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Venable Maryland Corporate Law Report

for corporations, real estate investment trusts and investment companies

Maryland differentiates usurpation of corporate opportunity from interested director transaction; determines guidelines for finding interested director

In the case of *Shapiro v. Greenfield*, 136 Md. App. 1, 764 A.2d 270 (2001), minority stockholders brought a derivative action against a corporation and its officers challenging the transfer of a shopping center owned by the corporation to a limited partnership. The minority stockholders claimed that the transaction involved was invalid because it was both an interested director transaction and constituted the usurpation of a corporate opportunity.

The court first addressed the issue of corporate opportunity, saying that both parties to the case relied on the case of *Independent Distributors, Inc. v. Katz*, 99 Md. App. 441, 637 A.2d 886, *cert. denied*, 335 Md. 697, 646 A.2d 363 (1994), "for the proposition that officers or directors will not be held liable for usurpation of corporate opportunity if the transaction was fair and reasonable to the corporation." In fact, Maryland Code, Corporations and Associations Article (CA), section 2-419 allows for certain "safe harbors" where a transaction is not void solely because a director has a personal interest in it. Specifically, under Maryland Code, CA, section 2-419(b)(2), a director can meet certain disclosure requirements or a board or the stockholders can meet certain ratification requirements to make the transaction valid. Furthermore, the statute also provides that a transaction will be valid simply because it is "fair and reasonable to the corporation." The court noted, however, that the application of this standard to the usurpation of corporate opportunity question in *Katz* has drawn scholarly criticism. One commentator has argued that since it is inherently unfair to take a profitable opportunity from a corporation, fairness should not be a part of the corporate opportunity analysis in the same sense that it is when determining the fairness of a transaction under the interested director transaction doctrine. Before the court could address this criticism, though, it discussed the differences between the corporate opportunity doctrine and the interested director transaction doctrine.

Unlike interested director transactions, the court explained that "'most corporate opportunities do not involve transactions with the corporation,'" but rather "'involve transactions that are taken from the corporation.'" While a director's interest in a transaction is determined by his involvement with the contract or transaction that the corporation is entering into, a corporate opportunity is based instead on the "'non-involvement of the corporation in a contract or transaction in which it may have an interest.'" The doctrine of corporate opportunity thus stands to keep a fiduciary from taking a business opportunity that rightfully belongs to the

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Venable is a strongly grounded law firm with a century-long history, energized by recent growth. Through offices in Maryland, Washington, D.C. and Virginia, we work with a diverse local, national and international clientele. Our business is providing service and we recognize that our continued success depends on delivering that service faster, more efficiently, and with high quality.

Venable attributes its success to the success of its clients. We are committed to building relationships that transcend the usual role of legal advisor. Our practice areas are built not only on legal experience, but also on knowledge and understanding of each client's industry. Our attorneys work as partners with clients, advising them on a number of levels. When clients face a challenge or opportunity, we immediately bring an experienced team from diverse specialties to coordinate advice. We seek not only to respond to our client's current legal issues, but also to identify potential problems early.

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corporation and using it for his or her own benefit. Whether or not an opportunity constitutes a corporate opportunity is determined by the "interest or reasonable expectancy" test. The court explained that this test "'focuses on whether the corporation could realistically expect to seize and develop the opportunity.'" If a corporation could take advantage of the opportunity, the director may not interfere by taking the opportunity for personal benefit.

While the *Shapiro* court gives a detailed description of the corporate opportunity doctrine, as well as explaining the criticism the application of the fairness/reasonableness standard to the doctrine receives, the court did not answer the criticism or apply the doctrine to the *Shapiro* case. This is because the court found that the *Shapiro* transaction was an interested director transaction instead of a usurpation of corporate opportunity. The transaction was not one where a director took advantage of an opportunity that belonged to the corporation. Rather, the transaction was between the corporation and other entities "in which certain directors had, or potentially had, a direct financial interest." The correct test for the court was to see if the transaction was valid under the Maryland Code, CA, section 2-419 governing interested director transactions. The court remanded the case for reconsideration based on this standard, but also felt it necessary to explain in detail the standard in Maryland for determining when exactly a director has an "interest" in a transaction.

The court's explanation was necessary because the directors (appellants) felt that a director who is related to a party with a material financial interest was not an interested party. The appellants' justification for this was that Maryland had rejected the Model Code and American Law Institute (ALI) definitions of "interested director" that contained the concept that a familial relationship could cause a party to be "interested." The court felt that this conclusion was "too broad," and felt it necessary to discuss what created an interested party under Maryland law.

The court began its discussion by explaining that the Maryland statute was modeled after the statutes of other jurisdictions, such as Delaware, New York, and California. Similar to the Maryland statute, none of these states define the term "interested director" in their statutes. Rather, these state statutes look to the "director's ability to exercise independent judgment and the expected influence of a particular relationship on the director" when making the determination of a director's interest in a transaction. The court added that these were the appropriate things to look at when trying to make such a determination. Based on this inquiry, it was clear to the court that "'directors are required to avoid only those self-interested actions which come at the expense of the [corporation]'" or the stockholders. Not all interested transactions are to be held void, but rather only the ones where the director's interest is such that it will impair his or her ability to make an unbiased decision in the corporation's best interest.

