REITS as Investment Companies: Advising the Independent Trustee of Real Estate Investment Trusts

by Richard S. Kraut

As a result of the 1960 amendments to the Internal Revenue Code,[1] REITs and their beneficial owners have enjoyed the same conduit tax treatment for income as mutual fund shareholders. This parity of tax treatment with mutual funds is probably logical considering the similarity of objectives and similarity of the forms of the two entities. They are treated differently, however, by federal regulatory agencies, which pay far more attention to investment companies than to REITs.

If REITs obtain the same or similar benefits and are structured in much the same way as investment companies, it is unclear that investors in REITs should not be entitled to the same protections provided investors in registered investment companies. REITs are now specifically excepted from the definition of "investment company" under the Investment Company Act.[2] It appears, though, that abuses that have come to light recently involving REITs[3] may, if not actually jeopardize the exception, at least qualify the REIT as a candidate for additional regulation for the protection of investors. Independent trustees of REITs can play a significant role in determining whether such regulation will eventuate. If the independent trustee properly performs his role he will also achieve the concomitant effect of avoiding personal liability, as well as affording protection to investors.

What, then, are the proper roles and responsibilities, as well as potential liabilities, of the independent trustee?

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RESPONSIBILITIES AND LIABILITIES OF INDEPENDENT DIRECTORS

All would agree that the roles and responsibilities of independent directors, to whom independent trustees have been likened, have changed enormously in recent years. While in years past directors were frequently chosen to decorate the boards of directors with impressive names and titles, to honor certain individuals and possibly to utilize their business contacts, independent directors now clearly have weighty affirmative responsibilities.

Illustrative of the Commission's attitude toward such past practices is a situation considered by the Commission in its early years in which the Commission administratively refused to permit amendments to a registration statement to become effective. The company involved[4] had an impressive board of directors, and a first prospectus prominently displayed photographs and biographies of the directors. They included a past Supreme Director of the Royal Order of the Moose, a contractor-builder who was described as having built a larger number of public and private buildings than any other contractor in the Washington, D.C. area, and a brigadier general and director of the United States Marine Corps, whose ". . . name is familiar to all students of American history" and whose "great grandfather . . . adopted and educated David Farragut who became the first Admiral of the American Navy . . ." Said the Commission: "The purpose of a display of this character is not difficult to penetrate . . . It gives the impression to innocent investors that this group of well known and presumably successful persons is giving its time and effort to building a highly worthy enterprise and that some safety to the investors springs from that fact. But the record illustrates that this was far from the truth. The use of these names in this manner is thus misleading." While the outside directors clearly only lent their names to the company, they nevertheless signed the registration statements. The Commission presumed that those signing were familiar with the nature and conduct of the business and also with the content of the registration statement and prospectus. However, generalizing from the testimony of one of such independent directors, the Commission concluded that the contrary was the case. Quoting from the record:

"Q. Are you familiar with the National Invested Savings Corporation?
A. Yes sir, to some extent.
Q. Are you associated with that company?
A. I was, and I suppose I still am.
Q. In what capacity were you associated?
A. I believe I was selected to be a director.
Q. Were you elected a director?
A. I suppose so, so far as I know.
Q. Did you ever serve?
A. No, sir.
Q. Did you ever attend any meetings?
A. No, sir."

While the only sanction imposed in this 1936 case was a stop order, today there is little doubt that such directors themselves would have been held liable for violations of the federal securities laws.

Negligence, Recklessness, and Intent

Leaving aside questions such as trading on inside information and short-swing profits, directors most frequently become targets of law suits in connection with registration statements and prospectuses, annual and interim reports, and proxy materials that are alleged to have been false and misleading. Allegations, findings, and holdings run the gamut from active participation to knowledge to reckless disregard of facts to mere negligence. In 1976, however, the Supreme Court held in the famous Hochfelder case[5] that intent is required to sustain a private action for damages under Rule 10b-5, the general anti-fraud provision. The Supreme Court left open the question as to whether negligence would suffice in an SEC action under that rule[6] or whether reckless disregard would satisfy the intent requirement. Since *Hochfelder*, several district and appellate courts have held that negligence will support an SEC action[7] although three district courts have held it will not.[8] The courts seem split on the negligence-"reckless disregard" issue.[9] But since the point at which negligence becomes reckless disregard is not susceptible to clear delineation in my opinion, the issue will be decided on a case by case basis and the debate among the bar will rage on. In the writer's opinion the Commission, however, will continue to urge that negligence is the proper standard in its cases, although the actual conduct involved in its cases is, more often than not, knowing and willful.

Attempts have also been made to hold directors liable as controlling persons. There is a split of authority as to whether a directorate raises a rebuttable presumption of control for purposes of liability.[10] The question running throughout, however, is what duty was owed by the director and what actions or failures to act in the circumstances resulted in liability. While formulations of that duty have generally been all over the lot, the best formulation is contained in the *White v. Abrams*[11] case which rejected the negligence versus intent analysis of other courts and adopted the "flexible duty standard." Said the court:

> The proper analysis, as we see it, is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts without inhibiting the standard with traditional fault concepts which tend to cloud rather than clarify. By adopting such a duty analysis, we avoid the confusion that arises from classifying the transactions as direct and indirect. This flexible approach, as compared to the compartmentalized approach, does away with the necessity of creating a separate pigeonhole for each defendant whose involvement in the transaction in question may not fit nicely into one of the previously defined classes.
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> We believe that . . . any attempt to limit the scope of duty in all 10b-5 cases by the use of one standard for state of mind or scienter is confusing and unworkable.

While a former chairman of the Commission publicly indicated several years ago that the Commission would endeavor to publish guidelines with respect to duties and responsibilities of independent directors,[12] that chairman's

successor acknowledged that the endeavor would be substantially delayed because the resolution of such issues was not susceptible to a clear formulation. Rather, he indicated that the Commission would take a case by case approach to issues involving possible director liability,[13] thus limiting a tacit acceptance of the flexible duty standard. Accordingly, the Commission has made its views known through its lawsuits, through occasional releases in connection with other enforcement action and through amicus briefs filed in private actions.

