. RES. J. 875 (1983); Kanda & Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985); Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962).

183. MD. CORPS. & ASS'NS CODE ANN. §§ 3-201 to -213 (1985 & Supp. 1988).

“fair value” if the corporation engages in a specified transaction.¹⁸⁴ For example, although shareholders who dispute the wisdom of a proposed merger may not possess sufficient voting power to block the transaction, they may require the corporation to cash them out.¹⁸⁵ In return for their shares, they will receive the fair value of their shares, generally determined without taking into account the “halo effect” of the triggering event.¹⁸⁶ If that value can be accurately calculated,¹⁸⁷ and if denying the dissenting shareholder any share of the halo effect is fair,¹⁸⁸ a dissenting shareholder is given the choice of exit or continued investment in the corporation. Under those conditions, she cannot be said to have been forced to accept the merger decision of her peers. If she elects to hold her shares instead of exercising her dissenters’ rights, she can be deemed to have consented to abide by the judgment of the shareholders who approved the transaction.

The drafters of the new provisions might adapt Maryland’s dissenters’ rights sections to provide the shareholders of closed corporations who oppose the application of the new provisions a method of exiting the corporation at a fair price. To do so the drafters first must offer the proposed governance changes to shareholders as a charter option. Although they have already structured liability-limiting provisions in that fashion,¹⁸⁹ they must revise the indemnification provisions if they are to be a charter option.¹⁹⁰ The drafters also must amend Maryland’s

184. See, e.g., *id.* § 3-202.

185. See, e.g., *id.* § 3-202(a)(1).

186. See, e.g., *id.* § 3-202(b).

187. That “fair value” can be accurately determined is admittedly an heroic assumption. Valuing shares in a closed corporation is a particularly difficult, imprecise exercise. Courts, apparently concerned that dissenters are attempting to hold up the corporation for a premium, have generally employed conservative techniques which tend to undervalue shares. See R. CLARK, *supra* note 147, at 452-456. At best, “fair value” as determined by the courts is likely to approximate only roughly the true value of dissenter’s shares.

That fact, however, does not undercut entirely the utility of employing “dissenters’ rights” to protect shareholders. The central question is whether the approach produces a less costly, fairer alternative. It might do so, particularly if the courts can be convinced to view dissenters as individuals who are simply exercising their contractual rights to resist modification of their deal. If the courts so viewed the appraisal remedy, they might improve their efforts at valuation. The Delaware courts, for example, have already taken a step in that direction. In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court announced that it would no longer employ the standard “Delaware block” approach as the exclusive valuation technique for valuing shares in an appraisal proceeding. The Maryland Court of Appeals has declined to adopt *Weinberger*, at least in an action seeking a preliminary injunction. *Lerner v. Lerner*, 306 Md. 771, 511 A.2d 501 (1986); see also *Walk v. Balt. & O.R.R.*, 847 F.2d 1100 (4th Cir. 1988).

188. See Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) (in some instances, dissenting shareholders ought to be permitted to share in the “halo effects”). For a discussion of the literature, see R. CLARK, *supra* note 147, at 472-478.

189. See *supra* notes 29, 32-40 and accompanying text.

190. See *supra* notes 30, 41-50 and accompanying text.

corporate code to provide dissenters' rights to shareholders who oppose charter amendments.¹⁹¹ To avoid the problems which might arise if all charter amendments triggered the dissenter's rights provisions, the drafters might make dissenters' rights available only with respect to specifically designated amendments—including amendments implementing the new liability and indemnification provisions. If they effected both changes, which would involve the difficult but essential task of formulating a workable but reasonably accurate method of ascertaining the fair value of a dissenter's shares, the drafters could credibly argue that shareholders who choose not to exercise their dissenters' rights should be deemed to have consented to their fellow shareholders' implementation of the new provisions.¹⁹²

A requirement that changes in the governance provisions be offered only on an opt-in basis, however, may be too expensive a solution. It would force shareholders in open corporations to meet to take advantage of the revisions.¹⁹³ Shareholder meetings are both expensive and time consuming, especially for open corporations that are subject to federal proxy regulation.¹⁹⁴ Given that the drafters formulated the new provisions primarily to benefit the shareholders of open corporations, it would be ironic if the drafters were to impose substantial transaction costs on the shareholders of open corporations solely to render the new provisions

