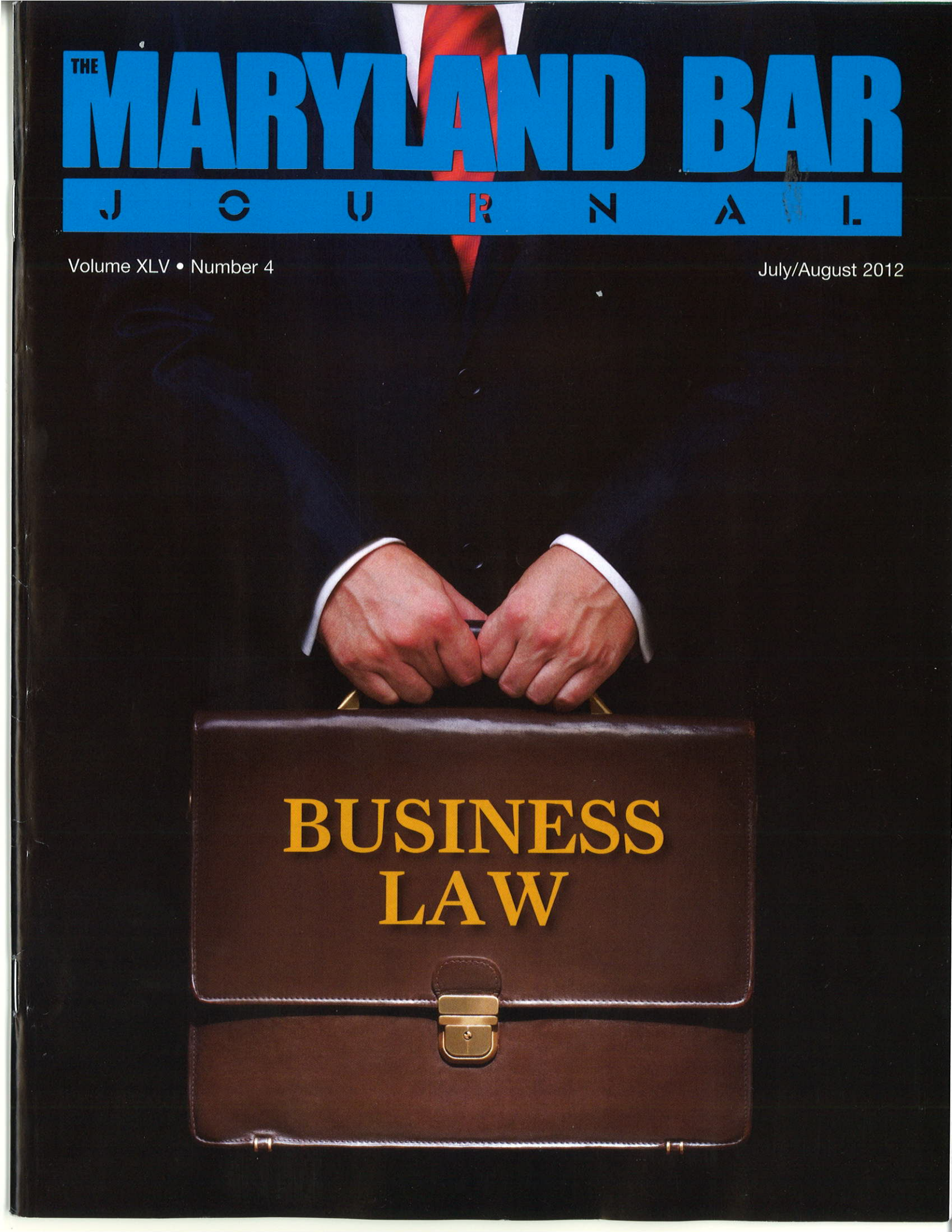


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Boland v. *Boland* –

The Court of Appeals Raises the Standard in Derivative Lawsuits

By A. Howard Metro
and Ginny Cascio

Client Company, a Maryland corporation, comes to you for advice. Client Company recently purchased a yacht for the use of the Board of Directors from another company controlled by the same board members. Angered by this frivolous purchase, the minority shareholders have demanded that the Board of Directors remedy this alleged self-dealing or they will take action. How do you advise your client?



