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SOLUTIONS IN A COMPETITIVE WORLD ©

THE DUTY OF DUE CARE FROM THE DEVELOPER'S PERSPECTIVE

It is almost commonplace now for large institutional lenders or investors to insist on a "duty of due care" standard in their financing agreements with real estate developers. This "due care" standard typically replaces a "gross negligence" benchmark that exonerated developers from liability other than that caused by "gross negligence." Most real estate professionals took considerable comfort in the fact that while they might overlook a factor on a particular project that -- in hindsight -- could be deemed "negligent," it would be a very rare day, indeed, when they would stumble so badly as to be "grossly negligent." How, then, should the prudent real estate developer handle the more imposing "duty of due care" demanded by its lender or investor?

It is unlikely that this problem is going to go away any time soon. Many lenders impose the standard because if they include it in their financing documents, they themselves are protected from certain liabilities. For example, the California State Teachers Retirement System, or CALSTRS, insists on "duty of due care" language in lending or joint venture documents. Who could blame them given the statutory protection they receive from California Education Code § 22257(b)? If the duty of due care standard is incorporated into CALSTRS contracts, that fact is admissible as evidence at any trial that the board acted with "care, skill, prudence, and diligence" in the selection of the developer or investment manager. Similar safety nets protect pension fund investors, even if those safeguards are not statutory.

Answering the duty of due care question as applied in the real estate world requires an understanding of: (a) the origins and history of the rule; (b) the scope of the rule's application to a variety of office undertakings; (c) the distinctions in how the rule would be applied to the particular activity challenged; and (d) a checklist of the practical steps one can take to maximize the probability of compliance. This memorandum addresses each of these topics in turn.

A. <u>The Origins And History Of The Duty Of Due Care.</u>
Delaware is the birthplace of the duty of due care, which is a derivative of the business judgment rule. The business judgment rule is a presumption that in making business decisions, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. Application of the business judgment rule (1) keeps courts

out of making business decisions, and (2) provides a powerful presumption in directors' favor in satisfying the duty of due care.

The modern outlines of the duty of due care finds its genesis in the 1985 case Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), involving the Trans Union merger. Despite the fact that there was no self-dealing, no conflict of interest, and that a very professional and experienced team of corporate directors were involved, the Supreme Court of Delaware held that the directors were liable for breaching their duty of due care in recommending shareholder approval of the proposed merger. At the time the Van Gorkom decision was rendered it provoked shock, astonishment, incredulity, and even self-pitying editorials (if one considers the Wall Street Journal capable of self-pity).

But consider the facts: The Trans Union CEO personally decided it should combine with a larger company to take full advantage of sizable tax write-offs. The Trans Union CEO then approached takeover specialist Jay Pritzker to purchase Trans Union at $55 per share, a price selected by the CEO. Pritzker made an offer to purchase at the $55 price on September 18 with a September 21 deadline. Outside counsel was hired September 19. The Trans Union board met on September 20, but only two of its members knew the purpose of the meeting ahead of time. The CFO expressed his opinion to management but not the board that $55 was too low a price. The board was never informed the price originated with their own CEO. The company's regular investment banker was not asked to render an opinion. The board relied on a 20 minute presentation by Van Gorkom, but asked not one question. No one asked for an extension of the September 21 deadline. The merger agreement was signed during an intermission at the opera.

The Delaware Supreme Court stated:

> Considering all of the surrounding circumstances – hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefore, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever – the directors were duty bound to make reasonable enquiry of Van Gorkom . . . and if they had done so, the inadequacy of that upon which they now claim to have relied would have been apparent.