Thus, in a private case, *Lanza v. Drexel & Company*,[14] involving Rule 10b-5 under the Exchange Act, the Commission articulated its position in its amicus brief, which stated:

> It is the Commission's view that in the context of a securities transaction a director who approves, or does not otherwise participate in, the transaction would not be liable to a third party unless he knew, or *had reasonable cause to believe*, that the responsible corporate officers had engaged in improper conduct in connection with the transaction. Absent circumstances which would put him on notice of a material failure in disclosure by the corporation, a director, acting with *due care* and relying in *good faith* on officers whom he has no reason to believe are acting improperly, would not incur liability under Rule 10b-5 or Section 20(a) [the controlling person provision] merely by reason of his having authorized or approved the transaction.

The majority in the Lanza case, which was a six to four decision and which accurately anticipated the Hochfelder outcome, held that the independent director, who was a partner in the company's investment banking firm, was not liable in damages to plaintiffs who had received stock in exchange for stock in a company acquired by the issuer. The issue articulated by the majority was whether the independent director had a duty under Rule 10b-5 "to insure" that all material adverse information was conveyed to prospective purchasers of the corporation's stock where the director did not know that the prospective purchasers were not receiving all such information. The independent director had an awareness that the company was having financial problems. Nevertheless, the court held that, since proof of a willful or reckless disregard was necessary to establish liability under Rule 10b-5, he was not liable for the failure of the company to make proper disclosure because the court could not conclude that the director "willfully closed his eyes to or turned his back on the fraudulent nature of the . . . negotiations."[15] To the contrary, the court found that the director displayed an attitude not ordinarily found in outside directors and played an active role in the company's affairs. The majority held that he had no duty "to insure." The majority also said that to be liable he had to be a culpable participant in some meaningful sense.

The dissent on the other hand focused upon whether he had a duty "to inquire," rather than "to insure," concerning the information the company's management furnished to the shareholders. The dissent concluded that he should have been held liable on the grounds that his financial sophistication and his awareness of the increasing problems imposed upon him a duty to inquire, which he failed to do, as to whether the shareholders of the acquired company were fully informed of the problems. One dissenting judge noted that,

> the independent director was the most experienced member of the board with regard to financial and business matters. He was aware that [the company] was acquiring [the other company] through an exchange of stock since he had voted for the acquisition in his capacity as a director. He was aware that [the company] had suffered many business reversals and had suffered from severe intracorporate dissension. Yet he did not know whether this unfavorable position had been disclosed to [the acquired company]. . . . [The independent director's] experience should have told him that, . . . since certain mistakes and problems had just recently been discovered, management obviously had not revealed these matters to outsiders such as [the acquired company].

Particularly because of his financial sophistication, he should have wondered how, if all the adverse facts were known to the shareholders of the company being acquired, they were induced to take stock of the acquiring company, which, in turn, should have led him to be skeptical as to whether all material facts had been diclosed to the shareholders of the company being acquired.

While commentators[16] and an SEC commissioner[17] indicated that *Lanza* would not be a great source of comfort to independent directors and that the view of the dissent in the Lanza decision would ultimately become the majority, *Hochfelder* has probably proved them wrong, but only with respect to private actions for damages and not with respect to Commission cases for injunctive relief. In any event, it still appears that directors will not be dealt with on an undifferentiated basis under the federal securities laws. Inquiry will be made by the courts to determine which of the independent directors—because of experience, knowledge, educational background, training, expertise in particular fields such as accounting, relationship to the corporation and its officers, length of service on the board, intimacy of involvement in the corporation's affairs, access to information, and awareness of the consequences of the corporate acts—should reasonably have been expected to heed warning signals, comprehend them, pursue questions, obtain information, and assure proper disclosure. In other words, a flexible duty standard will be imposed.

SEC Cases Involving Directors

The Commission may have applied the flexible duty standard in deciding to name only three of numerous outside directors in the Penn Central case. The three directors named were charged with violating the antifraud provisions. While acting as directors and controlling persons of Penn Central and two of its subsidiaries, they were alleged to have known or to have had reason to know of Penn Central's serious financial condition and of activities designed to conceal from investors and creditors the critical condition of the company, and to have known or to have had reason to know that information disseminated by Penn Central and its subsidiaries to investors was materially misleading.

While the case was settled with the directors by a consent undertaking, the role of the board was extensively discussed in the Commission's report of the collapse of the Penn Central.[18] In the report the Commission concluded that the outside directors failed in their obligation to the shareholders of the com-

pany to properly monitor the company's affairs, to select competent management and to review the performance and integrity of management, including compliance with the federal securities laws. It was found that after the merger with the New York Central Railroad, the directors were furnished only with voluminous dockets of routine capital expenditure authorizations for numerous individual transactions, a treasurer's report giving the current cash balance and a sheet listing revenues and expenses for the railroad for the period between the board meetings. The directors had no cash or income forecasts or budget, no guidelines to measure performance, no capital budgets, no information describing the earnings or cash performance of the subsidiaries to judge the progress of the merger or the effectiveness of management, and no cash flow budget to see the rate of cash drain, which was substantial. For this information, they relied on oral presentation by management. The Commission found that the board meetings were formal affairs which were not conducive to discussions or interrogation of management. Some of the directors had little opportunity to consult with other directors outside of the environment of the board meetings.

The board was further at fault in failing to establish procedures, including a flow of adequate financial information, to permit the board to understand what was happening and to enable it to exercise some control over the conduct of the senior officers. According to the Commission, the board also failed to respond to specific warnings about the true condition of the company and about the questionable conduct of the most important officers, but rather continued to accept the assurances of management that the company was under control. A more critical examination of management's statements, the Commission concluded, would have uncovered the enormity of the problems and the urgent need for corrective action. Even if corrective action were impossible, the directors would thus have assured that the investors were informed of the magnitude of the problems, rather than continuing to receive optimistic projections. The Commission concluded that the board caused investors to be deprived of adequate and accurate information about the condition of the company.

