

# NOTES

## ADVISORY SUCCESSION IN REAL ESTATE INVESTMENT TRUSTS

Since the late 1960's, one of the fastest growing forms of investment in the United States has been the Real Estate Investment Trust (REIT).<sup>1</sup> It now appears, however, that the REIT industry

---

1. Over a decade ago Congress inserted the Real Estate Investment Trust Act of 1960 into the Internal Revenue Code, INT. REV. CODE OF 1954, §§ 856-58, thereby laying the foundation for the attractiveness of the REIT as an investment vehicle. The provisions added by the Act allow a business trust which derives most of its income from investments in real estate, *id.* § 856(c), and which meets certain other qualifications, including the return of 90% of current capital and ordinary income to shareholders, *id.* § 857(a)(1), to avoid payment of any federal income tax on that portion of the trust income which is actually distributed to its shareholders during or with respect to the taxable year. *Id.* § 857(b).

Initially, most REIT's generated their profits by taking equity positions in various real estate investments. See Buffington, *A Brief Description of the Real Estate Investment Trust Industry and Its Tax Problems*, REAL ESTATE INVESTMENT TRUSTS 1973, 273-74 (Practising Law Institute 1973). By 1968, with investments concentrated in these so-called "equity REIT's," *id.*, there were only five REIT's with combined assets of approximately ten million dollars. Gutmann, *Analyst's Viewpoint—Mutual Funds for Real Estate*, THE MAGAZINE OF WALL STREET, April 24, 1971, at 32. However, during 1969 through 1971, soaring interest rates and a favorable outlook in the real estate and construction industry sparked the development of a new type of "mortgage REIT" which generated its profits primarily from interest income on real estate mortgages. See Buffington, *supra*, at 275. This development brought about a surge of investment in REIT's, *id.*, and by 1972 there were approximately 180 REIT's, whose assets totalled more than 11 billion dollars. DICKEY, REPORT OF THE REAL ESTATE ADVISORY COMMITTEE TO THE SECURITIES AND EXCHANGE COMMISSION, Oct. 12, 1972, at 92. Recently, total REIT asset value has been estimated at nearly 20 billion dollars. *REITs Face Shake-Out as Investments Sour, Cash Sources Dry Up*, The Wall Street Journal, Jan. 21, 1974, at 1, col. 1.

### THE FOLLOWING HEREAFTER CITATIONS ARE USED IN THIS NOTE:

Meyer & Sprayregen, *Equity Trusts: Real Estate Capitalists of the Seventies*, 3 REAL ESTATE REV. 81 (Summer 1973) [hereinafter cited as Meyer & Sprayregen];

Midwest Securities Commissioners Association, Statement of Policy on Real Estate Investment Trusts, Adopted on July 16, 1970, 1 BLUE SKY L. REP. ¶ 4801 (1970) [hereinafter cited as *1970 Statement*];

R. POWELL & P. ROHAN, THE LAW OF REAL PROPERTY (1973) [hereinafter cited as POWELL];

REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as SEC PUBLIC POLICY REPORT];

Sterrett, *Reward for Mutual Fund Sponsor Entrepreneurial Risk*, 58 CORNELL L. REV. 195 (1973) [hereinafter cited as Sterrett].

may be facing a major "shake-out."<sup>2</sup> As a consequence of the recent decline in the economic performance of the real estate and construction industry, many REIT's have found themselves saddled with heavy debt service requirements while holding investment portfolios increasingly made up of mortgages to defaulting developers.<sup>3</sup> If and when this shake-out occurs, many REIT shareholders<sup>4</sup> will search for means by which they may recoup their losses.

In their efforts to recover, disgruntled REIT shareholders are likely to look first to the REIT's investment adviser<sup>5</sup> to whom the trustees frequently delegate the active management of the REIT, including

---

2. See, e.g., *Are the REITs Played Out?* FORBES, Nov. 1, 1973, at 26; Morgello, *Wall Street: Where the Yields Are*, NEWSWEEK, FEB. 18, 1974, at 74; *REITs Face Shake-Out*, *supra* note 1, at 1, col. 1. See also *A REIT Files For Protection Under Chapter 11*, The Wall Street Journal, Mar. 18, 1974, at 5, col. 1 (describing the first bankruptcy filing by an REIT ever reported).

