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James J. Hanks Jr.
Venable LLP

Larry P. Scriggins
DLA Piper

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LET STOCKHOLDERS DECIDE: THE ORIGINS OF THE MARYLAND DIRECTOR AND OFFICER LIABILITY STATUTE OF 1988

James J. Hanks, Jr.†
Larry P. Scriggins‡

I. INTRODUCTION

The Director and Officer Liability Statute of 1988 (the Statute), enacted by the General Assembly of Maryland as emergency legislation early in the 1988 session and signed by Governor Schaefer on February 18, 1988, arose out of the crisis in the markets for director and officer (D&O) liability insurance in the mid-1980's. During this period, a combination of factors caused sharp increases in the cost of D&O liability insurance and led, in many cases, to its unavailability at any price. Contributing to these developments were the surging market for takeovers, the increasing number of highly visible companies becoming financially distressed, particularly in the banking and energy industries, and worldwide reduced underwriting capacity in the property and casualty industry. These factors led to an increased demand for coverage by insureds and an increased perception of risk by insurers, which further decreased underwriting capacity among insurers. Many carriers left the field altogether, reducing already-limited capacity and further increasing upward pressure on premiums.[1]

As the number and size of takeovers and troubled companies rose, the courts became increasingly willing to second-guess directors' decisions, culminating in the well-known case of *Smith v. Van Gorkom*.[2] In that case, the Supreme Court of Delaware held the directors of Trans Union Corporation liable for damages approaching $50 million for approving a negotiated merger without sufficient information and deliberation, even though the price offered was nearly 50% higher than the recent market price for Trans Union's stock and even though the investment bankers had been unsuccessful in obtaining a still higher price.[3]

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† A.B., 1964, Princeton University; LL.B., 1967, University of Maryland; LL.M., 1969, Harvard University. Partner, Weinberg and Green, Baltimore, Maryland. Mr. Hanks was Chairman of the Director Liability Subcommittee, Committee on Corporate Laws, Section of Corporations, Banking and Business Law, Maryland State Bar Association. The Director Liability Subcommittee drafted the bills that became the Director and Officer Liability Statute of 1988.

‡ A.B., 1958, Middlebury College; J.D., 1961, University of Chicago. Partner, Piper & Marbury, Baltimore, Maryland. Mr. Scriggins was a member of the Director Liability Subcommittee.

1. For further discussion of the D&O liability insurance market in the mid-1980s, see JOHNSTON, CAUSES AND EFFECTS OF THE LIABILITY INSURANCE CRISIS, IN PRIVATE INVESTORS ABROAD: PROBLEMS AND SOLUTIONS IN INTERNATIONAL BUSINESS IN 1986, § 11.05[1] (J. Moss ed. 1986).
2. 488 A.2d 858 (Del. 1985).
3. For further discussion of the *Trans Union* and post-*Trans Union* cases, see Note,

Although the court specifically reaffirmed the gross negligence standard for directors' liability for money damages,[4] at least one trial court in Maryland has suggested that the ambit of what constitutes gross negligence has expanded.[5]

The *Van Gorkom* decision was widely viewed, especially in the business community and by the insurance industry, as broadening the exposure of directors of corporations to personal liability for money damages. The fact that significant money damages could be imposed upon corporate directors based upon the facts of the *Van Gorkom* case led many directors, insurance companies and others to conclude that establishing the gross negligence standard was suddenly much easier than prior to *Van Gorkom*.

In addition to take over litigation, financially distressed companies have been another frequent source of litigation against directors and officers. In 1984, insurers paid approximately $25 million to settle stockholder suits alleging mismanagement by former directors and officers of The Wickes Companies.[6] In *Fox v. Chase Manhattan Corp.*,[7] the Delaware Chancery Court approved a settlement of $32.5 million in a suit against Chase Manhattan Corporation and six of its officers arising out of the collapse of Drysdale Government Securities. A few months later, Seafirst Corp., a bank holding company headquartered in Seattle, and five of its officers settled a derivative suit for $110 million,[8] although the company agreed to limit its recovery to the proceeds of the insurance policies covering the officers. Even doing nothing can be the basis for liability. A United States court of appeals has held that a director who acquiesces in a breach of fiduciary duty by another director may be held jointly and severally liable for the breach.[9] As the *Van Gorkom* court noted: "It is, of course, a fact of corporate life that today when faced with difficult or sensitive issues, directors often are subject to suit, irrespective of the decisions they make."[10]

D&O insurance carriers responded to the *Van Gorkom* decision and other litigation against directors and officers with sharp increases in the

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The Limitation of Directors' Liability: A Proposal for Legislative Reform, 66 TEX. L. REV. 411, 418-29 (1987).

4. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).
5. Maryland Deposit Insurance Fund Corp. v. Seidel, No. 13408 (Cir. Ct. Montgomery County, Md. Oct. 7, 1987) ("While gross negligence remains the standard of directorial culpability in the State, the gateway to that precinct is considerably less obstructed than might be supposed."); *see also Director Roundtable: The D&O Crisis and Board Liability*, Directors Boards, at 12 (Summer 1986) (remarks of Bayless Manning).
6. Wall Street Journal, Sept. 21, 1984, at 6, col. 4.
7. No. 8192-85 (Del. Dec. 6, 1985) (LEXIS, States library, Del. file).
8. National Union Fire Ins. Co. v. SeaFirst Corp., No. C85-396R (W.D. Wash. 1986); *Seafirst Lawsuit Settled*, Am. Banker, July 9, 1986, at 3, col. 1.
9. Thorn v. Reliance Van Co., 782 F.2d 1031 (3d Cir. 1985). This citation refers to an unpublished opinion which may be found in LEXIS, Genfed library, USAPP file.
10. Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985).

cost of D&O coverage through higher premiums, narrower insuring clauses, broader exclusions, expanded deductibles and lower policy limits.[11] Some carriers withdrew from the market altogether and some corporations were unable to obtain D&O insurance at any price, increasing the anxiety of directors about the risks of their positions. It is likely that directors were also concerned not only about personal liability for money damages, but also about non-pecuniary costs of litigation such as damage to reputation, loss of time and distraction from other activities. Consequently, outside directors of many publicly held corporations resigned, declined to stand for re-election or refused nomination — reversing a trend toward outside directors encouraged by the Securities and Exchange Commission, the New York Stock Exchange and various commentators.[12]

Surging D&O insurance costs and the resulting difficulty in retaining outside directors quickly led to action by state legislatures. The first state to respond was Indiana,[13] in April, 1986, followed by Delaware[14] in June. The enactment of director liability legislation in Delaware caused many corporations chartered in other states to reincorporatè in Delaware.[15] Today, more than forty other states have adopted legislation designed to reduce the risk of directors' personal liability for money damages.[16]

The two most common legislative approaches have been limitations on the personal liability of directors for money damages and expansion of the corporation's right to indemnify directors in derivative suits. Statutory limitations on the personal liability of directors for money damages generally take three approaches: (1) "charter option" statutes (*e.g.*, Maryland and Delaware) permitting stockholders to adopt charter provisions limiting the liability of directors, (and, in some states, officers) for money damages in suits by the corporation or its stockholders; (2) "self-executing" statutes (*e.g.*, Indiana) adjusting the standard of conduct giv-

11. Crown Central Petroleum Corporation, headquartered in Baltimore, reported that its annual D&O liability insurance premium increased from $13,000 in 1984 to $1,300,000 in 1987 — an increase of 10,000 percent. In addition, the limits of the policy were reduced from $30,000,000 to $10,000,000. Hanks, *The Risk of Running a Company*, The Baltimore Sun, May 1, 1987, at 11A, col. 1.

12. *E.g.*, Corp. Officers & Directors Liability Litigation Rep. (Andrews) at 2,102 (Dec. 10, 1986); Baum & Byrne, *The Job Nobody Wants*, BUS. WEEK, Sept. 8, 1986, at 56; N.Y. Times, Mar. 7, 1986, at D1, col. 3.

13. IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1988).

14. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986). For further discussion of the Delaware statute, see Veasey, Finkelstein & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399 (1987).

15. *E.g.*, BancTec, Inc. (Tex.), Clorox Co. (Cal.), Genentech, Inc. (Cal.), Environmental Diagnostics, Inc. (Cal.), Microsoft Corp. (Wash.), Penn Central Corp. (Pa.), Hechinger Co. (D.C.) and Walt Disney Co. (Cal.).

16. For a survey of this legislation, see Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnfication*, 43 BUS. LAW. 1207 (1988).

ing rise to liability for money damages in suits by the corporation or the stockholders (and, in some states, third parties); and (3) in Virginia only, a statutory cap on the liability of directors and officers for money damages to the corporation or stockholders.[17] All three approaches exempt certain conduct from exculpation.

In addition, many states, including Maryland, simultaneously amended their indemnification statutes, broadening the corporation's right to indemnify its directors and officers.

II. LEGISLATIVE HISTORY

The standard of conduct for directors of Maryland corporations is set forth in section 2-405.1(a) of the Maryland General Corporation Law (MGCL),[18] enacted in 1976. The statute requires that a director perform his duties:

> (1) In good faith;
> (2) In a manner he reasonably believes to be in the best interest of the corporation; and
> (3) With the care that an ordinarily prudent person in a like position would use under similar circumstances.[19]

Prior to 1988, section 2-405.1(c) provided:

> A person who performs his duties in accordance with the standard provided in this section has no liability by reason of being or having been a director of a corporation, unless, in a situation to which § 2-419(d) [relating to interested director transactions] of this subtitle applies, a contract or transaction is determined not to have been fair and reasonable to the corporation.[20]

In cases decided both before and after the enactment of section 2-405.1, Maryland courts have held that the standard for personal liability of directors of Maryland corporations for money damages is apparently "gross or culpable negligence."[21] Inexplicably, the court of appeals has

17. VA. CODE ANN. § 13.1-692.1 (Supp. 1988).
18. All statutory references hereafter, except as noted, refer to the MGCL section.
19. Section 2-405.1(a) was based upon section 8.30(a) of the Model Business Corporation Act. The official comment to section 8.30(a) states that section 8.30(a) "does not use the term 'fiduciary' . . . because that term could be confused with the unique attributes and obligations of a fiduciary imposed by the law of trusts, some of which are not appropriate for directors of a corporation." REV. MODEL BUSINESS CORP. ACT § 8.30(a) official comment (1984).
20. Section 2-405.1.
21. Devereux v. Berger, 264 Md. 20, 32, 284 A.2d 605, 612 (1971); Parish v. Maryland & Va. Milk Producers Ass'n, 250 Md. 24, 74, 242 A.2d 512, 540 (1968); Mountain Manor Realty, Inc. v. Buccheri, 55 Md. App. 185, 194, 461 A.2d 45, 51 (1983). A bridge between the provisions of section 2-405.1 (including section 2-405.1(c), both before and after the 1988 amendments) and the judicial "gross and/or culpable negligence" standard may be supported, albeit indirectly, by the application of the busi-

referred both to "gross *and* culpable" negligence and to "gross *or* culpable" negligence.[22]

A. The 1987 Bill

In June, 1986, the Subcommittee on Director Liability of the Committee on Corporate Laws of the Section of Corporations, Banking and Business Law (now the Section of Business Law) of the Maryland State Bar Association (MSBA Subcommittee) was appointed to consider director liability legislation for Maryland.[23] The MSBA Subcommittee met frequently throughout the summer and early fall of 1986 and reviewed the Indiana and Delaware statutes as well as legislation in other states. In November, 1986, the MSBA Subcommittee issued a report[24] proposing a "self-executing" statute, based on the Indiana statute. Early in 1987 the MSBA Subcommittee's recommended legislation was introduced in the Senate of Maryland as Senate Bill 223,[25] sponsored by Senate President Thomas V. Mike Miller, Jr. as an administration bill, and in the House of Delegates as House Bill 242, sponsored by House Judiciary Committee Chairman William S. Horne. The two bills are hereafter referred to collectively as the "1987 Bill."