One bright spot deserves mentioning: Louis Cabot, a new director who had attended his first board meeting in May, 1969, responded in writing to a request of the chairman of the board and chief executive officer for suggestions on the presentation of information to the board. I quote from his letter,[19] which I think has particular relevance to REITs today:

> I believe directors should not be the managers of a business, but they should insure the excellency of its management by appraising the management's performance. To do this they have to measure that performance against agreed upon yardsticks.
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> My first suggestion is that it would be most useful to the directors to have management tell us in quantitative terms what it is trying to accomplish . . .
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> My second suggestion is that the directors be given, perhaps annually, an opportunity to review objectives with the management, and endorse them . . . This is the only way we can give any input at all as directors without being in the position of second guessing after the facts. Furthermore, it can give management some assurance that the board supports what it is trying to do.

> My third suggestion is that the directors be told periodically how actual results are working out as against the short-term targets. Where are there shortfalls? What were the reasons? Were they some things not foreseen and beyond our control, or were they Penn Central shortcomings that need more attention?
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> To take a specific example, how does the $40 million we have lost in transportation so far this year compare with what it should have been? Did the directors know what anyone thought we would earn or lose? And on the basis of the expectation did they agree with what management was planning to do; that is, capital investment, cost cutting, services added or abandoned, organization changes? Why did we miss? It is not very helpful to be told the railroad business is terrible. [Parenthetically, it would not be very helpful to tell REIT trustees that the real estate business is terrible and that interest rates are skyrocketing.]
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> . . . Furthermore, if these kinds of losses are unacceptable, which I presume is the case, what shall we do different to reverse them? How and when can we tell whether the changes are working?
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> I do not think directors should know about every real estate deal, but I do think they should know what we are trying to accomplish. Are we trying to use up tax credits, or make large capital gains, or add to current earnings by a steady stream of profitable small trades, or what? . . . How much capital should we devote to real estate? And what do we think lies ahead?
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> I am more concerned about our overall finances. How much longer are we going to invest vastly more than our cash flow? Are we trying to borrow all the money we possibly can or is there a prudent limit? If so, what is it? Are our plans consistent with it?
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> I think I can defend myself as having been diligent as a director if I have the opportunity to participate in and vote on such issues as I have listed. If not, I don't think I can. I certainly cannot merely by listening to a long list of railroad capital expenditures once a month.

Unfortunately, according to the Commission's report, the information requested by Cabot was not supplied.

The Commission also faulted the independent directors in a report of investigation[20] in the Stirling Homex case where it separately sued the company, members of its management, its investment banker, and its independent auditors. The complaint charged recordation of fictitious sales, earnings, and assets by Stirling Homex, which was engaged in manufacturing and installing modular dwelling units. The report noted that management and others intentionally deceived the independent directors by making untrue representations and furnishing false and misleading financial and other information to them. However, the Commission concluded, again appearing to apply the flexible duty standard, that the outside directors did not play any significant role in the direction of Stirling Homex's affairs even though they possessed considerable business experience and sophistication, and did not provide any significant protection to shareholders in fact. Without detailing all the deficiencies here, suffice it to say that the independent directors did not obtain timely, accurate, or complete information with respect to the business operations of the company. As a result, they could not and did not make probing inquiries, and thus did not realize that the company was suffering serious operating and financial difficulties. Notwithstanding such problems, the independent directors signed a registration statement offering

securities to the public and did not raise any further questions about the business operations and accounting practices.

In connection with *SEC v. Gould, Inc., et al.*, the Commission issued a report of investigation pursuant to Section 21(a) of the Exchange Act concerning the conduct of the directors.[21] Members of Gould management had a personal interest in a real estate transaction involving the company. The board of directors was informed of the transaction after the fact. The Commission found that:

> (the) directors considered the fairness of the price paid by Gould for the seven-acre parcel and the offer by the partnership [consisting chiefly of Gould management] to sell the 32-acre parcel to the company at the price paid by the partnership, but did not address the question whether the allocation of the total purchase price between the two parcels resulted in the partnership receiving a benefit at Gould's expense. The board of directors, without additional investigation beyond inquiry of financially interested management at the board meeting, decided the purchase price for the seven-acre parcel was fair to Gould and that Gould should not purchase the 32-acre parcel.

The Commission concluded:

> With regard to the review by the board of directors of management involvement in a transaction affecting the company, the Commission is of the opinion that in such instances, the board should carefully ascertain all of the relevant facts to determine whether the transaction is in all ways fair to the company and to assure that it has been fully disclosed to shareholders as required by the federal securities laws. In ascertaining facts, the board should not rely solely on information from non-interested sources when available.

Had such information been sought, the directors would have likely learned that the prices asked by the single seller of the two parcels were $350,000 for the seven-acre parcel and $1,050,000 for the 32-acre parcel. However, Gould purchased the former for $940,000 and the partnership purchased the latter for $460,000.

Most recently, in connection with the Commission's injunctive action involving National Telephone Company, Inc., the Commission issued a report of investigation under Section 21(a) of the Exchange Act with respect to "basic questions concerning the obligations of 'outside' directors" to inform stockholders "on a timely basis, of material facts concerning the basic operations of the company."[22] National Telephone had reported high earnings and issued rosy public projections of growth, in fact, it was in serious financial condition and eventually filed in bankruptcy. The Commission found that:

> [the outside directors] were aware . . . of significant facts concerning National's troublesome financial condition. Moreover, they were also aware of the optimistic nature of the company's public disclosures, disclosures which were in direct contrast with the true state of the company's affairs. Under these circumstances, the company's outside directors had an affirmative duty to see to it that proper disclosures were made. The Commission is not saying that the directors of a company are responsible for approving every line of every press release and periodic filing made by a company; rather, the Commission is saying that, at a time of distress in a company's existence, the directors have an affirmative duty to assure

that the market place be provided accurate and full disclosures concerning the basic viability of the company and the continuity of its operations.

