HUNTON& WILLIAMS

Client Alert

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Shareholder Litigation at Externally Managed REIT Allowed to Proceed

A Delaware court recently denied a motion to dismiss a shareholder derivative suit brought against a REIT. The shareholder sued alleging that the board of directors breached its fiduciary duties in (1) renewing the REIT's management agreement with its external manager each year and (2) approving a transaction in which the REIT internalized its manager. The court held that the plaintiff had created a reasonable doubt as to whether the board of directors was adequately informed in making these decisions.

Background

H&N Management Group, Inc. & Aff Cos Frozen Money Purchase Plan v. Crouch involved a mortgage REIT (the "REIT") managed by an external advisor (the "Manager").[1] The initial term of the management agreement between the REIT and the Manager had expired, but it was renewed on an annual basis. The Manager also managed another mortgage REIT (the "Other REIT"). The boards of directors of the REIT and the Other REIT were identical during the relevant time periods.

After several years of renewing the management agreement annually, the REIT internalized its management function by acquiring the Manager. Leading up to the internalization, the boards of directors of the REIT and the Other REIT formed a joint subcommittee to act on behalf of both entities. According to the plaintiff, the joint committee allowed an executive who was an officer of the Manager and the Chief Executive Officer of the REIT and the Other REIT to lead the negotiations with the Manager and its private equity owner about the internalization.[2]

The Court's Opinion Denying the Motion to Dismiss

Challenge to the Renewals of the Management Agreement

The Compensation Committee was charged with considering whether to approve the management agreement each year. Plaintiff alleged that the Compensation Committee was uninformed because, for example, it met for "15 minutes or less either concurrently with or after the board meeting." Plaintiff further claimed that the Compensation Committee never retained an independent advisor to help it evaluate the renewals "despite the fact that this was the [REIT's] biggest business decision ... every year." In addition, the plaintiff said that in some years the Compensation Committee relied on a 250-page slide deck prepared by the Manager that was not distributed in advance of the Compensation Committee's meetings. Finally, the plaintiff alleged that the REIT was subsidizing the Other REIT by paying a much larger management fee to the Manager. This was problematic, according to the plaintiff,

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[1] C.A. No. 12847-VCMR, ltr. op. (Del. Ch. Aug. 1, 2017).

[2] Specifically, the plaintiff said this person was the Chief Executive Officer, President, Chief Investment Officer, and a director of the REIT and the Other REIT, that he was President of the Manager, and that he had been an officer of the Manager's owner.

because the directors had conflicting fiduciary duties since they were also on the board of the Other REIT, and because the two entities competed.

The court summarized the plaintiff's challenges to "the board's biggest yearly decision" as follows:

> (1) the Compensation Committee met briefly as a formality during or after the board meeting; (2) the Compensation Committee did not retain advisors; (3) the Compensation Committee was conflicted because non-renewal would directly affect [the Other REIT], a company to which all the members also owed fiduciary duties; (4) the Compensation Committee received its only information (which it did not have time to review in the meeting) from the self-interested Manager; and (5) the Compensation Committee purportedly relied on the previous year's "review," even though a detailed review never occurred.

The court thus concluded that the plaintiff adequately alleged the board was uninformed in renewing the agreement.

Challenge to the Internalization

The court expressed its concern over the allegations that the joint committee of the two boards allowed a conflicted executive to lead the internalization process with minimal oversight. According to the complaint, the joint committee "was fully aware of [the executive's] conflict as a fiduciary of [the REIT], [the Other REIT], and the manager; yet the Joint Committee allowed him to dominate their process, dictate the transaction structure, and direct the ultimate deal terms." Moreover, the court said the joint committee knew of the executive's "strong desire" for an internalization and that their financial advisor's "analysis was prepared 'at the direction' " of the executive. The court found these allegations sufficient to create a reasonable doubt as to whether the directors were adequately informed.

Take-Aways

There are several take-aways from the *Crouch* decision. The first is on the importance of board process in approving significant decisions, such as renewing the management agreement and analyzing the internalization. The court focused on the amount of time and number of meetings at which the renewal decisions were considered; the alleged absence of outside advisors; whether materials were provided to directors in advance of meetings; and the role of interested parties in the board's process.

The second is the importance of well-crafted meeting minutes. Meeting minutes should be used to document the board's decision-making process. Minutes can illustrate the board's process by, for example, referencing the fact that the directors had previously considered a particular matter, noting the occurrence of break-out or executive sessions, and reciting whether meeting materials were distributed in advance of the meeting. In addition, noting the length of time in which a board or committee met is not always helpful. Here, the plaintiff claimed the committee made its decision in less than 15 minutes.

Third, *Crouch* is a reminder about managing conflicts of interest. In this case, there were two key conflicts targeted by the plaintiff. The first was the overlapping boards of the REIT and the Other REIT. The second was the role of the conflicted executive, who owed duties to three different entities and allegedly led the price negotiations and "directed" the financial advisor's analysis. Delaware courts expect independent directors to exercise active oversight in these situations.

It should be noted that *Crouch* was decided on a motion to dismiss. This means that the court had to accept the plaintiff's allegations as true and could not hear any evidence. In fact, the defendants argued that the plaintiff had engaged in a "tortured" reading of the minutes, but the court could not consider this defense at the current procedural stage of the litigation. The defendants may prevail at trial after disproving plaintiff's allegations.

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