The 1987 Bill provided that, in order for a director to be liable for damages, his action or failure to act must constitute:

> 1. A breach of the standard of conduct set forth in section 2-405.1(a), if applicable, constituting "willful misconduct or deliberate recklessness;"
> 2. Actual receipt of "an improper benefit in money, property or services;"
> 3. Assent to declaration of a dividend or distribution contrary to the provisions of the MGCL; or
> 4. "Willful misconduct or recklessness" in any case to which section 2-405.1 does not apply.[26]

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ness judgment rule presumption. The official comment to section 8.30 of the Revised Model Business Corporation Act, on which section 2-405.1 was based, makes it clear that, if the standard of section 8.30(a) is met, the director is exonerated and there is no need to consider possible application of the business judgment rule; if that standard is not met, then consideration of the business judgment rule comes into play and may protect the director.

22. *Parish*, 250 Md. at 74-76, 242 A.2d at 540-41 (emphasis added); *see also* Parish v. Maryland & Va. Milk Producers Ass'n, 261 Md. 618, 681, 277 A.2d 19, 48, *cert. denied*, 404 U.S. 940 (1971).
23. The members of the subcommittee were Arthur F. Fergenson, James J. Hanks, Jr. (Chairman), Arthur W. Machen, Jr., Larry P. Scriggins, J. W. Thompson Webb and John J. Woloszyn.
24. *See* MARYLAND STATE BAR ASS'N, SECTION ON CORP., BANKING AND BUS. L., COMM. ON CORP. LAW, SUBCOMM. ON DIRECTOR LIABILITY REP. (Nov. 16, 1987) [hereinafter DIRECTOR LIABILITY REPORT] *reprinted in* 18 U. BALT. L. REV. 254 (1989) ("Appendix" to this article).
25. S.B. 223, 1987 Sess. (1987)
26. *Id.*

The 1987 Bill's limitation of liability was "self-executing" in the sense that it applied automatically to directors of all Maryland corporations without any requirement of the stockholders' approval. It also applied to all suits for damages, whether by the corporation, the stockholders (directly or derivatively) or third parties.

The MSBA Subcommittee found that a self-executing standard of "willful misconduct or deliberate recklessness" was desirable for several reasons. First, it added greater clarity and certainty to the law than is available under judicial precedents. Second, it followed self-executing director liability statutes already enacted in Indiana and Louisiana, thereby enabling Maryland courts to take advantage of cases decided in those states under this standard. Third, it tended to discourage directors of Maryland-chartered corporations from recommending reincorporation in other states because it assured directors that they would not be held personally liable for money damages for simple negligence. Fourth, newly established businesses, perceiving Maryland as having an up-to-date corporation statute, would be more likely to incorporate here. Fifth, a self-executing statute would add to the perception of Maryland as a state with a favorable and responsive business climate. Finally, it would encourage directors of Maryland-chartered corporations to continue serving as directors.[27]

Section 2-405.2(b) of the 1987 Bill gave the corporation the right to opt out of the self-executing provision of section 2-405.2(a), except for liability arising out of (1) actual receipt of "an improper benefit in money, property or services" or (2) a judgment establishing "active and deliberate dishonesty [that] was material to the cause of action so adjudicated. . . ."

The self-executing revised liability provision was set forth as a proposed new section 2-405.2 in order to eliminate any argument that, by its inclusion in section 2-405.1, the statutory limitation on liability was intended to apply only to a director's breach of the standard of care set forth in section 2-405.1(a) and not also to a breach of the duty of loyalty or some other duty. The words "willful" and "deliberate" were intended to indicate a requirement of specific intent to cause harm, as opposed to a general intent to perform the acts or omissions giving rise to the injury.

The 1987 Bill also added a new section 2-105(b)(8) authorizing the charter of a Maryland corporation to contain a provision "which varies in accordance with § 2-405.2(b) of this title the standards for liability of the directors of a corporation for money damages." Thus, even though proposed section 2-405.2 was self-executing, a corporation could opt out of it by including a provision in the original articles of incorporation or by amending its charter. The 1987 Bill also deleted the reference to in-

27. For a discussion of the rationale for the self-executing Wisconsin director liability statute by one of its drafters, see Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1234 n.68 (1988).

terested-director transactions in the liability limiting provision of section 2-405.1(c).

Along with the proposed amendment relating to the standard for director's liability for money damages, the 1987 Bill contained four amendments to section 2-418 relating to indemnification:

1. Presumption of Non-Compliance With Indemnification Standard

Section 2-418(b)(3) previously provided that termination of any proceeding by a judgment, order, settlement, conviction or a *nolo contendere* plea created a rebuttable presumption that the director did *not* meet the requisite standard for indemnification set forth in section 2-418(b)(1).[28] The Subcommittee recommended that, as to convictions and *nolo contendere* pleas, the rebuttable presumption should continue, but that as to judgments, orders and settlements, there should be no presumption one way or the other.

2. Non-Exclusivity

Under prior section 2-418(g), any contract between a corporation and its directors providing for indemnification was required to be "consistent with" the indemnification permitted by section 2-418. In the 1987 Bill, however, section 2-418(g) provided that any statutory indemnification "shall not be deemed exclusive of any other rights, by indemnification or otherwise, to which a director may be entitled under the charter, the bylaws, a resolution of stockholders or directors, an agreement or otherwise. . . ."

3. Advance Payment of Expenses

Prior section 2-418(f) required, as a prerequisite to advance payment of expenses during the pendency of a proceeding to which a director was a party, a determination in each case that indemnification would not be precluded under the facts known at the time of the determination. The 1987 Bill eliminated the necessity for this determination and authorized a corporation to adopt a general provision for advance payment of expenses in its charter, or bylaws or by contract.

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28. Prior to 1988, section 2-418(b)(1) permitted a corporation to indemnify a director if he:
   (i) Acted in good faith;
   (ii) Reasonably believed:
      1. In the case of conduct in the director's official capacity with the corporation, that the conduct was in the best interests of the corporation; and
      2. In all other cases, that the conduct was at least not opposed to the best interests of the corporation; and
   (iii) In the case of any criminal proceeding, had no reasonable cause to believe that the conduct was unlawful.

4. Determination of Permissibility of Indemnification

Section 2-418(e) formerly provided that indemnification must be "authorized in a specific case. . . ." The 1987 Bill proposed substituting the words "for a specific proceeding" for the words "in the specific case."

In the Senate, Senate Bill 223 was assigned to the Judicial Proceedings Committee (Senate Committee), which held a hearing on February 4, 1987, at which representatives of the MSBA and various business organizations testified in support of the bill. Following the hearing, the Senate Committee made five amendments to the bill.

First, the "willful misconduct or deliberate recklessness" standard was eliminated in favor of "a standard of misconduct or recklessness amounting to gross negligence." This amendment effectively eviscerated the bill. Indeed, it would have made liability for money damages even easier to prove than under the "gross or culpable negligence" standard adopted by the Maryland courts.[29] Second, the Senate Committee added an exception to the bill for actions brought against directors of a state-regulated savings and loan association or credit union that did not have federal insurance of accounts. Third, the Senate Committee also amended the bill to continue the presumption of non-compliance with the statutory standards for indemnification in the case of a conviction or a plea of *nolo contendere* or its equivalent. Fourth, the Senate Committee amended the non-exclusivity provision of section 2-418(g). Finally, the Senate Committee added an effective date provision providing that the liability limitation provisions would apply "only to actions arising from events or omissions occurring on or after the effective date of this Act" and that the amendments to section 2-418 would "apply only to indemnification granted on or after the effective date of this Act, whether the underlying events, omissions, or proceedings occurred prior or subsequent thereto."

Meanwhile, in the House of Delegates, House Bill 242 was assigned to the Judiciary Committee (House Committee) which held a hearing on February 17, 1987, at which representatives of the MSBA and the business community testified in support of the bill. Only the Maryland Trial Lawyers Association opposed it. Members of the House Committee expressed concern that the bill was "self-executing" and denied stockholders the opportunity to participate in the decision whether or not to limit directors' liability. Members also stated reservations about the application of the bill to suits by third parties. Following the hearing, the House Committee gave House Bill 242 an unfavorable report. On March 5, 1987, the Senate passed Senate Bill 223 but when it was introduced in the House of Delegates and referred to the House Committee, it too received an unfavorable report.

The reaction of the business community and the press to the House Committee's action was strongly negative. Henry A. Rosenberg, Jr.,

29. *See supra* notes 21-22 and accompanying text.

Chairman of the Board and Chief Executive Officer of Crown Central Petroleum Corporation, told the annual meeting of stockholders that management was "seriously considering" reincorporating in Delaware if the legislature did not pass director liability legislation in the 1988 session.[30] Donald P. Hutchinson, a former member of both the House of Delegates and the Senate, and President of Maryland Economic Growth Associates, Inc., representing over 75 major corporations, stated that many companies were "disenchanted [that] the legislature failed to recognize the problem but most are saying they are willing to give the legislature another chance to deal with the issue."[31] Jerome W. Geckle, Chairman of the Board of PHH Group, Inc., said that he would "be forced to take a hard look elsewhere" if the General Assembly did not pass adequate legislation.[32] *The Baltimore Sun* added its voice on May 12 with an editorial entitled "Stop the Move to Delaware!" stating that it was "encouraging to learn that members of the House Judiciary Committee are having second thoughts about their earlier decision to kill legislation that would have reformed Maryland corporate directors' liability law. . . . The sooner this bill is enacted, the better."[33]

B. The 1988 Bill

In late May, following the adjournment of the General Assembly, the chairman of the MSBA Subcommittee met with Chairman Horne of the House Committee and with Committee Counsel Douglas Nestor. Chairman Horne reiterated his committee's concern over the stockholder participation and third-party issues. He was told that the MSBA Subcommittee was willing to redraft the 1987 Bill to require any liability-limitation provision to be included in the corporation's charter (either as part of the original articles of incorporation or by amendment approved by the stockholders), and to eliminate limitation of liability in suits by third parties. Chairman Horne was also informed that the MSBA Subcommittee wished to include officers as a protected group in any new bill.

These and other issues were discussed at a hearing of the House Committee on June 2, 1987. Alan M. Rifkin, then Chief Legislative Officer to Governor Schaefer, and other representatives of the Schaefer Administration, the business community and the MSBA testified in support of the revised liability-limitation legislation. Most of the discussion focused on the need for stockholder approval, the standard of liability, third-party suits, officers and standard of proof. Chairman Horne and other legislators who had voted against House Bill 242 expressed support for new legislation requiring stockholder approval and eliminating liability limitation for third-party suits.

30. The Baltimore Sun, May 3, 1987, at 5F, col. 1.
31. *Id.*, col. 2; *see also Washington Business*, Washington Post, May 4, 1987, at 38, col. 3.
32. The Baltimore Sun, May 3, 1987, at 5F, cols. 2-3.
33. The Baltimore Sun, May 12, 1987, at 10A, col. 1.

In the succeeding months, the MSBA Subcommittee prepared a new report[34] recommending a modified bill (the 1988 Bill) with five principal changes from the 1987 Bill. First, any provision for limitation of liability must be included in the corporation's charter (the charter option). This revision reflected the concern of the House Committee that liability limitation should not be self-executing. Second, liability limitation for third party suits was eliminated because third parties do not participate in the liability limitation decision and, therefore, should not be precluded from recovery. Third, officers were included along with directors as a protected group. Fourth, the scope of possible liability limitation was expanded to include any conduct except (1) actual receipt of an improper benefit in money, property or services and (2) active and deliberate dishonesty established by an adjudication to be material to the cause of action adjudicated. Finally, the standard of permissible indemnification under section 2-418(b)(1) was broadened. Thus, the MSBA Subcommittee acceded to the House Committee's disapproval of self-executing liability limitation and inclusion of third-party suits in exchange for inclusion of officers as a protected group, a broader standard of possible liability limitation and a broader standard for permissible indemnification. The 1988 Bill also excluded suits brought by the State of Maryland or by a receiver, conservator or depositor against a director or officer of state-chartered banks, credit unions or savings and loan associations and their subsidiaries. National banks and bank holding companies were not included in the exception.

