DUTIES OF DIRECTORS OF MARYLAND CORPORATIONS

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March 9, 2016

I. STANDARD OF CONDUCT FOR DIRECTORS UNDER MARYLAND LAW

A. Generally

Under Maryland law, the business and affairs of a corporation are managed under the direction of a board of directors. Maryland General Corporation Law ("MGCL") § 2-401(a). Unlike Delaware, Maryland has a specific statutory standard of conduct for directors of a Maryland corporation that applies to all actions by directors. MGCL § 2-405.1(a). This standard applies individually, director by director, and not collectively to the board, and has three elements:

- A director of a Maryland corporation must act *in good faith*. This means the absence of any desire or reason to obtain a personal benefit, or a benefit for some person other than the corporation, that is not available *pro rata* to other stockholders.

- A director of a Maryland corporation must act with a *reasonable belief* that his or her action is in the *best interests of the corporation*. This means that a director must have some rational basis for believing that his or her actions are in the best interests of the *corporation*, as opposed to the interests of any stockholder or group of stockholders.

- A director of a Maryland corporation must act with the care of an *ordinarily prudent person* in a like position under similar circumstances. This means that a director should focus on the *process* by which he or she reaches decisions — asking questions, requesting information, deliberating carefully and the like. In short, the ordinary prudence requirement emphasizes the importance of process over substance. A director can be wrong, as determined retroactively, in a decision the director makes so long as he or she follows the right process in making it.[1]

[1] Although Section 2-405.1(a) of the MGCL applies by its terms only to directors of Maryland corporations, it is generally believed that the same standards apply to trustees of Maryland Title 8 trust REITs ("Title 8 REITs"). A bill pending in the Maryland legislature would apply the standards of Section 2-405.1(a) of the MGCL to trustees of Title 8 REITs. Generally in this memo references to "the company" and intended to cover both "corporations" and "Title 8 REITs", references to "directors" are intended to cover "trustees" and references to the "charter" are intended to cover the "declaration of trust."

The MGCL also permits a director of a Maryland corporation to rely on an officer or employee whom he or she reasonably believes to be reliable and competent; a lawyer, certified public accountant or other person as to a matter that he or she believes to be within the person's professional or expert competence; or a committee of the board on which he or she does not serve, as to a matter within its designated authority, if he or she reasonably believes the committee to merit confidance. MGCL § 2-405.1(b).[2] For example, a director is entitled to rely on financial statements, legal opinions, fairness opinions, solvency opinions or officer's certificates relating to matters that the director reasonably believes to be within the expertise of the person preparing the material. However, information and opinions of officers or professional advisors should be just one element in the exercise of a director's business judgment. A director should never take an action solely because "the lawyers said it was OK" or "the bankers delivered a fairness opinion."

B. Consideration of Strategic Alternatives, including a Change of Control

The specific actions that may be required of the board of directors in connection with a possible transaction will depend upon the nature of the transaction, including whether the transaction involves a change of control. A sale of the business for all cash – whether through merger, sale of assets or otherwise – will always be a change of control. Conversely, an all stock-for-stock merger will not be a change of control so long as there is no single stockholder or affiliated group of stockholders who did not have effective voting control of the company *before* the transaction but will hold effective voting control of the surviving company *after* the transaction. In between these two paradigms are many less clear possibilities that may constitute a change of control depending on, among other things, (a) the amount of stock or other continuing equity that the shareholders of the selling company receive in the transaction and (b) the percentage of ownership in the combined company that constitutes effective control.

In considering strategic alternatives, including a possible change of control of the company, there will be two decisions for the board: First, the board must decide what is the best alternative available to the company. Second, if the board decides that the best alternative available is a transaction that would result in a change of control of the company and the board decides to pursue that transaction, then a director should assume that her or his duty to act in the best interests of the *company* shifts to a duty to seek the best value and other terms reasonably available for the *shareholders*, which is analogous to the so-called *Revlon* duty under Delaware law.

To that end, some stockholders of Laureate Education, Inc., a Maryland corporation, challenged a going-private transaction between Laureate and an entity formed and controlled by several private equity investors and two Laureate management directors (including the Chairman and CEO), on the usual grounds of directors' breach of duties, including negotiating an inadequate price. In its decision, the Court of Appeals of Maryland, the state's

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highest court, held that "in the context of a cash-out merger transaction, where the decision to sell the corporation has already been made, corporate directors owe their shareholders common law duties of candor and good faith efforts to maximize shareholder value." *Shenker v. Laureate Educ., Inc.*, 411 Md. 317, 351 (2009).

