Straightening out Strougo: The Maryland Legislative Response to Strougo v. Scudder, Stevens & (and) Clark, Inc.

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In May 1997, Senior United States District Judge Robert W. Sweet ignited a firestorm in the investment company world with his holding in Strougo v. Scudder, Stevens & Clark, Inc.¹ that, under Maryland law, receipt of “substantial compensation” in directors’ fees for serving on the boards of several investment companies registered under the Investment Company Act of 1940 (the “Investment Company Act” or the “Act”)² with the same investment adviser “call[ed] into question the director’s independence from the manager of that complex.”³ As a result, Judge Sweet excused the plaintiff-shareholder from making a demand on the Board of Directors of the Brazil Fund, Inc., (the “Brazil Fund” or the “Fund”)⁴ before filing a derivative action challenging an offering by the Fund to its shareholders of rights to buy more stock, which would have had the collateral result of increasing the investment adviser’s asset-based fees because the sale of stock would have increased the Fund’s assets.

The reasoning of the court’s decision in Strougo implied that in any action affecting the investment adviser’s interests, directors receiving substantial compensation (possibly as a result of serving on multiple

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³ Strougo, 964 F. Supp. at 795.
⁴ The Brazil Fund is a closed-end investment company advised by Scudder, Stevens & Clark, Inc. See id. at 787 (noting that shares of the Fund trade on the New York Stock Exchange).
boards of commonly advised funds) would not be disinterested and, thus, their decisions would be open to attack under the standard of care for directors of Maryland corporations set forth in section 2-405.1 of the Maryland General Corporation Law (MGCL). Section 2-405.1(a) of the MGCL requires that a director of a Maryland corporation perform his duties: “(1) [i]n good faith; (2) [i]n a manner he reasonably believes to be in the best interests of the corporation; and (3) [w]ith the care that an ordinarily prudent person in a like position would use under similar circumstances.” Section 2-405.1(a) was adopted by the General Assembly of Maryland in 1976 and is derived, almost word for word, from former section 8.30(a) of the Model Business Corporation Act.

The court also emphasized that because only one of the directors did not serve on multiple commonly advised boards, the Fund’s board could not, under the MGCL, appoint a committee of disinterested directors to consider the plaintiff-shareholder’s demand. The MGCL, at the time of the relevant events, provided that the minimum number of directors to constitute a board committee was two. Following Judge Sweet’s decision, the same plaintiff filed a very similar complaint on behalf of a different closed-end fund, the Brazil Equity Fund, Inc., against its directors and the same investment adviser, seeking to

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6 Id.
7 Section 8.30(a) of the Model Business Corporation Act was recently amended. See Committee on Corporate Laws, Changes in the Model Business Corporation Act Pertaining to the Standards of Conduct and Standards of Liability for Directors—Final Adoption, 53 Bus. Law. 813 (1998) (covering final adoption of certain amendments).
8 Strougo, 964 F. Supp. at 795.
9 Id. (stating that in Maryland, “two is the minimum number of directors necessary to form a committee to consider a demand”). In 1996, section 2-411(a)(1) was amended to decrease that number to one. See MD. CODE ANN., CORPS. & ASS'NS § 2-411(a)(1) (1998). Judge Sweet did not give any indication in his initial opinion or in his subsequent opinion denying reargument and certification that he was aware of this amendment to section 2-411(a)(1).
have demand excused in part due to the directors' service on the boards of other commonly advised funds.\(^\text{10}\)

In August 1997, Judge Sweet denied reargument and further observed that his earlier order had "concluded that well-compensated service on multiple boards of funds managed by a single fund advisor can, in some circumstances, be indistinguishable in all relevant respects from employment by the fund manager, which admittedly renders a director interested."\(^\text{11}\) The judge also denied certification of his interlocutory order to the Court of Appeals of Maryland (the state's highest court) for a definitive ruling on the issue that all the parties conceded was solely an issue of Maryland law.\(^\text{12}\)