This language appears particularly apposite to outside trustees of REITs in light of the problems which appeared on the REIT scene beginning in 1973. Given the roller-coaster nature of the building industry in recent years and its sensitivity to developments in the money markets, outside trustees should be particularly sensitive to the problems of disclosure.[23]

A LOOK AT DIRECTORS OF MUTUAL FUNDS

In examining the duties and sources of liabilities of independent trustees, Benjamin Lopez, in his excellent monograph entitled "The Role of the Independent Trustee in a REIT," notes, and this writer would agree, that the role played by the independent REIT trustee is virtually identical with the role assigned to the independent director of a regulated investment company. Accordingly, it would be instructive to look at pronouncements of the Commission, the courts and commentators in this area.

In 1966 the Commission noted in its report entitled "Public Policy Implications of Investment Company Growth" that nonaffiliated directors were generally ineffective in safeguarding the interests of mutual fund shareholders. It has been commented that "their ineffectiveness in the past may be attributable more to their failure to identify their responsibilities, their lack of time and information, and their close identification with the adviser, as well as their lack of bargaining power needed to effect meaningful controls over the adviser, than to any conscious abdication of their duties."[24] It may also result from a misconception that their role is substantially similar to that of the unaffiliated corporate director, which misconception does not adequately reflect the special nature of mutual funds,[25] nor, I should add, of REITs.

The Management Agreement and Conflicts of Interest

It has been observed[26] that in the usual corporate situation the interests of management and shareholders are identical on most matters. Management and shareholders alike are interested in having the products or services sold by the corporation produced at the lowest possible cost and sold at the highest possible price. A REIT, like a mutual fund, primarily sells professional management of a diversified investment or loan portfolio. Although the advisers and the shareholders have parallel interests, there are important areas where their interests may conflict—particularly in the setting of management fees. In this area the shareholders' interest in low cost conflicts with management's interest in maximization of its fee and thereby its profits. This important conflict of interest defines the special problems and responsibilities of the independent trustees.

Section 15(a) of the Investment Company Act provides that the management agreement may not continue in effect for more than two years unless the continuance is approved at least annually by the board of directors or by a majority of the outstanding voting securities of the fund. Section 15(c) requires express approval by a majority of the directors who are not parties to the

contract or "interested persons" of the investment adviser and imposes on directors the duty to request from the adviser and evaluate such information as may reasonably be necessary to evaluate the terms of the advisory contract.

The unaffiliated directors' and unaffiliated trustees' major task, then, consists of evaluating the quality of the investment advice received from the adviser and the fairness of the fee.[27] All too often, this review seems to be made on the assumption that the existing investment adviser, particularly when it is the sponsor of the fund or REIT, has a vested right to remain the investment adviser, which assumption runs counter to the provisions of the Investment Company Act.[28] The independent trustees, like unaffiliated directors, should apply standards which are the same as those applied by a prudent individual investor in considering an arrangement for securing outside advice with respect to the management of his personal assets.[29]

The independent trustees should not shrink from considering available alternatives. They should determine whether or not the REIT, without undue cost or risk, can be sufficiently flexible to change its arrangements for securing investment advice if for any reason such a change is thought desirable, and should consider whether the most satisfactory arrangement involves internalizing the system for providing investment advice, that is, transforming the REIT into an internally-managed company. The NAREIT Fact Book for 1975 points out that REITs need not have an external adviser. In this regard, it should be noted that, as part of the relief obtained by consent in the Commission's suit against First Mortgage Investors,[30] its adviser and their principals, FMI agreed to discontinue its external adviser and to internalize the advisory functions.

Advisers' Compensation

The amount paid for the advisory service is, of course, a key item, for it is likely that shareholders of REITs will challenge advisory fees, if they have not already done so, on the ground of excessiveness. Similar challenges have been made in the mutual fund area.

For example, in the landmark case, *Brown v. Bullock*,[31] the complaint charged, among other things, that the independent directors were tools of the investment adviser and were "beholden" to the adviser for putting them on the board; that the insiders dominated and controlled the board of directors; that the contract and its respective yearly extensions were not the result of arm's length bargaining but were adopted as a result of arbitrary action, collusion, gross negligence, or reckless disregard of duty; that the directors made no effort to ascertain whether services similar to those supplied by the adviser could be secured elsewhere on more advantageous terms or whether the adviser itself could not have been persuaded to take less; that the directors were acting in the interests of the adviser and not the fund; and ultimately that the fees were excessive and out of proportion to the value of the services performed. The court held that the complaint, which also named the investment adviser and its principals, stated a cause of action under the Investment Company Act and under that section which made it unlawful for the invest-

ment adviser to act as such for more than two years after execution of the contract unless continuance of the contract was approved at least annually by the board of directors or a majority of the outstanding securities. While the court noted that the independent directors had voted in favor of the contract, the court held that Section 15 was concerned with the *substance* of oversight by the directors and not simply with the form. Therefore, the complaint stated a cause of action since it alleged that the directors' approval was given without any real consideration of the merits.

Accordingly, independent trustees would be well advised to thoroughly review the setting of fees and the renewal of advisory contracts and not merely rubber stamp the proposal submitted by the adviser. Since it is generally conceded that growth in asset size of the REIT is not accompanied by a proportionate growth in the cost of managing such assets, and since fees paid to REIT advisers have not generally been scaled down based on size, independent trustees should not consider as sacred the percentage of assets as the basis for the fee but rather should consider other possible alternatives. The independent trustees should look at the cost of comparable services. It is appropriate to inquire how much it costs the adviser to provide the REIT with the services it has agreed to furnish. In this regard, it would not only be appropriate but advisable to look at the profit made by the adviser. The trustees should consider the expenses incurred by the adviser attributable to the REIT and the general profitability to the adviser of its services to the REIT. They should consider their REIT's performance with that of other REITs with similar objectives. Independent trustees should consider the actual amount of all compensation paid to the adviser, including any indirect forms of compensation, such as income received from tie-in business, from interest on loans to the REIT where a bank owns the adviser, from the use of the REITs' deposits, and from use of the bank parent as the registrar or transfer agent. They should also obtain and evaluate information with respect to how the adviser allocates investment opportunities between the REIT in question and any other funds that the adviser may manage or in which it may directly invest.