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191. The Maryland corporate code currently provides dissenters' rights in an amendment of the corporate charter only if the amendment alters the contract rights, as expressly set forth in the charter, of any outstanding stock and substantially adversely affects the shareholders' rights. MD. CORPS. & ASS'NS CODE ANN. § 3-202(a)(4) (Supp. 1988). The proposal in the text would significantly expand the availability of dissenters' rights when a corporation amends its charter. *But see infra* note 192 and accompanying text.
 192. The discussion in the text assumes that a dissenting shareholder can exercise her dissenters' rights cheaply, and that the value of her shares as determined in such proceedings is accurate. Neither is the case. First, valuing shares absent a market transaction is notoriously difficult. Second, exercising one's dissenter's rights is costly. If the procedure is sufficiently expensive or the valuation sufficiently low, shareholders might retain their shares because they find it cheaper simply to bear the loss caused by the new rules than to pursue their dissenters' rights alternative. Under such conditions, holding one's shares cannot be deemed to be evidence of consent.
 193. So long as the Maryland code retains the market exception to its dissenter's rights provision, those open corporations whose shares are listed on a national securities exchange would not need to offer dissenter's rights to their shareholders; dissenters would be forced to sell their shares on the market. MD. CORPS. & ASS'NS CODE ANN. § 3-202(c) (Supp. 1988). Of course, not all corporations subject to the market exception are open corporations, as many have control blocks of sufficient size to defuse the market for control. The drafters would need to tighten the exception so that it applied only to open corporations. For a discussion of the market exception, which originated in Delaware in 1967, see E. FOLK, REVIEW OF THE DELAWARE CORPORATION LAW FOR THE DELAWARE CORPORATION LAW REVISIONS COMMITTEE 1965-1967, at 196-200. For a defense of the market exception, see Seligman, *Reappraising the Appraisal Remedy*, 51 GEO. WASH. L. REV. 829, 266 (1985). *But see* M. EISENBERG, THE STRUCTURE OF THE CORPORATION—A LEGAL ANALYSIS 80-84 (1976).
 194. See 15 U.S.C. § 78n(a) (1982).

acceptable to the shareholders of closed corporations. Drafters ought not to impose transaction costs on shareholders simply to maintain theoretical purity.¹⁹⁵

Rather than amending the new provisions so as to make them unobjectionable to the shareholders of all corporations, the drafters might find it preferable to apply the new liability-limiting and indemnification provisions only to open corporations. As previously noted, they could justify doing so because the new rules come into play primarily in hostile takeover battles.¹⁹⁶ Those contests are almost exclusively an open corporation phenomenon. Moreover, in open corporations, fiduciary duties (particularly the duty of care) play a relatively minor role in disciplining corporate directors and officers. Shareholders in those corporations tend to rely primarily on market forces to discipline managers; they usually find voice rules too expensive because they can be enforced only through litigation or at least the threat of litigation.¹⁹⁷ If the new rules were applied only to open corporations, the drafters could reduce transaction costs substantially by offering the new provisions to shareholders of open corporations as an "opt-out" option. That is, they could impose the new provisions as the code's default terms, yet permit those corporations whose shareholders preferred the prior rules to amend their organic documents to reimpose the prior regime. By this approach, the drafters would compel the shareholders of only a few corporations to bear the expense of meeting to amend their charter. The shareholders of most corporations would benefit from the new provisions without the need to act at all.¹⁹⁸

Finally, if the drafters believe that some variation of the new provisions is appropriate for all corporations, they might opt for a combination of the options described above. For example, they could create a special title of the corporations code that would be available only to corporations which qualify as open corporations.¹⁹⁹ The drafters would be

195. Though the drafters of the new provisions conditioned the availability of the liability limiting rules upon shareholder approval of charter provisions, they might have done so only because they realized that the new indemnification provisions permit the board to achieve the same result on a case-by-case basis. See *supra* notes 105-120 and accompanying text. They might have believed that the expense entailed in requiring a corporation to modify its charter to limit director and officer liability was tolerable only so long as directors could grant indemnification without engaging in costly shareholder action.

196. See *supra* notes 22-23, 52-54 and accompanying text.

197. See Manne, *Two Systems*, *supra* note 130.

198. Under such a system, management need not even disclose the new provisions to shareholders at the corporation's next annual meeting.

199. Such a subchapter would be structured somewhat like the existing chapter for "close corporations." See MD. CORPS. & ASS'NS CODE ANN. §§ 4-101 to -603 (1985 & Supp. 1988). The Commonwealth of Pennsylvania recently tested, but apparently abandoned, the possibility of creating a special set of rules for open-like corporations. In 1985, the Pennsylvania Senate considered a bill which, in amending that state's corporate code, *inter alia*, would have added special "registered corporation" provisions. Ultimately no action was taken on the bill. For a complete