488 A.2d at 870.

B. Due Care And Developers. Obviously, the issues confronting a Delaware board of directors in a merger setting differ substantially from those confronting a real estate developer on a particular project. The most common form of the due care clause appears to apply that duty to all aspects of the developer's enterprise -- from project decisions, to finance decisions, to employment and personnel issues. The duty of due care thus becomes a function of the particular

activity involved; the specifics of the duty of due care will be informed by that particular activity. For example, deciding the economic terms on a government project will be evaluated differently than a private development project. Whether one satisfied the duty of due care in conducting environmental due diligence will be assessed in a different framework than the adequacy of one's record keeping and bookkeeping functions. Whether a particular new hire satisfied due care requirements will be subject to yet a separate evaluation.

It is also important to remember the circumstances in which the duty of due care is likely to be tested. If you as a developer are subject to such enquiry, it will likely be made -- in the first instance -- by a lawyer combing through every piece of paper in the file and every byte of electronic data on the network. And of course, the lawyer sanctimoniously applies 20/20 hindsight. And just imagine how much fun and what an efficient use of your time those depositions will be. Real life teaches that this is probably not your first choice for performance evaluations.

C. Solving The Problem. How should you test your firm's due care compliance? You will have satisfied the duty of due care if you act in the best interests of the company and with that degree of care that an ordinarily prudent real estate professional in a like position would exercise under similar circumstances. But how do you measure that? And how do you accommodate the fiction that there is such a thing as an "ordinarily prudent real estate developer?"

Reconsider Van Gorkom. The court there was concerned with (i) haste in decision making; (ii) lack of preparation; (iii) lack of involvement, including questioning, by the board; and (iv) lack of a paper record. Based on these infirmities, the plaintiffs successfully rebutted the presumption of the business judgment rule that the directors had acted on an informed basis.

That relatively straightforward test can be applied to the real estate setting. If you are the executive responsible for making a development decision you will necessarily want to make a deliberate and fully researched decision. Your preparation should be manifest. Did you consider comparable projects? Their costs? Market forces? Margins. Return on investment. Alternative uses of investment funds? Exit timing and strategies. In short, all necessary variables that go into making a go/no go decision.

Now, consider how the duty of due care standard would apply to a human resources specialist hiring a property manager for a multifamily facility. Was a background check conducted? Were discrepancies or gaps in the employment record investigated? Could you fire someone on the maintenance staff with a criminal record? Could you hire one with a criminal record as a concierge? To help with day care? What constitutes a reasonably prudent real estate human resources manager will be the ultimate test, and will vary from case to case.

D. <u>The Duty of Due Care Checklist</u>. While these criteria may seem too abstruse to be of help, some general rules of thumb can be discerned. It is even easier to make a checklist of conduct one cannot engage in:

One cannot engage in self-dealing at company/firm expense;
One cannot usurp firm opportunities for oneself;
One cannot withhold information from the company gained in the course of one's employment;
One cannot take or receive hidden fees.

And how to maximize the probability of compliance?

A. Maximize the *process* of decision making. Be deliberate, thoughtful, inquisitive, ponder alternatives, review comparables, be patient and open in the decision-making process;

B. Even if you make the "wrong" decision from a development, or construction perspective, one can maximize the possibility that you have satisfied the standard of due care by making the right enquiries and conducting proper investigations;

C. Analyze all material information available;

D. Create a paper/electronic record. Record your *process;*

E. Probe regarding reports, assumptions, and recommendations from third-party experts. Do not delegate blindly;

F. Explore reasonable feasible alternatives;

G. Be prepared. Do your homework thoroughly; and

H. Remember, the party attacking a decision as uninformed bears the burden of rebutting the presumption under the business judgment rule that the decision was an informed one.

The Sperduto Law Firm, PLC specializes in financial services, real estate, and construction litigation. The firm has represented the developers of the new International Arrivals Terminal at JFK International Airport, the new Patent and Trademark Office campus in Virginia, and a public housing authority charged with constitutional violations in affordable housing. Our law degrees come from Harvard, Michigan, Duke, Virginia, and Georgetown. Our attorneys are admitted to practice in the District of Columbia, New York, Maryland, Virginia, Pennsylvania, California, and Georgia.

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