The Board of Directors of the Brazil Fund responded to Strougo's suit by electing an additional director, a visiting professor at the New York University business school with a Ph.D. in economics from Harvard and prior experience at Goldman Sachs, J.P. Morgan and the Federal Reserve Bank of San Francisco, who did not serve on any other boards of funds managed by the same investment adviser and thus was disinterested as a matter of Maryland law, even under Judge Sweet's ruling.\(^\text{13}\) This new director, together with the one director whom Judge Sweet previously had identified as disinterested, was appointed to serve as a special litigation committee of the Fund's Board to review the allegations of the \textit{Strougo} complaint.\(^\text{14}\) The Fund sought and received a three-month stay of action in \textit{Strougo} in order to permit the special litigation committee to complete its investigation.\(^\text{15}\) However, the judge ordered that the stay should run from the date the motion for stay was filed, which meant that the stay


\(^{12}\) Id. at *8.


\(^{14}\) See id.

\(^{15}\) See id. at 815-16 (stating that three-month stay was reasonable "[c]onsidering the complexity and seriousness of the allegations").
expired on December 15, 1997.\textsuperscript{16} The special litigation committee retained the New York City firm of Simpson Thatcher & Bartlett as independent counsel to the committee.\textsuperscript{17}

I. RATIONALE FOR CORRECTIVE LEGISLATION

Because Maryland has for many years been the favored jurisdiction for incorporation of mutual funds throughout the country, Judge Sweet’s decisions in May and August 1997, roiled the investment company industry.\textsuperscript{18} As a result, a drafting committee was formed under the auspices of the Committee on Corporate Laws (chaired by the author) of the Section of Business Law of the Maryland State Bar Association.\textsuperscript{19} By December 1997, the drafting committee had concluded that corrective legislation was necessary for several reasons.

First, the court’s holding, if not reversed, would have created tension between federal law and Maryland law. The investment company industry is predominantly organized in complexes — groups of funds offering different investment objectives but managed by the same investment adviser. Complexes generally employ a “pool” or “cluster” board structure in which the same independent directors serve on the boards of all or most of the funds in the complex. These structures permit

\textsuperscript{16} See id. at 816.
\textsuperscript{17} Id. at 814.
\textsuperscript{18} Mutual funds are open-end investment companies. The Brazil Fund and the Brazil Equity Fund are closed-end funds. However, the logic, or lack thereof, of the court’s decision applies equally to directors of open-end funds as to directors of closed-end funds. Thus, this article is written without regard for whether the situations described involve directors of open-end funds, closed-end funds or a combination thereof.
\textsuperscript{19} Members of the drafting committee included: Larry Scruggins, Jay Smith and Henry Kahn of Piper & Marbury, LLP; Lee Miller of Venable, Baetjer and Howard; Dick Phillips and Jeff Maletta of Kirkpatrick & Lockhart LLP; Henry Hopkins of T. Rowe Price Associates, Inc.; Craig Tyle of the Investment Company Institute; Will Rheiner and John Ake of the Philadelphia office of Ballard Spahr Andrews & Ingersoll, LLP; and the author.
knowledgeable and efficient governance of the funds with the independent directors’ oversight mandated by the rigorous requirements of the Investment Company Act. The Act sets forth specific criteria for determining when a director will be deemed an “interested person” of an investment company. Service on the boards of multiple funds with a common investment adviser and the receipt of “substantial” compensation for this service are not among these criteria. The Securities and Exchange Commission (SEC), which administers the Investment Company Act, has never determined that either service on multiple boards or the receipt of “substantial” compensation makes a director an interested person under the Act. Because approximately 1,600 investment companies registered under the Investment Company Act are incorporated in Maryland, it is important that Maryland law be consistent with federal law.