Conversely, if a transaction will *not* result in a change of control – for example, a stock-for-stock merger where there is no new controlling stockholder in the combined company – the board will *not* be required to get the best value for the stockholders but will be required to reasonably believe, acting in good faith and after the exercise of ordinary prudence, that the transaction is in the best interests of the company.

In a change of control transaction there is "no single blueprint" that a board must follow. Maryland law does *not* require an auction of the company. Any process chosen, however, should involve an opportunity for a market check, either before or after signing of an agreement and announcement of the transaction. Ordinarily, the greater the pre-signing market check, the less the need for a post-signing market check and *vice versa*. A pre-agreement market check may involve a survey of possible buyers and the advice and assistance of independent experts. A post-agreement market check may be advantageous to a company – and its shareholders – because it nails down one bidder while leaving the company open to pursuing higher offers, which may be attracted by announcement of the transaction. However, to be valid, a post-agreement market check must allow a fair opportunity for higher offers. *See* JAMES J. HANKS, JR., MARYLAND CORPORATION LAW, § 6.6(b) (Aspen Publishers, 2015 Supp.) ("HANKS"). That is, measures designed to protect a transaction from competing bidders, such as no-shop provisions, break-up fees and expense reimbursement, must be balanced against the costs of possibly precluding the opportunity for other bidders to make offers. Deal protection measures should be evaluated on a sliding scale: The greater the pre- or post-agreement market check, the more deference the courts will give to deal protection measures. On the flip side, the less expansive a market check, the less the deference will be given. The effect of deal protection measures can be offset to some degree by fiduciary outs and go-shop provisions.

If the company receives a proposal – solicited or unsolicited – that might result in a change of control, Maryland law specifically provides that the duties of directors do not require them to accept, recommend or respond to any proposal by a potential acquirer. Accordingly, the directors may "just say no." *See* MGCL § 2-405.1(d). In addition, Maryland law specifically provides that directors are *not* required to take any specific action with regard to takeover defenses or takeover statutes, directors are *not* required to act or fail to act because of the effect that your act or failure to act may have on the potential acquisition and directors are *not* required to act or fail to act solely because of the amount or type of consideration that may be offered. MGCL § 2-405.1(d) (also made applicable to Title 8 REITs by Maryland REIT Law § 8-601.1). Similarly, if directors decide to explore an offer to acquire control of the company but subsequently decide that the price and other terms that are being offered are not as favorable as continuing to own and run the business and remaining independent, they are free to change their minds and reverse their earlier decision that a change in control represents the best strategic alternative for the company.

C. Interested Director Transactions

In connection with the consideration of strategic alternatives available to the company, the board and each director individually must be mindful of interests that each director may have that may vary from those of the company. Under common law, a contract or other transaction between a corporation and a director (or a corporation or other entity in which the director is a director or has a material financial interest) was either void or voidable and could be rescinded in a stockholder's suit.

Section 2-419 of the MGCL, however, provides a safe harbor for interested director transactions, which removes the taint of the director's or directors' interests in a contract or transaction. Under Section 2-419, a contract or transaction in which one or more directors have an interest is not void or voidable solely because of the common directorship or interest, because of the presence of the director at the meeting of the board or board committee which authorizes, approves, or ratifies the contract or transaction or because of the counting of the vote of the director for the authorization, approval or ratification of the contract or transaction, if one of three conditions is satisfied:

- *First*, the fact of the common directorship or interest is disclosed or known to the board or board committee and the board or board committee approves the contract or transaction by the affirmative vote of a majority of disinterested directors, even if the disinterested directors constitute less than a quorum;

- *Second*, the fact of the common directorship or interest is disclosed or known to the stockholders entitled to vote and the contract or transaction is approved by a majority of the votes cast by the stockholders entitled to vote other than the votes of shares owned by the interested director or corporation or other entity; or

- *Third*, the contract or transaction is "fair and reasonable" to the corporation.[3]

