

THE **DIRECTOR DUTIES** BILL:

AMENDMENTS

TO **SECTION 2-405.1** OF THE

MARYLAND GENERAL CORPORATION **LAW**

By Bill Carlson and Scott Wilson

On April 26, 2016, Governor Hogan signed House Bill 354, which amends the Maryland General Corporation Law (“MGCL”) to clarify that a director of a Maryland corporation need only comply with the statutory standard of conduct – and not unspecified common law fiduciary duties – when acting in his or her capacity as a director. The amendments, effective October 1, 2016, will provide much needed clarity for directors of Maryland corporations and their stockholders.

Since 1976, when the General Assembly adopted Section 35 of the Model Business Corporation Act (now, Section 8.30) and enacted Section 2-405.1 of the MGCL, a director of a Maryland corporation has been required to act: in good faith; in a manner the director reasonably believes to be in the best interests of the corporation; and with the care that an ordinarily prudent person in a like position would use under similar circumstances. By adopting the standard of conduct articulated in the Model Business Corporation Act, the General Assembly codified director duties replacing the common law fiduciary duties that had historically governed director conduct. Model Business Corporation Act, Official Comment to § 8.30 (8-196) (2013 Rev.); VEASEY & MANNING, CODIFIED STANDARD – SAFE HARBOR OR UNCHARTED REEF? AN ANALYSIS OF MODEL ACT STANDARD OF CARE COMPARED WITH DELAWARE LAW, 35 BUS. LAW. 9191 (1980). Through House Bill 354, the General Assembly (i) confirmed its original intent that the codified standard of conduct super-

sedes and subsumes prior articulations of director fiduciary duties and (ii) clarified the reach of Section 2-405.1(c) (formerly subsection (a)). Most prominently, new subsection (i) provides that Section 2-405.1 is the sole source of duties of a director to the corporation or the stockholders of the corporation. This clarification resolves the ambiguity created by *Shenker v. Laureate Education, Inc.*, 411 Md. 317 (2009) and its progeny.

In *Shenker*, the Court of Appeals of Maryland held that, among other things, Maryland law recognizes certain undefined common law fiduciary duties that govern the actions of a director in addition to the standard of conduct articulated in Section 2-405.1. 411 Md. at 339-41. The court held that the statute applies to managerial decisions, but that there are other, unspecified common law fiduciary duties owed directly to stockholders that “may be triggered by the occurrence of appropriate events.” *Id.* at 335. While the legal duties of candor and maximization of value articulated by the court in *Shenker*

were widely viewed as subsumed within the standard of conduct, questions arose as to what *other* common law fiduciary duties might exist under the court’s formulation. Further, while the Court of Appeals recognized that common law fiduciary duties *could* be triggered by appropriate events, the court failed to explain what factual scenarios trigger such duties. See *Sutton v. Fedfirst Fin. Corp.*, 226 Md. App. 46, 85-86 (2015). In *Sutton*, in the absence of any standard, the Court of Special Appeals purported to adopt Delaware corporate law. *Id.* Somewhat confusingly, the Delaware standard articulated by the Court of Special Appeals is not concerned with springing legal duties, but with the court’s standard of review with regard to allegations that directors breached fiduciary duties owed stockholders in all circumstances. In short, *Shenker* and its progeny introduced deep uncertainty into the business world in which Maryland corporations and their boards of directors reside.

The amendments to the statute eliminate the distinction between managerial and non-managerial acts, resolve the surrounding confusion, and clarify that Section 2-405.1 is the sole source of a director's duties. Nevertheless, to preserve the ultimate outcome of *Shenker*, that a stockholder obtains a *direct* remedy for a breach of the director's duties under certain circumstances, the newly-enacted statute eliminates former subsection (g) of Section 2-405.1, which limited enforcement of the standard of conduct to those acting by or in the right of the corporation. As revised, a stockholder's right to sue directly or derivatively for a breach of the standard of conduct will be subject to case law analyzing direct versus derivative stockholders' claims (as was the case from 1976 until the addition of former subsection (g) in 1999). Indeed, perhaps the only substantive change with regard to so-called *Shenker*-claims is that any resulting direct action against a director will now be subject to the statutory business judgment rule articulated in amended subsection (g).