Second, there has never been any reason to believe that directors of an investment company or any other corporation are unable to act independently because they receive compensation — even “substantial” compensation — for their service on one or more boards. Directors are responsible to shareholders, not to the investment adviser of a fund complex or the management of an ordinary corporation, and receipt of directors’ fees has not been held to taint the independence of directors of investment companies or of corporations generally. Indeed, in Kamen v. Kemper Financial Services, Inc.,20 the United States Court of Appeals for the Seventh Circuit, applying Maryland law, held that receipt of directors’ fees does not mean that directors are not independent.21

20 939 F.2d 458, 460 (7th Cir. 1991).
21 Id. (rejecting plaintiff’s argument that directors’ fees meant directors were under fund’s “thumb” because “[i]f allegations of this kind sufficed, the demand rule would be negated — for almost all directors receive fees”); see also Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988) (directors’ fees, “without more,” do not affect directors’ independence); Parnes v. Balley Entertainment Corp., Del. Ch. C.A. No. 15192, slip op. (May 12, 1997) (directors’ fees and pensions, without more, do not imply that directors are not independent or disinterested).
Third, under Judge Sweet's holding, investment companies organized as Maryland corporations that share a common investment adviser could be precluded from having common independent directors. This would greatly increase the number of persons needed to serve on mutual fund boards, reducing the overall effectiveness and efficiency of these boards and unnecessarily increasing costs to shareholders with no resulting benefit.  

Fourth, many Maryland-incorporated investment companies operate multiple funds as separate series of shares of the same corporation, with one board of directors and one investment adviser, rather than as separate corporations, each with its own board. No one has ever objected to this structure as a matter of corporate governance. If the management of several series can be directed by one board of directors, there is no reason why several corporations cannot be capably governed by common boards.

Finally, under the judge's decision, boards composed of individuals who serve as directors of more than one mutual fund within the same complex would be disqualified from making many determinations affecting the investment adviser or other affiliates. This, in turn, would subject a board's judgments on numerous issues to the threat of constant litigation and further undermine effective governance of these companies. Virtually any decision presented to the board of directors of an investment company may have the effect of increasing the costs of educating each set of independent directors about the issues for which it is responsible could be significant and would be paid by shareholders.

22 Many issues addressed at a board of directors' meeting of one mutual fund in a complex must also be addressed at the meetings of other funds in the same complex. If each mutual fund in a complex must have a separate set of independent directors, the costs of educating each set of independent directors about the issues for which it is responsible could be significant and would be paid by shareholders.

23 Disinterested directors of an investment company have responsibility for oversight of transactions between the investment company and its affiliates, including affiliates other than the investment adviser. See, e.g., Investment Company Act Rule 17a-7, 17 C.F.R. § 270.17a-7 (1998). Transactions with these other affiliates could also be challenged under the reasoning in the court's decision.
company’s assets and, therefore, the investment adviser’s fees.

II. NEW LEGISLATION

Accordingly, the drafting committee developed a one-sentence bill, to add section 2-405.3 to the MGCL. The new bill provided:

A director of a corporation that is an investment company, as defined in the Investment Company Act of 1940, who with respect to the investment company is not an interested person, as defined in that Act, shall be deemed to be independent and disinterested when making any determination or taking any action as a director.

Thus, the proposed new section 2-405.3 tied the independence and disinterestedness of a director of a Maryland-incorporated investment company to the definition of “interested person” in the Investment Company Act.24 No implication was intended that failure to

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(19) “Interested person” of another person means:

(A) when used with respect to an investment company:

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer; and
meet the "interested person" standard of that Act would mean that a director of an investment company incorporated in Maryland could not be independent or disinterested.

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, that no person shall be deemed to be an interested person of an investment company solely by reason of: (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso: and

(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

(i) any affiliated person of such investment adviser or principal underwriter,

(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and
In early January 1998, the draft bill was submitted to the Maryland General Assembly's Legislative Reference Service, which re-organized the proposed section 2-405.3 into two subsections:

(a) This section applies to a corporation that is an investment company as defined by the Investment Company Act of 1940.

(b) A director of a corporation who with respect to the corporation is not an interested person, as defined by the Investment Company Act of 1940, shall be deemed to be independent and disinterested when making any determination or taking any action as a director.

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purpose of this paragraph (19), "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this subchapter or for any other purpose for any period prior to the effective date of such order.