In October, the House Committee held a work session on the 1988 Bill at which MSBA and business community representatives testified. By this time, however, several Maryland corporations had reincorporated in other states.[35]

The 1988 Bill was introduced as an emergency measure in the House as House Bill 273, sponsored by House Speaker R. Clayton Mitchell, Jr. as an administration bill, and in the Senate as Senate Bill 223, sponsored by Senate President Miller as an administration bill.

House Bill 273 was referred to the House Committee, which held a hearing on January 19, 1988. Representatives of the Schaefer Administration, the MSBA, the Maryland Chamber of Commerce, Maryland Economic Growth Associates, Inc., the Greater Baltimore Committee, the Greater Washington Board of Trade and other organizations testified in favor of the bill. Again, the only testimony in opposition came from the Maryland Trial Lawyers Association. Two days later, *The Baltimore Sun* weighed in with an editorial recommending "a ringing endorsement" by the House Committee.[36]

On January 26, 1988, the House Committee rejected an amendment

34. *See* DIRECTOR LIABILITY REPORT, *supra* note 24, at 254-55.
35. *E.g.*, Fairchild Industries, Inc., Luskin's, Inc., McKesson Corp. and Penta Systems International, Inc.
36. Editorial, *Spotlight on Judiciary*, The Baltimore Sun, Jan. 21, 1988, 10A, col. 1.

to substitute the exceptions in the Delaware statute for the improper benefit and active and deliberate dishonesty exceptions in House Bill 273. The House Committee also rejected an amendment to delete officers from the bill. The House Committee then gave House Bill 273 a favorable report, without amendments, by a margin of twenty-one yeas, no nays and one abstention. Two days later, the House of Delegates overwhelmingly rejected the same two amendments rejected by the House Committee and gave final approval, without amendments, to House Bill 273 by a margin of 121 yeas, 1 nay and 19 not voting. On February 18, the Senate approved House Bill 273 by a vote of forty-four yeas, one nay and two not voting.

In the Senate, Senate Bill 223 was referred to the Senate Committee, which held a hearing on January 26, 1988 at which representatives of the Schaefer Administration and many of the same organizations that appeared before the House Committee testified in support of Senate Bill 223. There was no opposing testimony. On January 29, the Senate Committee gave Senate Bill 223 a favorable report, without amendments, by a margin of ten yeas, no nays and one absent. On February 4, the Senate gave final approval, without amendments, to Senate Bill 223 by a margin of thirty-eight yeas, three nays, five excused and one not voting. The House of Delegates approved Senate Bill 223 on February 18 by a vote of 109 yeas, 6 nays, 1 excused and 25 not voting.

As an emergency bill, the legislation became law on February 18, 1988, the date it was signed by Governor Schaefer,[37] who cited the statute as "a good example of success through cooperation" between the Administration and the General Assembly.[38]

According to uncodified section 2 of the Statute, the liability-limitation provisions "apply only to actions arising from events or omissions occurring on or after" February 18, 1988. Thus, even though a liability-limitation charter amendment may not have any effect on events or omissions occurring prior to the February 18, 1988 enactment date, the Statute permits the exculpatory provisions, after stockholder adoption and upon filing and acceptance for record of articles of amendment, to relate back to events or omissions occurring on or after February 18, 1988. The indemnification provisions, which do not require stockholder action, may "apply only to indemnification granted on or after" February 18, 1988, without regard to when the underlying events or omissions occurred.

37. 1988 Md. Laws chs. 3, 4. The governor signed both H.B. 273 (which became chapter 3) and S.B. 223 (which became chapter 4); the bills were identical. Chapter 3 is reprinted as Addendum I to the Appendix of this article.

38. The Sun, Feb. 19, 1988, at 1F, col. 6.

III. OPERATION AND EFFECT

A. Liability Limitation

The liability-limitation provisions of the Statute are, like the statutes in Delaware and thirty other states, a "charter option" law. The Statute does nothing more than authorize the corporation, either in its original articles of incorporation or by charter amendment, to limit the liability of its directors and officers for money damages, with certain exceptions, in suits by the corporation or its stockholders, but not in suits brought by third parties. In a sense, the Statute is not a major expansion of the stockholders' authority. Section 2-104(b)(1) of the MGCL, like most state corporation statutes,[39] authorizes the charter to include "[a]ny provision not inconsistent with law which defines, limits, or regulates the powers of the corporation, its directors and stockholders. . . ." If it were not for the fact that "law" probably includes judicial decisions permitting recovery of money damages upon a showing of gross and culpable negligence[40] (and also that section 2-104(b)(1) does not refer to "liabilities" of directors or officers), the liability of directors and officers could probably be limited under existing section 2-104(b)(1) and the Statute would be unnecessary. Moreover, other provisions of the MGCL empower the stockholders to elect and remove directors,[41] approve mergers and other major corporate transactions[42] and dissolve the corporation.[43] All of these actions are far more common than suits by the corporation or its stockholders against directors and typically involve immediate economic consequences to the stockholders far greater than limiting the directors' or officers' liability. Thus, in authorizing the stockholders to limit the monetary liability of directors and officers to the corporation and the stockholders, the Statute is only a minimal expansion of the stockholders' existing powers.

In any event, without affirmative action by the corporation, the Statute will have no effect on the directors' or officers' monetary liability. Moreover, the liability limitation provisions of the Statute have no effect on the liability of directors or officers for equitable relief or on the right of the stockholders to remove directors[44] or the right of directors to remove officers.[45]

1. Scope of Liability Limitation

The exceptions to the Maryland charter option Statute in effect define the scope of the stockholders' right to limit the monetary liability of

39. *E.g.*, REVISED MODEL BUSINESS CORP. ACT § 2.02(b)(2) (1984); DEL. CODE ANN. tit. 8, § 102(b)(1) (1983); N.Y. BUS. CORP. LAW § 402(c) (McKinney Supp. 1989).
40. *See supra* note 21.
41. Section 2-406 (1985).
42. *Id.* §§ 3-101 to 3-105 (1985 & Supp. 1988).
43. *Id.* §§ 3-401 to 3-403, 3-413 (1985 & Supp. 1988).
44. *Id.* § 2-406 (1985).
45. *Id.* § 2-413(c).

the corporation's directors and officers from the corporation or its stockholders. The ambiguity of some of the Delaware exceptions (especially breach of the duty of loyalty,[46] acts or omissions not in good faith, and improper personal benefit) caused concern that they could be interpreted so broadly as to defeat the purpose of the Statute. Although many states have simply copied the Delaware statute in its entirety, including its exceptions, several of the more recent charter option states, now including Maryland, have adopted more targeted exceptions.

As a result of the Maryland Statute's two very limited exceptions for improper personal benefit or profit and for active and deliberate dishonesty, stockholders of a Maryland corporation may eliminate the liability of its directors and officers for a broad range of conduct — including not only simple and gross negligence, but also intentional misconduct, bad faith, unlawful distributions,[47] and violations of law — as long as it does not constitute actual receipt of an improper benefit or profit, or active and deliberate dishonesty. The two most important favorable differences between the exceptions in the Maryland and Delaware statutes are Maryland's limitation of the exception for improper receipt of a personal benefit to its actual value, *i.e.*, restitution, and Maryland's absence of a "duty of loyalty" exception. The narrowness and precision of the Maryland Statute's two exceptions make it possibly the most expansive corporate liability limitation statute in the nation.

The Statute permits the stockholders to adjust the limitation of liability to themselves or the corporation to whatever degree they wish. Although stockholders of many corporations will want to take full advantage of the Statute, some corporations' stockholders may decide, for example, to limit liability only for directors and not officers, or only for gross negligence, or only up to a certain monetary amount, or only above a certain monetary amount, or only for suits by or in the right of the corporation and not for direct suits by stockholders. Indeed, the Statute permits the stockholders to *expand* the standard of liability, of directors and officers as previously established by judicial decisions. For example,

46. The Delaware Supreme Court itself has had difficulty distinguishing the duty of care from the duty of loyalty. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 175 (trial court held that "the Revlon directors had breached their duty of care"); *id.* at 179 (trial court held that "the Revlon directors had breached their duty of loyalty") (Del. 1986). In fact, the trial court held that "the Revlon Board failed in its fiduciary duty to the shareholders. . . . [I]ts performance did not conform to the other component of the business judgment rule — the duty of loyalty." MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1250 (Del. Ch. 1985). For further discussion of the *Revlon* case, see McDaniel, *Bondholders and Stockholders*, 13 J. CORP. LAW 205, 287 (1988); *see also* Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 291 (1986).

47. In response to a question from Senator Norman R. Stone (D - Baltimore Co.) during a work session of the Senate Judicial Proceedings Committee in February, 1988, on amendments to title 2, subtitle 3 of the MGCL, MSBA representatives stated that liability for unlawful distributions under new section 2-312 could be limited by a charter amendment adopted by a corporation pursuant to the Statute.

the Statute permits stockholders to hold directors monetarily liable for simple negligence. Contrary to Professor Sargent's suggestion in an accompanying article,[48] the Statute does not "diminish[ ] . . . the value of the traditional distinction between [the duties of] care and loyalty. . . ." These duties will continue to be developed in suits by third parties, in suits by stockholders of corporations not adopting liability limitation provisions, in suits for equitable relief[49] and in suits against directors and officers of state-chartered financial institutions excluded from the Statute.

Finally, the Statute amended section 2-405.1(c) to eliminate its inapposite reference to section 2-419. Section 2-419 provides a procedure for insulating transactions between a corporation and a director from voidness or voidability and from recovery of damages from the director; it does not, however, provide for personal liability for directors.[50] Moreover, the issue addressed by section 2-419 relates to the duty of loyalty, whereas section 2-405.1 deals primarily with the duty of care. Accordingly, the reference to section 2-419 in section 2-405.1(c) was never appropriate and was therefore deleted by the Statute.[51] Thus, even if a corporation does not adopt a liability limitation charter provision (or adopts only a partial provision), section 2-405.1(c) will protect a director, but not necessarily an officer, from liability, both for money damages as well as equitable relief, if he performs his duties in accordance with the three-part standard of section 2-405.1(a). In addition, the director would have the benefit of the presumption of the business judgment rule, as indicated in the official comment to section 8.30(d) of the Revised Model Business Corporation Act,[52] on which section 2-405.1(c) was based.

2. Officers

Five states, including Maryland, now permit stockholders to limit the liability of officers. Since a charter option statute gives the stockholders the right to limit liability there is no logical policy reason for permit-

48. *See* Sargent, *Two Cheers for the Maryland Directors' and Officers' Liability Statute,* 18 U. BALT. L. REV. 278, 300 (1989).

49. In litigation testing the sufficiency of the deliberative process and the adequacy of price and other terms in takeovers, the most common and effective remedy is typically an injunction or writ of mandamus, not money damages.

50. The court of special appeals in Mountain Manor Realty, Inc. v. Buccheri, 55 Md. App. 185, 195, 198, 461 A.2d 45, 51, 53 (1983), speaks confusingly about "violation" of section 2-419. In fact, section 2-419 cannot be "violated." It is a safe harbor both from voidness or voidability and from any liability to a director arising out of being a party to a contract or transaction with the corporation. The fact that a contract or other transaction does not meet the standards of section 2-419 does not mean that it is void, voidable, invalid or unenforceable; it means only that the contract or transaction does not enjoy the statutory insulation from voidness or voidability. There may be other facts or circumstances that would shield it from voidness or voidability.

51. Section 8.30(b) of the Revised Model Business Corporation Act, the counterpart to section 2-405.1(c), contains no similar reference to the Model Act counterpart of section 2-419.

