

Understanding Maryland's Business Judgment Rule

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I. INTRODUCTION

The “Business Judgment Rule” (“BJR”) is a common law standard of judicial review.² The BJR is applied by the courts to favor the actions of corporate managers.³ According to Henry Manne, a leading commentator on corporate law, the BJR protects from judicial review “honest if inept business decisions” made by corporate managers.⁴ By accomplishing this strategic objective, the BJR tries to obtain its ultimate goal - preventing courts from exercising regulatory authority over corporate management.⁵ The creation of the BJR as a means of obtaining this goal is a direct product of the time period in which it originated. The BJR first appeared in the 19th century, a time when there was a fear of government regulation. Since then, the BJR has been used by the courts as a means to avoid the exercise of regulatory authority over corporations.⁶

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2. Douglas M. Branson, *The Rule that isn't a Rule – The Business Judgment Rule*, 36 VAL. U. L. REV. 631 (2002) [hereinafter BRANSON] and 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1036 (perm. Ed. Rev. vol. 2002).

3. BRANSON at 632.

4. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 271 (1967) [hereinafter MANNE]. As we shall see, the courts applying Maryland corporate law have taken a more limited view regarding the strategic objective of the BJR. Honest yes, but inept no. Even so, what is most important is that Manne provides a good general overview of how the BJR came to be.

5. *Id.* at 270.

6. *Id.* at 271.

The BJR is one of the most important doctrines in corporate law.⁷ Yet, leading commentators have persistently stated over the years that it is not properly understood. Close to 40 years ago, Manne stated that the BJR is “one of the least understood concepts in the entire corporate field.”⁸ Almost forty years later, leading commentators on corporate law such as Lyman Johnson, Stephen Bainbridge and Douglas Branson still seem to concur with that opinion.⁹

Why the BJR continues to be misunderstood is not a mystery. There are several sources of misunderstanding. The first source of misunderstanding results from the BJR being incorrectly perceived as a standard of conduct rather than a standard of review. According to Melvin Eisenberg, a leading commentator on corporate law, “[a] standard of conduct states how an actor should conduct a given activity or play a given role. A standard of review states the test a court should apply when it reviews an actor’s conduct to determine whether to impose liability or grant injunctive relief.”¹⁰ A corporate manager’s violation of the standard of conduct may not necessarily lead to liability or the business decision being overturned by the court because the actor is protected by a standard of review such as the BJR.¹¹

A second source of misunderstanding is derived from the importance placed on the BJR formulation found in the Delaware Supreme Court case of *Aronson v. Lewis*.¹² The court stated:

It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.¹³

7. *Id.* at 270.

8. *Id.*

9. Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 454 (2005); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 84 (2004) [hereinafter BAINBRIDGE] and BRANSON at 631.

10. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993) [hereinafter EISENBERG].

11. *Id.* at 467. See EISENBERG for a discussion of why standards of conduct and standards of review differ under corporate law.

12. 473 A.2d 805 (Del. 1984) (citations omitted).

13. *Id.* at 812.

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This BJR formulation has dominated the discussion of the BJR in law school classrooms and corporate law textbooks for many years. While elegant and economical in structure, this statement may have misled many students and practitioners into believing that it is the only BJR formulation that the courts apply. However, this is not correct. The Maryland courts, for example, have applied not only the *Aronson* formulation, but also the following BJR formulations:

- “Whenever any action of either directors or stockholders is relied on in a suit by a minority stockholder for the purpose of invoking the interposition of a Court of equity, if the act complained of be neither *ultra vires*, fraudulent, nor illegal, the Court will refuse its intervention”¹⁴
- “The ‘business judgment rule’ ... precludes judicial review of a legitimate business decision of an organization, absent fraud or bad faith.”¹⁵
- It is a “presumption that directors of a corporation acted in good faith and in the best interest of the corporation.”¹⁶
- “A director is presumed to act in good faith.”¹⁷
- The BJR is a presumption that directors have satisfied the statutory duty of conduct required of them.¹⁸

But an even greater source of misunderstanding is derived from the fact that the *Aronson* formulation incorporates the phrase “on an informed basis.”¹⁹ Incorporating such an element adds significant complexity to the understanding of the BJR because it requires an analysis of the relationship of this element to the duty of

14. *Shaw v. Davis*, 28 A. 619, 621 (1894).

15. *Black v. Fox Hills North Community Assoc.*, 599 A.2d 1228, 1231 (1992).

16. *Wittman v. Crooke*, 707 A.2d 422, 425 (1998).

17. *Yost v. Early*, 589 A.2d 1291, 1298 (1991).

18. *Id.*

19. Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 641 (2000).

care.²⁰ Such incorporation raises two important questions.²¹ First, “is the ‘informed’ element simply one aspect of, or is it the same as, the concept of due care?”²² Second, “is the injection of the ‘informed’ element ... meant ... as a precondition to the substantive protection of the BJR?”²³ Furthermore, if the element is perceived to be a precondition, does the violation of this precondition, by itself, create liability for the infringing director?²⁴ Beginning one’s study of the BJR with a formulation that incorporates such an element is bound to lead to misunderstanding. It is like starting a book in the middle. A study of the BJR should start with formulations that do not include such an element. This article will take such an approach.

Finally, another source of misunderstanding may result if the BJR is not equally applied to a situation where the plaintiff is seeking equitable relief versus that where the plaintiff is seeking damages from corporate directors. The first situation is the result of a business decision where the corporate action has yet to be done or has only partially been done and there is still time to stop the corporation from allegedly doing harm. The second situation is a result of a business decision that has resulted in a corporate action that has allegedly caused damage to the corporation.²⁵

As explained by Joseph Hinsey, a leading commentator on corporate law, the BJR is really a combination of two equitable concepts, the “business judgment rule” and the “business judgment doctrine.” The first concept shields directors from liability for damages resulting from their business decisions, while the second

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.* at 642.

25. R. Franklin Balotti and Joseph Hinsey IV, *Director Care, Conduct, and Liability: The Model Business Corporation Act Solution*, 56 BUS. LAW. 35, 37 (November 2000) [hereinafter BALOTTI AND HINSEY] (“[t]he business judgment rule ... operates in two basic contexts: transactional justification cases and personal liability cases. (footnote omitted). In a transactional justification case, the rule protects the decision itself from challenge, such as when a plaintiff seeks to invalidate a merger or other transaction. In a personal liability case, the rule shields directors from personal liability, such as when a derivative or class action plaintiff seeks to recover money damages from directors.”).

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concept protects the business decision itself.²⁶ The business judgment doctrine acknowledges the legal right of the board of directors to manage the affairs of the corporation and the substantial deference provided by the courts when reviewing board decisions.²⁷ The significance in viewing the BJR from this perspective lies in the possibility that courts might apply a different standard of judicial review in addressing the issue of whether to provide deference to a corporate decision versus the question of whether to award damages.²⁸

This article analyzes how the BJR has been applied under Maryland corporate law. As part of this analysis, this article will explore whether or not Maryland corporate law provides support for Hinsey's hypothesis.²⁹ Besides understanding how the BJR is applied in Maryland, the goal of this article is to provide a model for analyzing the BJR in any jurisdiction, especially one where a large amount of BJR case law may not exist.

