VENABLE® LLP

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

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.

VENABLE® LLP

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

April 9, 2014

Board Classification in Maryland: Evaluating Section 3-803 of the MGCL

Since 1999, Section 3-803 of the Maryland General Corporation Law (the "MGCL") has permitted the board of directors of a Maryland corporation or the board of trustees of a Maryland real estate investment trust with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors or trustees to elect to classify itself notwithstanding any contrary provision in the charter, declaration of trust or bylaws and without a stockholder vote. This statute, adopted by the Maryland legislature specifically to address the abuses of hostile takeovers, has recently received negative commentary from governance scorekeepers and activists. Green Street Advisors has urged boards to opt out of Section 3-803, REIT Zone Publications has issued several missives similarly attacking Section 3-803 and a union group, focused on the hotel industry, has sent stockholder proposals seeking an opt-out from this provision of Maryland law.

As is regrettably common with corporate governance scorekeepers and activists, they take an unbending one-size-fits-all position. On this issue, they declare with utter certainty that it is never appropriate for the board of any Maryland corporation or REIT to classify itself without stockholder approval under any circumstance now or in the future. Recently, they have asserted that, as is permitted by the MGCL, the boards of all Maryland companies should opt out of the provisions of Section 3-803 and condition any future opt-in on a stockholder vote. This approach ignores the fact that the directors, who are statutorily required to act in the best interests of the company, have the most information about the company and are, therefore, in the best position to evaluate the governance of the company.

Classified boards have been a common feature of corporate governance for nearly 100 years. At the most, they defer a change of control of the board for a year. We continue to believe that a classified board serves important and legitimate corporate governance objectives, including (a) providing a modest measure of continuity and stability in business strategies, operations and management; (b) enabling the board to focus on long-term value maximization strategies rather than short-term stock price movements; and (c) protecting the company from coercive takeovers by encouraging would-be acquirers to negotiate with the board, as the stockholders' elected representatives. In addition, a board's power under Section 3-803 to classify itself provides a valuable tool to promptly and effectively respond to a hostile attack that is not in the best interests of stockholders, which would likely not be possible if it were necessary to obtain stockholder approval in advance. Let's be clear: A classified board will not stop a fully-financed premium bid for a company, but it will prevent a sudden shift of the board into the hands of people seeking a low-ball sale of the company or other transaction not necessarily in the best interests of the company or all the stockholders.

Unlike the governance scorekeepers and activists, we do not take a hard and fast, arbitrary position with no exceptions or acknowledgement of differing situations. We recognize that a classified board and the board's power to classify itself may not be right for all companies at all times and under all circumstances. We also recognize that there are arguments in favor of a declassified board or opting out of Section 3-803, including that a declassified board enables stockholders to register their views annually on the performance of the entire board and each director and that declassifying or opting out of Section 3-803 would be popular with many institutional investors and corporate governance critics. We think these arguments should be weighed by a board together with the benefits of classification in various circumstances, and we are especially concerned about a board effectively renouncing for all future boards of the company the availability of a protection against hostile takeovers.

We have advised many boards on opting into Section 3-803 and on considering whether to retain the power to classify itself. In addition, we have recently received questions from clients and others on Section 3-803. In general, we recommend that a board:

- Receive legal, financial and other relevant advice (including empirical data) on the advantages and disadvantages, for the company, of a classified board and Section 3-803;

- Analyze the company's existing and desired governance profile, considering its overall takeover risk profile and available defenses;

- Evaluate options in between remaining subject to Section 3-803 and opting out of it entirely (*e.g.*, providing that any opt-in to Section 3-803 be submitted for stockholder approval within twelve months); and

- Discuss the board's position on these issues with and solicit the views of the company's major stockholders.

Electing to opt out of Section 3-803 is a significant and likely permanent loss to a company's defenses against hostile takeovers and we recommend that a board carefully evaluate the facts as they relate to the particular company.

* * * *

As always, please do not hesitate to call any of us if you have any questions or comments about any of the foregoing or any other matter of Maryland law.

Jim Hanks
Mike Schiffer
Brian Field
Gabe Steele
Sharon Kroupa
Chris Pate
Hirsh Ament
Dan Mendelsohn
Patsy McGowan
Carmen Fonda
Michael Sheehan
Gueter Aurelien
Michael Leber
Jeff Keehn
Nick Collevecchio

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.