The draft bill was sponsored by Delegate Robert L. Frank (Baltimore County), who had sponsored many corporate bills for the Maryland State Bar Association (MSBA) over the first three years of his service in the House of Delegates of the General Assembly, and Delegate Anne Marie Doory (Baltimore City). The Council of the Section of Business Law of the MSBA also approved the bill.
III. DEVELOPMENTS IN THE MARYLAND HOUSE OF DELEGATES

A. INTRODUCTION AND HEARING

On January 30, 1998, this legislation was introduced in the House of Delegates as House Bill 356 ("H.B. 356" or the "Bill") and was assigned to the House Economic Matters Committee.26 On February 19, 1998, the Committee held a hearing on the Bill.27 Henry Hopkins of T. Rowe Price & Associates, Inc., Bryson Popham, representing the Maryland Securities Association, and the author, on behalf of the MSBA, testified at the hearing in support of the Bill. BT Alex. Brown, Inc. and Legg Mason, Inc. also sent letters in support. No one appeared in opposition to the Bill.

After the February 19 hearing, an amendment was proposed28 providing that the Bill "shall be construed retroactively and shall be applied to and interpreted to affect only those cases filed on or after January 30, 1998."

26 The House Economic Matters Committee was chaired by Delegate Michael E. Busch (Anne Arundel County).

27 Shortly before the hearing, Dean Mark A. Sargent of Villanova University School of Law, formerly Chair of the MSBA Committee on Corporate Laws, sent a letter to the House Committee strongly criticizing Judge Sweet's decisions and supporting enactment of the Bill. In pertinent part the letter stated:

Judge Sweet's holding that disinterested directors of commonly-advised investment companies may not be independent for purposes of considering an action that may increase the net assets and, therefore, the asset-based fees of the funds' advisers, is contrary to federal law on the subject and is unprecedented as a matter of state law....

In my opinion, Judge Sweet's decision is wrong as a matter of Maryland law, as its extremely stringent conception of directors' independence is not based on any Maryland authority. It is also wrong as a matter of public policy. If not corrected promptly, it could be applied to an almost limitless number of board decisions, resulting in either sharply increased costs of administration or an industry-wide flight from Maryland.

Letter from Mark A. Sargent, Dean of the University of Villanova School of Law, to The Honorable Michael Busch, Chairman, House Economic Matters Committee (Feb. 16, 1998) (on file with the Villanova Journal of Law and Investment Management).

28 Delegate Michael R. Gordon (Montgomery County), Vice-Chairman of the House Economic Matters Committee, proposed the amendment.
The proposed date (the date the Bill was introduced) was a compromise — it did not affect pending litigation, but it did close the potential window of opportunity for new suits to be filed before the customary effective date of October 1 for Maryland legislation. Proponents of the Bill acquiesced in the amendment.

B. OPPOSITION

Shortly thereafter, the first opposition to the Bill emerged. The first salvo was a one-page document, which made several fallacious arguments that were often repeated.

One of the opposition arguments was that H.B. 356 would somehow limit the power of the shareholders of a Maryland corporation to bring a derivative suit. Nothing in

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29 The single opponent to the Bill was a plaintiffs' securities lawyer in Montgomery County.
30 See Statement in Opposition to HB 356 (on file with the Villanova Journal of Law and Investment Management). The document contained the following points (as stated in the document — underlining replaced here with italics).

1. House Bill 356 seeks to create a special exception in Maryland law for investment companies ONLY — not available to any other Maryland Corporation.
2. The bill is the result of the finding in the Strougo case where Maryland law was applied and the Court found that there may not be two "disinterested Directors" (as required by Maryland law) and therefore did not dismiss the lawsuit brought by stockholders. The "disinterested" directors in the Strougo case were being paid $81,000 and $132,000 respectively for service on the Boards of 8 and 14 separate funds managed by Scudder, the investment company against which the action was brought. The mutual fund industry did not like the result of Strougo and therefore has introduced House Bill 356.
the Bill, of course, eliminated or diminished the right of shareholders to bring a derivative action. It simply adopted the standard of the Investment Company Act regarding who is an "interested person" in a decision by the board of directors of an investment company incorporated in Maryland. Shareholders of investment companies retain the full right to file suits on behalf of investment companies. Moreover, since 1881, the Court of Appeals of Maryland has required that a shareholder who brings a derivative action must first make demand upon the corporation to sue in its own name and the demand must be refused.\textsuperscript{31} The reason for the demand requirement is because a derivative suit, in the words of the Court of Appeals, "is a matter for the corporate authorities themselves [that is, the board of directors], and not for the stockholders to determine.\ldots"\textsuperscript{32} In fact, Maryland shareholders have substantially greater rights to bring derivative suits than shareholders in many other states.

