

October 24, 2013

Maryland Trial Court Upholds Maryland's Narrow Futility Demand Exception and Special Committee's Approval of Acquisition of REIT's External Manager

In an opinion issued yesterday, Judge Althea Handy of the Maryland Business and Technology Case Management Program in the Circuit Court for Baltimore City dismissed, with prejudice, the Amended Complaint in a suit challenging the acquisition by Cole Real Estate Investments, Inc., a Maryland corporation (formerly known as Cole Credit Property Trust III, Inc.) ("CREI"), of its external manager, Cole Holdings Corporation, an Arizona corporation, for stock of CREI and \$20 million in cash. The transaction was reviewed and approved by a Special Committee of the Board of Directors of CREI, composed of the three independent directors. The Special Committee also reviewed and rejected two subsequent acquisition proposals by American Realty Capital Properties, Inc., a Maryland corporation ("ARCP"). (ARCP and CREI yesterday announced an acquisition by ARCP of CREI.)

The plaintiff stockholders filed a putative class action, alleging breach of fiduciary duties, aiding and abetting, unjust enrichment, waste and breach of the duty of candor and seeking an injunction of the stockholder vote on certain charter amendments and damages.

Plaintiffs argued that their allegations constituted direct claims for damages to the stockholders arising from (a) the issuance of the new shares in the transaction and (b) insufficient due diligence before rejecting ARCP's offers. Judge Handy disagreed, holding their claims were derivative in nature because there were no allegations of any separate harm to plaintiffs apart from any harm to CREI. The Court then held that plaintiffs were required to make demand on the Board, subject to Maryland's narrow futility exception, set forth in the decision of the Court of Appeals of Maryland (our highest state court) in *Werbowsky v. Collomb* in 2001. This narrow exception applies only where (a) demand or a delay in waiting for a response to a demand would cause "irreparable harm to the corporation" or (b) a majority of the board is "so personally conflicted and committed to" the transaction "that they could not be expected to respond to a demand in good faith and within the ambit of the business judgment rule." To succeed in the conflict exception, according to the Court of Appeals, plaintiffs must identify "clearly" and in "a very particular manner" the disqualifying conflicts of a majority of the board.

Judge Handy recognized the sufficiency of plaintiffs' allegations that the two management directors "were personally and directly conflicted in terms of the Merger" and that a demand made on them "would have been futile." However, with respect to the three members of the Special Committee, the Court held that allegations that they would continue to serve as directors and "earn hundreds of thousands of dollars in [director] fees" were "insufficient" to invoke the futility exception under the *Werbowsky* case. Indeed, the Court of Appeals in *Werbowsky* specifically rejected continued service and compensation as a director as a ground

for demand futility. Judge Handy noted that plaintiffs alleged no other conflict as to the three Committee members and thus demand was required.

Having rejected plaintiffs' arguments for the futility exception, Judge Handy nevertheless went on "to address Defendants' alleged breaches of their fiduciary duties in light of the business judgment rule." Starting from the three-part statutory standard of conduct for directors in Section 2-405.1(a) of the Maryland General Corporation Law (which expressly applies to actions of members of a board committee) and quoting from the Supreme Court of Delaware in *Barkan v. Amsted Indus., Inc.*, that "there is no single blueprint that a board must follow to fulfill its duties," the Court noted that plaintiffs had failed to plead the "particularized facts" necessary to overcome the presumption in favor of the actions of the members of the Special Committee.

Judge Handy dismissed the Amended Complaint with prejudice because she had already allowed plaintiffs to amend once and the problems she identified, especially on the demand futility issue, should have been corrected, if plaintiffs had any facts to address those issues, in the Amended Complaint.

Although the Court held that "dismissal of Plaintiffs' entire Consolidated Complaint [was] proper" for the reasons stated above, she specifically included in her dismissal a rejection of plaintiffs' "duty of candor" claim because the duty of candor has been "rigidly" limited by the Court of Appeals to "cash-out mergers" and also because plaintiffs had failed to plead direct claims against defendants for the reasons stated above.

Judge Handy's decision is another recognition by the judges of the Maryland Business and Technology Case Management Program that the actions of directors, particularly independent directors, of Maryland corporations will continue to receive broad judicial deference.

* * * *

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

Jim Hanks
Sharon Kroupa
Chris Pate

This memorandum is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations for which Venable LLP has accepted an engagement as counsel.