52. REVISED MODEL BUSINESS CORP. ACT § 8.30(d) official comment (1984).

ting them to limit the liability of directors but not officers. Moreover, if plaintiffs are foreclosed only from suing directors, they will be increasingly motivated to sue officers, particularly senior officers, in order to reach the D&O liability insurance policy. D&O insurers are more likely to reduce their premiums if they are assured that the liability of both directors and officers is limited. Furthermore, treating directors and officers alike for purposes of liability limitation is consistent with the identical treatment of directors and officers under Maryland's indemnification statute.[53] Finally, many of the matters typically submitted to a board of directors originate among the officers and, if approved by the directors, are referred to the officers for implementation. They are entitled, if the stockholders so decide, to be protected to the same degree as directors.

B. Indemnification.

The Statute makes several amendments to the indemnification provisions of section 2-418.

1. Scope of Indemnification

Formerly, section 2-418(b)(1) set forth the "good faith," "reasonable belief" standard for the right of a corporation to indemnify its directors and officers.[54] The Statute amends section 2-418(b)(1) to permit a corporation to indemnify a director *unless* it is "proved" that the individual (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) "[i]n the case of any criminal proceeding, had reasonable cause to believe that [his] act or omission was unlawful."[55] Thus, the requirement in section 2-418(e)(1) for a determination that the director "has met the standard of conduct set forth in subsection (b)" is initially satisfied simply by a determination that it has not yet been proved that the director's conduct fell within any of the three exceptions. Of course, if the proceeding eventually results in a determination that the director's conduct did fall within one of the three exceptions, then the director would be required, by the written undertaking required by section 2-418(f)(1)(ii), to repay any expenses advanced during the course of the proceeding. The inclusion of the word "personal" in the phrase "improper personal benefit" in section 2-418(b)(1)(ii), as opposed to the phrase "improper benefit or profit" in new section 2-405.2(a)(1), was not intended to have any substantive significance. The words "or profit" in

53. Section 2-418(j)(1) (1985).
54. *Supra* note 28.
55. In 1989, the General Assembly amended section 2-418(b)(1) again, by substituting the word "established" for the word "proved" and the words "matter giving rise to" for the words "cause of action adjudicated in." The purpose of this amendment is to clarify that section 2-418(e)(1) applies to settlements as well as to adjudicated causes of action.

section 2-405.2(a)(1) were added to the 1988 Bill at the request of the Attorney General's Office; no request was made to include these words in section 2-418(b)(1)(ii).

Because of the "bad faith" exception, the corporation's right to indemnify its directors and officers is slightly less expansive than the right of stockholders to limit their liability. This is appropriate in view of the fact that the corporation may indemnify directors and officers by board action without the participation of stockholders, whereas liability limitation may be achieved only by stockholder action.

The Statute also expands the scope of indemnification in derivative suits. Section 2-418(b)(2)(ii) formerly provided that indemnification in a derivative suit may be made only for reasonable expenses, but not if the individual was adjudged to be liable to the corporation (unless ordered by a court). The new Statute permits indemnification for amounts paid in settlement of derivative suits. This change should encourage settlements by no longer limiting indemnification to expenses.

2. Presumption of Noncompliance with Indemnification Standard

Prior to the passage of the D&O statute, Maryland was the only state that provided that termination of a proceeding by judgment, order, settlement, or conviction *created* a rebuttable presumption that the director or officer did not meet the standard for indemnification in section 2-418(b)(1). Consistent with the indemnification provisions of more than forty states, the Statute now provides that a judgment, order or settlement does *not* create a presumption of non-compliance. A proceeding may be settled for many reasons having nothing to do with whether the director's conduct met the standard for indemnification. For example, a suit may be settled for its "nuisance" value at an amount that is less than the cost of litigation. There is no reason why a settlement should create a presumption that the director did not meet the standard for indemnification in section 2-418(b)(1). Even a judgment adverse to the director may be entered for reasons other than his conduct as a director. Nonetheless, a conviction or *nolo contendere* plea continues to create the presumption.

3. Determination of Permissibility of Indemnification

Prior to the 1988 amendment, section 2-418(e) provided that indemnification must be "authorized in the specific case. . . ." The word "case" was never defined in the statute. Its use, especially in view of the definition of "proceeding," raised the question of whether indemnification for each payment of expenses must be separately authorized. Substituting the phrase "for a specific proceeding" for the phrase "in the specific case" resolves any question.

4. Advance Payment of Expenses

As a condition to advance payment of expenses, section 2-418(f)(1) formerly required a determination that indemnification would not be pre-

cluded under the facts known at the time of the determination. This requirement has been eliminated. Instead, section 2-418(f)(3) now permits a corporation to make general provision for advance payment of expenses in its charter or bylaws, by contract or in the manner specified in section 2-418(e).

5. Non-Exclusivity

Section 2-418(g) previously required that any contract between a corporation and the director or officer providing for indemnification must be "consistent with" the indemnification permitted by section 2-418. This provision, patterned after section 8.58(a) of the Revised Model Business Corporation Act, was much more restrictive than the comparable provision in section 145(f) of the Delaware General Corporation Law, which provides that the indemnification provided by statute "shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled under any bylaw, agreement, . . . or otherwise. . . ." Even the Delaware statute, however, could be read to limit any indemnification right (as opposed to "other right") to section 145.

Section 2-418(g), as amended by the Statute, now makes clear that section 2-418 does not preclude "other rights," by indemnification or otherwise, to which a director or officer may be entitled. Of course, the "other rights" would be limited by public policy considerations. Public policy would, however, probably be interpreted at least as broadly as the indemnification now permitted by section 2-418(b) and possibly as broadly as the limitation of liability now authorized by section 2-405.2(a). The phrase "those seeking indemnification" appearing in section 145(f) of the Delaware statute has been replaced with the words "a director" in order to clarify that a person need not seek indemnification in order to have the benefit of the new non-exclusivity provision of section 2-418(g).

6. Alternative Sources of Reimbursement

Finally, the Statute expands section 2-418(k) to specifically authorize a corporation to provide sources of reimbursement other than conventional insurance, including a trust fund, letter of credit, surety bond or insurance issued by a captive subsidiary. This provision was not contained in the 1987 Bill.

IV. PROSPECTS

The result of the *Van Gorkom* case, in Maryland as elsewhere, has been that the deliberative processes of many boards of directors have been strengthened through more information for the directors and better documentation of board actions.[56] This development is entirely consis-

56. For some helpful suggestions in this regard, see Manning, *Reflections and Practical Tips on Life in the Boardroom after Van Gorkom*, 41 BUS. LAW. 1, 5 (1985).

tent with the recognition that the duty of directors should not be measured by the results of their decisions but by the process by which their decisions are made.[57] As one court has recognized, "after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information."[58] The immediate benefit of the Statute has been to encourage competent, qualified, experienced men and women to continue to serve as directors of Maryland corporations. Enactment of the Statute surely also kept many Maryland corporations from reincorporating elsewhere.

Directors are not likely to act much differently after the adoption of a liability-limitation charter provision under new section 2-405.2 than they acted before the statute. They are unlikely to view liability limitation as a *carte blanche* for self-dealing, inattention or other mischief simply because they are now less exposed to suits for money damages by the corporation or stockholders. They know that they can still be sued by third parties or for equitable relief. Most directors, like most men and women, do not enjoy the litigation process even when their own assets are not at risk.

V. CLOSING

The General Assembly, by enacting the Statute, has reaffirmed the broad right of stockholders to decide for themselves the allocation of the economic risk of directors' or officers' misconduct. Indeed, Maryland corporations moved quickly to take advantage of the liability-limitation provisions of the Statute. Because the legislation was signed by the governor on February 18, 1988, many calendar year corporations were able to include liability limitation proposals in the proxy statements for their annual meetings of stockholders in 1988.[59] In all cases, the stockholders

57. *See* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982); *see also* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 203 (1968) ("After the fact, where the result has been catastrophic, juries are more likely to err on the side of the severe than on the lenient side in dealing with the director attacked.") (Footnote omitted).

58. *See* Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, A Commentary*, 41 BUS. LAW. 1237, 1239 (1986); *see also* REVISED MODEL BUSINESS CORP. ACT § 8.30 Official Comment (1984): section 8.30 "sets forth the standard by focusing on the manner in which the director performs his duties, not the correctness of his decisions."

59. Among the Maryland-chartered publicly-owned corporations whose stockholders have approved liability-limitation charter amendments are Alex. Brown Inc., Alexander & Alexander Services Inc., The Black & Decker Corp., Crown Central Petroleum Corp., Equitable Bancorp., First Maryland Bancorp., Legg Mason, Inc., McCormick & Company, Inc., McDonnell Douglas Corp., NCR Corp., Martin Marietta Corporation, PHH Corp., T. Rowe Price Associates, Inc. and USF&G Corp.

approved the limitation of liability of both directors and officers to the fullest extent permitted by the Statute.

APPENDIX
MARYLAND STATE BAR ASSOCIATION
SECTION OF CORPORATIONS, BANKING AND BUSINESS LAW
Committee on Corporate Laws
Subcommittee on Director Liability
Report

The undersigned Subcommittee was appointed in June, 1986, to consider the crisis in directors' and officers' liability insurance and related legislative activity in other states with a view to recommending legislation for consideration by the General Assembly of Maryland. Following extensive research and numerous meetings during the summer and early fall of 1986, the Subcommittee issued a Report unanimously recommending the introduction and passage of legislation which would (a) clearly define the standard required to impose money damages against directors of Maryland corporations and (b) modify the current Maryland indemnification provisions to eliminate unwarranted restrictions and procedural complexities. See Maryland State Bar Association, Section on Corporations, Banking and Business Law, Committee on Corporate Laws, Subcommittee on Director Liability, Report (Nov. 5, 1986). The proposed bill's provision concerning the standard required to impose money damages against directors of Maryland corporations was completely self-executing, *i.e.*, it applied directly to all Maryland corporations without the necessity of stockholder approval.

The proposed bill was introduced in 1987 in the Senate of Maryland as S.B. 223 and in the House of Delegates as H.B. 242. Both bills were strongly supported by Governor Schaefer and his Administration. S.B. 223 was approved, with amendments, by the Judicial Proceedings Committee in the Senate and was passed by the Senate and sent to the House of Delegates, where it was referred to the Judiciary Committee, which rejected both H.B. 242 and S.B. 223. There were indications by members of the Committee that they were concerned about the facts that (1) both bills would have limited the liability of director in suits by third parties as well as in suits by the corporation or by its stockholders and (2) no provision was made for approval by the stockholders of limitation of liability of the directors.

Following the conclusion of the 1987 session of the General Assembly, the Chairman and certain members of the House Judiciary Committee, some of whom had opposed the 1987 bills, indicated that they would support revised legislation on the subject. The Committee held a hearing on June 2, to consider new legislation. Representatives of the Schaefer Administration, the business community and this Subcommittee testified in support of legislation addressing the issue.

Following the hearing, the Subcommittee submitted a revised bill, drawing on statutes enacted in Delaware and other states, which would permit, but not require, stockholders to limit the liability of both direc-

tors and officers to the corporation or stockholders (but not to third parties) for money damages for any act or omission except for (1) actual receipt of an improper benefit in money, property or services and (2) active and deliberate dishonesty that was material to an adjudicated cause of action.

The subject of this legislation was discussed by the House Judiciary Committee at a retreat at Deep Creek Lake on September 30 and October 1. The Committee further considered the proposed legislation at a work session in Annapolis on October 13. Representatives of the State Insurance Commissioner, the business community and this Subcommittee testified in support of legislation permitting stockholders to limit the liability of both directors and officers of Maryland corporations. In addition, Kenneth C. Lundeen, a former Chairman of the Section, who was invited by a member of the Judiciary Committee to present his views as an independent observer, testified in support of the legislation, including the addition of officers.