It may be said with equal application to independent trustees that, like unaffiliated directors of mutual funds, they may not realize the strength of their bargaining positions which arises from the fact that "businessmen want to do what is 'right'—or at least they want to appear to their peers to be doing what is right."[32] Accordingly, "strong and reasoned objections" by independent trustees to an advisory contract "on the ground of unfairness to . . . shareholders will, in many cases, produce modifications of the contract."[33] If modifications are not produced, it would seem that independent trustees have a right to have their disapproval of the advisory contract disclosed in the proxy statement submitted to shareholders. Threat of public statements that a particular contract is unfair to REIT shareholders provides an effective bargaining weapon because the REIT sponsor or adviser will be reluctant to incur the risk of unfavorable publicity which such a public statement would produce.[34]

In testimony before a Senate committee investigating the impact of the REIT industry on banks, it was commented that the "honey which drew the com-

mercial banks, along with many others, into sponsorship of REITs was a generous fee structure."[35] It was noted that the fee structure "obviously provided a strong incentive for REIT advisers to recommend ever higher levels of leveraging; for the more invested assets, the higher the fee."[36] The Commission's staff has been concerned that investment advisers may have caused their REITs to extend high risk loans for the purpose of increasing the size of the loan portfolios and thereby the size of the advisers' fees without disclosure of that fact to the unaffiliated trustees of the REIT. Independent trustees, therefore, should consider this in determining investment policy in view of the obvious relation between investment policy and the fee. In one case history noted in testimony before the Senate committee, the REIT during a one-year period had expanded its portfolio of short-term mortgages by over 400%, while the advisory fee increased by 13.7%. However, net income had decreased by 13.5% and the share price had decreased by 44.6%. It was asserted that this was not an isolated case.[37] Recognizing the reduction in fees in most recent years to either actual costs of operation or a fixed amount above such actual costs paid by some REITs in view of their losses, the pre-tax profit margins for many advisers in previous years, in the area of 60 to 70% of the total advisory fee[38] may very well be found to have been excessive.

Legislative Policies and Declarations of Trust

This article makes no attempt to compare the performance of internally managed REITs with externally managed REITs, or of externally managed REITs with different fee structures. The point is merely that independent trustees must consider available alternatives, in good faith, if they are to do their jobs as well as successfully insulate themselves against liability. It would also appear prudent for independent trustees to bring certain policies expressed in their declarations of trust into line with policies expressed through legislation contained in the Investment Company Act.

For example, the typical REIT declaration of trust contained in the NAREIT Fact Book provides: "No person shall be prohibited for any reason from transferring all or any portion of such securities to another person by sale, exchange, or otherwise, or shall be required to obtain the consent of the trust or any of the shareholders for such transfer." Under Section 15(a) of the Investment Company Act, however, any assignment of the advisory contract must result in automatic termination of such contract. Sale of the controlling block of securities of the adviser would constitute an assignment of the contract under the Act.[39] In view of the crucial relationship between the REIT and the investment adviser, it would seem that the 1940 Act provision should govern the relationship, and not the quoted provision from the declaration of trust.

The declaration of trust also provides that trustees may participate in a meeting of trustees "by means of conference telephone or similar communications equipment . . . and participation in a meeting pursuant to such communications shall constitute presence in person at such meeting." Presumably, the REIT's advisory contract could be approved at such a meeting. Under Section

15(c) of the Investment Company Act the advisory contract and its renewal must be approved by a vote of the majority of the independent directors cast in person at a meeting called for the purpose of voting on such approval. The Commission has publicly indicated that the "in person" provision cannot be complied with by voting over the telephone, by the use of a closed circuit television conference, by proxy, or otherwise than by personal appearance.[40] Selection of the independent accountant is also subject to a similar provision.[41] Such provisions are designed to insure that the discussions pertaining to and review of the advisory contract and selection of accountant are thorough and not perfunctory. To fulfill their duties to their beneficiaries, as well as to avoid liability, independent REIT trustees should insist on "in person" meetings of trustees to consider in detail these vital matters.

Conflicts of Interest

Such detailed and informed discussions are particularly important where conflict of interest is involved. The recapture of brokerage commission cases involving conflicts between mutual funds and their investment advisers illustrate such importance. The issue in these cases was whether the adviser, through a broker-dealer affiliate, should have recaptured commissions for offset against the advisory fee charged the fund or used the commissions to reward other dealers who sold fund shares or provided the adviser with research and other services.

In *Moses v. Burgin*,[42] the management company had not set up a structure for the recapture of brokerage commissions and testimony was that the outside directors of the fund were not aware of the ability to recapture. The court held that the management company and the affiliated directors, motivated by self-interest, had breached their fiduciary duty to the fund in intentionally not disclosing to the outside directors the ability to recapture and in not having the outside directors consider and pass on the issue, and thus they were liable. The court held the unaffiliated directors not liable since they were not shown to have had any knowledge of the possibility of recapture nor any personal conflicting interest "which should have sharpened their attention."[43] The court did admonish, however, that "unaffiliated directors are not free of all obligations to consider matters on their own."[44]

In contrast with the Moses case, no liability was found in the *Tannenbaum v. Zeller* case.[45] The court found full disclosure by the management company and the inside directors to the outside directors and extensive periodic and physically documented review by the board of directors, which had been regularly supplied by management with the latest information about developments in the field of recapture of commissions each time there was a significant development in the area. A subcommittee of outside directors was established to consider the question and no management directors were involved in the direct consideration. Moreover, the subcommittee sought the advice of outside counsel. Based on such a record, the court was able to conclude that good faith business judgment was exercised. While the Commission's amicus brief in the case questioned the business decision, it urged

no liability if the court could find that the board was informed and acted in good faith.