3. It has been suggested that most REIT's can tolerate holding from three to five percent of their loan portfolios in defaulted loans without substantial impairment of earnings. *REITs Face Shake-Out*, *supra* note 1, at 1, col. 1. However, "[f]or many REITs, loans in default or involved in foreclosure proceedings have increased sharply in recent months to where they now account for more than 10% of investment portfolios." *Id.* As a result of these defaults and their impairment of REIT earnings, many REIT's are finding it difficult to attract additional investment funds. *Id.* at 27, col. 5. This problem is acutely exacerbated by the fact that REIT's, unlike the otherwise highly similar mutual funds, usually borrow heavily against their equity capital. In a favorable economic climate the REIT thus increases the return on the shareholders' equity investment by the spread between the rates it must pay on these borrowed funds and the higher rates it charges on its construction loans. *Id.* However, this highly leveraged position also imposes upon the REIT the necessity of generating a continuous inflow of funds to meet the relentless interest payments due on its heavy debt. As external investment in REIT's begins to slow and defaults by developers on REIT construction loans threaten the REIT's capacity to generate funds internally, their ability to meet their heavy debt commitments has come sharply into question, and a number of experts have predicted ". . . a real industry shake-out as cash-pressed REITs sell out at bargain prices and merge with the stronger ones." *Id.* at 27, col. 6.

4. An REIT almost universally adopts the form of a publicly-held business or "Massachusetts" trust. 4A POWELL ¶ 573B[1]. Equitable ownership of an REIT rests in its shareholders, *id.* at ¶ 573A, while legal ownership of the trust is vested in trustees elected by the shareholders to manage it, *id.* at ¶ 573B[6][i].

5. In several recent cases, REIT shareholders have successfully sued their advisers. *Greenspun v. Bogan*, Nos. 73-1303 & -1304 (1st Cir., Feb. 22, 1974) (approving settlement providing for reduced advisory fees); *Ridley v. Continental Ill. Realty*, No. C 19550 (Los Angeles County Super. Ct., Jan. 22, 1974) (Notice of Intended Decision), discussed in note 58 *infra*.

The shareholders' stake in such suits may be extremely large, for if an REIT fails, its shareholders may lose more than their investment in its stock. In many states the possibility exists that REIT shareholders have unlimited liability for trust debts. Comment, *The Real Estate Investment Trust: State Tax, Tort, and Contract Liabilities of the Trust, Trustee, and Shareholder*, 71 MICH. L. REV. 808, 815-17 (1973).

responsibility for the selection and policing of investments.<sup>6</sup> Not only is the adviser frequently the party that initially sponsored the trust,<sup>7</sup> but also the adviser, for several reasons, enjoys considerably greater control than its title and even its substantial managerial authority would seem to imply. First, trustees are not independent of the REIT adviser,<sup>8</sup> and even the unaffiliated trustees who have no financial interest in the adviser often owe their selection and retention to the adviser's endorsement.<sup>9</sup> Furthermore, trustees who feel no special allegiance to the adviser may be extremely hesitant to suggest its ouster because of the difficulty of ascertaining whether a proposed successor would be more effective than the incumbent, the disruption which would occur in the management of the REIT's affairs,<sup>10</sup> and the realization that at least some REIT shareholders may have invested in reliance upon the incumbent adviser's reputation.<sup>11</sup> The cumulative effect of these factors is that the REIT adviser, in addition to exerting a substantial degree of control over the REIT's operations, typically labors under little if any fear of being involuntarily removed by the trustees or shareholders.<sup>12</sup>

---

6. 4A POWELL ¶ 573B[6][a]; Meyer & Sprayregen, *supra* note 1, at 83; Schulkin, *Real Estate Investment Trusts*, FINANCIAL ANALYSTS J., May/June 1971, at 35-36. The typical duration of an advisory contract is from one to three years, Schulkin, *supra* at 35, although this seems not a practically operative limitation on the adviser's tenure. See note 12 *infra* and accompanying text. Although the adviser can be an individual, it is typically a corporation. See Bartram, *Connecticut General's Approach to the Real Estate Investment Trust*, 109 TRUSTS & ESTATES 870 (1970); Downes, *Why Chase Manhattan Sponsored a Real Estate Investment Trust*, 109 TRUSTS & ESTATES 1026 (1970); Tyson, *Banks Finding Many Benefits in Sponsoring Formation of REITs, Chiefly Management Fees*, AM. BANKER, Oct. 14, 1970, at 1.