Thankfully, the recent October 2011 Maryland Court of Appeals decision, *Boland v. Boland*, gives direction to Maryland corporations' Boards of Directors (the "Board"), dissatisfied shareholders ("Shareholders"), and their attorneys involved in derivative lawsuits. Settling an important question in Maryland corporate law, *Boland* establishes the definitive judicial standard that Maryland courts must apply when reviewing the propriety of a Board's response to allegations of wrongdoing. *Boland v. Boland*, 31 A.3d 529, 561-62 (Md. 2011).

Of significance, the Court declined to adopt Delaware's *Zapata* standard, which permits court intervention and review of the Board's or special litigation committees' ("SLC") judgment, even when it is established that the Board acted in good faith and satisfied standards of procedural fairness. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del 1980). By rejecting *Zapata*, the Court has opted not to disturb the Board's decisions, as long as the courts find that the Board properly exercised business judgment, were independent, and followed appropriate procedures. *Boland*, 31 A.3d. at 561-62.

This article begins by summarizing the evolution of Shareholder rights and derivative actions in Maryland that created the foundation for *Boland*. It then explains the new standard set by the Court and makes practical suggestions for the Board and the SLC to promote responsible corporate management and prevent derivative lawsuits.

Pre *Boland*: The Muddy Water of Derivative Suits in Maryland

Maryland has a rich common law recognizing the rights of Shareholders with legitimate complaints about the

actions of corporate Boards. On behalf of the Shareholders, the Board manages the company and must follow the Maryland business judgment rule, which is the standard of conduct for directors. James J. Hanks, Jr., *Maryland Corporation Law*, § 6.1(a), 6.6 (2011). Under this rule, the courts presume that the director acted in good faith, in a manner in the best interests of the corporation, and as "an ordinarily prudent person in a like position would ... under similar circumstances." Md. Code Ann. Corp. & Assn's § 2-405.1(a); (e) (2012). As long as the Board satisfies these requirements, courts defer to the Board's decisions. Hanks, *supra*, § 6.8. If a single director or group of directors is interested or involved in a transaction with the corporation, then those directors are no longer protected by the presumption that they acted in good faith. *Id.* § 6.6; 6.8(b). Directors become interested when they either "appear on both sides of a transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing." *Werbowsky v. Collomb*, 766 A.2d 123, 138 (Md. 2001) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

Corporate governance breaks down when the Board fails to protect the corporation's interests due to its own irresponsibility, self-interest, or wrongdoing. See Hanks, *supra*, § 7.21(a). To remedy this problem, the courts created a mechanism, the derivative suit, to give Shareholders the opportunity, on behalf of the corporation, to "enforce a legal right of the corporation . . . against directors, officers, or employees or agents of the corporation" and hold directors accountable to the Shareholders' interests. *Id.* To begin a derivative action and seek a remedy for a wrong inflicted on the company, Maryland law requires the

Shareholders to either make a demand on the directors to correct the issue or prove that the demand is excused. *Id.* § 7.21(c). The court may excuse the Shareholders from making a demand and deem it futile if the Shareholders can prove that a demand would cause irreparable harm to the company or that the interested directors are incapable of correcting their actions. *Werbowsky*, 766 A.2d at 144.

