VENABLE® LLP

750 E. PRATT STREET SUITE 900 BALTIMORE, MD 21202
T 410.244.7400 F 410.244.7742 www.Venable.com

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Maryland Trial Court Upholds Board Actions in Sale of Maryland Corporate REIT Against Multiple Attacks

In an important case decided just last month, Judge Ronald Rubin of the Circuit Court for Montgomery County upheld the actions of the boards of directors of both the seller and the buyer in several important respects. In *Frederick v. Corcoran*, No. 370685-V, 2013 MDBT 5 (Md. Cir. Ct. Aug. 14, 2013), CreXus Investment Corporation, a Maryland REIT, learned that Annaly Capital Management, Inc., which owned 12.4% of the shares of CreXus and 100% of the shares of CreXus's investment manager, was interested in purchasing CreXus's remaining outstanding shares. The CreXus Board appointed a Special Committee composed of the three independent directors. The Special Committee retained independent legal and financial advisors and negotiated an agreement with Annaly providing for an all-cash, friendly tender offer followed by a squeeze-out merger at a price per share representing a 17% premium over the pre-announcement share price. CreXus's share price had not exceeded the agreement price in the previous twelve months.

The agreement also provided for a fairness opinion from the financial adviser, a 45-day go-shop period, a majority-of-the-minority stockholder vote as a condition to closing and a maximum termination fee of 2.5% of the transaction value (unclear whether equity or enterprise) that was fully creditable to the fee payable by CreXus on termination of the management agreement. That is, the manager (an Annaly subsidiary) would get its fee for termination of the management agreement but reduced by the deal termination fee, if triggered.

During the go-shop period, 47 potential bidders were contacted and no superior bids were received. Holders of over 82% of public shares (not including Annaly) voted for the transaction, which closed on May 23, 2013. After announcement of the transaction, plaintiffs' law firms issued a joint press release stating that they were conducting an "investigation" into whether the CreXus stockholders would receive adequate compensation for their stock, whether the transaction undervalued CreXus and whether CreXus's Board was attempting to obtain the highest stock price for all stockholders.

Plaintiff stockholders filed suit before the merger agreement was signed. After a procedural ruling, plaintiffs abandoned any attempt to enjoin the tender offer and squeeze-out merger but continued to pursue claims for breaches of duties. Plaintiffs alleged that (1) the Special Committee was not independent, (2) the Committee's process in deciding to sell CreXus was inadequate and did not sufficiently maximize stockholder value, (3) the price was inadequate, (4) the deal protection measures were unreasonable and (5) the disclosure in the Schedule 14D-9 was inadequate. Defendants filed a motion to dismiss.

In a careful and comprehensive opinion, Judge Rubin rejected all of plaintiffs' claims.

1. *Independence of the Special Committee.* The Judge first noted that the Special Committee had authority to "just say no" and was authorized to explore any other potential transaction. This reinforces that a broad mandate is an important factor in considering the independence of a special transaction committee. Citing language from several Delaware cases, Judge Rubin held that the standard of independence for a director in the context of a merger was whether the director in question had "material ties to the proponent of the transaction sufficiently substantial that she simply cannot fulfill her fiduciary duties."

With respect to whether compensation payments for board service affect a director's independence, the Court framed the question as whether it can be inferred that "the payments at issue are material to the particular director in question." Judge Rubin then answered that board fees alone do not make a director interested, particularly where there is no allegation of materiality.

Holding that the allegations regarding dominion and control by Annaly were either conclusory or too general to form the basis for a challenge to the independence of the Special Committee members, the Court said that plaintiffs "insufficiently alleged that the Special Committee was either conflicted or controlled by Annaly, or interested in the transaction, or that their independence reasonably may be called into question." Further, he said that plaintiffs' theory was that "because CreXus was externally managed by an affiliate of Annaly there [was] virtually no transaction structure that would be appropriate whereby Annaly could acquire CreXus, absent a pre-market check or an auction."

Indeed, Maryland law does not prohibit externally-managed REITs and no Maryland appellate case has required an auction or pre-agreement market check in the sale of a company. In addition, some Maryland trial courts have expressly rejected these as requirements. An auction or pre-agreement market check is not a prerequisite to the independence of a special transaction committee.