Interpretation of the amendments to Section 2-405.1 is now left to the judiciary, but in the interim, we have received several inquiries concerning our view on the prospective application of the amended statute. Below are some common questions and our conclusions as to how the amended statute should be applied.

Why did the General Assembly eliminate former subsection (g), which limited enforcement of the standard of conduct to the corporation or individuals acting in the right of the corporation? What does it accomplish?

As the Court of Appeals in *Shenker* observed, former subsection (g) prohibited stockholders from bringing direct claims for a breach of the standard of conduct, regardless of circumstance. 411 Md. at 347-49. This subsection was enacted by the General Assembly during a very different corporate culture and at a time when the General Assembly was concerned about the hostile takeover of Maryland corporations. Accordingly, in light of the other amendments to Section 2-405.1 and the implicit policy goals of *Shenker*, elimination of former subsection (g) was necessary and appropriate. We believe that elimination of former subsection (g) makes clear that it is the legislative intent that the standard of conduct run directly to the stockholders of a Maryland corporation under limited circumstances and that the stockholders have a direct remedy for any breach of the standard of conduct in such circumstances.

If all acts of a director are subject to the statutory presumption contained in amended Section 2-405.1(g) (frequently identified as Maryland's statutory business judgment rule), must a court simply defer to any action of a board of directors?

No. The statutory business judgment rule is a *presumption* that director action satisfies the standard of conduct articulated in Section 2-405.1(c). See *Mona v. Mona Elec.*, 176 Md. App. 672, 696-97 (2007). At the pleading stage, the factual allegations contained in the complaint – accepted by the court as true – must be sufficient to overcome that presumption. Further, in

any resulting evidentiary hearing or trial, the party challenging the presumption bears the burden to prove that the decision making process followed by directors lacked good faith or was not within the realm of sound business judgment. The presumption does not end the court's inquiry, but merely places the burden upon the person attacking the board's action to prove a lack of good faith or absence of an informed basis for the challenged decision. In other words, the statutory business judgment rule is not the end of a court's inquiry into director conduct, but its beginning.

Section 2-405.1(c)(2) only requires that a director act "in the best interest of the corporation." What happens if the corporation has no interest in the resulting transaction such as the cash-out merger in *Shenker*?

The standards articulated in amended Section 2-405.1(c)(1), which requires that a director act in good faith, and amended Section 2-405.1(c)(3), which requires that a director act with the care of an ordinarily prudent person in a like position under similar circumstances, run to both the corporation and, in limited circumstances, directly to the stockholders. Moreover, the "best interests of the corporation" when the corporate body has no such interest, although undefined, almost certainly requires that a director act in the best interests of the stockholders in the aggregate. See JAMES J. HANKS, JR., MARYLAND CORPORATION LAW § 6.6[b] (2015 Supplement). Further, the standard of conduct subsumes the common law duty of good faith and fair dealing as well as the duty of candor that a director owes directly to the stockholders of

the corporation. *See* Model Business Corporation Act, Official Comment to § 8.30 at 1 (8-196)(2013 Rev.).

Therefore, where a stockholder articulates a direct claim (under applicable common law analysis) against a director for a breach of the standard of conduct, the stockholder will have a remedy. For example, were a director to knowingly adopt or apply an invalid bylaw to a stockholder, we anticipate that a direct stockholder action would be appropriate. In the context of the cash-out sale transaction described in *Shenker*, the standard of conduct and the good faith obligation contained therein require a board of directors to obtain the best deal for the stockholders (subject to such prudent considerations such as deal certainty and the limitations described in amended Section 2-405.1(f)) and a breach of the same would facilitate a direct stockholder claim. In other words, the

only substantive difference that we anticipate with regard to so-called *Shenker*-claims is that such claims would flow through the standard of conduct and be subject to the statutory business judgment rule.

Do the amendments to the statute make any other changes about which Maryland corporate law practitioners should be made aware?

It is also worth noting that amended Section 2-405-1(a) now clarifies that an "act" includes not only an overt act, but also an omission, a failure to act or a determination made not to act. Acts are also distinguished from "duties" owed by directors. Further, the bill makes contemporaneous grammatical and technical changes to the statute to clarify its content and application, and conforming changes to Section 5-417 of the Courts and Judicial Proceedings Article and Section 8-601.1 of the Maryland REIT Law.

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