A director is "disinterested" in a contract or transaction if neither the director nor any entity in which the director has a material financial interest is a party to or has a material financial interest in the contract or transaction. HANKS, § 6.22 (Supp. 2015). A material financial interest is one of such significance to the director that it would reasonably be expected to influence the director's judgment if he or she were called upon to vote on approving the transaction. *See* MODEL BUS. CORP. ACT § 8.60(1) (1999). A financial interest of other persons related economically or familially to the director could be a financial interest of the director. These persons could, depending upon the circumstances, include: (a) an entity (other than the corporation) of which the director is a shareholder, partner, director, officer or employee; (b) a spouse, parent, child, grandchild, sibling or co-resident of the director or a trust or the estate of

[3] Section 2-419 of the MGCL does not apply by its terms to Title 8 REITs. However, its provisions provide useful analogues.

any such individual; or (c) a trust or estate of which the director is a fiduciary or beneficiary. *See* MODEL BUS. CORP. ACT § 8.60(3) (1994). The Maryland courts have concluded that there should not be a *per se* rule that a director is deemed to be "interested" by virtue of the director's economic or familial relationships, but rather the test should be whether such a relationship would reasonably be expected to compromise the director's exercise of independent judgment. *See Shapiro v. Greenfield*, 136 Md. App. 1, 23-24, 764 A.2d 270, 282 (2000).

If either one of the two approval procedures – disinterested director or disinterested stockholder approval – is not followed because all the company's directors have an interest and it is not practical to obtain stockholder approval, then, as noted above, the contract or transaction will not be void or voidable if it is "fair and reasonable" to the corporation. This, however, is the least desirable safe harbor as the person (in this case, the corporation) asserting the validity of the transaction bears the burden of proving that it was fair and reasonable to the corporation; in the other two cases the burden of proof is shifted to the person challenging the transaction.

Several Maryland courts have examined whether a transaction was fair and reasonable and concluded that the word "fair" means that the material terms of the transaction are within the range that might have been agreed to by economically motivated disinterested persons negotiating at arm's length with knowledge of all material facts known to any party to the transaction. *See Independent Distrib., Inc. v. Katz*, 99 Md. App. 441, 457, 637 A.2d 886, 893, *cert. denied*, 335 Md. 697, 646 A.2d 363 (1994); *Tobacco Tech., Inc. v. Taiga Int'l N.V.*, 626 F. Supp. 2d 537 (D. Md. 2009). *See also Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 25–26, 204 A.2d 795, 808 (1964), which also held that "fairness is basically a factual determination and the lower court's findings will not be disturbed unless clearly erroneous." *Id*. at 26, 204 A.2d at 808. The word "reasonable" means that it makes sense for the corporation to enter into the transaction under the particular circumstances prevailing at the particular time that it was approved or authorized. *See Katz*, 99 Md. App. at 457, 637 A.2d at 893 (citing HANKS, § 6.22). *See also Tobacco Tech., Inc.*, 626 F. Supp. 2d at 550. The terms of a transaction may be "fair" but in the circumstances it may not be "reasonable" for the corporation to enter into the transaction.

II. POTENTIAL LIABILITY OF DIRECTORS UNDER MARYLAND LAW

Maryland law specifically provides that a director who performs her or his duties in accordance with the standard of conduct discussed above "has no liability by reason of being or having been a director of a corporation." MGCL § 2-405.1(c); MD. CODE ANN. CTS. & JUD. PROC. § 5-417. Boards of directors continuously make decisions involving a balancing of risks and benefits for the corporation. Although some decisions turn out to be mistaken or unwise, Maryland courts have recognized that it is unreasonable to re-examine these decisions with the benefit of hindsight. Indeed, the MGCL contains a presumption that an act of a director satisfies the statutory standard of conduct under Maryland law. MGCL § 2-405.1(e).

In order that directors may carry out their duties without undue fear of exposure to monetary liability, the MGCL and the Maryland REIT Law provide for several measures protecting directors against personal liability for money damages. Maryland law permits a Maryland company, by provision in its charter, to eliminate the liability of a director or officer for money damages in suits by or on behalf of the company or its shareholders except to the extent of the director's or officer's actual receipt of an improper benefit or profit in money, property or services or for liability resulting from the director's or officer's active and deliberate dishonesty that is material to the cause of action. MD. CODE ANN. CTS. & JUD. PROC. §§ 5-418, 5-419. This provision covers suits for money damages under state law, but not suits seeking to enjoin a particular transaction or suits under federal securities or other laws. The typical Maryland company charter contains a provision limiting the liability of its directors and officers for money damages in suits by the company or its shareholders to the maximum extent permitted by Maryland law.