Part II of this paper will present the BJR as applied primarily in cases where the plaintiff was seeking equitable relief and the majority stockholders controlled and managed the corporation. Part III will discuss how the Maryland courts have dealt with BJR cases where the plaintiff was seeking equitable relief, but where the majority stockholders *did not* control and manage the corporation. Part IV will present the BJR as applied in cases where the plaintiff was seeking damages. Part V will discuss the relationship between Maryland's Duty of Care and the BJR. Part VI will discuss the implications of the BJR being applied as a presumption that directors have satisfied their statutory duty of conduct. Part VII will conclude by discussing the major BJR issue facing the Maryland courts and the support found for Hinsey's hypothesis under Maryland corporate law.

26. Joseph Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, The Doctrine, and the Reality*, GEO. WASH. L. REV. 609, 611-12 (1984). [hereinafter HINSEY]. The Delaware Supreme Court has acknowledged the distinction made by Hinsey. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 n. 10 (Del. 1986). Eisenberg has also acknowledged this distinction. EISENBERG at 446.

27. HINSEY at 612.

28. Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage of Misguided Notion?* 67 S. CAL. L. REV. 287, n.19 (1994).

29. The ability to accept or reject this hypothesis based on Maryland case law is hampered by the small number of published appellate decisions applying the BJR where the plaintiff is seeking damages.

II. SEEKING EQUITABLE RELIEF AND MARYLAND'S BJR: MAJORITY STOCKHOLDERS CONTROLLING AND MANAGING AFFAIRS OF THE CORPORATION

Starting with the 1894 opinion of *Shaw v. Davis*,³⁰ the Maryland Court of Appeals has applied the BJR in several cases where the plaintiff was seeking equitable relief. In *Shaw*, a minority stockholder in the West Virginia Central and Pittsburgh Railway Company ("WVC") brought suit in the Baltimore City Circuit Court seeking an injunction to stop the execution of a lease agreement and demanding an accounting of financial transactions between WVC and Piedmont and Cumberland Railway Company, ("PCR").³¹ The complaint charged that the defendants had used the power which they held as owners of a majority of WVC's stock to compel the ratification and acceptance of a lease which they, as *officers* of WVC, had agreed on with themselves as *officers* of PCR.³² Prior to the proposed lease being presented to the shareholders of WVC for approval, the plaintiff was granted an injunction restraining the defendants from executing the permanent lease upon the terms proposed or executing any other lease except with the approval of the court and upon the terms that the court prescribed. Plaintiff alleged that the proposed lease was a *fraud* upon the stockholders of WVC and would result in shifting the burden of railroad repair from PCR to WVC. The injunction was subsequently dismissed and then appealed.³³

Without referring to the following as the BJR, the Maryland Court of Appeals applied the following standard of review:

Whenever any action of either directors or stockholders is relied on in a suit by a minority stockholder for the purpose of invoking the interposition of a Court of equity, if the act complained of be neither *ultra vires*, fraudulent, nor illegal, the Court will refuse its intervention because powerless to grant it, and will leave all such matters to be

30. 28 A. 619.

31. *Id.* at 621.

32. *Id.* at 624. According to the court, the fact that the same persons held the majority of the stock in both companies did not change the standard of review. In such a scenario, it also would not have made a difference if it were the directors and not stockholders that did the act complained of. *Id.* at 622.

33. *Id.* at 620-21. The complaint also prayed for an accounting of transactions between the two companies. *Id.* at 621.

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disposed of by the majority of the stockholders in such a manner as their interests may dictate, and their action will be binding on all, whether approved of by the minority or not.³⁴

In essence, if any action is taken by a director or stockholder which is supported by the majority stockholders, but is challenged by a minority stockholder, a court will not grant judicial review unless the plaintiff makes a showing that the acts complained of were either *ultra vires* (not authorized by the corporate charter), fraudulent or illegal. This is a very powerful standard of review. In order to justify judicial review, the plaintiff cannot just make a showing that the corporate manager acted with a lack of good faith; he must make a showing of fraud!³⁵ However, this BJR needs to be understood as resulting from a fact pattern where the majority stockholders, officers and directors were one and the same and in operational control of the corporation.

The *Shaw* court affirmed the dismissal of the injunction as no evidence of an act *ultra vires*, illegal or fraudulent was shown.³⁶ In rejecting the appeal, the court, citing English law for its authority,³⁷ made very clear that the majority stockholders have the right to act for the corporation. The court went on to state that it could not accept the potential tyranny of the minority owners over the majority owners and that a free government could never tolerate such interference:

And if the proposed lease be not *ultra vires* or unlawful or fraudulent, no Court, at the instance of a minority stockholder, or at the instance of any one else, has the power or the right to restrain the majority from dealing with the property as they may deem most advantageous to their

34. *Id.* at 621.

35. While the standard of conduct required of the majority owners/corporate managers was not discussed in regard to the lease transaction, it was discussed in regard to the demand for an accounting of financial transactions between WVC and PCR. The standard of conduct required was "good faith" while the standard of review was the same as that required for the lease transaction. *Id.* at 624. What the court meant by good faith is not clear, even though in other states it is generally synonymous with the duty of loyalty or the duty of fair dealing. James J. Hanks, Jr., *Maryland Corporation Law* § 6.6[b] at 171, n. 99 (Aspen Publishers Supp. 2003) [hereinafter HANKS].

36. *Shaw*, 28 A. at 626.

37. Specifically, quoting extensively from the English case of *MacDougall v. Gardiner*, L.R., 1 Ch. Div 13, 21. *Id.* at 621-22.

own interests. Any other doctrine would put it in the power of a single stockholder, owning but one share out of many hundreds, to transfer the entire management of a corporation to a Court of equity and would effectively destroy the right of the owners of the property lawfully to control it themselves. It would make a Court of equity practically the guardian, so to speak, of such a corporation, and would substitute the Chancellor's belief as to what contracts a corporation ought, as a matter of expediency, or policy, or business venture to make, instead of allowing such questions to be settled by the persons beneficially interested in the property. No such arbitrary or dangerous power has ever been claimed by any Court, and, if laid claim to, it would never be tolerated in a free government.³⁸

This policy statement, by referencing how a "free government" would never tolerate such a regulatory role for any court, reflects the ultimate goal of the BJR; keeping the courts out of the business of regulating corporations. Again, this strong policy against court interference in the affairs of the corporation, like the application of the BJR, must be understood in context. It is being utilized in a fact pattern where the majority stockholders, officers and directors were one and the same and in operational control of the corporation. In such a situation, the property rights of the majority must be protected against interference by the minority.

The BJR found in *Shaw* was next applied in *Du Puy v. The Transportation and Terminal Company of Baltimore City*.³⁹ In *DuPuy*, a minority stockholder appealed from a decree of the circuit court dismissing a complaint that sought the appointment of a receiver for the defendant corporation ("TTC"). The plaintiff was seeking a receiver as a result of a series of allegedly fraudulent and illegal acts perpetrated on the Du Puy by the majority stockholder of TTC⁴⁰ and TTC's Board of Directors.⁴¹

38. *Shaw*, at 625. The court noted that the fact that the same persons held the majority of stock in both companies did not of itself enlarge the court's jurisdiction. Furthermore, this would be true even where it is the directors and not the stockholders that did the act complained of. *Id.* at 622.

39. 33 A. 889 (1896).

40. *Id.* at 893.

41. *Id.* at 894.