A copy of the bill proposed by the Subcommittee is attached hereto as [Addendum I]. Relevant portions of the bill are quoted as discussed in this Report.

The Subcommittee continues to believe strongly that such legislation is of great importance for the State of Maryland. The Subcommittee also believes that the legislation is consistent with sound public policy as expressed in decisions of the appellate courts of Maryland, in recent legislative activity in more than 30 other states and in current commentary.

I. BACKGROUND

In the past two years, the cost of obtaining liability insurance for directors and officers of corporations throughout the nation has escalated dramatically.[1] According to the *Wall Street Journal* (March 21, 1986), premiums for D&O insurance increased over 360% in one year. Simultaneously, coverage has been reduced through decreased limits, increased deductibles, narrowed insuring clauses and expanded exclusions. Thus, the cost of D&O insurance relative to the amount of coverage has soared. For many companies, the cost of this insurance is simply not affordable and, indeed, some companies have not been able to obtain quotes at any price. "Crisis" is not too strong a word to describe the current situation and has been employed frequently in this context.

This crisis originated, at least in part, in the general trend toward higher premiums in liability insurance throughout the country — a trend which may be attributed to many factors beyond the scope of this Report

1. Insurance against liability of directors and officers of corporations, commonly called "Directors and Officers Liability Insurance" or "D&O Insurance", is, in fact, two types of insurance: (1) insurance which covers the directors and officers directly for any losses incurred by them as directors and officers and (2) insurance which covers the company against any amounts which it may pay to directors and officers pursuant to its indemnification obligation.

and which contributed to the passage of Senate Bill 600 (limiting the liability, in certain situations, of directors of charitable organizations) in the 1986 session of the General Assembly. More specifically, however, the current trend in the cost of D&O insurance has probably been influenced by the growing number of lawsuits against directors and officers, resulting in increased defense costs, settlements and even judgments.

Two areas, in particular, have given rise to an unusually large number of suits against directors and officers: takeovers and troubled companies.

Directors are particularly likely to be sued in connection with mergers and takeovers, whether or not "friendly." Because of the high stakes and the pressures on the board to act quickly, directors face risks of liability almost regardless of whether they vote for or against a takeover. One notable example is the well-known case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), in which the Supreme Court of Delaware held that the directors of Trans Union Corporation could be held liable for damages approaching $50,000,000 in approving a negotiated merger without sufficient information and deliberation even though the price was nearly 50% higher than the recent market price for Trans Union's stock and even though the investment bankers had been unsuccessful in trying to obtain a still higher price.

Financially-troubled companies are another frequent source of litigation against directors and officers. In 1984, for example, insurers paid approximately $25,000,000 — believed to be the largest D&O insurance payment in history — to settle stockholder suits alleging mismanagement by former directors and officers of The Wickes Companies.

In *Fox v. Chase Manhattan Corporation*, No. 8192-85 (Del. Ch. Dec. 6, 1985) (LEXIS, DEL library, Cases file), the Delaware Chancery Court approved a settlement of $32,500,000 in a suit against Chase Manhattan Corporation and six of its officers arising out of the collapse of Drysdale Government Securities, Inc. A few months later, Seafirst Corp., a bank holding company headquartered in Seattle, and five of its officers agreed to entry of a judgment against the officers for $110,000,000. *American Banker* (July 9, 1986), p. 3. The company agreed to limit its recovery to the proceeds of the insurance policies covering the officers.

Even doing nothing can be the basis for liability. The United States Court of Appeals for the Third Circuit held recently that a director who acquiesces in a breach of fiduciary duty by another director may be held jointly and severally liable for the breach. *Thorn v. Reliance Van Company, Inc.*, 782 F.2d 1031 (1985) (LEXIS, Genfed Library, USAPP file).

Unfortunately, as the Court in *Van Gorkom* noted: "It is, of course, a fact of corporate life that today when faced with difficult or sensitive issues, directors often are subject to suit, irrespective of the decisions they make." *Id.* at 881. Moreover, as another court has recognized, "after-the-fact litigation is a most imperfect device to evaluate business decisions. The circumstances surrounding a corporate decision are not easily

reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information." *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982).

As a result of these and other cases, some of the few remaining primary D&O insurance carriers began to exclude all activities in the context of hostile takeovers from coverage in new or reissued D&O policies. Almost immediately, outside directors of many major publicly-held corporations began to resign rather than continue to serve without insurance. *The New York Times* (March 7, 1986). Most of the resigned directors have been outsiders. If this trend continues, many publicly-held corporations will be left with only inside directors — a reversal of the position which the Securities and Exchange Commission, the New York Stock Exchange and various commentators have tried to encourage. 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.

Older executives, in particular, with the greatest experience and the greatest wealth, are unlikely to be willing to risk exposing their personal assets to the increased hazards of serving as a director. Obviously a trend which results in reducing the number of qualified outside directors is poor public policy.

II. ACTION IN OTHER STATES

Already, several other states have responded legislatively to this predicament. In general, these states have followed one or more of four approaches:

1. *Charter Amendment.* In June, 1986, the General Corporation Law of Delaware (the "Delaware Code") was amended to permit Delaware corporations by charter provision to reduce the liability of directors for their acts or omissions. The heart of the new legislation, which became effective on July 1, 1986, is a provision amending Section 102(b) of the Delaware Code to permit, with certain exceptions, a Delaware corporation to include in its certificate of incorporation, either as originally filed or by an amendment approved by its stockholders, a provision "eliminating or limiting the personal liability of a director to a corporation or its stockholders for money damages for breach of fiduciary duty as a director. . . ." The statute specifically excepts breaches of the duty of loyalty, acts not in good faith, intentional misconduct and improper benefit. Several other provisions of the bill amended various subsections of Section 145 of the Delaware Code dealing with indemnification of directors and officers. Unfortunately, there are questions surrounding the new law, principally its exceptions which may restrict its efficacy in solving the problems it purports to address.

Charter option, or enabling, statutes have been adopted by 24 other states. The principal difference among the charter option statutes is

found in their exceptions. Eleven states (Arizona, Colorado, Iowa, Kansas, Massachusetts, Michigan, Minnesota, Oklahoma, Oregon, South Dakota and Wyoming) have copied all six of the Delaware exceptions. The other states (Arkansas, California, Georgia, Montana, Nevada, New Jersey, New York, North Carolina, Pennsylvania, Tennessee, Texas, Utah and Washington) have modified these exceptions in whole or in part.

2. *Expanded Indemnifiability.* At least nine states — Florida, Indiana, Louisiana, Michigan, Nevada, New York, North Carolina, Pennsylvania and Wisconsin — have enacted statutes expanding the right of corporations to indemnify their directors for expenses, settlements and adverse judgments in derivative suits. The typical indemnification statute, as applied to derivative suits, permits the director or officer to be indemnified only against expenses in the case of a successful defense or a settlement and permits no indemnification, even for expenses, in the case of an adverse judgment (unless ordered by a court). Some states permit indemnification for amounts paid in settlement of derivative actions while others do not permit such indemnification.

The most far-reaching statutory developments affecting derivative suits are provisions adopted in four states — Wisconsin, Indiana, North Carolina and Virginia — eliminating or substantially eliminating the distinction between third-party and derivative suits and permitting indemnification against judgments, settlements and expenses for any director or officer who meets the general statutory standards for indemnification.

Five other states — Florida, Michigan, Missouri, New York and Nevada — now permit indemnification against expenses (except in the case of liability) and settlements.

3. *Money Limit on Liability.* Virginia, our most vigorous competitor for business development, has enacted a statute limiting the damages which may be "assessed against an officer or director" in a suit by or in the right of the corporation or by the stockholders directly to the lesser of (1) the amount specified in the charter (or, if approved by the stockholders, in the bylaws) or (2) the greater of (a) $100,000 or (b) "the amount of cash compensation received by the officer or director from the corporation during the twelve months immediately preceding the act or omission for which liability was imposed." 1987 Va. Acts Ch. 257, amending VA. CODE ANN. § 13.1-692.1(A) (Supp. 1987). Thus, if the shareholders take no action to amend the charter or bylaws, the liability of a director or officer of a Virginia corporation will be limited to the greater of $100,000 or his cash compensation over the year preceding the contested act or omission. The stockholders, however, may reduce (but not increase) by amendment to the charter or bylaws the $100,000/12-month cash compensation limit. Indeed the stockholders may eliminate monetary liability altogether.

The statute does not apply to "willful misconduct or knowing violation of the criminal law or of any federal or state securities law. . . ."

4. *Increased Standard of Liability For Money Damages.* Four states — Indiana, Florida, Ohio and Wisconsin — have enacted statutes which directly alter, without any requirement for stockholder approval, the standard of liability for imposition of money damages against directors. Under the new Indiana statute, a director is liable only if he has breached or failed to perform his duties in compliance with the statutory standard of care *and* "the breach or failure to perform constitutes willful misconduct or recklessness." IND. CODE ANN. § 23-1-35-1(e) (Burns Supp. 1987). The Florida, Ohio and Wisconsin statutes have similar exceptions for egregious misconduct. As noted above, the 1987 bills which were rejected by the General Assembly followed this approach.

III. PROPOSALS FOR MARYLAND

The Subcommittee has considered all of the foregoing approaches in conjunction with its review of the applicable provisions of the Maryland General Corporation Law ("MGCL"). The Subcommittee believes that if Maryland does not act (a) directors of many Maryland corporations will refuse to continue to serve as directors, thus depriving these corporations and their stockholders of some of the most experienced and qualified directors, and/or (b) Maryland will face the loss of many Maryland-chartered corporations to other states with more favorable legislation. Indeed, several Maryland corporations (*e.g.* Fairchild Industries, Inc., Luskin's, Inc., Penta Systems International, Inc. and PUBCO Corporation) have already reincorporated to other states.

With respect to the principal problem of the standard of conduct for directors, the Subcommittee has concluded that the charter option approach (*i.e.*, permitting the stockholders to limit the liability of directors and officer for money damages in suits by the corporation or its stockholders) is preferred. Even the stockholders, however, would not be permitted to limit the liability of directors or officers for actual receipt of an improper personal benefit in money, property or services or for active and deliberate dishonesty that was material to an adjudicated cause of action.

The principal Maryland cases on director liability, *Parish v. Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 74, 242 A.2d 512, 540 (1968), and *Mountain Manor Realty v. Buccheri*, 55 Md. App. 185, 194, 461 A.2d 45, 51 (1983), already establish a standard of "gross and culpable negligence" as a prerequisite to money liability for directors.[2] This judicial standard would continue to apply to corporations, the stockholders of which do not take advantage of the new legislation by approving a charter amendment limiting the liability of their directors or officers. If, and only if the stockholders approved, a Maryland corporation could

2. Inexplicably, the Court of Appeals has referred both to "gross *and* culpable" negligence and "gross *or* culpable" negligence. *Parish, supra,* 250 Md. at 74-76, 242 A.2d at 540-41 (1968). *See also, Parish v. Maryland & Virginia Milk Producers Ass'n,* 261 Md. 618, 681, 277 A.2d 19, 48, *cert. denied,* 404 U.S. 940 (1971).

limit the liability of its directors and officers for all acts or omissions except, as noted above, for improper personal benefits and active and deliberate dishonesty. It should be emphasized, however, that the stockholders, if they so desire, could limit the liability of their directors and officers to some lesser standard, *e.g.*, gross negligence.

In particular, the Subcommittee believes that this new standard would have no impact upon truly venal or egregious conduct by self-dealing directors and officers of Maryland corporations. Finally, nothing in this proposal would in any way affect the right of stockholders under Section 2-406 to remove directors "with or without cause. . . ."