2. *Inadequate Price and Process*. Judge Rubin next noted that in the *Shenker* case in 2009, the Court of Appeals of Maryland, our highest state court, held that "in a cash-out merger transaction where the decision to sell the corporation has already been made, shareholders may pursue direct claims against directors for breach of their fiduciary duties of candor and maximization of shareholder value." Thus, Judge Rubin held that "when a board of directors decides to sell a company for cash, it must obtain the best value reasonably attainable for the company's stockholders." Further, he declared that any favoritism toward a particular bidder must be justified solely by the objective of maximizing stockholder value and, quoting from *Toys "R" Us* (Del. Ch. 2005), that the court's task is "to examine whether the directors have undertaken reasonable efforts to fulfill their obligations to secure the best available price [and the best available terms], and not to determine whether the directors have performed flawlessly." Judge Rubin speculated that it was "doubtful" that the Court of Appeals would "invariably require" an auction, bidding contest or market check before a target could enter into a merger

agreement.

As for deal protection measures, the Court said that they must be balanced against the possible chilling effect on other bidders. The Judge rejected plaintiffs' argument that the mere execution of a merger agreement without a pre-agreement market check would scare off bidders or result in a failure to maximize stockholder value. Indeed, he observed, the argument is inconsistent with business realities – the Annaly-CreXus agreement established a floor, not a ceiling, and the floor was adequately tested by the post-agreement 45-day go-shop and the right to negotiate with any bidder making a superior proposal, which together were "reasonable and effective protectors of stockholder value under the circumstances." The absence of any other bidder simply means no one wanted to top the Annaly bid. Judge Rubin also held that the matching right was not unreasonable in the circumstances.

As for termination fees, after noting that they are regularly used and are ordinarily reasonable if not above 3% transaction value (although it is not clear whether he meant equity or enterprise value), the Court held that the $25 million termination fee was a reasonably small percentage of the over $720 million total transaction value, especially where, as here, the termination fee was fully creditable against the manager's fee for termination of its management agreement. Thus, there was no favoritism toward Annaly.

In short, the deal protection measures, either singly or together, were not shown to be unreasonable and did not result in a breach of duty by the directors.

3. *Inadequate Disclosure*. Plaintiffs argued that the Schedule 14D-9 disclosures were inadequate or misleading, especially regarding the manager's financial projections. Judge Rubin agreed that when directors of a Maryland corporation seek stockholder approval for a merger, they have a duty to provide all material facts relevant to making an informed decision and must not make materially misleading or partial disclosures that distort the history of actual events or skew material facts. "[F]ulfillment of the duty of candor is paramount when seeking stockholder action." The Court noted that the Schedule 14D-9 disclosed that projections were prepared by the manager at the request of the Special Committee and that plaintiffs had not questioned the validity or clarity of the financial adviser's analyses and gave no reason for the materiality of any information omitted from the Schedule 14D-9.

4. *Standard of Judicial Review*. The Court declined to address the applicability of Delaware's "entire fairness" standard of judicial review for certain controlling shareholder and interested party transactions, since the issue had not been briefed. (If the Court had reached the issue, it could have noted that Section 2-405.1(f) of the Maryland General Corporation Law specifically rejects any "higher duty or greater scrutiny" for an act of a director in connection with an acquisition of control.) However, Judge Rubin noted that Maryland's intermediate appellate court has specifically rejected a higher standard in a demand-refused stockholder derivative suit and the Court of Appeals has implicitly done so in a case involving stockholders challenging a merger.

Judge Rubin also observed that this is an evolving area of law, even in Delaware, citing, by way of example, *In re MFW S'holder Litig.* (Del. Ch. 2013), in which Chancellor Strine concluded that business judgment, not entire fairness, is the applicable standard when an interested party transaction is approved by both an independent special committee and a majority vote of unaffiliated stockholders.

5. *Annaly Breach of Fiduciary Duty*. The Court noted that 12.4% ownership of CreXus by Annaly is far below the amount needed to control CreXus and that no facts were alleged as to how the Annaly-affiliated directors had breached any duty to CreXus or its stockholders. (According to CreXus's Proxy Statement filed with the U.S. Securities and Exchange Commission on April 12, 2013, CreXus's next largest holder beneficially owned 7.1% of CreXus's shares.) Thus, he held that Annaly's offer to buy CreXus was not a breach of any duty owed by Annaly to the other CreXus stockholders.

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As always, please feel free to call either of us or any of our colleagues at any time for any questions concerning Maryland law.

Jim Hanks
Nick Collevecchio

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