The advisability of independent trustees retaining separate counsel, or at least retaining separate counsel from the adviser, to represent the REIT is illustrated in the *Papilsky v. Berndt*,[46] case, another "recapture" case. The court held that the insiders were liable on the recapture question but did not reach the outside directors who had been sued, since the case against them was dismissed on procedural grounds. Unlike *Tannenbaum*, the outside directors did not have separate counsel. Noting the inherent conflict of interest between the adviser and the fund and the dependency on the flow of information to the independent directors to enable them to perform their role, the court indicated that " 'investigation of recapture methods and their legal consequences [should have been] performed by disinterested counsel furnished to the independent directors,' "[47] the same admonition given in yet another recapture case.[48] The court in *Papilsky* found that the insiders did not suggest to the independent directors that they seek independent counsel. Moreover, the court found that the adviser "funnel[led] to the Board business reasons why recapture was a poor idea,"[49] with concurrent legal opinions from counsel which also represented the adviser—a pretty persuasive one-two punch. The court found that the legal opinions conflicted in some instances with a Commission report on mutual funds, which report was "brushed aside"[50] in meetings with the fund's board. The significance of the effect of the legal advice was unequivocally noted: "Where business reasons would probably not have provided a bar to recapture efforts, the unwavering nature of the legal advice presented to the independent directors became crucial."[51]

In light of these cases, it would seem incomprehensible why independent trustees would not set up special committees and retain independent counsel in conflict situations. Of course, good faith is crucial; retaining counsel merely to go through the motions will not afford relief to the trustees or protection to investors.

Trustees may want to consider prohibiting conflict of interest transactions involving the REIT, other than the advisory fee, since "the only certain way to insure full compliance with [the fiduciary duty] is to eliminate any possibility of personal gain."[52] Even though certain transactions in which conflicts are inherent may be explicitly permitted under the declaration of trust, and therefore may be within the morals of the market place, "equity imposes a higher standard" than " 'the morals of the market place.' "[53] Chief Judge Cardozo once stated: "Many forms of conduct permissible in a work-a-day world for those acting at arm's length, are forbidden to those bound by fiduciary ties . . ."[54]

Valuation of Portfolio

The declaration of trust also provides that the trustees shall have the power to determine conclusively the value of any assets of the trust property and to provide for reserves. A substantial duty as well as authority is thus imposed. This duty may give rise to liability. Again, drawing on the mutual fund area,

"fair value" is determined in good faith by the board of directors under the Investment Company Act,[55] with respect to securities and assets for which market quotations are not readily available. The Commission has stated[56] that it is incumbent upon the board of directors to consider all appropriate factors relevant to such value and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, the Commission said that the board may appoint persons to assist them in the determination of such value to make the actual calculations pursuant to the board's direction. However, the board must also continuously review the appropriateness of the method of valuation. The directors must also carefully review the findings of such other persons to satisfy themselves that the resulting valuations are fair. While recognizing that no single standard for determining "fair value in good faith" can be laid down, since fair value depends upon the circumstances of each individual case, the Commission said that as a general principle "fair value" would appear to be the amount which the owner might reasonably expect to receive upon current sale. Such determination would involve hard information as well as judgment factors.

Since a REIT is an investment company, the foregoing would be applicable to valuation of a REIT's portfolio. It is critically important that REITs properly value their portfolios. Any distortion in the valuation of properties, overvaluation of loan collateral, or failure to write down or reserve against probable losses from loans will result in inflation of the investment adviser's fee where he is compensated on the basis of net asset value. It also will result in overstatement of the REIT's income, in false and misleading reports to investors—and in liability.

The Commission has recently taken enforcement action in this area. On January 16, 1978, the Commission filed suit against Continental Advisers[57] and various former members of that REIT's senior management, as well as against CMI's independent auditor.[58] CMI, now in bankruptcy, was a short-term mortgage trust which financed the construction and development of a broad variety of real estate projects. The Commission charged, in essence and among other things, that CMI's earnings were falsely inflated, that its reserves for probable losses were materially understated, and that it continued to accrue interest on loans upon which no further accrual could be justified. The case is presently being litigated. Previously, in the Franklin National Bank[59] case, the Commission charged that the defendants failed to disclose the deterioration and the quality of the bank's loan portfolio, a situation analogous to that of mortgage REITs. In another Commission case involving an offshore unregistered fund managed by a domestic adviser,[60] the Commission found material overvaluations over a period of time, with a peak overstatement of 43.5% in one month. The Commission held that the overvaluations were fraudulent since "they deceived investors who bought on the strength of illusory performance records." Significantly, the Commission observed that even an unregistered investment company, which could just as easily have been a REIT, "does not acquire a license to deceive because it happens to fall outside the purview of the Investment Company Act." In a third case, the Commission criticized the performance of a mutual fund's

board in ratifying the evaluation of restricted or non-freely tradeable securities in the fund's portfolio.[61] While the board considered the possibility of giving separate consideration to each restricted security, it rejected such approach after the adviser "represented that such procedure would create a time-consuming administrative burden." Instead, the board chose to apply a predetermined discount from the market quote automatically, and thus did not determine fair market value in good faith. A similar "automatic" approach used by REITs in establishing reserves for losses has come to the Commission staff's attention. Some have used percentage of assets as a basis for computing reserves. Others have used another basis, the percentage of net income, an approach which makes no sense at all, since as net income goes up reserves go up, but as net income goes down, indicating that the REIT is in trouble, reserves also go down. Independent trustees should approach valuation of the portfolio and establishment of reserves for losses with the utmost seriousness and avoid the automatic use of formulas.