The Subcommittee's proposals are discussed in detail below:

1. *Charter Option*

The Subcommittee proposes that a new paragraph (8) be added to Section 2-104(b) of the MGCL, that subsection (c) of Section 2-405.1 of the MGCL be amended and that a new section (§ 2-405.2) be enacted, as follows:

> (b) The articles of incorporation may include:
>
> (1) Any provision not inconsistent with law which defines, limits, or regulates the powers of the corporation, its directors and stockholders, any class of its stockholders, or the holders of any bonds, notes or other securities which it may issue;
>
> (2) Any restriction not inconsistent with law on the transferability of stock of any class;
>
> (3) Any provision authorized by this article to be included in the bylaws;
>
> (4) Any provision which requires for any purpose the concurrence of a greater proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose;
>
> (5) A provision which requires for any purpose a lesser proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose, but this proportion may not be less than a majority of all the votes entitled to be cast on the matter;
>
> (6) A provision which divides its directors into classes and specifies the term of office of each class; [and]
>
> (7) A provision for minority representation through cumulative voting in the election of directors and the terms on which cumulative voting rights may be exercised[.]; AND
>
> (8) A PROVISION WHICH VARIES IN ACCORDANCE WITH § 2-405.2(A) OF THIS TITLE THE STANDARDS FOR LIABILITY OF THE DIRECTORS AND OFFICERS OF A CORPORATION FOR MONEY DAMAGES.
>
> 2-405.1
>
> (c) A person who performs his duties in accordance with

the standard provided in this section has no liability by reason of being or having been a director of a corporation [, unless, in a situation to which § 2-419(d) of this subtitle applies, a contract or transaction is determined not to have been fair and reasonable to the corporation].

2-405.2

(A) THE CHARTER OF THE CORPORATION MAY INCLUDE ANY PROVISION EXPANDING OR LIMITING THE LIABILITY OF ITS DIRECTORS AND OFFICERS TO THE CORPORATION OR ITS STOCKHOLDERS FOR MONEY DAMAGES BUT MAY NOT INCLUDE ANY PROVISION WHICH RESTRICTS OR LIMITS THE LIABILITY OF ITS DIRECTORS OR OFFICERS TO THE CORPORATION OR ITS STOCKHOLDERS:

(1) TO THE EXTENT THAT IT IS PROVED THAT THE PERSON ACTUALLY RECEIVED AN IMPROPER BENEFIT IN MONEY, PROPERTY, OR SERVICES, FOR THE AMOUNT OF THE BENEFIT IN MONEY, PROPERTY, OR SERVICES ACTUALLY RECEIVED;

(2) TO THE EXTENT THAT A JUDGMENT OR OTHER FINAL ADJUDICATION ADVERSE TO THE PERSON IS ENTERED IN A PROCEEDING BASED ON A FINDING IN THE PROCEEDING THAT THE PERSON'S ACTION, OR FAILURE TO ACT, WAS THE RESULT OF ACTIVE AND DELIBERATE DISHONESTY AND WAS MATERIAL TO THE CAUSE OF ACTION ADJUDICATED IN THE PROCEEDING; OR

(3) WITH RESPECT TO ANY ACTION DESCRIBED IN SUBSECTION (B) OF THIS SECTION.

(B) THIS SECTION DOES NOT APPLY TO AN ACTION BROUGHT BY OR ON BEHALF OF A STATE GOVERNMENTAL ENTITY, RECEIVER, CONSERVATOR, OR DEPOSITOR AGAINST A DIRECTOR OR OFFICER OF:

(1) A BANKING INSTITUTION AS DEFINED IN § 1-101 OF THE FINANCIAL INSTITUTIONS ARTICLE;

(2) A CREDIT UNION. . . .;

(3) A SAVINGS AND LOAN ASSOCIATION. . . .:

(4) A SUBSIDIARY OF A BANKING INSTITUTION, CREDIT UNION, OR SAVINGS AND LOAN ASSOCIATION DESCRIBED IN THIS SUBSECTION.

(C) THIS SECTION MAY NOT BE CONSTRUED TO AFFECT THE LIABILITY OF A PERSON IN ANY CAPACITY OTHER THAN THE PERSON'S CAPACITY AS A DIRECTOR OR OFFICER.

The revisions recommended by the Subcommittee reflect the conclu-

sion that, with respect to the principal issue of directors' and officers' liability discussed above, the preferred approach is to permit the stockholders to decide for themselves the standard required to impose personal liability for money damages in suits by the corporation or by its stockholders.

Section 2-405.1(a) of the MGCL provides that a director of a Maryland corporation must perform his duties in "good faith", "[i]n a manner he reasonably believes to be in the best interests of the corporation" and "[w]ith the care [of] an ordinarily prudent person in a like position . . . under similar circumstances." (This standard of care, which was adopted by the General Assembly in 1976, follows the standard of care set forth in Section 8.30 of the Revised Model Business Corporation Act and has been adopted by Indiana, Virginia and several other states.) In performing these duties, the director is permitted to rely upon legal opinions, financial statements and other reports or information prepared by officers or employees of the corporation or by outside experts as long as the director has no "knowledge concerning the matter in question which would cause such reliance to be unwarranted." MGCL, § 2-405.1(b).

Under current law, if a director performs his duties in accordance with the tripartite standard of Section 2-405.1(a), he will have "no liability by reason of being or having been a director of a corporation, unless, in a situation to which § 2-419(d) . . . applies, a contract or transaction is determined not to have been fair and reasonable to the corporation." *Id.*, § 2-405.1(c).

The Subcommittee recommends that the stockholders be permitted to provide, by charter, that directors and officers will not be liable for money damages in suit by the corporation or the stockholders unless an act or omission constitutes actual receipt of an improper benefit or active and deliberate dishonesty. The purpose of setting out the revised liability standard as a new section is to eliminate any argument that, by its inclusion in Section 2-405.1, the statutory limitation on liability is intended to apply only to a director's breach of the standard of care set forth in Section 2-405.1(a) and not to a breach of the duty of loyalty.

The proposed Section 2-405.2(a) addresses the liability of directors and officers for damages only. That is consistent with existing Section 2-405.1(c). The protection sought to be provided is intended to limit the availability of directors' and officers' personal assets as a source for recovery by the corporation or stockholders. It is not intended to affect in any way the availability of equitable remedies, such as an injunction or rescission, for a director's violation of his duties or the right of the stockholders to remove a director at any time with or without cause.

The Subcommittee believes that permitting stockholders to decide whether to limit the liability of directors and officers for money damages is desirable for several reasons: First, and most importantly, it allows the owners of the corporation — the stockholders — to decide the issue for themselves. Second, it follows similar legislative precedents already es-

tablished in Delaware and 24 other states and will enable Maryland courts to take advantage of subsequent cases decided in those states under this standard. Third, it will add greater clarity and certainty to the law than is available under judicial precedents. Fourth, it will add to the perception of Maryland as a state with a favorable and responsive climate to business. Fifth, it will discourage directors and officers of existing Maryland-chartered publicly-held corporations from recommending reincorporation in other states by reassuring the directors and officers that they will not be held personally liable for money damages for simple negligence. Sixth, newly-established businesses are more likely to incorporate in Maryland to the extent that it is perceived as having an up-to-date corporation statute. Finally, enactment of this proposed legislation will encourage directors of existing Maryland-chartered corporations to continue to serve s directors.

Failure to enact such legislation is likely to result in (a) the reincorporation of many Maryland corporations in other states, thus injuring the state's efforts to be perceived as a favorable business climate, and/or (b) the resignation of directors of Maryland corporations, thus depriving the stockholders of these corporations (many of whom are Maryland residents) of some of the most qualified individuals to supervise the managements of these corporations.

Accordingly, the Subcommittee proposes adding a new paragraph (8) to Section 2-104(b) of the MGCL permitting a charter provision varying the standard for liability for money damages but only to the extent permitted in subsection (a) of new Section 2-405.2. New Section 2-405.2(a) explicitly authorizes eliminating or limiting the liability of directors for money damages except that the charter may not restrict or limit liability if (1) a director has actually received an improper personal benefit in money, property or services or (2) an adverse judgment establishes that a director's acts or omissions resulted from active and deliberate dishonesty and were material to the cause of action.

An exception for improper personal benefit appears in many, although not all, of the 25 charter option statutes. The Subcommittee proposes limiting it in the Maryland bill to benefits actually received in the form of money, property or services in order to eliminate any argument that such ambiguous items as business goodwill or social ingratiation may constitute a benefit to a director or officer. The exception for "active and deliberate dishonesty" is based upon a similar exclusion appearing in virtually every directors and officers liability insurance policy and also upon the language of a New York statute enacted last year.

Subsection (a)(3) specifically prohibits the stockholders from limiting the liability of directors or officers with respect to any action brought by or on behalf of a state governmental entity, receiver, conservator or depositor against a director or officer of a banking institution, a credit union, a savings and loan association or a subsidiary of any such entity.

Directors occupy a unique place in the governance of American cor-

porations. Often, particularly among larger corporations with the most stockholders, they are outsiders with little or no equity investment of their own in the corporation; yet they are charged with protecting the investments of thousands, sometimes hundreds of thousands, of stockholders, in Maryland and elsewhere. Their compensation is insignificant relative to the magnitude of their risks and responsibilities. Generally, it is a part-time position. Indeed, some of the individuals most sought as corporate directors are senior executive officers of other corporations who can bring a wide range of experience and knowledge to the corporation.

The Subcommittee believes that inclusion of officers in the proposed legislation is particularly important:

First, many of the decisions and transactions which are submitted to a Board of Directors originate among the officers and, if approved by the Board, are referred to the officers for implementation. They are entitled, if the stockholders so decide, to be protected to the same degree as officers.

Second, unlike the 1987 bills, the proposed 1988 bill permits the stockholders to decide the issue of limitation of liability. Under the proposed bill, the stockholders would be able to limit the liability of directors alone, officers alone, both or neither.

Third, the 1987 bills did not limit the liability of directors to suits by the corporation or its stockholders. The proposed 1988 bill is expressly limited *solely* to suits by the corporation or its stockholders. It would *not* include suits by third parties. Thus, the only claimants whose rights would be affected by a limitation on the liability of directors and officers would be the stockholders, and then only with their approval.

Fourth, there is no logical policy reason for permitting stockholders to limit the liability of directors but not permitting them to limit the liability of officers. Moreover, treating directors and officers alike for purposes of permitting their liability to be limited is consistent with the identical treatment of directors and officers under the indemnification provisions of Section 2-418 of the MGCL. It would be inconsistent for directors and officers to be working together on evaluating, negotiating or implementing a major corporate transaction for which the directors' liability could be limited and the officers' liability could not.

Fifth, directors and officers liability insurers are more likely to reduce their premiums if they are assured that the liability of both directors and officers has been limited. Since most D&O insurance policies cover both directors *and* officers, the liability of an officer could result in a claim against the insurance company even though the directors' liability had been limited.

Sixth, the recently-enacted Virginia statute, discussed above, applies to both directors and officers. One Baltimore-based Maryland-chartered corporation has already reincorporated in Virginia, another has indicated in a proxy statement that it may reincorporate there and other corpora-

tions incorporated in other states have also reincorporated in Virginia. Other states, *e.g.*, New Jersey, have also enacted legislation authorizing limits on the liability of officers as well as directors.

Finally, permitting stockholders to decide whether to decide whether to limit the liability of both officers and directors enhances the role of the stockholders incorporate governance. The stockholders are already charged with the duty of voting on mergers, charter amendments, election of directors and other significant corporate acts. Permitting the stockholders to decide for themselves whether to limit the liability of officers in addition to directors is not only consistent and sound public policy, as indicated above, but broadens the right of the stockholders to determine for themselves the best interest for the corporations they own.

Section 2-405.1(c) is amended by eliminating the reference to Section 2-419. Section 2-419 provides alternative means of insulating from voidness or voidability transactions between a corporation and a director; it does not provide for personal liability for directors. Accordingly, the reference to Section 2-419 in Section 2-405.1(c) is inappropriate and should be deleted. Section 8.30(d) of the Model Act — the counterpart to Section 2-405.1(c) — contains no similar reference to the counterpart of Section 2-419.