Recent cases suggest that proving futility is difficult and *Boland* further implies, although does not explicitly declare, that a demand on the Board is a requirement prior to initiating litigation. *Boland*, 31 A.3d at 550 n. 25. In most demand actions at least part of the Board is interested and is not entitled to the business judgment rule protection. *Boland*, 31 A.3d. at 550-51. Regardless, in the face of a demand, Boards must investigate the allegations to determine if the demanded litigation or the suggested remedies are in the corporation's best interest. *Schenker v. Laureate Educ., Inc.*, 983 A.2d 408, 423-24 (Md. 2009). When Boards are comprised entirely of interested directors, the corporation may form an SLC of independent directors. Hanks, *supra*, § 7.21(c). Bestowed with the Board's authority to act on behalf of the corporation, the SLC investigates the allegations and recommends the corporation's response. *Id.* The SLC may either find the demand has merit and address the remedies or refuse to act on a meritless claim. *Id.* If the demand is refused, then the court will allow the Shareholders to file a "demand-refused" action and the court will review the SLC's decision. *Id.*

It is at this next stage that courts in Maryland have been inconsistent. Prior to *Boland*, most Maryland courts either applied the standard of judicial review established by New York's



Auerbach case or Delaware's *Zapata* case to the SLC's decision. See *Boland*, 31 A.3d at 555 n. 32. In *Auerbach*, the New York Court of Appeals recognized that "courts are ill equipped . . . to evaluate what are and must be essentially business judgments" and applied the business judgment rule to the SLC's decisions. *Auerbach v. Bennett*, 393 N.E.2d 994, 1000 (N.Y. 1979). *Auerbach* instructed courts to review the SLC's "methodologies and procedures" to ensure the disinterested independence of the SLC members and the use of reasonable procedures but *not* the substance of the decision. *Id.* at 1000-02.

In a drastic departure from *Auerbach*, the Delaware Supreme Court in *Zapata* granted the court the power to use *the court's* independent business judgment to review

the SLC's decision which, if applied, usurps the corporation's right to regulate itself. *Zapata*, 430 A.2d at 788-89. *Zapata* allows the courts to consider the "balance of many factors – ethical, commercial, promotional, public relations, employee relations, fiscals as well as legal" in its independent review to ensure that the decision satisfies the best interests of the company, protects the shareholders, and complies with matters of law and public policy. *Id.* at 788-89. As opposed to the court in *Auerbach*, *Zapata* instructs that "such factors are not 'beyond the judicial reach'" of the court. *Id.* at 788. For over twenty years, most states have either applied the *Auerbach* or *Zapata* rule. In *Boland*, the Maryland Court of Appeals finally chose the Maryland judicial standard of review for SLC decisions.

***Boland v. Boland*: Raising the Standard**

Boland is a very dense and complicated case procedurally, factually, and legally. In short, two shareholders of two family-owned corporations brought a derivative suit against the corporations' directors alleging self-dealing and a breach of fiduciary duty. *Boland*, 31 A.3d at 536-37. The directors hired two independent directors to investigate the claims and make a recommendation. *Id.* The SLC members did not have business relationships with the corporations, yet they did have extensive experience in business. *Id.* at 543. The independent directors hired an attorney to serve as independent counsel. *Id.* Over the course of five months, the SLC interviewed all parties, reviewed pertinent documents, and allowed both sides to submit memoranda. *Id.*

Upon completion of the investigation, the SLC found that “none of the derivative claims have merit and the actions on behalf of the corporation should be terminated.” *Id.* The Circuit Court accepted the SLC’s recommendation and pursuant to the business judgment rule granted summary judgment in favor of the board. *Id.* at 545. Upon a grant of the writ of certiorari, reviewing the *Auerbach* and *Zapata* standards of judicial review, the Maryland Court of Appeals chose to establish Maryland’s standard and remanded the case back to the Circuit Court. *Id.* at 561; 569. The Court disagreed with other courts’ interpretations that *Auerbach* required the court to “rubber stamp” the SLC’s decision and give broad deference to the SLC. *Id.* at 556. Instead, the Court interpreted *Auerbach* to require a rigorous review and established an “enhanced” *Auerbach* test. *Id.* at 557; 561.