7. Korobow & Gelson, *REITs: Impact on Mortgage Credit*, 40 APPRAISAL J. 43 (1972); see Meyer & Sprayregen, *supra* note 1, at 83.

8. Many sponsors of REIT's, in order to assure their retention as adviser, name directors and officers of their own company or affiliated companies to serve as trustees for newly formed REIT's. NATIONAL ASS'N OF REAL ESTATE INVESTMENT FUNDS 383, 673 (1971-72 ed. 1971). "Normally, 51 percent of the [REIT] trustees are independent of the manager. However, there are exceptions." Remarks of Don Augustine, REAL ESTATE INVESTMENT TRUSTS 10 (Practising Law Institute 1970).

9. Remarks of Don Augustine, *supra* note 8.

10. It has been stated that mutual fund shareholders have no choice but to approve the advisory contract because "[i]f such approval were withheld by either [directors or shareholders], this would have the disastrous [sic] consequence of leaving the company without management." H.R. REP. NO. 1382, 91st Cong., 2d Sess. at 87 (1970).

11. See 4A POWELL ¶ 573B[6][c][ii]; Adler, *Real Estate Investment Trusts and the Commercial Banker*, JOURNAL OF COMMERCIAL BANK LENDING, Sept. 1972, at 23 (observing that the prominent financial institutions, which are among the leading sponsors of REIT's, commonly incorporate their names in the name of the sponsored REIT of which they then become the adviser); cf. Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 786 (1964).

12. The problem of an independent board "kicking out" the manager is not a

This degree of control has enabled the typical REIT adviser to anticipate, in addition to significant management fees,<sup>13</sup> a rather unusual form of "retirement benefits." Where it has chosen to relinquish its position, the REIT adviser has traditionally been able to extract from its designate among the aspiring replacements a "succession fee"—an amount arguably representing payment for the incumbent's valuable expectation of contract renewal,<sup>14</sup> as well as for its decisive recommendation of a successor.<sup>15</sup>

real fear.

I think if you look for an analogy to the mutual funds you will see very few, if any, when management has been ousted. Remarks of Don Augustine, *supra* note 8.

Mr. Augustine's remarks are directly confirmed by the experience of the Securities Exchange Commission, which has observed no such ouster of an investment adviser in the mutual fund area. See note 21 *infra*.

13. Cf. Adler, *supra* note 11, at 29. This fee is usually one to one-and-one-half percent annually of the total invested assets of the trust, which generally includes all outstanding loans and loans to which the trust is committed in the future. Cates, *Banks' Big Stakes in "REIT" Field*, BANKER'S MONTHLY, Aug. 15, 1970, at 45. One student commentator has concluded that shareholders often lack effective control over these fees. See Note, *Real Estate Investment Trusts: A Current Assessment*, 39 BROOKLYN L. REV. 590, 607 (1973).

14. See Jaretzki, *The Investment Company Act: Problems Relating to Investment Advisory Contracts*, 45 VA. L. REV. 1023, 1032 (1959).

It can be persuasively argued that an adviser does not deserve to be compensated for his expectation of contract renewal, since this expectation does not arise out of his own efforts or performance as an adviser, nor out of the agreement among the parties as embodied in the typical advisory contract, but instead springs from the adviser's practical power to control his renewal or the appointment of his successor *in spite* of the fund's governing instruments. See Sterrett at 239-47.

15. An advisory office can in effect be transferred where the advisory contract terminates according to its stated term or pursuant to an adviser's exercise of its option to terminate and a new adviser is thereafter selected; where there is a conventional assignment by the adviser; where the adviser is merged or consolidated into another corporation controlled by a different group of shareholders; or where the controlling block of shares in the adviser is sold. However, the advisory agreement is likely to impose restrictions on assignment of advisory office. See note 94 *infra*.