\textsuperscript{3} Since 1881, the Court of Appeals of Maryland has permitted stockholders to bring a derivative action on behalf of the company if they believe that the Board of Directors has been engaged in self-dealing or breached its fiduciary duties to the corporation.

\textsuperscript{4} House Bill 356 seeks to prevent stockholders from bringing such an action directly before the Court if they believe that the Board of Directors is not "disinterested" and is engaging in self-dealing.

\textsuperscript{5} The last serious attempt to undermine these rules occurred in the mid-1960s. The Court of Appeals of Maryland soundly rejected the suggestion that the protections of Maryland law be weakened and stockholders be forbidden from asking a judge to look at their claims.

\textsuperscript{6} The Courts in Maryland have not had difficulty applying Maryland law to mutual funds and other companies. No segment of the legitimate business community has been hurt by a judge's ability to consider claims of fraud, waste or mismanagement. There is no reason to change Maryland law.

\textsuperscript{7} The Security (sic) and Exchange Commission (SEC) was asked by the Investment Company Institute to take industry's side in \textit{Strougo} but the SEC refused to do so. Only the party that lost in the case thinks the judge was wrong.

\textsuperscript{8} HB 356 weakens the State's ability to protect investor's interests and does not better the mutual fund industry.

\textsuperscript{31} Booth v. Robinson, 55 Md. 419, 439 (1881).

\textsuperscript{32} Davis v. Gemmell, 70 Md. 356, 376 (1889).
because Maryland retains the futility exception to the demand requirement.  

Another opposition argument was that H.B. 356 would weaken the ability of the State of Maryland to protect the interests of fund shareholders. This argument overlooked the fact that protection of investors in funds has historically been primarily the responsibility of the SEC, which has never adopted Judge Sweet’s position. The MGCL, however, is the responsibility of the General Assembly of Maryland. For several decades the Maryland legislature has adopted reasonable and responsible legislation concerning the governance of investment companies formed in Maryland.

33 The futility exception excuses the requirement of demand on the board before a derivative action is brought. See, e.g., ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03 (1994) (explaining that “[w]hat constitutes futility varies among jurisdictions”). In Maryland, however, the exception has been construed very narrowly. For example, in Kamen, the court held that under Maryland law, “a demand is ‘futile’ only if the directors’ minds are closed to argument.” Kamen, 939 F.2d at 462. Moreover, both The American Law Institute and the Model Business Corporation Act have eliminated the futility exception and have adopted a requirement of demand in all cases, subject only to a limited exception for irreparable harm to the corporation. See ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.03 (1994); REVISED MODEL BUS. CORP. ACT § 7.42 (1998). The Supreme Court of Pennsylvania, in a recent landmark case, specifically adopted the universal demand rule of the ALI. Cuker v. Mikalauskas, 692 A.2d 1042, 1049 (Pa. 1997).

34 As noted above, the SEC administers the Investment Company Act. The Act provides numerous protections for fund shareholders. See, e.g., 15 U.S.C. §§ 80a-12 & 80a-17 (1998). The Act does not, however, preclude the application of state corporate law to funds incorporated in a particular state.