With this in mind, the court observed that the Model Code and ALI provisions related to interested directors also incorporate this idea. While it is easy to determine that a director is interested when he is directly involved in a transaction, the Model Code and ALI provisions state no per se rule that determine when a director with no direct interests will be considered an "interested director." Though an interest can follow from a familial or business relationship, neither one of these automatically makes a director interested because such a relationship "does not necessarily destroy an individual's independent judgment." The Model Code and ALI standards put emphasis on the question

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of would the relationship "'reasonably be expected to exert an influence on the director's judgment.'"

The court felt that the purpose of the Model Code and ALI provisions, as well as the Delaware, California, and New York statutes (which Maryland's is based on) would be undermined by a per se rule such as the one appellants tried to push in their argument. The court argued that to hold that a director is interested simply because of a familial or business relationship in essence could preclude some directors who are able to maintain independent judgment from considering certain transactions. Conversely, to hold that a director was disinterested because of a lack of a direct interest could in fact allow some directors to act for the corporation when a familial or business relationship did impair the director's judgment. For this reason, the court felt that the appellants' assertion that a familial relationship could not cause a party to be classified as "interested" was incorrect. Rather, the standard in Maryland is to look at the facts and circumstances surrounding a director's relationship. If "it would reasonably be expected that the director's exercise of independent judgment would be compromised" because of the director's relationship with an interested party to the transaction, the director will also be classified as an interested director.

Maryland Allows Staggered Board Without Stockholder Vote

Many executives or Maryland corporations are unaware of recent changes to the anti-takeover provisions of Maryland corporate law that affect the corporate governance of Maryland corporations. Specifically, Maryland law now permits a Maryland corporation that is public and meets certain other requirements to add certain anti-takeover provisions to its charter without a stockholder vote. Further, such provisions generally supercede contrary provisions set forth in the company's existing charter and bylaws.

Included in such anti-takeover provisions are the following:

Classified or Staggered Board

Under a classified board structure, directors are divided into three classes and each class serves for a three-year term. As a result, at each annual meeting of stockholders only one-third of the board is up for election and it generally takes at least two annual meetings for an acquirer or dissident stockholder group to replace a majority of the members of the board.

Removal of Directors Only for Cause

A classified board is not very helpful if dissidents holding a majority of the outstanding stock can remove directors at will. Accordingly, this provision supports the classified board by requiring dissident stockholders to demonstrate cause for removal before a director can be removed.

Increase Voting Percentage for Director Removal

Many Maryland corporations have charter provisions lowering the percentage vote required for stockholder action to a simple majority from a two-thirds majority. This provision makes any such charter provision inapplicable to a vote on the removal of directors thereby leaving the vote requirement at a two-thirds majority.

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Venable Maryland Corporate Practice Group

The Venable Maryland Corporate Practice Group has a broad practice acting as local Maryland counsel to publicly-held corporations, real estate investment trusts and investment companies organized under Maryland law. Venable's practice includes drafting and modifying the charters, bylaws and other organizational documents of Maryland entities to revise their capital structures, limit director and officer liability and implement anti-takeover protections. Venable also provides legal advice and written opinions on substantive issues of Maryland corporate law in connection with acquisitions, capital raising transactions, contests for corporate control and general corporate governance issues. Venable lawyers have substantial experience in working with general counsel and primary outside counsel to provide quality legal services under the often tight deadlines arising in transactions involving public companies organized under Maryland law.

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Number of Directors

This provision ensures that only the board of directors can fix the number of directors. This provision prevents dissident stockholders from voting to change the charter or bylaws to increase the number of directors and elect directors to fill such vacancies.

Vacancy on Board

In the event of a vacancy on the board caused by an increase in the size of the board or the death, resignation or removal of a director, the vacancy can be filled only by the remaining directors and the new director serves for the remainder of the full term of the class in which the vacancy occurred. This provision ensures that even if dissident stockholders are successful in removing a director for cause, the remaining majority will retain control of the company through the power to appoint the director's successor and dissident stockholders will not have the opportunity to replace the replacement director at the next annual meeting.

Limits on Special Meetings of Stockholders

Provides that special meetings of stockholders be called only upon the request of stockholders holding a majority of the outstanding votes to be cast at the meeting. Often, dissident stockholders attempt to take action at a special meeting to change control of a company. This provision makes it more difficult for them to call a special meeting.

Explicit Approval of Stockholders' Rights Plans (Poison Pill)

A poison pill is an anti-takeover device that distributes additional securities to all stockholders other than stockholders that are attempting to make a hostile acquisition of the company. The explicit approval of certain poison pills by the Maryland corporate statute makes the poison pill a particularly attractive anti-takeover device for Maryland corporations.

The provisions outlined above are important changes because institutional investors are often opposed to any charter provisions that reduce the likelihood of a hostile acquisition. As a result, companies often are unable to obtain sufficient stockholder support to include these provisions in their charters. Notwithstanding this opposition, many directors and officers of public companies believe that anti-takeover provisions like those discussed above enhance the long term value of a company and empower the board to negotiate a better deal on behalf of all stockholders when an acquisition offer is presented.

For more information about the issues addressed above or comments with respect to this Report, please contact Michael W. Conron, Esq. at (410) 244-7424. If you would like to be added to our mailing list, please contact Kathy Page in the Venable Marketing Department at KPage@venable.com.

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