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TTC was a newly formed pooling company, investing in the stock and property of several other corporations. Relying on the honesty of statements in a prospectus prepared by the majority stockholder, the Du Puys subscribed to minority stakes in the common and preferred stocks of TTC. However, the money paid for the subscription went not for its intended corporate purpose, but into the pockets of the directors. Subsequent to the subscription and the misdirection of the funds, the Board of Directors approved the winding up of the affairs of TTC even though the company was not insolvent. The Board then authorized the execution of a deed of trust so that a trustee could sell off the assets of TTC.⁴² The Court of Appeals reversed the decree dismissing the complaint, remanding the cause for further proceedings, based on a clear showing of illegal conduct, fraudulent acts and ultra vires proceedings.⁴³

In following *Shaw*, the *Du Puy* court provided a very concise and elegant statement on the standard of review and the policy behind it when reviewing a suit by minority stockholders challenging the acts of a corporation controlled and managed by its majority owners:

Mere internal dissensions among stockholders, or mere differences or disputes as to corporate management, so long as the officers or stockholders do not act in a way that is fraudulent, illegal or ultra vires, will not warrant the intervention of a Court of Chancery; because in the absence of fraud, illegality or conduct that is ultra vires, the will of the majority is entitled to control the policy and the business of the body corporate.⁴⁴

This statement was quoted and applied in *Powers Foundry Co. v. Miller*.⁴⁵ In *Powers*, the minority stockholders sought appointment of a receiver even though the company, while in bad financial shape, was not insolvent.⁴⁶ The circuit court found in favor of the plaintiffs and appointed a receiver. The Court of Appeals summarized the dispute as being a situation where the majority of

42. *Id.* at 890-93.

43. *Id.* at 895.

44. *Id.* at 890.

45. 171 A. 842, 845 (1934).

46. *Id.* at 844-45.

stockholders were in favor of holding corporate property for more favorable business conditions while the minority of stockholders wanted the property sold and the corporation dissolved.⁴⁷

In reversing the lower court opinion, the Court of Appeals refused to review the merits of corporate strategy emphasizing the right of the majority to control the affairs of the corporation even when the strategy appears doomed to failure. It also established a good faith standard of conduct when it said: "So long as the majority, acting in *good faith*, are in favor of going on, the minority shareholders are without remedy, although bankruptcy may be the probable consequence of continuing."⁴⁸

Forty-five years after *Shaw*, the general principle of that case was reaffirmed in *Williams v. Salisbury Ice Co.*⁴⁹ The facts in *Williams* are similar to what is found in *Shaw* except that only one individual owned and controlled the corporation. A complaint was filed against the corporation and the relief sought was a court appointed receiver for the corporation.⁵⁰

In *Williams*, William Messick purchased the majority interest in Salisbury Ice Co.⁵¹ Mr. Messick was also the majority shareholder in a rival ice company, W.F. Messick Ice Company.⁵² Subsequent to Mr. Messick taking control, a minority stockholder and former board member of Salisbury Ice Co. filed suit against Salisbury Ice Co. requesting the circuit court to appoint a receiver to take charge of the assets and business of the company. The plaintiff alleged that Mr. Messick, through his actions as general manager (officer) of both corporations, instigated a series of fraudulent transactions between the two companies. The result of these transactions was allegedly the looting of Salisbury Ice Co. of its assets to the benefit of Mr. Messick and W.F. Messick Ice Company.⁵³ The circuit court dismissed the complaint and the decision was then appealed.⁵⁴

47. *Id.* at 845.

48. *Id.* citing France on Corporations, sec. 163.

49. 3 A.2d 507 (1939).

50. *Id.* at 508.

51. *Id.*

52. *Id.*

53. *Id.* at 509-10.

54. *Id.* at 508.

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The Court of Appeals identified the issue to be whether, in spite of Mr. Messick's ownership and management of a competing corporation, he acted in "good faith" in his individual and official dealings with Salisbury Ice Co.⁵⁵ As in *Shaw*⁵⁶ and *Powers*, the court established "good faith" as the standard of conduct. More importantly, the court stated, for the first time in a case applying *Shaw*, the strategic objective of the BJR. In referring to the conduct of Mr. Messick, the court said:

Unwise and indiscreet management on his part, due to mistakes of judgment or mere default, would not be sufficient to grant the relief prayed. There must be proof of fraud, and the onus of that proof is upon the complainant.⁵⁷

Thus, the BJR precludes judicial review of business decisions that turn out badly, as long as they were mistakes of judgment or the product of inaction. This a much more limited view of the strategic objective of the BJR than the one provided by Manne. There is no indication in the quote above that the Maryland BJR is meant to protect inept business decisions as proposed by Manne, assuming inept is understood to mean "lacking the competence or skill for a particular task."⁵⁸

The court affirmed the decree of the lower court denying the appointment of receiver as the facts presented did not allow the court to intervene and thwart the control of the majority stockholders.⁵⁹

In addition to the cases where the majority owners were in operational control of the corporation, the BJR of *Shaw*, *Du Puy*, *Powers* and *Williams* has also been applied by the Maryland Court of Appeals to deny equitable relief in situations where there was not a majority stockholder but two 50% stockholders, *Murray-*

55. *Id.* at 512.

56. *See supra* note 35.

57. *Williams v. Salisbury Ice Co.*, 3 A.2d 507, 512 *citing* *Booth v. Robinson*, 55 Md. 419; *Pocomoke City National Bank v. Crockett*, 125 A. 712.

58. MSN Encarta Dictionary, www.encarta.msn.com, January 4, 2006.

59. *Williams*, 3 A.2d at 514. Because taking control away from the majority stockholders is not taken lightly by the court, asking for equitable relief in the form of an appointed receiver creates another standard of judicial review. For a court of equity to appoint a receiver, it must clearly appear "that there is fraud, spoliation or imminent danger of the loss of the property involved in the case,...." *Id.* at 514.

Baumgartner Surgical Instrument Co. v. Requardt,⁶⁰ and where a physician was challenging a board decision made by a private, non-profit hospital not to reappoint him to its visiting staff, *Levin v. Sinai Hospital*.⁶¹ The unique feature of *Levin* was that the challenge to corporate authority came from a stakeholder (the physician) who stood outside the corporation, rather than from a minority stockholder.

Interestingly, not one of the cases discussed above used “BJR” as a descriptor for the standard of review being applied. It was not until 2003, in *Sadler v. Dimensions Healthcare Corp.*,⁶² a case that does not apply the BJR but made reference to it, that the court explicitly stated that the standard of review found in *Levin* was the BJR.⁶³ *Sadler* also noted that the authority for this BJR came from *Williams* and *Requardt*.⁶⁴

III. SEEKING EQUITABLE RELIEF IN THE LOWER COURTS

The Maryland Court of Special Appeals has applied the BJR in two cases where the plaintiff was seeking equitable relief. Both cases are notable because they totally ignore the line of authority first established by the Maryland Court of Appeals in *Shaw*. However, these cases had completely different fact patterns than those in *Shaw*, etc. Furthermore, these cases appear to be supported in their approach by the Maryland Court of Appeals in its discussion of the BJR in *NAACP v. Golding*.⁶⁵

A. *The Foundation Case of Black v. Fox Hills North Community Assoc., Inc.*

The most influential decision provided by the Court of Special Appeals has been *Black v. Fox Hills North Community Assoc., Inc.*⁶⁶ As BJR authority, *Black* has been followed by the Maryland

60. 23 A.2d 697 (1941).

61. 46 A.2d 298 (1946).

62. 836 A.2d 655, 665 (2003).