35 One of the early reasons why many investment companies formed in Maryland was that Maryland law permitted redemption of shares of common stock. See Md. CODE ANN. CORPS. & ASS’NS § 2-105(a)(5) (1998). The Maryland legislature has also enacted many statutes specifically for investment companies, including unilateral redemption of small accounts, see id. at § 2-310.1, exemption from annual meetings, see id. at § 2-501(b), and power to make certain charter amendments without stockholder approval. see id. at § 2-605(a)(4). For further discussion, see Mark A. Sargent, Maryland’s Leadership in the Law of Business Organizations, Md. B.J. (Jan./Feb. 1997), at 15. 17-18. In addition, there are many generally applicable features of the MGCL that are attractive to investment companies, including the absence of any franchise tax.
C. Passage by the House

After a favorable report from a specially constituted work group, the House Economic Matters Committee voted on March 24, 1998, to give a favorable report to H.B. 356. Three days later, H.B. 356 was passed by the House of Delegates by a vote of 83-36. The three dozen votes against the Bill in the House indicated that there could be serious opposition to the Bill in the Senate of Maryland.

IV. DEVELOPMENTS IN THE MARYLAND SENATE
A. Opposition Arguments

In the Senate, the Bill was referred to the Committee on Judicial Proceedings. On April 3, 1998, the opponent sent a letter to the chairman of that committee that was filled with various incorrect and irrelevant statements. For example, the letter asserted that the proponents of the Bill were wrong when they claimed that Judge Sweet's decision "misstates Maryland law." To support its assertion, the letter then cited several cases establishing the demand requirement and the futility exception in derivative proceedings — issues that were totally beside the point of Judge Sweet's decision.

The letter also challenged the claim that compensation for service as a director does not taint a director's independence by citing several cases involving some form of compensation or some relationship other than directors' fees. In addition, the letter miscited an article in The New

36 Chairman Busch appointed a "work group," chaired by Delegate Michael A. Crumlin (Prince George's County), to review H.B. 356 and all other pending legislation relating to corporations and other forms of business entities.
37 The vote was 16 in favor, three opposed, with one abstention and one absent.
38 The Senate Committee on Judicial Proceedings was chaired by Senator Walter M. Baker (Cecil County), one of the most senior and respected members of the Senate.
York Law Journal, co-authored by Dennis J. Block, for the proposition, as stated in the letter, that directors "who receive substantial payments for these services" are not "independent." In fact, Mr. Block in the then-current edition of his celebrated treatise, The Business Judgment Rule: Fiduciary Duties of Corporate Directors, specifically states that demand is not excused merely because directors "receive compensation for service as directors . . . ."

Most egregiously, however, the letter claimed that H.B. 356 would "insulate the actions of a mutual fund's Board of Directors from any judicial scrutiny." There was no acknowledgment of the fundamental distinction that the Bill was not aimed at derivative suits but only at the narrow issue addressed by Judge Sweet — the disinterestedness of investment company directors who receive "substantial compensation" for serving on multiple boards of commonly advised investment companies.

B. HEARING

On April 6, 1998, a hearing regarding H.B. 356 was held before the Senate Judicial Proceedings Committee. Testimony offered in opposition to the Bill included several inflammatory and irrelevant comments. It referred to the "futility demand" cases in Maryland, apparently meaning

41 Letter from Ronald B. Rubin to The Honorable Walter M. Baker, supra note 39.
43 Letter from Ronald B. Rubin to The Honorable Walter M. Baker, supra note 39.
44 Although it is the tradition of the Committee not to invite witnesses other than the sponsor to testify on bills already passed by the House of Delegates, Senator Baker asked the author of this article and the opponent's representative to testify before his Committee on H.B. 356.
45 The author testified first, so he did not have an opportunity at the time to rebut the inaccurate statements made in opposition to the Bill. The author did submit a letter after the hearing responding to the erroneous points in that testimony. Letter from James J. Hanks to The Honorable Walter M. Baker, Chairman, Committee on Judicial Proceedings (April 8, 1998) (on file with the Villanova Journal of Law and Investment Management). The discussion of the testimony in...
cases establishing the futility exception to the demand requirement in derivative suits, none of which were affected by H.B. 356. It also repeatedly referred to "stacking of fees" and "stacking of directorships," despite the fact that Judge Sweet's point in the Strougo case was not the number of directorships but the amount of compensation involved. More to the point, the testimony in opposition not only ignored cases holding that the compensation paid to directors does not affect their independence but also noticeably failed to cite a single case holding that the amount of compensation paid to directors does taint their independence.\footnote{For a discussion of cases holding that the compensation paid to directors does not affect their independence, see supra note 21.}

