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James J. Hanks, Jr. and seven other attorneys join Venable's Maryland corporate law practice.

Venable is pleased to announce the addition of eight new Maryland corporate law attorneys, including partners James J. Hanks, Jr. and Sharon A. Kroupa, who have made the switch from Ballard Spahr Andrews & Ingersoll, LLP. Both Mr. Hanks and Ms. Kroupa, along with of counsel William A. Agee and Teresa B. Carnell, and associates Michael A. Leber, Patricia McGowan, Christopher W. Pate and Michael D. Schiffer, will represent local and international clients, including REITs, in connection with mergers and acquisitions, securities work, dispositions, financings, corporate transactions, investment management and corporate governance.

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Venable Maryland Corporate Law Report

for corporations, real estate investment trusts and investment companies

Lerner - Court of Special Appeals rules that the standard in Maryland for evaluating reverse stock splits which eliminate a minority stockholder's interest should be the Fairness Test

The Court of Special Appeals of Maryland, in *Lerner v. Lerner Corp.*, 132 Md. App. 32, 750 A.2d 709 (2000), was faced with the issue of whether or not a reverse stock split which had the effect of eliminating a minority stockholder's interest was allowable under Maryland law. In 1998, Lerner Corporation (the Corporation) proposed an amendment to the Corporation's charter which had the effect of converting each common share in the Corporation into 1/68th of a share. The result of the amendment would be that a minority stockholder, Lawrence Lerner (Lawrence), would see his interest reduced to less than one share. The Corporation provided that Lawrence would be paid cash for his interest, thus eliminating him as a stockholder. Lawrence brought suit against the Corporation, asking the court for an injunction to prevent the reverse stock split or, in the alternative, for a rescission. The Corporation, however, felt that an appraisal was the appropriate remedy for Lawrence.

The court held that the issuance of fractional shares was permissible under Maryland law, as Maryland Code, Corporations and Associations Article, section 2-214 specifically allowed fractional shares and detailed how a corporation was supposed to administer those shares. Furthermore, sections 2-214(a)(2) & (4) provided that a corporation was authorized to "eliminate a fractional interest by rounding off to a full share of stock," or to "pay cash for the fair value of a fractional share of stock determined as of the time when the person entitled to receive it is determined." Thus, Maryland law specifically allows a corporation to eliminate fractional shares. The court added, citing an earlier decision involving the two parties in this case, that Maryland law permitted a corporation to eliminate fractional shares "for the purpose of eliminating minority stockholders." (*See Lerner v. Lerner*, 306 Md. 771, 511 A.2d 501 (1986)). However, because of the fiduciary duty owed by a majority stockholder to a minority stockholder in a close corporation, the court realized that it may interfere in such a transaction if issues of

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Michael W. Conron, Esq., *Editor*
mwconron@venable.com
(410) 244-7424

Teresa B. Carnell, Esq., *Editor*
tcarnell@venable.com
(410) 244-7526

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fairness or business purpose justified intervention. The main issue, then, before the *Lerner* court was what should the standard be in Maryland for evaluating a reverse stock split which eliminated a minority stockholder's interest.

The court evaluated three different standards that different jurisdictions use with regards to this issue. Some jurisdictions use a business purpose rule for evaluating these transactions. This standard places a burden on the majority stockholder to demonstrate a legitimate business purpose for the corporation's actions and, if this is shown, it is then up to the minority stockholders to show that the same legitimate objective could have been achieved by an alternative method. The court also studied a "reasonable expectations" approach to evaluating corporate actions. Under this approach, the court determines, on a case-by-case basis, the express or implied reasonable expectations that a stockholder has and makes sure that those are protected throughout the corporation's actions.