63. *Id.* (“It is a general rule that a court of equity will not interfere with the internal management of a corporation, unless the act complained of is fraudulent or ultra vires.”)

64. *Id.*

65. 679 A.2d 554 (1996).

66. 599 A.2d 1228.

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lower courts in cases involving non-stock Maryland corporations, such as community associations and voluntary membership associations, as well as a large, publicly-owned stock corporation with thousands of investors and no one investor or group of investors having operational control of the corporation. In *Black*, a property owner in a subdivision erected a fence on their property that had been properly approved by their community association, a non-stock Maryland corporation. The Blacks, property owners in the same subdivision, complained to the community association that the fence did not conform to the association's Declaration of Covenants and Restrictions and sought its removal. When the community association's Board would not take action to require the fence to be removed, the Blacks sought declaratory judgment in circuit court. The complaint alleged that the association approved the fence in error and requested reimbursement of costs and legal fees incurred by them to enforce the covenants and injunctive relief requiring the property owners to remove the fence. The circuit court dismissed the case against the community association but ordered the fence to be removed.⁶⁷ The Blacks appealed the dismissal of their suit and requested a declaratory judgment stating that the community association approved the fence in error and that the association was guilty of a breach in its duties and obligations to them.⁶⁸

In *Black*, the Maryland Special Court of Appeals formulated the BJR to "... preclude[s] judicial review of a legitimate business decision of an organization, absent fraud or bad faith."⁶⁹ The definition of fraud is clear, but bad faith is harder to define. According to Black's Law Dictionary, bad faith generally implies the intent to mislead or deceive.⁷⁰ The court's understanding of bad faith is found in quotations from the New Jersey Superior Court case of *Papalexidou v. Tower West Condominium*,⁷¹ the case upon which the court based its standard of review. Quoting from *Papalexidou*, the *Black* court said: "If the corporate directors' conduct is authorized, a showing must be made of fraud, self-dealing or unconscion-

67. *Id.* at 1229-30.

68. *Id.* at 1231.

69. *Id.* at 1231.

70. Black's Law Dictionary 139 (6th ed. 1990).

71. 401 A.2d 280 (1979). In *Papalexidou*, the BJR was applied to a decision by a board of trustees of a New Jersey condominium association.

able conduct to justify judicial review.”⁷² Furthermore, “[c]ourts will not second-guess the actions of directors unless it appears that they are the result of fraud, dishonesty or incompetence.”⁷³ Therefore, under *Black*, bad faith is present when a showing is made of self-dealing, unconscionable conduct, dishonesty or incompetence.

It is also possible that the *Black* BJR formulation is not the complete standard of review and that references to self-dealing, unconscionable conduct, dishonesty or incompetence are meant to fill in the gaps of the formulation. However, since the court affirmed the dismissal of the complaint, as there was no allegation in the complaint of any fraud or bad faith,⁷⁴ it is more likely that these additional references were made as a means to round out the definition of bad faith.

But more importantly, there are two major differences between the BJR found in *Shaw* and the one found in *Black*. First, in *Shaw*, a showing of *fraud*, not *bad faith* was required to justify judicial review of a plaintiff’s claims. But in *Black*, a showing of bad faith would have been enough to justify review. Second, in contrast to *Shaw*’s BJR, even though consistent with *Shaw*’s strategic objective for the BJR, *Black*’s BJR did not preclude judicial review of a business decision if a showing of incompetence was made. The result is that the BJR found in *Black* provided significantly weaker protection of a business decision than the one found in *Shaw*.

1. *Black and Maryland’s Statutory Standard of Conduct for Directors*

In *Black*, the standard of conduct applied to directors was to “act reasonably and in good faith in carrying out their duties.”⁷⁵ This standard of conduct is distinguished from the standard previously discussed in *Shaw*, etc. by incorporating the additional requirement of “acting reasonably.”⁷⁶ The effect of this modification on the courts’ development of the standard of review is unclear.

72. *Black v. Fox Hills North Community Assoc., Inc.*, 599 A.2d 1228, 1231 (quoting *Papalexioiu*, 401 A.2d at 285-86).

73. *Id.*

74. *Id.* at 1231-32.

75. *Id.* at 1231.

76. *Id.*

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More interesting is the fact that the *Black* court totally ignored the statutory standard of conduct required of directors that was in existence at the time the opinion was written and which remains in effect today!

In 1976, the Maryland legislature codified the standard of conduct required of a corporate director under § 2-405.1 of Maryland's Corporations and Associations Article.⁷⁷ This codified standard of conduct for directors is entitled "Standard of Care Required of Directors."⁷⁸ However, the wording of the statute is clear that it creates a general standard of *conduct* expected of directors, not just a standard of *care*. Section 2-405.1(a) provides that:

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

- (1) In good faith;
- (2) In a manner he reasonably believes to be in the best interests of the corporation; and
- (3) With the care that an ordinarily prudent person in a like position would use under similar circumstances.⁷⁹

Black is not the only case where the courts seem to have ignored this statute when applying or discussing the BJR.⁸⁰ Cases discussed below, such as *NAACP v. Golding*,⁸¹ *Wittman v. Crooke*,⁸² and *Danielwicz v. Arnold*,⁸³ only required directors to act reasonably and in good faith; each of which were decided subsequent to the enactment of § 2-405.1. It is not clear why the courts felt that these BJR cases allowed for a different standard of director conduct than what was legislatively enacted or if and how the courts would have modified their BJR formulations and business judg-

77. MD. CODE ANN., Corporations and Associations § 2-405.1 (2004).

78. *Id.*

79. *Id.* at § 2-405.1(a).

80. See *accord* HANKS at § 6.6[b] at 171, n.99 (noting the failure of some courts to apply § 2-405.1 when analyzing director liability).

81. 679 A.2d 554 (Md. 1996).

82. 707 A.2d 422 (Md. App. 1998).

83. 769 A.2d 274 (Md. App. 2001).

ment policies if they would have utilized Section § 2-405.1 as their standard of conduct.

2. *Maryland Court of Appeals Support for Black*

NAACP involved an unincorporated voluntary membership association - not a corporation.⁸⁴ The case centered on the decision of the association not to allow youth members the vote in an election.⁸⁵ The court discussed how the BJR would apply if the organization were a voluntary membership corporation.⁸⁶

The *NAACP* court relied on *Black's* BJR formulation, standard of conduct and business judgment policy. The court defined the BJR as a rule that "insulates business decisions from judicial review absent a showing that the officers acted fraudulently or in bad faith."⁸⁷

The *NAACP* court presented the following excerpt from *Black* as the rationale behind the BJR:

Although directors of a corporation have a fiduciary relationship to the shareholders, they are not expected to be incapable of error. All that is required is that persons in such positions act reasonably and in good faith in carrying out their duties.... Courts will not second guess the actions of directors unless it appears that they are the result of fraud, dishonesty or incompetence.⁸⁸

The first sentence is a statement of business judgment policy. The second sentence is a statement on the standard of conduct expected of directors. Directors are expected to act reasonably and in good faith. (Again, a Maryland court ignores the statutory standard of conduct required of directors.) However, the third sentence is either an addition to the standard of review or, as in *Black*, a means to round out the definition of bad faith. Later in the opinion, the court said that "[a]s in the case of corporations, decisions of the unincorporated organization are insulated from

84. *NAACP v. Golding*, 679 A.2d at 556.

85. *Id.* at 555-56.

86. *Id.* at 558-59.