The Court instructed the courts to review the composition and procedures of the SLC extensively but not the merits of the SLC’s decision. *Id.* at 561. Significantly, the Court departed from the traditional interpretations of the business judgment rule, holding that there is *no presumption* that “the SLC was independent, acted in good faith, or followed reasonable procedures.” *Id.* at 556. Instead, the directors must demonstrate through minimal proof (the Court suggests an affidavit may be sufficient) the process used to pick the SLC’s members and that the SLC “followed reasonable procedures and no substantial business or personal relationships impugned the SLC’s independence and good faith.” *Id.* If the court finds that the directors have met this burden, then the Shareholder(s) must submit proof to the contrary in order to survive summary judgment. *Id.* If

the Shareholder(s) submit sufficient proof to demonstrate an issue of material fact, the burden is on the directors to prove at trial “that the SLC was independent, acted in good faith, and made a reasonable investigation.” *Id.*

The Court requires two inquiries: (i) whether any business or personal relationships impugned the SLC’s independence and good faith; and (ii) whether the SLC followed reasonable investigation procedures that led to reasonable principled conclusions. *Id.* at 561-62. (collectively, the “*Boland* Standard”).

To answer the first question, the Court focused on the directors’ relationships with the SLC’s members and the procedure for selecting the members. The Court looked at *any* significant business, personal, or social relationships or incentives that may influence the SLC’s members. *Id.* at 564-65. *Contra Boland*, 31 A.3d at 582 (Battaglia, J., dissenting) (“This standard is unworkable and intrusive”). As to the process, the Court considered why the directors chose the SLC members, how the directors learned of the members, and any specific circumstances surrounding the selection and delegation of responsibility to the SLC that would affect its independence and good faith. *Boland*, 31 A.3d at 565. The Court recognized that “a mere acquaintance at a party would not be disqualified . . . and prior service on another board or commission would not show *per se* bias,” but the directors must disclose all relationships with the members to the court and then the court must decide whether the SLC was capable of acting in good faith and with independence. *Id.*

For the second inquiry into the reasonable procedure of the SLC, the Court focused its analysis on whether the SLC had a reasonable basis for its conclusion. The length and volume of

the report was not enough to demonstrate reasonable procedures; rather, the Court examined whether the SLC considered the correct legal and factual issues and whether its recommendation was well-reasoned and rooted in law. *Id.* at 566.

Post-Boland: Navigating the New Waters

The most significant “take home” lesson of *Boland* is the elimination of any presumption that the SLC was independent, acted in good faith, and used reasonable procedures. While the Court suggests that it has placed a “minimal burden” on corporations to prove these factors, *Boland* provides Shareholders with new ways to attack the SLC’s decision and gives the courts broad deference to examine “facts and circumstances” supporting each prong of the *Boland* Standard. In the wake of *Boland*, corporate counsel should advise their clients to take preventative measures and, when faced with a demand, carefully plan its response to ensure the court upholds the SLC’s recommendation. Understanding that many clients may spurn additional corporate formalities, the following are suggestions that should be considered based on the client’s particular needs.

Formation and Operation of the Entity with Minority Shareholders

1. *Board Members.* Consideration should be given to the directors’ selection, orientation and on-going education to encourage responsible corporate management, to prevent future demands, and, in the case of demand, to alleviate *Boland* concerns.

- *Selection.* *Boland* leaves unsettled the issue of whether a

disinterested board member is independent because his relationship established by working with interested board members may taint his decision-making. However, corporations should consider enacting by-laws provisions, whether at the corporation's formation or as necessary, which require independent directors. This is especially important to family businesses with participating and non-participating family shareholders.

- *Orientation and Training.* It is now important and perhaps strategic to provide an initial orientation and continual training at the annual meeting to all directors. This training should include instruction on the directors' fiduciary duties and procedures necessary to maintain the business judgment rule, especially for decisions that have inherent conflicts, such as compensation, benefit plans, and issuance of equity.
- 2. *Insurance.* As a practical matter, the corporation should acquire a Directors Liability Insurance policy that includes subsequent directors and SLC members. Other than covering the cost to defend the Board members, such a policy is essential to finding and securing disinterested directors for the SLC, who will not join the SLC without protection from the litigation costs.
- 3. *Adoption of Corporate Internal Procedures.* Prior to any demand, corporations should consider the adoption of a well-considered plan and procedure for choosing an independent SLC should the need arise. Such a procedure should be flexible enough to adapt to

diverse factual circumstances but strict enough to prevent the suggestion of impropriety and self-interest by the Board. Requiring a Board to consider and adopt such a procedure prevents future accusations that an interested Board influenced the SLC.