In situations where controlling shareholders in a corporate REIT adviser are selling their interest, the allegation has been made that any amount they receive in excess of the net asset value of their shares represents a succession fee. See notes 43-57 *infra* and accompanying text. A partial response to this claim is that such an excess may represent an ordinary corporate control premium—a payment which seems to be generally recognized as valid, see W. CARY, CORPORATIONS 827 (4th ed. 1969), though several theories have developed by which such payments have been successfully attacked in recent years. *Id.* at 827-31. Furthermore, such a payment may constitute compensation for goodwill built up by the adviser. Thus, in *Newman v. Stein*, 464 F.2d 689, 697-98 (2nd Cir. 1972), the court stated:

With its impressive record of performance, the Corporation [a mutual fund adviser in whom the defendants had sold a controlling block] would have had little difficulty in forming a new fund or in selling its services to existing ones or to other institutional investors. Although the value deriving from this potential would hardly have been as great as the capitalization of the Corpora-

Recently, the retention of a succession fee by an investment adviser in the mutual fund area has come under attack. In *Rosenfeld v. Black*<sup>16</sup> the Second Circuit held that an outgoing mutual fund adviser may not receive a succession fee since the acceptance of such a payment from an incoming adviser would violate the incumbent's fiduciary duty to the fund's shareholders. The initial resemblance between REIT advisers and mutual fund advisers is striking.<sup>17</sup> A mutual fund adviser, like its counterpart in the REIT area, regularly assumes almost complete management of the enterprise's affairs, including the important function of investment selection.<sup>18</sup> Furthermore, mutual fund advisers, like REIT advisers, are generally the founders of the fund,<sup>19</sup> remain in office as long as desired,<sup>20</sup> and have the ef-

---

tion's earnings as adviser to a fund which had grown to some \$937,400,000 in net assets . . . and paid \$2,290,203 in management fees [during the six-month period immediately preceding the sale], even after termination of its contracts with the Fund, [it] would be worth something more than the figure shown in the balance sheet.

Similarly, the SEC has also conceded that such payments may be justifiable to the extent that they reflect compensation to the retiring management "for the elements of value in the relationship which they may have built up over the years." SEC PUBLIC POLICY REPORT 152. Thus, where an excess over net asset value is paid for the shares of a corporate REIT adviser, it would seem inappropriate to include within the definition of an advisory succession fee those portions of that excess which in fact constitute an otherwise legally valid control premium or compensation for goodwill.

Furthermore, it may also be asserted that part of such an excess received on the sale of controlling interest in a corporate REIT adviser, or part of a direct payment by an incoming adviser to an incumbent, represents a payment for successful risk-taking. Where the adviser previously served as the sponsor of the REIT, it is very likely that the sponsor-advisor subjected its money to an entrepreneurial risk by seeking investors and by incurring the startup expenses of the REIT. See *Sterrett* 266-67. Where it can be shown that a portion of such a payment constitutes a capitalization of successful risk-taking of this type, it too should arguably not be labeled an advisory succession fee. In apparent recognition of these principles, the Los Angeles County Superior Court recently stated that "the receipt by the . . . [adviser's] shareholders for their stock of an amount in excess of the net asset value of the stock does not, *per se*, amount to a prohibited sale of office or receipt of consideration for a breach of fiduciary obligation." *Ridley v. Continental Ill. Realty*, No. C 19550, at 28 (Los Angeles County Super. Ct., Jan. 22, 1974) (Notice of Intended Decision), discussed in note 58 *infra*.

However, delineating what represents a succession fee from what is being paid for control, goodwill, and capitalization of successful risk-taking is likely to be difficult in practice. Such delineation may be so speculative that permitting payment for these latter elements would result in the danger of allowing a hidden succession fee as well.

16. 445 F.2d 1337 (2d Cir. 1971), *rev'g* 319 F. Supp. 891 (S.D.N.Y. 1970).

17. Because of their similarity, REIT's are sometimes referred to as "the mutual funds of real estate." Rose, *Real Estate Investment Trusts: How They Grow and Go*, JOURNAL OF COMMERCIAL BANK LENDING, Sept. 1972, at 11.

18. See *Survey, The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732, 881-86 (1969). See note 6 *supra* and accompanying text.