87. *Id.* at 559 citing *Black*, 599 A.2d at 1231.

88. *Id.* quoting *Black*, 599 A.2d at 1231 (quoting *Papalexioiu*, 401 A.2d at 285-86).

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judicial review absent fraud, irregularity, or arbitrary action.”⁸⁹ The court went on to state: “Moreover, even under Maryland corporations law, applying the business judgment rule, we would not interfere with the organization’s decision because the NAACP did not engage in any fraud, arbitrariness, or bad faith.”⁹⁰ These statements can serve one of two purposes: (1) to complete the standard of review where not only a showing of fraud or bad faith, but also dishonesty, incompetence, irregularity or arbitrary action may lead to judicial review; or (2) an aide in defining bad faith. Both options lead to the same results.

B. Formulating the BJR as a Presumption

In *Wittman v. Crooke*,⁹¹ a minority stockholder brought an action claiming that the directors of Baltimore Gas and Electric Company (“BG&E”) violated their fiduciary duties of care and loyalty by approving a merger with Potomac Electric Power Company (“PEPCO”).⁹² The purpose of this suit was to nullify a shareholder vote ratifying the merger. This is the first Maryland appellate court case where the BJR was applied to a large corporation with a large and diffuse stockholder base and the directors and officers held only a small percentage of the outstanding stock. Both BG&E and PEPCO were large publicly traded corporations, with assets over \$8 billion and \$7 billion, respectively, at the end of 1995.⁹³ BG&E had approximately 147,527,000 shares outstanding⁹⁴ and a total of 76,929 stockholders.⁹⁵ BG&E directors and officers (27 in total) owned only 556,233 shares combined.⁹⁶ The plaintiff, the owner of 300 shares of BG&E stock, alleged that the

89. *Id.* at 561. The court in *NAACP* would weaken the BJR even further by not precluding judicial review of a business decision if a showing of arbitrary action was made.

90. *Id.* at 563 (“Appellees do not argue that any decision of the *Branch* was tainted by fraud, irregularity, or arbitrary action”).

91. 707 A.2d 422 (Md. App. 1998).

92. *Id.* at 425.

93. See their respective 1996 10-K filings with the Securities and Exchange Commission, www.sec.gov.

94. *Wittman*, 707 A.2d at 425, n.1.

95. See BG&E’s 1996 10-K filing with the Securities and Exchange Commission, www.sec.gov.

96. *Id.*

directors were interested in the transaction because they wanted to become directors of an even larger corporation. The circuit court dismissed the suit and the plaintiff appealed.⁹⁷

The *Wittman* court relied on two federal cases applying Maryland law to determine its BJR formulation. Both cases involved the actions of the board of directors of large, publicly traded corporations who were responding to takeover attempts. First, following *Zimmerman v. Bell*,⁹⁸ a case arising out of an attempted corporate takeover, the *Wittman* court formulated the BJR to be a rebuttable “presumption that directors of a corporation acted in good faith and in the best interest(s)⁹⁹ of the corporation.”¹⁰⁰ Second, based on its understanding of *NCR Corp. v. AT & T Co.*,¹⁰¹ a case arising out of the attempted takeover of NCR Corporation by AT & T Co., the court then explained that stating the standard of review in the form of a presumption meant that the plaintiff has the burden of going forward. Quoting from *NCR*, the court said “In order to rebut a business judgment claim, the party challenging the validity of a board’s actions must produce evidence sufficient to rebut this presumption....”¹⁰²

The *Wittman* court found policy support for its BJR in the Maryland Court of Appeals case of *Devereux v. Berger*.¹⁰³ *Devereux* did not apply the BJR, but required for its purposes a discussion of how the BJR interacted with the judicial review of an alleged breach of a director’s duty of care. The court stated:

97. *Wittman*, 707 A.2d at 423.

98. 800 F.2d 386 (4th Cir. 1986).

99. The *Wittman* court most likely meant “best interests”, not best interest as it stated in the opinion. This is evidenced by the court later on stating that “Appellant is unable to overcome the presumption that appellees acted in good faith and in the best interests of the corporation.” *Wittman*, 707 A.2d at 425.

100. *Wittman*, 707 A.2d at 425.

101. 761 F.Supp. 475, 491 (S.D. Ohio 1991).

102. *Wittman*, 707 A.2d at 425. What procedural value is added by stating the BJR in the form of a presumption is not clear. As an evidentiary matter, the burden of proof should be on the plaintiff whether or not the BJR is in the form of a presumption. R. Franklin Balotti and James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1345, Randolph Stuart Sargent, *The Corporate Director’s Duty of Care in Maryland: Section 2-405.1 and the Business Judgment Rule*, 44 HOW. L.J. 191, 227-31 [hereinafter SERGENT], and BRANSON at 643-45.

103. 284 A.2d 605 (Md. 1971).

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It is, of course, “well established that courts generally will not interfere with the internal management of a corporation” and that the “conduct of the corporation’s affairs are placed in the hands of the board of directors and if the majority of the board properly exercises its business judgment, the directors are not ordinarily liable.”¹⁰⁴

However, the court did not ignore *Black*. The court presented the following as the holding from *Black*:

[i]f the corporate directors’ conduct is authorized, a showing must be made of fraud, self-dealing or unconscionable conduct to justify judicial review. This presents an issue of law rather than of fact...[D]irectors of a corporation... are not expected to be incapable of error. All that is required is that persons in such positions act reasonably and in good faith in carrying out their duties...¹⁰⁵

In its decision, the *Wittman* court agreed with the lower court that there was no evidence that the directors failed to act in good faith and in the best interests of the corporation. The presumption of the BJR could not be overcome just because the appellees were likely to become directors of the surviving corporation.¹⁰⁶

IV. SEEKING DAMAGES AND MARYLAND’S BJR

The Maryland Court of Appeals has yet to decide a case where the BJR was being applied to a cause of action for damages. However, the Maryland Court of Special Appeals has provided two such decisions, *Danielwicz v. Arnold*¹⁰⁷ and *Yost v. Early*.¹⁰⁸ These cases are notable for totally ignoring the line of authority provided by the Maryland Court of Appeals in *Shaw*, *Du Puy*, *Powers* and *Williams*, where the plaintiff was seeking equitable relief. This is very interesting given that the ownership and management structure of the corporations in *Danielwicz* and *Yost* were very similar to that found in *Shaw*, etc. Ignoring this established line of

104. *Id.* at 612 (quoting *Parish v. Maryland and Virginia Milk Producers Association*, 242 A.2d 512, 540 (Md. 1968)).

105. *Wittman*, 707 A.2d at 425.

106. *Id.*

107. 769 A.2d 274 (Md. App. 2001).

108. 589 A.2d 1291 (Md. App. 1991).

authority lends support for Hinsey's hypothesis that the courts, at least in Maryland, apply a different standard of judicial review in BJR cases where equitable relief rather than damages is being sought.¹⁰⁹

However, this support for Hinsey's hypothesis is not strong, as the court in *Danielwicz* did follow the authority found in *Wittman*, a case where the plaintiff was seeking equitable relief. Relative to *Shaw*, etc., the BJR in *Wittman* was more favorable to the plaintiff. Instead of providing support for Hinsey's hypothesis, *Danielwicz* and *Yost* may simply be examples of the courts trying to avoid applying the BJR found in *Shaw*, etc., a BJR that makes it very difficult for the plaintiff to justify judicial review of a business decision.