The SLC's Investigation

SLCs provide corporations an opportunity to maintain autonomy over its decisions. As such, it is incumbent upon a Board to pass a resolution which creates an independent SLC, defines the nature of the investigation, provides it with adequate resources, insures transparency, and pledges full cooperation.

Upon creation of the SLC, in addition to what *Boland* has provided as guidance, SLCs must fundamentally undertake a process to determine: (i) the legal questions at issue in the demand and the nature of the remedy; (ii) the proper methods to use in the investigation which seek to obtain accurate facts; and (iii) appropriate application of the legal issues to the facts to ensure a well-reasoned and supported recommendation. See Kevin H. Michels, *Internal Corporate Investigations and the Truth*, 40 Seton Hall L. Rev 83, 105 (2010). Even though the following suggestions are made with the aim to satisfy the *Boland* Standard, they more importantly encourage a thorough investigation to arrive at a recommendation in the best interests of the corporation.

1. *Procedures.* The SLC (and only the SLC) must adopt and strictly follow a set of procedures that use reasonable methodologies designed to fully and thoroughly investigate the demand's allegations.
 - *Legal Question.* *Boland* instructs courts to examine whether the

SLC reviewed the appropriate legal issues as part of the reasonable procedures inquiry. *Boland*, 31 A. 3d at 566. The SLC should confirm with both parties' counsel that the legal issues are represented accurately. Otherwise, an investigation which commences based on disputed legal issues is doomed to failure.

- *Independent Counsel.* The SLC, as needed, must retain and consult with independent counsel to prevent any conflict of interest and ensure that the SLC's procedures will meet *Boland*'s requirements.
 - *Cooperation with Parties' Counsel.* The SLC should consult both the Shareholders' and the Board's counsel on its procedural approach including who is present when witnesses are interviewed, whether witnesses are under oath, and the cooperation that will be expected. While there may be disagreements with regard to the type of procedures ultimately adopted, the opportunity of all parties to provide what they believe will constitute a fair investigation gives the SLC an opportunity to ensure that the investigation may commence with clear objectives and procedures.
2. *Fact Gathering.* The SLC must gather facts in a broad and discerning manner. It must request all relevant documents from the parties. The SLC should use letters or memoranda, interrogatories, fact-finding conferences, or any other methods that efficiently address the matters at issue. It may also conduct interviews of all relevant

parties under oath or affirmation. If a written statement is requested it should be provided, if possible, under penalties of perjury. During the interviews, the SLC's members should weigh the facts, demeanor, and credibility of the witnesses. They should also provide detailed records of all fact-finding in order to substantiate their report.

3. *SLC's recommendation.* *Boland* instructs courts to examine the substance and not the length of the SLC's report, and use the report as evidence for whether the SLC followed the *Boland* Standard. *Id.* The report should summarize the background of the SLC's members and state any personal, professional or financial relationships with the directors. It should detail the

SLC's procedure throughout the investigation and outline the law it applied. The SLC should summarize the facts including personal impressions of the witnesses' credibility and the documents' genuineness. The SLC should also state any assumptions it made with regard to the facts. The final part of the report is a thorough application of the facts to the law with a well-reasoned, factually supported recommendation.

For both litigators and transactional corporate attorneys, *Boland* settles one question but creates many new ones. *Boland* sets the standard for judicial review of SLC's decisions but gives lower courts minimal guidance on how to apply the *Boland* Standard. If a corporation fails to anticipate and carry out

Boland's directives, Shareholders have a tool chest of allegations and issues to attack. As such, attorneys must evaluate the impact of this decision on their clients and advise them to continue methods that encourage responsible corporate management and, hopefully, prevent future derivative claims.

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