2. *Change in Standards for Indemnification*

Section 2-418(b)(1) currently sets forth the "good faith", "reasonable belief" standards which a director or officer[3] must satisfy in order to be entitled to indemnification. The Subcommittee recommends amending Section 2-418(b)(1) to permit a corporation to indemnify a director *unless* it is proved that the individual (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) in the case of a criminal proceeding had reasonable cause to believe that his act or omission was unlawful:

> (b)(1) A corporation may indemnify any director made a party to any proceeding by reason of service in that capacity [if the director:
>
> (i) Acted in good faith;
>
> (ii) Reasonably believed:
>
> 1. In the case of conduct in the director's official capacity with the corporation, that the conduct was in the best interests of the corporation; and
>
> 2. In all other cases, that the conduct was at least not opposed to the best interests of the corporation; and]
>
> UNLESS IT IS PROVED THAT:

---

3. As noted above, Section 2-418(j)(1) provides that, unless the charter provides otherwise, an officer "shall be indemnified as and to the extent provided . . . for a director. . . ."

> (I) THE ACT OR OMISSION OF THE DIRECTOR WAS MATERIAL TO THE CAUSE OF ACTION ADJUDICATED IN THE PROCEEDING: 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 PERSONAL BENEFIT IN MONEY, PROPERTY, OR SERVICES; OR
>
> (III) In the case of any criminal proceeding, THE DIRECTOR HAD [no] reasonable cause to believe that the [conduct] ACT OR OMISSION was unlawful.

Expanding the right of the corporation to indemnify its directors and officers is consistent with statutory amendments enacted by numerous other states. It should be noted that, as in the case of limitation of liability, the proposed bill would merely permit, not require, the corporation to act.

3. *Expansion of Indemnification in Derivative Suits*

Section 2-418(b)(2)(ii) currently provides that, in a derivative suit, indemnification may only be made against reasonable expenses and may not be made, even for expenses, if the individual has been adjudged to be liable to the corporation. The Subcommittee recommends deleting the limitation of indemnification in derivative suits to reasonable expenses in order to permit a director to be indemnified for settlements of derivative suits:

> (2)(i) Indemnification may be against judgments, penalties, fines, settlements, and reasonable expenses actually incurred by the director in connection with the proceeding.
>
> (ii) However, if the proceeding was one by or in the right of the corporation, indemnification [may be made only against reasonable expenses and] may not be made in respect of any proceeding in which the director shall have been adjudged to be liable to the corporation.

This change will encourage settlements by permitting indemnification for amounts paid in settlement and not just for expenses. In addition, as noted below, as a result of the expansion of the language of Section 2-418(g), relating to non-exclusivity, it is no longer necessary to limit indemnification in derivative suits to reasonable expenses.

4. *Changes in Indemnification Procedures*

The Subcommittee recommends the following four amendments to Section 2-418 of the MGCL relating to the procedures for indemnification:

Presumption of Non-Compliance (Section 2-418(b)(3))

(b)(3) (I) The termination of any proceeding by judgment, order, OR settlement [, conviction, or upon a plea of nolo contendere or its

equivalent creates a rebuttable] DOES NOT CREATE A presumption that the director did not meet the requisite standard of conduct set forth in this subsection.

(II) THE TERMINATION OF ANY PROCEEDING BY CONVICTION ON A PLEA OF NOLO CONTENDERE OR ITS EQUIVALENT CREATES A REBUTTABLE PRESUMPTION THAT THE DIRECTOR DID NOT MEET THAT STANDARD OF CONDUCT.

Section 2-418(b)(3) currently provides that termination of any proceeding by judgment, order, settlement, conviction or a *nolo contendere* plea creates a rebuttable presumption that the director did *not* meet the requisite standard of conduct set forth in Section 2-418(b)(1). The Subcommittee recommends that, as to convictions and *nolo contendere* pleas, a rebuttable presumption should continue but that, as to judgments, orders and settlements, there should be no presumption one way or the other.

Read literally, the termination of a proceeding by a judgment of no liability presently creates a rebuttable presumption that the director did not meet the requisite standard of conduct. While the Subcommittee believes that such a result would be overridden by the requirement of indemnification in subsection (d)(1), it is at least superficially inconsistent with that subsection.

The problem with Section 2-418(b)(3) as it currently reads is most acute in the case of settlements. A settlement may be the result of many factors other than an assessment of the likelihood of liability. For example, a suit may be settled for its "nuisance" value at an amount less than the cost to the corporation of litigating to a successful conclusion. It is difficult to imagine, therefore, why a settlement should create a presumption of non-compliance with the standards of Section 2-418(b)(1).

As a matter of public policy, 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.

The Revised Model Business Corporation Act (Section 8.51(c)) and the new Virginia Stock Corporation Act (Section 13.1-697(C)) both specifically provide that a judgment, settlement or other termination of the proceeding does *not* create a presumption that the director did not meet the requisite standard of care. Likewise, Section 145(a) of the Delaware statute provides:

> The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall *not*, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or

> proceeding, had reasonable cause to believe that his conduct was unlawful.

(Emphasis added.) The statutes of 41 other states are similar. Maryland is the *only* state in which a settlement *creates* a presumption that the director did not meet the requisite standard of care. Members of the Subcommittee are personally aware of many situations in which counsel to Maryland-chartered corporations (including counsel located in other states) have expressed surprise and apprehension about the presumption of non-compliance in Section 2-418(b)(1).

The revisions recommended by the Subcommittee are based largely upon Section 145(a) of the Delaware statute. However, the phrase "of itself" appearing in the Delaware statute (as well as in the Model Act and most other state statutes) has been deleted because it was felt that this phrase suggested the possibility that the termination of the proceeding could be combined with some other fact to create a presumption. The Subcommittee believes that all of the facts and circumstances surrounding the termination should be available as evidence, subject to the usual evidentiary rules, but that no presumption should be created.

Non-Exclusivity (Section 2-418(g))

> (g) [A provision for the corporation to indemnify a director who is made a party to a proceeding, whether contained in] THE INDEMNIFICATION AND ADVANCEMENT OF EXPENSES PROVIDED OR AUTHORIZED BY THIS SECTION MAY NOT BE DEEMED EXCLUSIVE OF ANY OTHER RIGHTS, BY INDEMNIFICATION OR OTHERWISE, TO WHICH A DIRECTOR MAY BE ENTITLED UNDER the charter, the bylaws, a resolution of stockholders or directors, an agreement or otherwise, [except as contemplated by subsection (k) of this section, is not valid unless consistent with this section or, to the extent that indemnity under this section is limited by the charter, consistent with the charter] BOTH AS TO ACTION IN AN OFFICIAL CAPACITY AND AS TO ACTION IN ANOTHER CAPACITY WHILE HOLDING SUCH OFFICE.

Under current Section 2-418(g), any contract between a corporation and its directors providing for indemnification must be "consistent with" the indemnification permitted by Section 2-418.

This provision is much more restrictive than the comparable provision in Delaware, Section 145(f), which provides that the indemnification provided by state "shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled under any bylaw, agreement, . . . or otherwise. . . ." Thus, Maryland's Section 2-418(g) is a limitation upon indemnification while Delaware's Section 145(f) is a non-exclusive provision for indemnification. Approximately 30 other

states and the District of Columbia have non-exclusivity provisions substantially similar to Delaware's.

Even the Delaware statute, however, could be read to limit any indemnification right to Section 145, although "other rights" would not be deemed to be excluded by Section 145.

Current Section 2-418(g) is based upon Section 8.58(a) of the Revised Model Act. The Official Comment to Section 8.58(a) notes that the non-exclusive statutory provisions, such as Delaware's, make "no attempt to limit the nonstatutory creation of rights of indemnification. This kind of language is subject to misconstruction . . . since nonstatutory conceptions of public policy limit the power of the corporation to indemnify or to contract to indemnify directors. . . ." Significantly, however, the Official Comment also notes that the phrase

> "to the extent it is consistent with" is not synonymous with "exclusive." Situations may well develop from time to time in which indemnification is permissible under Section 8.58 but would be precluded if all portions of [the indemnification statute] were viewed as exclusive.

Kentucky follows the 1980 version of the Model Act in its indemnification provision, except for its non-exclusivity provision, which follows the Delaware statute.

The purpose of the revisions to Section 2-418(g) is to make clear that any rights, by indemnification or otherwise, to which a director may be entitled are not precluded by Section 2-418. Of course, the "other rights" referred to in Section 2-418(g) would be limited by public policy considerations.

The revisions recommended by the Subcommittee are based largely upon Section 145(f) of the Delaware statute. However, the phrase "those seeking indemnification" has been replaced with the words "a director" in order to clarify that a person need not seek indemnification in order to have the benefit of the non-exclusivity provision of new Section 2-418(g).

By virtue of Section 2-418(j), the proposed non-exclusivity provision would also apply to officers, employees and agents as well as to directors.

> *Determination of Permissibility of Indemnification (Section 2-418(e))*
>
> (e) (1) Indemnification under subsection (b) of this section may not be made by the corporation unless authorized [in the specific case] FOR A SPECIFIC PROCEEDING after a determination has been made that indemnification of the director is permissible in the circumstances because the director has met the standard of conduct set forth in subsection (b) of this section.

Section 2-418(e) currently provides that indemnification must be

"authorized in the specific case. . . ." The word "case" is nowhere defined in Section 2-418 and its use, especially in view of the fact that the word "proceeding" is defined, frequently raises the question of whether indemnification for each bill for expenses in connection with a proceeding must be separately authorized after each submission for expenses to be paid in advance under subsection (f). This interpretation could lead to repeated and unnecessary reexamination of the same issue and the same circumstances each time expenses are incurred, at excessive cost to the corporation. The substitution of the phrase "for a specific proceeding" for the phrase "in the specific case" solves this problem.

Advance Payment of Expenses (Section 2-418(f))

> (f)(1) Reasonable expenses incurred by a director who is a party to a proceeding may be paid or reimbursed by the corporation in advance of the final disposition of the proceeding [, after a determination that the facts then known to those making the determination would not preclude indemnification under this section,] upon receipt by the corporation of:
>
> (i) A written affirmation by the director of the director's good faith belief that the standard of conduct necessary for indemnification by the corporation as authorized in this section has been met; and
>
> (ii) A written undertaking by or on behalf of the director to repay the amount if it shall ultimately be determined that the standard of conduct has not been met.
>
> (2) The undertaking required by subparagraph (ii) of paragraph (1) of this subsection shall be an unlimited general obligation of the director but need not be secured and may be accepted without reference to financial ability to make the repayment.
>
> (3) [Determinations and authorizations of payments] PAYMENTS under this subsection shall be [in the manner] MADE AS PROVIDED BY THE CHARTER, BYLAWS, OR CONTRACT OR AS specified in subsection (e) of this section.

Section 2-418(f) currently requires, as a prerequisite to advance payment of expenses, a determination in each case that indemnification would not be precluded under the facts known at the time of the determination. The proposed revisions would eliminate the necessity for this determination.

Instead, a corporation could adopt a general provision for advance payment of expenses in its charter or bylaws or by contract. Alternatively, a corporation could still advance expenses pursuant to a determination under Section 2-418(e) "that indemnification is permissible in the circumstances because the director has met the standard of conduct set forth in subsection (b). . . ." In either case, advance payment of expenses could be made only upon receipt of (a) a written affirmation of the direc-

tor's good faith belief that he met the standard of conduct for indemnification and (b) a written undertaking to repay if it is ultimately determined that the standard of conduct was not met.

The proposed revision follows closely the amendment recently enacted in Delaware. The amendment would allow Maryland corporations the same flexibility in administering these matters as Delaware corporations.

