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Delaware Suit Brings Lessons For Externally Managed REITs

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A Delaware court recently denied a motion to dismiss a shareholder derivative suit brought against an externally managed real estate investment trust. The shareholder alleged that the board of directors breached its fiduciary duties by (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. As a result, the derivative demand requirement was excused. Although the decision was rendered on the pleadings without considering any evidence proffered by the defendants, the decision offers several takeaways for externally managed REITs and other investment advisers.

Background

H&N Management Group Inc. & Aff Cos Frozen Money Purchase Plan v. Crouch, C.A. No. 12847-VCMR, ltr. op. (Del. Ch. Aug. 1, 2017), involved a mortgage REIT (the "REIT") managed by an external adviser (the "manager"). The initial term of the management agreement between the REIT and the manager had expired, but thereafter was up for renewal 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. In the process leading 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 internalization negotiations with the manager and its private equity owner.[1]

The Court's Opinion Denying the Motion to Dismiss

Challenge to the Renewals of the Management Agreement

The REIT's compensation committee was charged with determining whether to renew the management agreement each year. The 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." The plaintiff further claimed that the compensation committee never retained an independent adviser to help 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. Although the REIT was much larger than the Other REIT, the plaintiff argued that the fee structure was problematic because the REIT's 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.

Based on these allegations, the court concluded that the plaintiff had adequately alleged the board was uninformed in renewing the management 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 adviser'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.

Takeaways

There are several takeaways 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. In reviewing the complaint's allegations, the court focused on the amount of time and number of meetings at which the renewal decisions were considered, whether the board committee met separately, the alleged absence of outside advisers, whether materials were provided to directors in advance of meetings, and the role of interested parties in the board's process.

Second, Crouch is a reminder about managing conflicts of interest. In this case, the plaintiff honed in on two potential conflicts of interest. 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 adviser's analysis. There are many ways to manage conflicts of interest (e.g., forming committees, recusal, etc.), but Delaware courts expect independent directors to exercise active oversight in these situations. Executives also face an additional risk because, as officers, they are ineligible for exculpation.

The third takeaway is on the importance of well-crafted meeting minutes. Minutes should be used not just to document actions taken, but also to document the board's decision-making process. This can be done, for example, by referencing the fact that the directors had previously considered a particular matter, noting the occurrence of executive or breakout sessions, and reciting whether meeting materials were distributed in advance of the meeting. Delaware judges have also strongly encouraged "long-form" minutes that explain "why" a board made a particular decision.[2] In addition, noting the length of time in which a board or committee met or is scheduled to meet — whether in the minutes or the meeting agenda — is usually not helpful, especially for short meetings. Here, the plaintiff claimed the committee made its decisions in less than 15 minutes.

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 from the defendants. In fact, the defendants argued that the plaintiff had engaged in a "tortured" reading of the minutes. Thus, while Crouch is a noteworthy ruling, the plaintiff's allegations may not be proven at trial and the defendants may prevail.

[1] Specifically, the plaintiff said this person was the chief executive officer, president, chief investment officer, and a director of both the REIT and the Other REIT, that he was president of the manager, and that he had been an officer of the manager's parent company.

[2] See, e.g., Leo E. Strine, Jr., Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-making and Reduce the Litigation Target Zone, 70 Bus. Law. 679 (2015).

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