In *Danielwicz*, a stockholder brought a derivative suit against a director (mother of plaintiff and spouse of 100% owner of company) for breach of fiduciary duty. The focal point of the suit was a corporate transaction where the corporation issued stock in exchange for stock of another company. The plaintiff claimed that this transaction, a transaction in which the director participated in and consented to, was unfair to the corporation due to the overvaluation of the stock being purchased.¹¹⁰ At the time of the transaction, the plaintiff's father was the 100% owner of the corporation and the board of directors included the plaintiff's husband, father and mother. The stock purchased by the corporation was held by plaintiff's father. The plaintiff was not a stockholder at the time the transaction, but held a remainder interest in a significant number of shares owned by her father.¹¹¹ *Wittman's* BJR formulation, business judgment policy and director standard of conduct was applied.¹¹² In denying plaintiff's appeal, the Maryland Court of Special Appeals noted that there was no evidence showing that defendant acted fraudulently or did not act in good faith.¹¹³

In *Yost*, a case that preceded *Black*, the president/director of a corporation appealed the awarding of damages in a shareholder derivative action. The complaint was filed by a minority stock-

109. HINSEY at 611-12.

110. *Danielewicz*, 769 A.2d at 295.

111. *Id.* at 279.

112. *Id.* at 296.

113. *Id.*

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holder who was a former officer and director of the corporation (Saturn). The complaint alleged that the president mismanaged the company's affairs and misappropriated and wasted the funds of the corporation when he executed a series of lease agreements with a company (Rosepoint) that he owned with his wife.¹¹⁴

At most, the corporation had five stockholders including the plaintiff. The president appeared to control the corporation but the court did not state whether he had majority ownership. The court did disclose that the minority stockholder filing the action owned 22 percent of the corporation's stock.¹¹⁵

The court interpreted the complaint to be, in essence, an allegation that the president did not fulfill the requirements of Md.Corps. & Assoc.Code Ann. § 2-405.1(a).¹¹⁶ To determine if the actions of the president came under the protection of the BJR, the Maryland Court of Special Appeals applied three different versions of the BJR at the same time. Interestingly, all were stated in the form of a presumption. First, it stated the BJR to be the *Aronson* formulation,¹¹⁷ then, citing *Zimmerman v. Bell*, it stated that "a director is presumed to act in good faith"¹¹⁸ and finally it stated the BJR to be "a presumption that corporate directors acted in accordance with § 2-405.1."¹¹⁹

The court found that the presumption of the BJR had been overcome, and a prima facie case established, when evidence showed that Saturn transferred to Rosepoint a \$35,000 tax credit for no consideration, that Saturn continued to lease equipment at a significant monthly sum for 14 months beyond the time the corporation had returned the equipment and that significant terms of the lease agreements were never negotiated by Saturn or voted on by the directors.¹²⁰

Besides not following the authority established in *Shaw, etc.*, *Yost* is significant for introducing two BJR formulations into Maryland law; (1) the *Aronson* formulation, and (2) "a presump-

114. *Yost*, 589 A.2d at 1297.

115. *Id.* at 1295. The court in *Yost* should be given credit for recognizing the existence of § 2-405.1.

116. *Id.* at 1297.

117. *Id.* at 1298.

118. *Id.*

119. *Yost*, 589 A.2d at 1298.

120. *Id.* at 1299-1300.

tion that corporate directors acted in accordance with § 2-405.1.” As we previously discussed in Part I (Introduction) of this article, the *Aronson* formulation, through the incorporation of the “informed” element, increases the complexity of BJR analysis.¹²¹ However, the second new BJR formulation introduced in *Yost*, a presumption that corporate directors have satisfied their statutory duty of conduct, should have been the most worrisome for proponents of the BJR. In this BJR formulation, corporate directors are presumed to have acted “[w]ith the care that an ordinarily prudent person in a like position would use under similar circumstances.”¹²² Incorporating this element into the BJR creates a potential conflict with the principal intended result of the BJR.

According to Manne, the principal intended result of the BJR is to reduce the amount of duty of care litigation associated with corporate business decisions.¹²³ Theoretically, the BJR could preclude review of all claims that a director breached his duty of care in the making of business decisions! As Bainbridge stated, “if the business judgment rule does anything, it insulates directors from liability for negligence.”¹²⁴ But by incorporating a standard of care into the BJR that appears equivalent to ordinary negligence, “[w]ith the care that an ordinarily prudent person in a like position would use under similar circumstances,”¹²⁵ the ability of the BJR to preclude from judicial review claims that a director breached his duty of care in the making of business decisions is compromised. Under such a BJR formulation, the plaintiff need only make a showing that the defendant did not use ordinary care in the making of a business decision and the protections of the BJR are overcome. This severely impedes the ability of the BJR to achieve its principal intended result.

V. MARYLAND’S DUTY OF CARE AND THE BJR

Before we can discuss the potential ramifications of a BJR that incorporates a standard of care such as that found in *Yost*, we

121. *See supra* text notes 19-24.

122. MD. CODE ANN., Corporations and Associations § 2-405.1(a)(3).

123. MANNE at 271. Of course, the general result of the BJR is to reduce the amount of litigation involving corporate business decisions, both in a transactional justification and in a director liability context.

124. BAINBRIDGE at 88.

125. MD. CODE ANN., Corporations and Associations § 2-405.1(a)(3).

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need to discuss the existing relationship between Maryland's Duty of Care and the BJR. In the context of director liability, the Maryland Court of Appeals has historically limited the ability of the BJR to preclude review of claims that a director has breached his duty of care in the making of a business decision. This was not done by incorporating a standard of care into the BJR, but by being very unequivocal that the BJR cannot limit judicial review when a showing of gross or culpable negligence has been made.¹²⁶ In *Booth v. Robinson*¹²⁷ and *Carrington v. Thomas C. Basshor Co.*¹²⁸ and later reaffirmed in *Parish v. Maryland and Virginia Milk Producers Association, Inc.*,¹²⁹ the Court of Appeals established a limitation that the BJR does protect from judicial review properly made business decisions of directors that turn out to be mistakes of judgment *unless* they are the result of gross or culpable negligence.

In *Booth*, the court stated:

[F]acts which may show *imprudence* in the exercise of powers clearly conferred upon directors will not subject them to personal responsibility; but if the imprudence be so great and manifest as to amount to *crassa negligentia*, and consequently a breach of trust, personal responsibility will be incurred. Indeed, all the cases agree that directors are not liable for the consequences of unwise or indiscreet management, if their conduct is entirely due to mere default or mistakes of judgment.¹³⁰

While *Booth* makes clear that directors should not be held liable for decisions that turn out badly if they result from mistakes of judgment or inaction (the Maryland BJR's strategic objective), directors will be held liable when their conduct rises to the level of gross negligence.

In *Parish*, the court stated:

126. One way for a Maryland corporation to mitigate such director liability is to amend its corporate charter in conformity with Maryland Code sections 2-405.2 and 5-418. These code sections allow a Maryland corporation to incorporate a charter provision limiting the liability of its directors and officers to the corporation or its stockholders. MD. CODE ANN., Corporations and Associations §2-405.2 and §5-418 (2004).

127. 55 Md. 419 (1881).

128. 84 A. 746 (Md. 1912).

129. 242 A.2d 512 (Md. 1968).

130. *Booth*, 55 Md. at 438.