The standard that the Court of Special Appeals found to be the correct one, however, was the fairness test which Delaware courts have implemented. The court felt that in the instance of a reverse stock split in a closely held corporation, which eliminated a minority stockholder, the fairness rule was appropriate because it "permits intervention on the facts of any given case when intervention is justified," providing "courts with greater ability to fashion appropriate relief." The court also felt that in most cases it would not be difficult to find a plausible business purpose, so that the fairness test would offer minority stockholders more protections from majority stockholder breaches of fiduciary duty. The existence of a business purpose is not necessarily connected to the entire fairness of a transaction, especially when the majority stockholders are using their power to eliminate or change the ownership of the minority stockholders. Under the fairness rule, appraisal of interest would still be the available remedy for a minority stockholder bringing suit, unless he or she were able to prove "acts or omissions resulting in unfairness to the minority." A remedy such as an injunction or rescission would only be available to a minority stockholder who specifically plead "fraud, misrepresentation or other misconduct in the implementation of the transaction," or "reasons why the transaction is unfair to the minority." Once the minority stockholder made this pleading it would be up to the majority stockholders to show that the transaction was fair to the minority. The court felt that "so long as the process by which the transaction was accomplished and the consideration received by the minority stockholders are fair, the majority stockholder has the right to use its power to cause the corporation to engage in any legally permissible transaction." Applying the fairness test to the reverse stock split in *Lerner*, the court felt that the standard had been met because there were more reasons for the reverse stock split than just the desire to eliminate a minority stockholder.

About Venable

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.

Our 400-plus attorneys comprise a team of skilled, experienced professionals. Our clients rely on our great breadth of experience and sound legal judgment for assistance in achieving solid and practical business solutions. We represent businesses of all sizes - from emerging companies to large national and international companies in industries that include financial, manufacturing, hospitality, health care, transportation, mass media, and information technology, as well as governmental entities, nonprofits and individuals.

Werbowsky – Court of Appeals sets futility exception standard for stockholder derivative suits

In *Werbowsky v. Collomb*, 362 Md. 581, 766 A.2d 123 (2001), the Court of Appeals of Maryland was faced with the issue of whether a minority stockholder's derivative suit was barred because the stockholder did not make a demand on the corporation's directors. The derivative suit was based on a transaction between two corporations, Lafarge and LSA, where LSA was the majority stockholder of Lafarge. The minority stockholders brought suit because they alleged that Lafarge had overpaid for assets that LSA had recommended Lafarge purchase from it. They felt that any pre-suit demand on the directors to bring suit would have been futile because a majority of the directors had a conflict of interest through their personal business ties with each corporation and the personal financial benefit they would receive from the transaction. The Circuit Court, in granting summary judgment for the directors, held that demand was required for a derivative suit unless demand could be shown to be futile, but that there was no such showing by the minority stockholders because they could not show that a majority of the Lafarge board lacked independence.

The Court of Appeals began its analysis of the case with a detailed history of the futility exception to the demand requirement. In Maryland, the futility excuse had stood more or less the same since its common law beginnings. Futility was a valid excuse from making a demand if the plaintiff could show that a demand would be useless because of fraud, self-dealing, or the director's adverse interest. However, the court explained that Maryland had not done much to expand or develop this futility exception over the years, while the American Bar Association (ABA), American Law Institute (ALI), and Delaware courts in recent years had clarified the exception. The court looked to these new interpretations to determine how Maryland should apply the exception now. The Delaware standard is a two-prong test that allows a trial court to decide if a demand would have been futile. A demand is excused if the court finds a reasonable doubt that "the directors are disinterested and independent" and that "the challenged transaction was otherwise the product of a valid exercise of business judgment." In applying this standard, Delaware courts have held that it is not enough to show that a director was nominated by others controlling the corporate decision-making or that a director merely approved of a transaction. Rather, a plaintiff needs to show "particularized facts" that a director lacked independent judgment in making decisions for the corporation.

The ABA and ALI, however, felt that Delaware's reasonable doubt standard allowed for too much judicial discretion in deciding when demand would be excused. The two bodies created "universal" demand

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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.

United Dominion Realty Is Latest REIT to Reincorporate in Maryland

United Dominion Realty is a Richmond-based REIT that was incorporated in Virginia about 30 years ago. In May, shareholders approved a proposal to reincorporate in Maryland. According to a company press release, "[T]here are 176 public REITs with a total equity market capitalization of approximately $121 billion. . . . As of today, seven of the top ten apartment REITs and 109 of 176 publicly traded REITs are incorporated in Maryland . . . The press release indicates that Maryland has attracted a clear majority of public REITs due to its body of legislative and case law developed specifically for REITs. Further, Institutional Shareholder Services, Inc., widely recognized as the leading independent proxy advisory firm in the nation, recommended that United Dominion's shareholders vote in favor of the reincorporation.