Concealment

The Commission has sued a REIT in connection with the REIT's efforts to conceal an adverse and deteriorating loan portfolio. First Mortgage Investors, the first REIT formed under the 1960 tax provisions, was charged with having arranged for the purchase by others at inflated prices of certain real properties and outstanding loans in FMI's portfolio which were on the brink of foreclosure. FMI booked profits on several such sales.[62] In connection with such transactions, the complaint charged that FMI provided 100% financing, indemnification agreements and commitments for future loans to the purchasers which were not disclosed. Also alleged was that FMI employed real estate appraisers who were instructed to issue appraisals for predetermined amounts. The complaint further alleged that FMI accrued as income interest on outstanding loans at a time when it knew or should have known that collectibility was in doubt.

It is with respect to such conduct that independent trustees may have the greatest exposure. I cannot urge too strongly that trustees should adopt a healthy skepticism in reviewing, for example, portfolio transactions at year end that generate profits, or transactions involving "dogs" in the portfolio that are somehow miraculously disposed of without loss. The Commission's staff intends to review additional situations involving concealment of the true shape of REITs' portfolios and it is reasonable to expect that additional enforcement action will be taken.

Exercise of Discretion Over Portfolio Transactions

Other provisions in the declaration of trust may expose independent trustees to substantial risk of liability if they do not perform their functions. The declaration grants the trustees substantial powers over the trust property and they have "full power to make any investments . . . that they in their discretion shall determine." That phrase implies that they *will* exercise discretion and make determinations.

In a Commission stop order proceeding involving an investment company,[63] the prospectus represented that "it shall be the definite policy of the board of directors in selecting securities for all industry classes of shares to limit selections to those industries that are obviously engaged in a character of business indicated by the class." The Commission found that this statement implied that the directors gave consideration to suitable investments by the various classes and that the statement was materially misleading since nearly all the discussions at board meetings was concerned with dividends, there were no discussions concerning selection of securities for purchase, the independent directors did not know who selected securities for purchase or sale for the fund, and the directors failed to discharge their duties and responsibilities as directors and failed to perform the functions which the prospectus impliedly represented they were performing.

Accordingly, if it is to be represented that the independent trustees will act, they must act.

CONCLUSION

The foregoing identification of problem areas is not intended to be exhaustive. Space, unfortunately, does not permit mention of other possible conflicts between provisions and policies under the Investment Company Act and the ways in which REITs are operated as indicated in the sample declaration of trust. A detailed comparison of those provisions under the Act and the declarations of trust governing REITs that deal with comparable subjects should be made with a view toward bringing the declarations into line with the Act.

REFERENCES

1. P.L. 86-799, Section 10(a), which added Sections 856-858 to Chapter 1, Subchapter M of the Internal Revenue Code of 1954; amended by the Tax Reform Act of 1976, which also added Sections 859 and 860 to Chapter 1, Subchapter M.
2. Sec. 3(c)(5)(C).
3. See, for example, *SEC v. Continental Advisers, et al.*, Civil No. 78-0066 (D.D.C.), Litigation Rel. No. 8256 (Jan. 16, 1978).
4. National Invested Savings Corp., 1 SEC 825 (1936).
5. *Hochfelder v. Ernst & Ernst*, 425 U.S. 185 (1976).
6. Before *Hochfelder*, negligence was clearly sufficient in most circuits which had considered the question. See, e.g., *SEC v. Management Dynamics Inc.*, 515 F.2d 801 (2d Cir. 1975); *SEC v. Dolnick*, 501 F.2d 1279 (7th Cir. 1974); *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2nd Cir. 1973); *SEC v. Pearson*, 426 F.2d 1339 (10th Cir. 1970); *Contra, SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974).
7. *SEC v. Universal Major Industries*, 546 F.2d 1044 (2d Cir. 1976) (involving the registration provisions); *SEC v. World Radio Mission, Inc.* 544 F.2d 535 (1st Cir. 1976) (involving the antifraud provisions); *SEC v. Shiell, et al.*, CCH Fed. Sec. L. Rep. [Current] para. 96,190 (N.D. Fla. Sept. 27, 1977). See also *SEC v. Lummis, et al.*, No. C-75-0589 (N.D. Cal.), where, in partially granting the Commission's motion for summary judgment against one defendant, the court appeared to accept the rationale of *World Radio Mission* in some instances, i.e., where "the action to be enjoined is itself, without regard to the defendant's state of mind, a violation of the securities laws, e.g., material misstatements made in connection with stock sales." However, in other instances, including the one under consideration, the court held that "the legality of defendant's acts cannot be evaluated in isolation from his state of mind. The sale of stock was illegal only if done with the proscribed motive, i.e., to drive down the market price of the stock, thereby putting pressure on the Air West directors to accede to the Hughes offer." Memorandum Opinion and Order Re Summary Judgment, Nov. 23, 1977, p. 6, n. 3. The court found such intent on the basis of the undisputed facts.