It is well established that courts generally will not interfere with the internal management of a corporation at the request of a minority stockholder or a member. The conduct of the corporation's affairs are placed in the hands of the board of directors and if the majority of the board properly exercises its business judgment, the directors are not ordinarily liable. This sound general rule, however, is subject to the important exception that directors will be held liable if they permit the funds of the corporation or the corporate property to be lost or wasted by their gross or culpable negligence.¹³¹

In the context of director liability, the BJR can preclude judicial review of claims that a director breached his duty of care in the making of a business decision as long as the alleged breach does not rise to the level of gross or culpable negligence. In the context of equitable relief, this limitation on the Maryland BJR has not yet been applied by the courts.

The federal district court case of *Edge Partners v. Dockser*¹³² demonstrated how Maryland's BJR is not allowed to interfere with the judicial review of an action for gross or culpable negligence. In *Dockser*, the plaintiff brought a derivative action against the corporate managers of a Maryland corporation claiming gross negligence and corporate waste as a result of the board decision to purchase a mortgage business.¹³³ In its motion to dismiss, the defendant directors and officers argued that the plaintiffs had not alleged specific conduct that would overcome the presumptions of the BJR.¹³⁴ Consistent with *Parish*, the plaintiff argued that since it stated causes of action against defendants for gross negligence and corporate waste, the presumption of the BJR was not applicable.¹³⁵

In *Dockser*, the court first acknowledged the existence of the BJR under Maryland corporate law:

It is well settled that the business judgment rule is a presumption that the decisions of corporate directors were

131. *Parish*, 242 A.2d at 540.

132. 944 F. Supp. 438 (D. Md. 1996).

133. *Id.* at 439-40.

134. *Id.* at 441.

135. *Id.*

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made on “an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.” *Yost*, 589 A.2d at 1298 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).¹³⁶

The court then went on to say that the BJR does not interfere with a plaintiff's right to seek judicial review of gross or culpable negligence leading to waste:

If Defendants properly exercised their business judgment, they will not be liable unless they committed acts that constitute gross negligence, waste of corporate assets or culpable negligence. *Parish v. Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 242 A.2d 512, 540 (1968).¹³⁷

In denying defendants motion to dismiss, the court concluded that the plaintiff had alleged sufficient facts to state such a cause of action for gross negligence and waste of corporate assets.¹³⁸

VI. THE CODIFIED BJR

The codification of the directors' standard of conduct in § 2-405.1 led the Maryland Attorney General to erroneously conclude that this statutorily required standard of conduct was equivalent to the BJR:

Maryland law imposes upon an officer or director of a corporation a standard of care which must be met by him in the management of the corporation.... This standard of care has been referred to as the 'business judgment rule'. In order to define and expressly delineate the parameters of the 'business judgment rule', the Maryland Legislature, in 1975, enacted Section 2-405-1 of the Cor-

136. *Id.* at 442.

137. *Dockser*, 944 F. Supp. at 442.

138. *Id.*

porations and Associations Article of Annotated Code of Maryland.¹³⁹

To a large degree, the Maryland Court of Special Appeals has supported the Attorney General's incorrect understanding of § 2-405.1. The court in *Billman v. State of Maryland Deposit Insurance Fund Corporation* stated that the statute "embodies the business judgment rule in Maryland."¹⁴⁰ However, the court in *Yost* challenged the Attorney General's position when it stated that:

[c]ontrary to the opinion of the Attorney General, § 2-405.1 and the business judgment rule differ in that the former is the code of conduct for corporate directors, while the latter is an aid to judicial review. Nevertheless, the two do overlap. For example, proof of the lack of good faith defeats both the presumption of the business judgment rule and the requirements of § 2-405.1(a)(1). The better position is to view the business judgment rule as a presumption that corporate directors acted in accordance with § 2-405.1.¹⁴¹

Subsequent events indicate that the BJR formulation proposed in *Yost*, "a presumption that corporate directors acted in accordance with § 2-405.1"¹⁴² may now have some credibility. In 1999, the legislature added several new subsections to § 2-405.1. The whole thrust of these new subsections was to protect Maryland

139. 62 Md. Op. Att'y Gen. 804, 811-12 (1977), 1977 WL 35846, *5 (citations omitted). Perhaps this misunderstanding arose from § 2-405.1 being based on Section 35 of the 1974 amendment to the Model Business Corporation Act. SERGENT at 10 and HANKS at § 6.6[b] at 162. The 1974 Official Comment was silent on Section 35's relationship to the BJR. This caused a minority of commentators to express the opinion that Section 35 codified the BJR. BALOTTI AND HINSEY at 42. Overall, the ambitions of Section 35 were quite limited, intending only to address director conduct and not the BJR or director liability. *Id.* at 40-41.

140. 593 A.2d 684, 697 (Md. App. 1991) *accord* *Independent Distributors, Inc. v. Katz*, 637 A.2d 886, 895 (Md. App. 1994) *accord* *Shah v. Healthplus, Inc.*, 696 A.2d 473, 480 (Md. App. 1997). *See also* SERGENT at 192.

141. *Yost*, 589 A.2d at 1298.

142. *Id.*

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corporations from unwanted takeovers.¹⁴³ The key subsection for our purposes is subsection (e), which incorporated the following presumption language into the statute:

Presumption of satisfaction. – An act of a director of a corporation is presumed to satisfy the standards of subsection (a) of this section.¹⁴⁴

The intention of these changes was to codify the BJR, but only in the narrowly defined fact pattern where a Maryland corporation is the target of a takeover. According to the Floor Report for Senate Bill 169 of the Senate Judicial Proceedings Committee, the intent of incorporating § 2-405.1(e) was as follows:

Under current law, the standard of conduct for a corporate director in Maryland is the “business judgment rule”, which creates a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Zimmerman v. Bell, 800 F.2d 386, 392 (4th Cir. 1986). This bill **codifies** this standard as it applies to an act of a director relating to or affecting an acquisition or potential acquisition of control of a corporation and establishes

143. The opening statements in the Floor Report and Bill Analysis for Senate Bill 169 of the Senate Judicial Proceedings Committee attest to this fact: “Senate Bill 169 makes a number of changes to strengthen Maryland’s laws relating to unsolicited takeovers of corporations and real estate investment trusts.” Senate Judicial Proceedings Committee, Floor Report for Senate Bill 169, at 1 (1999) and “Senate Bill 169 makes a number of changes relating to unsolicited takeovers of corporations and real estate investment trusts.” Senate Judicial Proceedings Committee, Bill Analysis for Senate Bill 169, at 1 (1999).

144. MD. CODE ANN., Corporations and Associations § 2-405.1(e) (2004).

that it may not be subject to higher duty or greater scrutiny than is applied to any other act of a director.¹⁴⁵ _

Therefore, in conjunction with § 2-405.1(f), “[a]n act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director,”¹⁴⁶ it appears that the function of § 2-405.1(e) was to confirm that the burden of proof did not shift to the directors of a Maryland corporation when defending decisions made in response to a takeover.¹⁴⁷

However, the plain language of § 2-405.1(e) does not express the narrowly defined intent as just described. The plain language makes clear that § 2-405.1(e) applies to all acts of directors, not just takeover-related acts. This gives the courts wide latitude in determining what § 2-405.1(e) means, if anything, in terms of the BJR.