required to delineate the qualifications for eligibility for open corporation status. For example, they might determine that an "open corporation" is one whose shares are "publicly traded" (defined perhaps as being traded on a national securities exchange, or in terms of average float),²⁰⁰ and in which no shareholder, or group of shareholders, may own control of the corporation. Because Maryland continues to follow the old two-thirds rule in shareholder voting,²⁰¹ it would be appropriate to define "control" as ownership of shares possessing more than one-third of the voting power to be cast on resolutions to amend the corporation's charter. Shareholders of eligible corporations could elect open corporation status by including such an election in their initial articles or by amending their existing articles.²⁰² To ensure that no shareholder would be locked into an open corporation or be forced to sell in a market made skittish by the election, shareholders who dissent to the election should be granted dissenters' rights.²⁰³ Once a corporation is designated an open corporation, its shareholders could further amend their charter to "opt-out" of newly enacted governance rules without providing dissenters' rights.²⁰⁴ In effect, election of open corporation status would be tantamount to shareholder approval of a blank-check charter.²⁰⁵ Finally, the drafters might make the changes in governance rules available to shareholders of closed corporations on an "opt-in" basis only. Again, dissatisfied shareholders would be granted dissenters' rights.²⁰⁶

If the drafters provided for a system combining the "closed corpora-

discussion of the proposed Pennsylvania legislation, see Porrata-Doria, *The Proposed Pennsylvania Business Corporation Law: A Horse Designed By Committee*, 59 TEMP. L. Q. 437 (1986).

200. The Maryland General Corporations Law already makes a somewhat similar distinction in its "Fair Price" legislation. See MD. CORPS. & ASS'NS CODE ANN. §§ 3-202, 3-601 to -603 (1985 & Supp. 1988). That legislation, the prototype for "fair price" anti-takeover legislation, is not applicable to corporations having fewer than 100 beneficial owners of stock. *Id.* § 3-603(e)(ii).
201. *Id.* §§ 2-604(d), 3-105(d).
202. *Cf. id.* §§ 4-101, 4-201.
203. For a discussion of dissenters' rights, see *supra* notes 182-188 and accompanying text.
204. The significant benefit of the separate, elective open corporation title is that it permits the General Assembly to avoid the definite line-drawing task of defining "open corporation." It must be recognized, however, that if shareholders of existing corporations must amend their corporate charters to elect "open corporation" status, they will incur the same transactions costs in doing so that they would incur in opting into a new set of rules. But they would incur those costs only once. After electing "open corporation" status, they could subject themselves to future rule changes without the need for shareholder votes.
205. As noted earlier, some consensualists maintain that "opting in" or "opting out" charter provisions should be deemed valid only if they are adopted in the initial chartering of the corporation; mid-stream amendments of the charter create the potential for opportunistic modification. See, e.g., Gordon, *supra* note 144, at 39-60. It is unclear how such critics would respond to a proposal permitting shareholders to enact the type of "blank check" charter proposed here.
206. For a discussion of dissenters' rights, see *supra* notes 182-188 and accompanying text.

tion/opt-in/dissenters' rights" pattern and the "open corporations/opt-out/no dissenters' rights" pattern, they could make the new provisions available to shareholders of all corporations in a way that minimizes transactions costs, especially for open corporations. At the same time, they could ensure that shareholders affected by governance changes continue to hold their shares because they approve of them, and not because they lack a financially feasible alternative.

VII. CONCLUSION

It appears that the drafters of the new liability-limiting and indemnification provisions amended the Maryland corporation code primarily to permit directors and officers of Maryland's open corporations to react to takeover bids and restructuring needs without the fear of incurring personal liability. In formulating the new provisions, they offered several rationales as justifications. In the final analysis, none—not even the shareholder empowerment justification—can support the new provisions in their entirety. In the main, however, the application of the new provisions—whatever their economic wisdom—to open corporations can be justified as an application of the contract model of the corporation. Shareholders who disagree can exit relatively easily and inexpensively by selling their shares on the market.

Following the well-established pattern of applying identical governance rules to all corporations, however, the drafters crafted the new provisions so that they apply to closed corporations as well as to open ones. Yet, because the shareholders of such corporations have no ready market for their shares, they—unlike their counterparts in open corporations—cannot be deemed to have consented to the new provisions simply because they continue to hold their shares. Shareholders in closed corporations may choose to hold rather than sell simply to minimize their loss. The Contract Model provides no support for forcing shareholders to accept losses which the drafters of reform legislation deem worthwhile.

To the extent that drafters seek the support of the Contract Model to justify their efforts, they must amend the recent legislation to assure that the new provisions are not imposed on unwilling shareholders. The drafters could cure their error by limiting the application of the governance provisions to open corporations only, or by providing an exit for shareholders of closed corporations who object to modification of their corporate contract. If they do so, drafters need not be shy about altering rules. They can permit shareholders the widest latitude possible. Until they refashion the provisions, however, the drafters should expect to find their efforts criticized by both traditionalists and contractarians.