The testimony also stated that "Maryland law requires two disinterested directors" to approve dismissal of a derivative suit. There is no such law. Perhaps the testimony was referring to Judge Sweet's reference to the two-director requirement for members of committees of the board of directors of Maryland corporations. As noted above, after the events giving rise to the Strougo case, the General Assembly, following Delaware and many other states, amended the MGCL to decrease the minimum number of directors for board committees from two to one.\footnote{See supra note 9.}

C. UNFAVORABLE REPORT, AMENDMENT, ENACTMENT

The Judicial Proceedings Committee on April 9, 1998, gave an unfavorable report to H.B. 356 by a vote of eight to three. The fact that two other corporate law bills heard the same day were also given unfavorable reports suggests that the unfavorable report of H.B. 356 was based on the end-of-the-session crush of bills or other considerations not relating to the merits of the bills.

The proponents of H.B. 356 were discouraged but not deterred by the unfavorable report in the Senate Judicial opposition to the Bill is based on the letter from the author to Chairman Baker, rather than a copy of the testimony.
Proceedings Committee. During the last few days of the 1998 session, the substance of H.B. 356 was amended onto another bill, S.B. 468 (which had already passed the Senate), on the floor of the House of Delegates with the help of members of the House Economic Matters Committee. Debate on the House floor was particularly lively but after a delegate stood up and announced that Maryland investment companies would consider reincorporating in other states if S.B. 468 failed, S.B. 468 passed the House by a vote of 113 to 10, giving the amended S.B. 468 thirty more favorable votes than H.B. 356 on final passage in the House. After passing the House, the bill was sent back to the Senate, which concurred with the House amendment to the bill by a vote of 27 to 19 on April 12, the final day of the 1998 legislative session.

Senate Bill 468 was signed by Governor Parris N. Glendening on May 12, 1998, as Chapter 397 of the Laws of Maryland (1998), and became effective on October 1, 1998. On November 3, 1998 most of the Maryland State Senators and Delegates responsible for straightening out Strougo were reelected. The sponsor of H.B. 356 was not, however, on the ballot. He had lost in the Democratic primary election in September.

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48 Strong support for the Bill was provided by George Roche and Henry Hopkins of T. Rowe Price and Associates, Inc.; Bryson Popham and John Stierhoff, representing the Maryland Securities Association; and Paul Tiburzi of Piper & Marbury, aiding the author's efforts in representing the MSBA.

49 Chairman Busch and Delegate Crumlin were particularly helpful.

50 Delegate Crumlin.

51 Senator Thomas V. Mike Miller, Jr. (Prince George's County), President of the Senate, and Chairman Baker aided in passage of the amended Senate bill.

52 In the quadrennial elections for the General Assembly in November, 1998, Senate President Miller, Senator Baker, Delegate Busch and Delegate Gordon were easily re-elected. Delegate Crumlin did not run for re-election. Delegate Frank, the sponsor and tireless worker for H.B. 356, was defeated in the Democratic primary election in September, 1998, by 96 votes.
While the legislative wheels were beginning to turn in Maryland, on January 7, 1998, defendants in the original Strougo suit filed a motion to dismiss based on the recommendation of the two-director special litigation committee.

On May 27, 1998, the same day that the House of Delegates gave final approval to H.B. 356, the Court of Special Appeals of Maryland decided Wittman v. Crooke. The court held that the possibility of serving on the board of directors of an acquiring corporation does not violate the duties of the directors of the target corporation in approving a merger with the acquiring corporation. Wittman arose out of the proposed merger between Baltimore Gas & Electric Company (BG&E) and Potomac Electric Power Company. The plaintiff, a shareholder in BG&E, alleged that the BG&E directors were prohibited from recommending the merger because each director might be elected to the board of the successor. The court held that the possibility that one or more members of the board of directors of an acquired corporation might be elected as directors of the acquiring corporation is not "sufficient to cause the kind of conflict of interest that cannot be ratified by the shareholders." Likewise, the adoption of employment contracts for the directors and the CEO did not create a non-ratifiable conflict. This ruling of the Court of Special Appeals strongly reinforced the position taken by the proponents of H.B. 356.