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requirements, with the exception that demand would be excused if irreparable injury to the corporation would occur by making a demand before filing suit. The demand requirement would cut down on the costly process of litigating the demand question, while also possibly avoiding litigation by giving directors a chance to review their decision and possibly cure the alleged problems.

The *Werbowsky* court felt that the Maryland standard for demand futility should be different from both the ABA/ALI and the Delaware approaches. The court saw that the ABA and ALI were right in that a demand can be a beneficial and non-onerous thing in most cases, but that to adopt a strict demand requirement would be contrary to Maryland's common law principles that allow a futility exception. Such a change should be a job for the legislature rather than the courts. Additionally, the court felt that the Delaware approach should not be adopted in full because few states have rejected their existing law in favor of the Delaware approach in light of the criticism it receives, particularly for the judicial discretion it allows.

The standard the *Werbowsky* court ended up using is a very limited futility exception. A demand will be regarded as futile only when clear evidence demonstrates "in a very particular manner" one of two situations. One of these is that "a demand, or a delay in awaiting a response to a demand, would cause irreparable harm to the corporation." The other is that "a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule." The court felt that such an analysis would go to the main issue at hand, the futility of a pre-suit demand, rather than addressing whether or not there was self-dealing or a lack of business judgment in the actual transaction under fire.

Applying this standard, the court held that a demand on the Lafarge board would not have been futile. While the stockholders had accusations and speculation of interested directors, the court found that there was no clear evidence that the directors' employment with Lafarge or dealings between Lafarge and other companies would have interfered with the directors' ability to independently make decisions for Lafarge.

News From Annapolis

This year, the General Assembly of Maryland enacted three bills that further improve the Maryland General Corporation Law (the "MGCL"). House Bill 471 and House Bill 473 were sponsored by Delegate Ann Marie Dorry of Baltimore City. House Bill 549 was sponsored by Delegate Brian Feldman of Montgomery County. Senate Bill 495 was sponsored by Senator Rob Garagiola of Montgomery County. Each legislator worked with the Maryland State Bar Association Committee on Corporate Laws, currently chaired by Tea Carnell and formerly chaired by Jim Hanks and Beth Hughes. All bills were unopposed in the General Assembly. Governor Ehrlich has signed the bills, all of which have an effective date of June 1, 2003. (All Section references below are to the MGCL.)

House Bill 471

Power to Authorize Distributions

New Section 2-309(c) allows a board of directors that has given a general authorization for a distribution to delegate to a committee of the board or to an officer of the corporation the power to fix the amount and other terms of dividends and other distributions. The board would be required to provide for or establish a method or procedure for determining the maximum amount of the distribution. *This provision may be especially helpful to real estate investment trusts and investment companies that need to pay dividends at certain levels in order to maintain a preferred tax status. It may also be helpful to operating companies that are subject to dividend limitation covenants in credit agreements.*

Short-Form Mergers

Section 3-106 currently permits the parent of a 90-to-100%-owned subsidiary to approve an upstream (sub into parent) or downstream (parent into sub) merger without stockholder approval. Section 3-106 also requires the parent to give notice of the proposed merger to any minority stockholders. The amendment to Section 3-106(d) of the MGCL clarifies that this notice may be given by an entity that **proposes to acquire** 90% or more of the stock of a Maryland corporation **before** it actually reaches the 90% ownership level. *This change should be helpful in facilitating a speedy second-step clean-up merger following a tender offer.*

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Appraisal Rights

Under existing Section 3-202, stockholders who are not entitled to vote on a merger or other action are not entitled to appraisal rights on the matter. The amendment to Section 3-202 clarifies that minority stockholders in a short-form parent-subsidiary merger under Section 3-106 of the MGCL are not denied appraisal rights just because they were not entitled to vote on the merger.

Cure for Failure to File Articles Supplementary

Under current law, before newly classified stock is authorized for issuance, articles supplementary must be filed for record with the State Department of Assessments and Taxation of Maryland (the "SDAT"). Unfortunately, some companies inadvertently issue stock without first filing the articles supplementary, which calls into question whether the stockholders have received validly issued stock and whether the stock is voidable by the stockholders or void.