III. CONCLUSION

The Subcommittee wishes to reemphasize its unanimous view that legislation in these areas is essential in order to provide a sound response by the State of Maryland to problems that have truly reached crisis proportions. In addition, we believe that this legislation will contribute to a perception of Maryland as a state with a favorable and responsible climate for new and established businesses. This legislation, we believe, represents sound fundamental public policy and not merely a short-term reaction of undue alarm or an effort to prevent migration of Maryland corporations out of state at any cost. The basic elements of the proposed legislation have been reviewed and approved by the full Committee on Corporate Laws. Respectfully submitted,

James J. Hanks, Jr., Chairman
Arthur F. Fergenson
Arthur W. Machen, Jr.
Larry P. Scriggins
J. W. Thompson Webb
John J. Woloszyn
Dated: November 16, 1987

ADDENDUM I

WILLIAM DONALD SCHAEFER, Governor

CHAPTER 3

(House Bill 273)

AN ACT concerning

Corporations and Associations -
Standard of Liability and Indemnification

FOR the purpose of authorizing a corporate charter to alter the standard for imposing liability for damages on corporate directors and officers; providing for certain exceptions; modifying the presumptions applicable to, and the procedures for establishing the basis for, indemnification and advancement of expenses to corporate directors and certain other persons; providing for the application and construction of certain provisions of this Act; generally relating to the standards for liability for corporate directors and officers and indemnification of corporate directors and certain other persons; and making this Act an emergency measure.

BY adding to

Article - Corporations and Associations
Section 2-405.2
Annotated Code of Maryland
(1985 Replacement Volume and 1987 Supplement)

BY repealing and reenacting, with amendments,

Article - Corporations and Associations
Section 2-104(b), 2-405.1(c), and 2-418(b), (e)(1), (f), (g), and (k)
Annotated Code of Maryland
(1985 Replacement Volume and 1987 Supplement)

SECTION 1. BE IT ENACTED BY THE GENERAL ASSEMBLY OF MARYLAND, That the Laws of Maryland read as follows:

Article - Corporations and Associations

2-104.

(b) The articles of incorporation may include:

EXPLANATION: CAPITALS INDICATE MATTER ADDED TO EXISTING LAW; [Brackets] indicate matter deleted from existing law.

(1) Any provision not inconsistent with law which defines, limits, or regulates the powers of the corporation, its directors and stockholders, any class of its stockholders, or the holders of any bonds, notes, or other securities which it may issue;

(2) Any restriction not inconsistent with law on the transferability of stock of any class;

(3) Any provision authorized by this article to be included in the bylaws;

(4) Any provision which requires for any purpose the concurrence of a greater proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose;

(5) A provision which requires for any purpose a lesser proportion of the votes of all classes or of any class of stock than the proportion required by this article for that purpose, but this proportion may not be less than a majority of all the votes entitled to be cast on the matter;

(6) A provision which divides its directors into classes and specifies the term of office of each class; [and]

(7) A provision for minority representation through cumulative voting in the election of directors and the terms on which cumulative voting rights may be exercised; AND

(8) A PROVISION WHICH VARIES IN ACCORDANCE WITH § 2-405.2(A) OF THIS TITLE THE STANDARDS FOR LIABILITY OF THE DIRECTORS AND OFFICERS OF A CORPORATION FOR MONEY DAMAGES.

2-405.1.

(c) A person who performs his duties in accordance with the standard provided in this section has no liability by reason of being or having been a director of a corporation[, unless, in a situation to which § 2-419(d) of this subtitle applies, a contract or transaction is determined not to have been fair and reasonable to the corporation].

2-405.2.

(A) THE CHARTER OF THE CORPORATION MAY INCLUDE ANY PROVISION EXPANDING OR LIMITING THE LIABILITY OF ITS DIRECTORS AND OFFICERS TO THE CORPORATION OR ITS STOCKHOLDERS FOR MONEY DAMAGES BUT MAY NOT INCLUDE ANY PROVISION WHICH RESTRICTS OR LIMITS THE LIABILITY OF ITS DIRECTORS OR OFFICERS TO THE CORPORATION OR ITS STOCKHOLDERS:

(1) TO THE EXTENT THAT IT IS PROVED THAT THE PERSON ACTUALLY RECEIVED AN IMPROPER BENEFIT OR PROFIT IN MONEY, PROPERTY, OR SERVICES, FOR THE AMOUNT OF THE BENEFIT OR PROFIT IN MONEY, PROPERTY, OR SERVICES ACTUALLY RECEIVED;

(2) TO THE EXTENT THAT A JUDGMENT OR OTHER FINAL ADJUDICATION ADVERSE TO THE PERSON IS ENTERED IN A PROCEEDING BASED ON A FINDING IN THE

PROCEEDING THAT THE PERSON'S ACTION, OR FAILURE TO ACT, WAS THE RESULT OF ACTIVE AND DELIBERATE DISHONESTY AND WAS MATERIAL TO THE CAUSE OF ACTION ADJUDICATED IN THE PROCEEDING; OR

(3) WITH RESPECT TO ANY ACTION DESCRIBED IN SUBSECTION (B) OF THIS SECTION.

(B) THIS SECTION DOES NOT APPLY TO AN ACTION BROUGHT BY OR ON BEHALF OF A STATE GOVERNMENTAL ENTITY, RECEIVER, CONSERVATOR, OR DEPOSITOR AGAINST A DIRECTOR OR OFFICER OF:

(1) A BANKING INSTITUTION AS DEFINED IN § 1-101 OF THE FINANCIAL INSTITUTIONS ARTICLE;

(2) A CREDIT UNION AS DESCRIBED IN § 6-201 OF THE FINANCIAL INSTITUTIONS ARTICLE;

(3) A SAVINGS AND LOAN ASSOCIATION AS DEFINED IN § 8-101 OF THE FINANCIAL INSTITUTIONS ARTICLE; OR

(4) A SUBSIDIARY OF A BANKING INSTITUTION, CREDIT UNION, OR SAVINGS AND LOAN ASSOCIATION DESCRIBED IN THIS SUBSECTION.

(C) THIS SECTION MAY NOT BE CONSTRUED TO AFFECT THE LIABILITY OF A PERSON IN ANY CAPACITY OTHER THAN THE PERSON'S CAPACITY AS A DIRECTOR OR OFFICER.

2-418.

(b)(1) A corporation may indemnify any director made a party to any proceeding by reason of service in that capacity [if the director:

(i) Acted in good faith;

(ii) Reasonably believed:

1. In the case of conduct in the director's official capacity with the corporation, that the conduct was in the best interests of the corporation; and

2. In all other cases, that the conduct was at least not opposed to the best interests of the corporation; and] UNLESS IT IS PROVED THAT:

(I) THE ACT OR OMISSION OF THE DIRECTOR WAS MATERIAL TO THE CAUSE OF ACTION ADJUDICATED IN THE PROCEEDING; 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 PERSONAL BENEFIT IN MONEY, PROPERTY, OR SERVICES; OR

(iii) In the case of any criminal proceeding, THE DI-

RECTOR had [no] reasonable cause to believe that the [conduct] ACT OR OMISSION was unlawful.

(2)(i) Indemnification may be against judgments, penalties, fines, settlements, and reasonable expenses actually incurred by the director in connection with the proceeding.

(ii) However, if the proceeding was one by or in the right of the corporation, indemnification [may be made only against reasonable expenses and] may not be made in respect of any proceeding in which the director shall have been adjudged to be liable to the corporation.

(3)(I) The termination of any proceeding by judgment, order OR settlement[, conviction, or upon a plea of nolo contendere or its equivalent creates a rebuttable] DOES NOT CREATE A presumption that the director did not meet the requisite standard of conduct set forth in this subsection.

(II) THE TERMINATION OF ANY PROCEEDING BY CONVICTION, OR A PLEA OF NOLO CONTENDERE OR ITS EQUIVALENT, OR AN ENTRY OF AN ORDER OF PROBATION PRIOR TO JUDGMENT, CREATES A REBUTTABLE PRESUMPTION THAT THE DIRECTOR DID NOT MEET THAT STANDARD OF CONDUCT.

(e)(1) Indemnification under subsection (b) of this section may not be made by the corporation unless authorized [in the specific case] FOR A SPECIFIC PROCEEDING after a determination has been made that indemnification of the director is permissible in the circumstances because the director has met the standard of conduct set forth in subsection (b) of this section.

(f)(1) Reasonable expenses incurred by a director who is a party to a proceeding may be paid or reimbursed by the corporation in advance of the final disposition of the proceeding[, after a determination that the facts then known to those making the determination would not preclude indemnification under this section,] upon receipt by the corporation of:

(i) A written affirmation by the director of the director's good faith belief that the standard of conduct necessary for indemnification by the corporation as authorized in this section has been met; and

(ii) A written undertaking by or on behalf of the director to repay the amount if it shall ultimately be determined that the standard of conduct has not been met.

(2) The undertaking required by subparagraph (ii) of paragraph (1) of this subsection shall be an unlimited general obligation of the director but need not be secured and may be accepted without reference to financial ability to make the repayment.

(3) [Determinations and authorizations of payments] PAYMENTS under this subsection shall be [in the manner] MADE AS PROVIDED BY THE CHARTER, BYLAWS, OR CONTRACT OR AS specified in subsection (e) of this section.

(g) [A provision for the corporation to indemnify a director who is

made a party to a proceeding, whether contained in] THE INDEMNIFICATION AND ADVANCEMENT OF EXPENSES PROVIDED OR AUTHORIZED BY THIS SECTION MAY NOT BE DEEMED EXCLUSIVE OF ANY OTHER RIGHTS, BY INDEMNIFICATION OR OTHERWISE, TO WHICH A DIRECTOR MAY BE ENTITLED UNDER the charter, the bylaws, a resolution of stockholders or directors, an agreement or otherwise, [except as contemplated by subsection (k) of this section, is not valid unless consistent with this section or, to the extent that indemnity under this section is limited by the charter, consistent with the charter] BOTH AS TO ACTION IN AN OFFICIAL CAPACITY AND AS TO ACTION IN ANOTHER CAPACITY WHILE HOLDING SUCH OFFICE.

(k)(1) A corporation may purchase and maintain insurance on behalf of any person who is or was a director, officer, employee, or agent of the corporation, or who, while a director, officer, employee, or agent of the corporation, is or was serving at the request of the corporation as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, other enterprise, or employee benefit plan against any liability asserted against and incurred by such person in any such capacity or arising out of such person's position, whether or not the corporation would have the power to indemnify against liability under the provisions of this section.

(2) A CORPORATION MAY PROVIDE SIMILAR PROTECTION, INCLUDING A TRUST FUND, LETTER OF CREDIT, OR SURETY BOND, NOT INCONSISTENT WITH THIS SECTION.

(3) THE INSURANCE OR SIMILAR PROTECTION MAY BE PROVIDED BY A SUBSIDIARY OR AN AFFILIATE OF THE CORPORATION.

SECTION 2. AND BE IT FURTHER ENACTED, That the provisions of §§ 2-104(b)(8) and 2-405.2 of the Corporations and Associations Article added by this Act shall apply only to actions arising from events or omissions occurring on or after the effective date of this Act, and that, except as provided in Section 3 of this Act, the amendments to § 2-418 of the Corporations and Associations Article added by this Act shall apply only to indemnification granted on or after the effective date of this Act, whether the events, omissions, or proceedings underlying the indemnification occurred before or after the effective date of this Act.

SECTION 3. AND BE IT FURTHER ENACTED, That with respect to a banking institution, credit union, or savings and loan association described in this Act, or a subsidiary of a banking institution, credit union, or savings and loan association described in this Act, the amendments to Section 2-418 of the Corporations and Associations Article added by this Act shall apply only to indemnification granted on or after the effective date of this Act for events, omissions or proceedings occurring after the effective date of this Act.

SECTION 4. AND BE IT FURTHER ENACTED, That this Act is an emergency measure, is necessary for the immediate preservation of the public health and safety, has been passed by a yea and nay vote supported by three-fifths of all the members elected to each of the two Houses of the General Assembly, and shall take effect from the date it is enacted.

Approved February 18, 1988.