Apparently, § 2-405.1(e) does mean something to the Maryland Court of Appeals in terms of the BJR. In *Werbowsky v. Col-lomb*,¹⁴⁸ a very important Maryland Court of Appeals case that established the demand futility standard in Maryland but did not apply the BJR, the court stated in a footnote that § 2-405.1(e) created the same presumption for Maryland corporate directors that

145. Senate Judicial Proceedings Committee, Floor Report for Senate Bill 169, at 5 (1999) *accord* Senate Judicial Proceedings Committee, Bill Analysis for Senate Bill 169, at 4 (1999). Even though the intent of the paragraph is clear, it should be pointed out that there are several misstatements in the quoted paragraph. First, as we have already discussed, the BJR is a standard of review and not a standard of conduct. The standard of conduct for directors is provided in § 2-405.1(a). Second, even though *Zimmerman v. Bell*, 800 F.2d 386 (4th Cir. 1986) was a federal case where the BJR was being applied to a takeover of a Maryland corporation, the notion that the quoted BJR formulation was current Maryland law at the time was incorrect. As noted by SERGENT, *Zimmerman* only tangentially utilized Maryland case law to create its BJR formulation. Furthermore, the formulation attributed to *Zimmerman*, in actuality the *Aronson* formulation, is not to be found in *Zimmerman*! In *Zimmerman*, the BJR formulation used was “[i]n all cases, the business judgment rule creates the presumption that directors act in good faith.” *Zimmerman v. Bell*, 800 F.2d 386, 392 (4th Cir. 1986). _

146. MD. CODE ANN., Corporations and Associations § 2-405.1(f) (2004).

147. Senate Bill 169: Summary of Major Bill Provisions, at 2 (“Bill would establish a presumption that an action of the Board of Directors satisfies the duty to act in a manner they reasonably believe in the best interests of the corporation. This is consistent with current law (the burden of proof).”)

148. 766 A.2d 123 (2001).

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the *Aronson* formulation did for Delaware corporate directors,¹⁴⁹ “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹⁵⁰

In this author’s opinion, the only way the court could have ended up endorsing the *Aronson* formulation, at least in the context of demand futility, was if someone on the court had read the Floor Report and Bill Analysis discussed previously, noted that the BJR formulation in those two reports was actually the *Aronson* formulation and had incorrectly understood this to be the law in Maryland.

However, if the Maryland courts were to adopt the *Aronson* formulation as suggested by *Werbowsky*, this would not be the worst possible outcome. The Maryland courts, in attempting to understand the element represented by the wording, “on an informed basis,” have a wealth of Delaware case law to draw upon. The real risk is that the Maryland courts may take a different direction and interpret the addition of § 2-405.1(e) to mean that the BJR is to be codified in a formulation suggested in *Yost*; a presumption that the directors had satisfied the standards of § 2-405.1(a).

With such a codified BJR, the ability of the BJR to preclude duty of care claims against corporate directors may be severely limited. This would depend on how the courts interpret § 2-405.1(a)(3), “[w]ith the care that an ordinarily prudent person in a like position would use under similar circumstances,”¹⁵¹ as an element of the BJR. If the courts interpret § 2-405.1(a)(3) to mean gross or culpable negligence, then a sort of equivalency can be maintained. However, if the courts interpret § 2-405.1(a)(3) to mean something less than gross or culpable negligence, such as ordinary negligence, then the ability of the BJR to protect from judicial review claims that a director breached his duty of care in the making of business decisions will be severely jeopardized.

149. *Id.* at 609, 138 n.7. In *Sadler v. Dimensions Healthcare Corp.*, another Maryland Court of Appeals case subsequent to the incorporation of § 2-405.1(e) where the BJR was discussed but not applied, the court stated that the BJR was codified at Maryland Code § 2-405.1 of the Corporations and Associations Article. *Sadler v. Dimensions Healthcare Corp.*, 836 A.2d 655, 665 (2003). However, it is not clear what motivated this comment.

150. *Id.* (quoting *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)).

151. MD. CODE ANN., Corporations and Associations § 2-405.1(a) (2004).

VII. CONCLUSION

In *Werbowsky*, the Maryland Court of Appeals provided an indication, albeit in a footnote, that § 2-405.1(e) somehow codifies Maryland's BJR. This creates an opportunity for the Maryland courts to reevaluate exactly what they want from the BJR. As stated above, the BJR developed out of a 19th century fear of government regulation. Is this fear still warranted? If not, or if this fear has lessened over time, introducing a BJR with an "informed" element such as found in the *Aronson* formulation may be desirable.

On the other hand, the Maryland courts, except in certain select situations such as where the majority stockholders both managed and controlled the corporation, have always applied the BJR with moderation. The stated strategic objective has been that the BJR precludes judicial review of business decisions that turn out badly, as long as they were mistakes of judgment or the product of inaction. Furthermore, the Maryland courts, as established in *Booth*, *Carrington*, and *Parish*, have traditionally limited the ability of the BJR to preclude review of claims that a director has breached his duty of care in the making of a business decision if a showing of gross or culpable negligence has been made. Perhaps the correct balance has already been struck and the codified BJR needs to be interpreted accordingly.

Certainly, the Maryland courts have the discretion to maintain the status quo. They can do this by interpreting the relationship of § 2-405.1(e) with the BJR to mean that the BJR has been codified to the extent that the burden of proof is always on the plaintiff and that no burden shifting can occur. This would be consistent with the *Wittman* court's understanding of what a presumption means in the context of the BJR.¹⁵² In this way § 2-405.1(e) is given the significance it deserves as statutory law, but its resulting impact on Maryland's BJR is minimal.

Support for minimizing the impact of § 2-405.1(e) on the evolution of the BJR as a common law standard of judicial review is found in the Official Comment to the Model Business Corporation Act ("Model Act"). Section 2-405.1(a) was originally based on Section 35 (becoming Section 8.30 in subsequent revisions) of the 1974 revision to the Model Act.¹⁵³ Even though the 1974 Official

152. *Wittman*, 707 A.2d at 425. See *supra* text note 102.

153. SERGENT at 10 and HANKS at § 6.6[b] at 162.

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Comment was silent on Section 35's relationship to the BJR,¹⁵⁴ subsequent revisions to the Model Act have incorporated into the Official Comment clear language that the intent of the Model Act is not to codify the BJR. Instead, the BJR should continue to be refined through case law.¹⁵⁵

The Maryland courts have yet to provide enough published BJR opinions, where the plaintiff was seeking damages, to determine whether or not Hinsey's hypothesis can be supported. The BJR of *Shaw, Du Puy, Powers* and *Williams*, as established by the Maryland Court of Appeals, applies to fact patterns where the majority stockholders control and manage the corporation and the plaintiff is seeking equitable relief. Most significantly, this authority was ignored by the Maryland Special Court of Appeals in *Yost* and *Danielwicz*, two cases where the plaintiffs were seeking damages, but the ownership and management structures of the corporations involved were very similar to what was found in *Shaw, etc.* Yet, *Danielwicz* did follow the lower court case of *Wittman*, a case where the plaintiff was seeking equitable relief. Relative to *Shaw, etc.*, the BJR in *Wittman* was more favorable to the plaintiff. This provides support for the argument that instead of supporting Hinsey's hypothesis, the courts were simply trying to localize the application of *Shaw's* BJR, a BJR that makes it very hard for the plaintiff to justify judicial review of a business decision.

154. Balotti and Hinsey at 42.

155. *Id.* at 46-47, 56-57. "The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts, in view of that continuing judicial development, section 8.30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of director conduct set forth in this section." MODEL BUS. CORP. ACT § 8.30 Official Commentary (1998).