8. *SEC v. American Realty Trust*, CCH Fed. Sec. L. Rep. [Current] para. 95,913 (E. D. Va. 1977), appeal docketed, Docket No. 77-1839 (4th Cir. Sept. 9, 1977); *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976), *aff'd*, Docket No. 76-6189 (2d Cir. Sept. 30, 1977) (the Circuit Court did not reach the *scienter* issue); *SEC v. Cenco, Inc.*, CCH Fed. Sec. L. Rep. [Current] para. 96,133 (N.D. Ill., 1977).
9. *Compare, Wright, et al. v. Heizer, et al.*, No. 76-1140 et al. (7th Cir. June 30, 1977); *Sanders v. Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, CCH Fed. Sec. L. Rep. [Current] ¶95,660 (2d Cir. 1976); *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976); *SEC v. Cenco, Inc.*, CCH Fed. Sec. L. Rep. [Current] ¶96,133 (N.D. Ill. 1977); *McLean v. Alexander*, CCH Fed. Sec. L. Rep. [Current] ¶95,725 (D. Del. 1976); *Kaback v. Schweickart & Co.*, CCH Fed. Sec. L. Rep. [Current] ¶95,619 (S.D.N.Y. 1976); *Carroll v. Bear, Stearns & Co.*, CCH Fed. Sec. L. Rep. [Current] ¶95,642 (S.D.N.Y. 1976); *Siclari v. Rio de Oro Mining Co., Inc.*, CCH Fed. Sec. L. Rep. [Current] ¶95,672 (S.D.N.Y. 1976); *Rich v. Touche, Ross & Co.*, CCH Fed. Sec. L. Rep. [Current] ¶95,514 (S.D.N.Y. 1976); *Coleco Industries, Inc. v. Berman*, CCH Fed. Sec. L. Rep. [Current] ¶95,764 (E.D.Pa. 1976); *Franke v. Midwestern Oklahoma Development Authority*, 428 F. Supp. 719 (W.D. Okla. 1976).
10. See, e.g., *Camrose v. The Intervestor U.S. Real Estate Fund*, CCH Fed. Sec. L. Rep ¶95,469 (S.D.N.Y. 1976); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967); *Moerman v. Zipco, Inc.*, 302 F. Supp. 439 (E.D.N.Y. 1969).
11. 495 F.2d 724 (9th Cir. 1975). *Hochfelder* may have overruled *White v. Abrams, sub silentio*, to the extent that the latter case would support liability for damages based on negligent conduct under Rule 10b-5.
12. G. Bradford Cook, "Directors' Responsibilities," CCH Fed. Sec. L. Rep. [1973 Transfer Binder] para. 79,302 at 82,916, April 6, 1973.
13. Ray Garrett, Jr., "A Commission Dilemma: Directors' Guidelines Revisited," San Francisco, Cal., May 7, 1974.
14. 479 F.2d 1277 (2nd Cir. 1973).
15. *Ibid.*; p. 1306.
16. Sonde and Freedman, *"Seagulls on the Water—Some Ships in a Storm": A Comment on Lanza v. Drexel, N.Y.U. Law Rev.* (May-June 1974), pp. 270 *et seq.*
17. A. A. Sommer, Jr., *Directors and the Federal Securities Laws*, (Denver, Colorado: February 21, 1974).
18. *The Financial Collapse of the Penn Central Company*, Staff Report of the Securities and Exchange Commission, Aug. 1972 ("Penn Central Report"), pp. 151-172.
19. Penn Central Report, pp. 164-165.
20. Exchange Act Release No. 11516 (July 2, 1975).
21. Civil No. 77-0981 (D.D.C. June 9, 1977), Litigation Rel. No. 7963 (June 9, 1977) and Exchange Act Rel. No. 13612 (June 9, 1977).
22. *S.E.C. v. Hart, et al.*, Civil No. 78-0065 (D.D.C.), Litigation Rel. No. 8256 (Jan. 16, 1978) and Exchange Act Release No. 14380 (Jan. 16, 1978).
23. An outside trustee is by no means immune from suit by the Commission. On facts or rationales similar to *Stirling Homex* and *National Telephone*, non-management directors, as well as management, were charged with violating the antifraud provisions in *SEC v. Shiell, et al.*, (N.D. Fla.), Litigation Rel. No. 7763 (Jan. 31, 1977), a case involving The Commonwealth Corporation, a Florida mortgage banker.
24. Glazer, *A Study of Mutual Fund Complexes*, 119 *U. of Pa. L. Rev.* 205, 234 (1970).
25. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 *U. of Pa. L. Rev.* 1058, 1059 (1967).
26. *Ibid.*
27. See Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 *U. of Pa. L. Rev.* 1058, 1063 (1967).
28. *Ibid.*
29. *Ibid.*, p. 1064.
30. Litigation Rel. No. 7072 (Sept. 8, 1975).
31. 294 F.2d 415 (2d Cir. 1961).
32. Mundheim, p. 1067.
33. *Ibid.*
34. *Ibid.*
35. Statement of Kenneth D. Campbell, Hearing Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 94th Cong., May 27, 1976.
36. *Ibid.*
37. Neuberger and Hughes, *The REITs: Operating Losses and Conflicts of Interest*, Hearing Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 94th Cong. May 27, 1976, pp. 19-20.
38. Statement of Kenneth D. Campbell, p. 26.

39. Sec. 2(a)(4).
40. Investment Company Act Rel. No. 6336 (Feb. 2, 1971).
41. Sec. 32(a).
42. 445 F. 2d 369 (1st Cir. 1971).
43. 445 F. 2d at 384
44. *Ibid*
45. 552 F. 2d 402 (2d Cir. 1976).
46. CCH Fed. Sec. L. Rep. [Current] ¶95,627 (S.D.N.Y. 1976).
47. CCH Fed. Sec. L. Rep. [Current] ¶95,627 at 90,133.
48. *Fogel v. Chestnutt*, CCH Fed. Sec. L. Rep. ¶95,393 (2nd Cir. 1975).
49. CCH Fed. Sec. L. Rep. [Current] ¶95,627 at 90,133.
50. *Ibid*
51. *Ibid* pp. 90,134.
52. *Rosenfeld v. Black*, 445 F.2d 1337, 1342 (2d Cir. 1971).
53. *Ibid* p. 1343.
54. *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).
55. Sec. 2(a) (41).
56. Investment Company Act. Rel. No. 6295 (Dec. 23, 1970).
57. Continental Advisers was the investment adviser to Continental Mortgage Investors.
58. Litigation Rel. No. 8256 (Jan. 16, 1978).
59. Litigation Rel. No. 6551 (Oct. 17, 1974).
60. *Matter of Robert F. Lynch*, Exchange Act Rel. No. 11737 (Oct. 15, 1975).
61. *Matter of Winfield & Co., Inc.*, Exchange Act Rel. No. 9478 (Feb. 9, 1972).
62. Litigation Rel. No. 7072 (Sept. 8, 1975).
63. *Matter of Managed Funds, Inc.*, 39 SEC 313 (1959).