In addition, a director of the company who fails to satisfy his or her duties may be entitled to indemnification or advance of expenses by the company, including in connection with direct or derivative claims brought by stockholders. Section 2-418 of the MGCL, which is made applicable to Title 8 REITs by Section 8-301(15) of the Maryland REIT Law, permits a Maryland corporation to indemnify its present and former directors and officers against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceeding to which they may be made, or threatened to be made, a party to, or witness in, by reason of their service in those or other capacities unless it is established that (a) the act or omission of the director or officer was material to the matter giving rise to the proceeding and (i) was committed in bad faith or (ii) was the result of active and deliberate dishonesty, (b) the director or officer actually received an improper personal benefit in money, property or services or (c) in the case of any criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful. The MGCL also permits a Maryland corporation to advance the expenses of a director or officer, without requiring a determination of the director's or officer's ultimate entitlement to indemnification, upon receipt of (a) a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification and (b) a written undertaking by him or her or on his or her behalf to repay the amount paid or reimbursed if it is ultimately determined that the standard of conduct was not met. MGCL § 2-418.

In addition, many companies provide additional protection for directors and officers through indemnification agreements and D&O liability insurance. Most directors' and officers' insurance policies are written in two parts: (a) reimbursement to the company for payments by it pursuant to its indemnification obligations and (b) reimbursement to the directors and officers directly if the company is unwilling (as sometimes happens following a change of control) or unable (as in the case of insolvency) to comply with its indemnification obligations.

III. BOARD PROCESS AND PROCEDURES

In any high-profile transaction, the possibility of litigation against the company and its directors is not insignificant. Although directors and officers have substantial protection against personal liability for money damages, if directors and officers do not satisfy their duties under Maryland law, any transaction may be enjoined or rescinded. Thus, a director should be prepared for the possibility of being deposed and testifying under oath. In a potential change of control of a company, a director should also be able to explain why his or her decision, whether to recommend or not recommend selling control of the company, is the best available alternative to the company and why, if the transaction is a change of control, it represents the best value and other terms reasonably available for the shareholders. In a non-change-of-control transaction, a director should be able to explain why he or she was reasonable in believing that his or her actions are in the best interests of the company.

This underscores the importance of each director doing some or all of the following:

- Obtaining as much information as possible, including the advice and opinions of experts, and weighing it carefully.

- Questioning information provided by management or advisors if the director feels, based on his or her individual knowledge and experience, that such information may be inaccurate or incomplete.

- Considering all reasonable alternatives.

- Deliberating carefully as a board, asking questions, expressing his or her views and listening to the views of others.

- Taking whatever time, including additional meetings, that the director feels he or she reasonably needs to deliberate and reach a decision.

- Generally satisfying himself or herself that the board's action is in the best interests of the company.

- If the company is insolvent, or is nearing insolvency, considering the contract rights and other legal rights of creditors.

A director should not hesitate to ask for more information or for more time if he or she feels the need for it.

Considering a range of strategic alternatives that may include the sale of the company or other change of control is obviously a very important decision. Each director should do whatever he or she reasonably feels needs to be done to reach an individual and collective decision on the best strategic alternative available to the company, and, if it is the sale of control of the company, then whether that alternative represents the best value and other terms reasonably available for the shareholders. A director must be able to ask the hard questions and, if necessary, to just say no to a proposal, even one endorsed by management, if the director disagrees.

In addition, as discussed above, if certain members of the board have an interest in a transaction that is different than the interests of shareholders generally, especially an interest that could create negative legal and public perception issues, it may be useful to establish a special committee of the board consisting of disinterested directors. A properly established and functioning special committee may minimize those issues and enhance the likelihood of a positive outcome.

Finally, we are often asked by directors about taking notes. Our advice is that a director should take whatever notes she or he feels would be necessary or helpful in performing her or his functions of oversight and decision-making. However, directors should remember that any notes taken by them may be discoverable in litigation. If a director discards or destroys notes, that fact may also be discoverable and a court may draw adverse inferences of fact against the director. Directors should also be reminded that even conversations, especially those outside the boardroom, except those clearly involving communications with counsel relating to legal advice, are discoverable. The attorney-client privilege varies from jurisdiction to jurisdiction and often turns out to be not as broad as some clients (and some lawyers too) think.

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If you have any questions or comments in connection with the foregoing information, please do not hesitate to call.