19. Most mutual funds are established by their initial adviser. SEC PUBLIC POLICY REPORT 46; WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL

fective power to choose a successor.<sup>21</sup> Thus, although the wisdom of the *Rosenfeld* decision has generated much controversy,<sup>22</sup> its potential application to REIT's has frustrated the ability of REIT advisers to profit from their departure.<sup>23</sup> This Note will attempt to ascertain whether *Rosenfeld's* flat prohibition of advisory succession fees should be applied to REIT's. In addressing this issue it will examine: the factual background and the basic premises of the *Rosenfeld* decision;<sup>24</sup> factors which possibly distinguish mutual fund advisers from REIT advisers;<sup>25</sup> methods which may be utilized to circumvent the *Rosenfeld* rule if it is indeed applied to REIT's;<sup>26</sup> and the feasibility of applying a "fairness test" rather than a flat prohibition to REIT succession fees.<sup>27</sup>

### *Rosenfeld v. Black*: RESTRICTIONS ON SUCCESSION FEES

In *Rosenfeld* the plaintiffs were shareholders in the Lazard Fund

---

FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 44-51 (1962). Similarly, most REIT's are sponsored by their initial adviser. See authorities cited note 7 *supra*.

20. See WHARTON STUDY, *supra* note 19, at 8, 24, 449, 453, 463-65; Jaretzki, *Duties and Responsibilities of Directors of Mutual Funds*, 29 LAW & CONTEMP. PROB. 777, 786 (1964); Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 216 (1971); SEC PUBLIC POLICY REPORT 129. See generally *Hearings on H.R. 9510 & H.R. 9511 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., pt. 2, at 633, 671 (1967) (statements of R. Jennings & M. Cohen, respectively).

21. The SEC has stated that "[it] knows of no instance where fund shareholders have rejected a new advisory contract proposed by their managers in connection with a sale by them of the [adviser]." SEC PUBLIC POLICY REPORT 150. See *Ridley v. Continental Ill. Realty*, No. C 19550 (Los Angeles County Super. Ct., Jan. 22, 1974) (Notice of Intended Decision) (where merger agreement between incumbent and successor adviser was contingent upon shareholder approval of management contract with successor, REIT shareholders approved the agreement by a vote of 1,842,036 to 12,407). For the facts of this case, see note 58 *infra*. See note 12 *supra* and accompanying text.

22. *E.g.*, Sterrett; Note, *Fiduciary Requirements and the Succession Fee Upon the Change of Mutual Fund Advisers*, 85 HARV. L. REV. 655 (1972); Note, *Advisory Succession in the Mutual Fund Industry*, 67 NW. U.L. REV. 278 (1972); Note, *Common Law Prophylactic Rule Threatens Traditional Mutual Fund—Investment Adviser Relationship*, 45 SO. CALIF. L. REV. 1150 (1972); Note, *Mutual Fund Control—Transfer Profits: Congress, The SEC, and Rosenfeld v. Black*, 58 VA. L. REV. 371 (1972); 46 N.Y.U.L. REV. 1029 (1971); 50 TEX. L. REV. 583 (1972).

23. In addition to *Ridley v. Continental Ill. Realty*, No. C 19550 (Los Angeles County Super. Ct., Jan. 22, 1974) (Notice of Intended Decision), discussed in note 58 *infra*, two other cases have been filed: one in connection with the sale of an REIT adviser to Builders Investment Group of Valley Forge, Pennsylvania and the other in connection with the transfer of the adviser of Citizens Mortgage Investment Trust of Southfield, Michigan. Letter from G.N. Buffington, Executive Vice-President and General Counsel, National Association of Real Estate Investment Trusts, Inc., to the *Duke Law Journal*, Mar. 14, 1974.