New Sections 2-208(e) and 2-208.1(e) clarify that a corporation may cure the failure to file articles supplementary. Up until the time that the articles supplementary are filed, the issuance of the shares would be voidable by the stockholders. After the articles supplementary are filed, the issuance would be considered valid (not void or voidable). Any right or liability that has accrued by reason of the issuance of stock prior to the time the articles supplementary with respect to the stock are effective is extinguished upon the filing of the articles supplementary, except to the extent that someone has acted detrimentally in reliance on the right or liability solely by reason of the stock issuance.

House Bill 473

Series Funds – Status of Assets and Liabilities

New Section 2-208.2 clarifies the status of assets and liabilities with respect to a series fund registered under the Investment Company Act of 1940 (the "1940 Act"). In general, new Section 2-208.2 provides that if the charter of a corporation registered as an investment company creates one or more classes or series of stock and separate and distinct records are maintained for those classes or series and the assets associated with that class or series are accounted for separately from the other assets of the corporation, then (1) the debts, liabilities, obligations and expenses existing with respect to a particular class or series are enforceable **only against the assets of that class or series** and not against the assets of the corporation generally and (2) none of the debts, liabilities, obligations and expenses otherwise existing with respect to the corporation generally or associated with any other class or series are enforceable against the assets associated with that class or series. *This provision should be helpful to multi-series investment companies in reassuring stockholders that assets of their series will not be exposed to claims against another series.*

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Transfer of Assets by Open-End Investment Companies

Section 3-105(a) currently provides that a corporation must obtain the approval of its stockholders prior to the transfer of all or substantially all of the corporation's assets. There are currently several exceptions to this rule in Section 3-104. The amendments provide an additional exception for the transfer of all or substantially all of the assets by a Maryland corporation registered as an open-end investment company under the 1940 Act. *This change will be particularly useful for open-end funds that seek to liquidate and are required to sell underlying assets to pay for the redemption of their shares.*

Senate Bill 495 / House Bill 549

Electronic Meetings, Notices and Consents

Several amendments to the MGCL enable Maryland corporations to take advantage of recent advances in communications technology for board and stockholders meetings and consents. Among other things, the MGCL will allow directors and stockholders to hold electronic meetings and consent to action via e-mail and other electronic transmissions. In addition, the corporation may give notice of stockholders and board meetings electronically and stockholders and directors may deliver notices electronically.

Did you know that according to a recent survey, Maryland is now second in the number of New York Stock Exchange listed companies?

Householding

The SEC's proxy rules permit "householding" of certain documents such as proxy statements and information statements sent to stockholders. Senate Bill 495 clarifies the procedures necessary to permit "householding" of notices to stockholders. Stockholders who want to continue to receive separate notices may opt out of the householding provisions.

* * * *

We are pleased that the Maryland legislature has once again enacted responsible legislation benefiting corporations formed under Maryland law and their stockholders. Many of these provisions will also apply to real estate investment trusts formed as trusts under Maryland law either by cross-reference to the MGCL or by analogy.

Venable Maryland CorporateLaw Practice Group

William A. Agee, Esq.
wagee@venable.com
(410)244-7520

Teresa B. Carnell, Esq.
tcarnell@venable.com
(410)244-7526

Michael W. Conron, Esq.
mwconron@venable.com
(410) 244-7424

Thomas W.W. Haines, Esq.
twhaines@venable.com
(410) 244-7743

James J. Hanks, Jr., Esq.
jhanks@venable.com
(410) 244-7500

Elizabeth R. Hughes, Esq.
erhughes@venable.com
(410) 244-7608

Sharon A. Kroupa, Esq.
skroupa@venable.com
(410) 244-7509

Lee M. Miller, Esq.
lmmiller@venable.com
(410) 244-7680

Ariel Vannier, Esq.
avannier@venable.com
(410) 244-7567

Melissa A. Warren, Esq.
mawarren@venable.com
(410) 244-7695

Thomas D. Washburne, Jr., Esq.
tdwashburne@venable.com
(410) 244-7744

Alan D. Yarbro, Esq.
adyarbro@venable.com
(410) 244-7622

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.