54 See id. at 425 ("We reject appellant's argument that the opportunity for a position on the board of directors of the new corporation is sufficient to cause the kind of conflict of interest that cannot be ratified by the shareholders.").
55 Id. at 423.
56 Id. at 425.
57 Id.
58 See id. Unfortunately, the court repeated the mistake of earlier decisions in holding that section 2-419, the interested director statute of the MGCL, could be "violated." The court also erroneously analyzed the BG&E directors' duties under the business judgment rule, which has largely been superseded by section 2-405.1 of the MGCL. See James J. Hanks, Jr., Maryland Corporation Law § 6.8 (Aspen Law and Business Supp. 1998).
On April 6, 1998, the same day as the hearing before the Senate Committee, Judge Sweet denied the defendants' motion to dismiss the original Strougo complaint against the Brazil Fund. The judge ruled that, although the issue had not been decided by a Maryland court, Maryland would apply the standard established by the Supreme Court of Delaware in Zapata v. Maldonado and (a) impose on the corporation the burden of proving that the board committee recommending dismissal of a derivative action was independent, acted in good faith and had a reasonable basis for its recommendation and (b) permit the court to apply its own business judgment to the committee's recommendation. Although Judge Sweet noted that the Brazil Fund "has met its prima facie burden of proof with respect to the Zapata standard," he permitted further discovery by the plaintiff, including inspection of the 30 boxes of documents made available to the special litigation committee, inspection of the notes of interviews by the committee and drafts of the committee's report and deposition of the members of the committee — just the sort of fishing expedition that the universal demand rule is designed to avoid.

On that same day, Judge Sweet also denied a motion to dismiss the derivative action claims in the suit against the Brazil Equity Fund on the ground that Strougo had established futility of demand because of the receipt of fees (less in aggregate amount than in Strougo's first action) by directors from multiple commonly advised funds.

In late November, 1998, Judge Sweet dismissed the remaining claims brought by Strougo and his suit against the Brazil Fund. The dismissal was based on the determination by the special litigation committee that continuation of the action was not in the best interests of

59 Strougo v. Padegs, 1 F. Supp. 2d 276, 282 (S.D. N.Y. 1998) (stating that motion to dismiss is denied and additional discovery is permitted).
60 430 A.2d 779 (Del. 1981).
62 Id. at 282.
the Fund or its shareholders. Judge Sweet determined that both members of the committee were independent and rejected the argument that bias due to the independent directors’ relationship to the other directors tainted the committee’s independence. The court then found that the committee had reached its conclusions in good faith, independently and with a reasonable basis, thus satisfying the first requirement of the Zapata standard of review. Applying the second requirement of the Zapata standard — application by the court of its own business judgment — the court found that Strougo’s claim that the directors and the Fund’s investment manager had breached their duties was unlikely to succeed, that there was no proof of damages to the Fund from the rights offering and that Strougo’s claims did not merit further consideration.

VI. EPILOGUE

On December 4, 1998, Massachusetts Governor Paul Celluci signed Senate Bill 2079, the Massachusetts Prudent Investor Act, providing, among other things, that a trustee of a trust registered under the Investment Company Act as an investment company with the SEC who “is not an interested person, as defined in said Investment Company Act of 1940, shall be deemed to be independent and disinterested when making any determination or taking any action as a trustee.”65 The Massachusetts legislation adopted almost the exact words of H.B. 356.

Finally, by the Fall of 1998, at least five suits had been brought against various funds and advisers challenging the independence of directors serving on multiple boards of commonly advised mutual funds under the Investment Company Act itself, rather than under state law.66

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66 Carol Carangelo, Common Boards Targeted at Prudential and Fidelity, FUND DIREcTIONS (Oct. 1998). One of the two co-counsel in all five suits was the sole opponent to H.B. 356.