24. See text accompanying notes 28-38 *infra*.

25. See text accompanying notes 39-78 *infra*.

26. See text accompanying notes 79-110 *infra*.

27. See text accompanying notes 111-131 *infra*.

(the Fund), a mutual fund organized by the defendant Lazard Freres & Co. (Lazard), which had also served as the Fund's adviser since its inception. With the knowledge and approval of the Fund's directors, Lazard arranged for a merger of the Fund into a second mutual fund to be organized by Dun & Bradstreet, Inc., whose subsidiary was then to become the adviser of the resulting combined fund.<sup>28</sup> In addition to arranging the merger, Lazard, which controlled the Fund's proxy machinery, solicited the necessary shareholder approval of the merger and the new advisory contract.<sup>29</sup> Pursuant to a contract contingent upon the merger, Dun & Bradstreet agreed to pay Lazard 75,000 shares of its common stock.<sup>30</sup> Prior to shareholder approval of the agreement, shareholders of the Lazard Fund brought an action for an injunction and accounting against Lazard, Dun & Bradstreet, and its subsidiaries, alleging in essence that Lazard, as a fiduciary, could not be allowed to profit from its role in the selection of a new adviser by the receipt of such a payment.<sup>31</sup> The defendants countered that the true consideration given by Lazard for these shares was that stated in its contract with Dun & Bradstreet—a covenant not to compete in the mutual fund field and other promises to assist temporarily in operating the fund after the merger.<sup>32</sup>

Agreeing that Lazard's conduct might have violated a fiduciary duty to the Fund's shareholders, the Second Circuit reversed a summary judgment for the defendants and remanded the case for a factual determination of the true basis for the payment.<sup>33</sup> In so doing the court held that (1) a mutual fund investment adviser occupies a fiduciary position with respect to the fund's shareholders;<sup>34</sup> (2) under common law principles which prohibit a fiduciary from selling its office, mutual fund shareholders are entitled to recover "any payment

---

28. 445 F.2d at 1339.

29. The Investment Company Act of 1940 makes it unlawful for any person to serve as adviser to a mutual fund except pursuant to a vote of a majority of the fund's shareholders. 15 U.S.C. § 80a-15 (1970). The Act makes it explicit that a change of adviser in any form requires shareholder approval. After broadly defining "assignment" to include "any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor," the Act then mandates that an advisory contract provide "in substance, for its automatic termination in the event of its assignment." 15 U.S.C. §§ 80a-2(a)(4), -15(a)(4) (1970).

30. 445 F.2d at 1340.

31. *Id.* at 1341-42.

32. *Id.* at 1339-40.

33. *Id.* at 1342-48. Before this factual determination was made, the parties in the case reached a \$1,000,000 settlement which was approved by the district court. *Rosenfeld v. Black*, 336 F. Supp. 84 (S.D.N.Y. 1972).

34. 445 F.2d at 1342. See notes 59-60 *infra* and accompanying text.

made to the outgoing adviser by his successor . . . over and above the value of any continuing services";<sup>35</sup> and (3) the Investment Company Act of 1940<sup>36</sup> impliedly incorporated this common law prohibition.<sup>37</sup> By so holding, the Second Circuit attempted to ensure that the departing adviser's recommendation of a successor would not be influenced by the prospect of personal gain, but would be based solely upon an objective judgment as to the best interests of the beneficiary.<sup>38</sup>

#### THE APPLICATION OF *Rosenfeld v. Black* TO REIT'S

##### *The Inapplicability of the Investment Company Act*

Unlike mutual funds, REIT's are not subject to the Investment Company Act of 1940, since virtually all REIT's fall within the Act's exemption for companies primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on interests in real estate."<sup>39</sup> It might thus be contended that the source of the prohibition of succession fees announced in *Rosenfeld* was the Investment Company Act, and that *Rosenfeld* therefore does not provide a precedent for denying succession fees to REIT advisers. This contention should be rejected. An analysis of the *Rosenfeld* opinion shows that it derives its substantive prohibition from common law sources and not from the language of the Act.<sup>40</sup> *Rosenfeld* addresses the language of the Act only

35. *Id.* at 1343-44.

36. 15 U.S.C. §§ 80a-1 to -52 (1970).

37. 445 F.2d at 1345. See notes 39-42 *infra* and accompanying text.

38. 445 F.2d at 1347 n.13. The court stated:

The prime vice in the realization of profit by an investment adviser or a controlling shareholder from a would-be successor lies in the danger that in return for this he may exert his influence to secure stockholder approval of the new or reinstated contract when that may not be the best possible course.  
*Id.*

As the *Rosenfeld* court recognized, the same rationale has been invoked by numerous courts to prohibit an officer or director from selling his corporate office for personal gain. *Id.* at 1342; *cf.*, *Kratzer v. Day*, 12 F.2d 724 (9th Cir. 1926); *Gabriel Indus., Inc. v. Defiance Indus., Inc.*, 22 N.Y.2d 405, 239 N.E.2d 706, 293 N.Y.S.2d 65 (1968); *Cox v. Berry*, 19 Utah 2d 352, 431 P.2d 575 (1967). *Contra*, *Wright v. Webb*, 169 Ark. 1145, 278 S.W. 355 (1925).

39. 15 U.S.C. § 80a-3(c)(5)(C) (1970). Although this test for exemption is somewhat imprecise, in practice almost all REIT's clearly qualify for the exemption, since the favorable tax treatment, which is the *raison d'etre* for REIT's, similarly requires that a large percentage of its income be derived from real estate investments. See INT. REV. CODE OF 1954, § 856; *Wheat & Armstrong, Regulation of Securities of Real Estate Investment Trusts*, 16 BUS. LAW. 919, 924-25 (1961). See note 1 *supra*.

40. See 445 F.2d at 1342-44. Remarks of Fredric J. Klink, REAL ESTATE INVESTMENT TRUSTS—PROBLEMS AND OPPORTUNITIES 186 (Practising Law Institute 1973).

The issue of whether the Investment Company Act preempts state regulation regarding an adviser's fiduciary duties with respect to succession fees in the mutual funds area has not been resolved. Note, *Mutual Fund Control*, *supra* note 22, at 395 n.118.



for the purpose of concluding that it impliedly incorporates equitable prohibitions previously existing under common law.<sup>41</sup> Thus, even if this implied incorporation concept were rejected,<sup>42</sup> *Rosenfeld* would remain strong authority for the proposition that, as a matter of common law, REIT advisers may not receive succession fees.

*A Direct Challenge to the Common Law Rule of Rosenfeld v. Black*

Before considering whether the fiduciary duties enunciated by *Rosenfeld* should be applied to an REIT adviser, however, it is first necessary to consider a contrary interpretation of the mutual fund adviser's duties. *SEC v. Insurance Securities, Inc., (ISI)*,<sup>43</sup> represents imposing authority to contradict *Rosenfeld's* holding that the shareholders of a mutual fund are entitled at common law to recover an advisory succession fee. In the *ISI* case, shareholders of a corporate mutual fund adviser sold their controlling interest for a profit despite the SEC's position that a sale price in excess of the net asset value of the shares violated both equitable principles and the express provi-

---

However, exemption of REIT's from the Act and founding the REIT adviser's duty to forego the charging of a succession fee upon the authority of common law would appear to obviate any question of federal preemption in the REIT area.

41. See 445 F.2d 1344-45.

42. Even prior to the *Rosenfeld* case, its conclusion that the Investment Company Act incorporated the common law prohibition of succession fees was implicitly rejected by the Ninth Circuit in *SEC v. Insurance Securities, Inc.*, 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958). See also *Krieger v. Anderson*, 40 Del. Ch. 61, 173 A.2d 626 (Ch. 1961), on rehearing, 40 Del. Ch. 151, 177 A.2d 203, aff'd, 40 Del. Ch. 363, 182 A.2d 907 (Sup. Ct. 1962). Subsequent to *Rosenfeld* this conclusion was explicitly renounced by the Northern District of Illinois in *Kukman v. Baun*, 346 F. Supp. 55 (N.D. Ill. 1972), discussed in notes 85-89 *infra* and accompanying text. Based upon substantially similar interpretations of the Act's legislative history, both the Ninth Circuit and the Northern District of Illinois concluded that Congress did not intend to incorporate common law fiduciary principles into the Act.

The Ninth Circuit in *ISI* reached its conclusion that the Act was not intended to prohibit profit from the sale of controlling stock in an adviser primarily on the ground that the Act explicitly prohibits assignment of advisory contracts without shareholder approval but makes no reference to the price paid for the assignment. 254 F.2d at 648-49, 651. In *Kukman*, the district court concurred with the Ninth Circuit's analysis in *ISI* and further found that Congress had tacitly adopted the result in *ISI* by its failure to include in subsequent amendments to the Act any provision proscribing succession fees. 346 F. Supp. at 62-64.

Some commentators have also voiced strong disagreement with this aspect of the holding in *Rosenfeld*. See Note, *Common Law Prophylactic Rule*, *supra* note 22, at 1158-63; Note, *Mutual Fund Control*, *supra* note 22, at 396-406. See generally Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 *YALE L.J.* 1258 (1961). But see Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 *GEO. WASH. L. REV.* 266 (1959).

43. 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958).

sions of the Investment Company Act of 1940.<sup>44</sup> In allowing the succession fee in this form,<sup>45</sup> the Ninth Circuit relied upon two closely related rationales. First, since the advisory contract terminated under the Act at the moment of the sale of the controlling block of stock,<sup>46</sup> and since that sale occurred prior to the date when the adviser was re-appointed, the adviser technically retained no "office" which it could have transferred in the sale.<sup>47</sup> Second, the court concluded that no fiduciary duty was breached by the sale because it deemed the succession fee a payment for the outgoing adviser's expectation of contract renewal rather than for an asset of the fund.<sup>48</sup>

These two reasons for the Ninth Circuit's holding that no fiduciary duty was breached have been soundly criticized<sup>49</sup> and cannot withstand close scrutiny. The first argument, that in such a case there is no sale of office because the office has terminated before it could be sold, is a triumph of form over substance. Whether termination of the office occurred before, upon, or after the sale of office should be irrelevant, for a fiduciary duty does not depend upon the existence of a contract,<sup>50</sup> and it is now well established that fiduciary duties can survive the abdication of a fiduciary office.<sup>51</sup> Furthermore, although

---

44. By contending that controlling stock can be sold only for its proportionate share of the net asset value of the corporation, the SEC would have denied even the premium which a controlling interest in a corporation normally commands. Valuation of a control premium is discussed in Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986, 994-96 (1957). For a discussion delineating a succession fee from the total purchase price where sale of controlling stock of a mutual fund adviser exceeds its market price, see Note, *Fiduciary Requirements*, *supra* note 22, at 662-65. See also *Newman v. Stein*, 464 F.2d 689, 697-98 (2d Cir. 1972).

45. See note 15 *supra*.

46. See 15 U.S.C. §§ 80a-2(a)(4), -15(a)(4) (1970).

47. 254 F.2d at 650-51.

48. *Id.*

49. *E.g.*, Sterrett 236-37; Note, *Mutual Fund Control*, *supra* note 22, at 388-94; Note, *Protecting the Interests of Mutual-Fund Investors in Sales of Management-Corporation Control (Or, Policing the Traffic in Other People's Money)*, 68 YALE L.J. 113, 120-28 (1958).

50. "A fiduciary is a person who undertakes to act in the interest of another person. It is immaterial whether the undertaking is in the form of a contract." Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 540 (1949).

51. *E.g.*, *Perlman v. Feldman*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *B.R. Paulsen & Co. v. Lee*, 95 Ill. App. 2d 146, 237 N.E.2d 793 (1968); *Opie Brush Co. v. Bland*, 409 S.W.2d 752 (Mo. Ct. App. 1966); *Matter of Caplan*, 20 App. Div. 2d 301, 246 N.Y.S.2d 913, *aff'd*, 14 N.Y.2d 679, 198 N.E.2d 908, 249 N.Y.S.2d 877 (1964).

Mutual Fund sponsors create and operate funds in such a manner that the shareholders are reliant upon the sponsor's external management and administration. A momentary hiatus in the contractual relationship produced by the unilateral action of an adviser does not diminish this necessary reliance. Sterret 236.

the adviser's contract in *ISI* had technically terminated when the controlling shareholders transferred their interest, *ISI* retained control over the fund's proxy machinery and used this mechanism to secure the approval by the fund's shareholders of its reappointment of the newly-controlled fund adviser.<sup>52</sup> Since it is just as improper for a fiduciary to secure the transfer of his office by influencing trust beneficiaries as it is to sell his office directly,<sup>53</sup> the same fiduciary obligation developed in the direct sale of office cases should have been imposed in *ISI* with respect to the conduct of the selling shareholder-directors of the adviser.

The second argument, that succession fees purchase the adviser's contract renewal expectation rather than a fund asset, is equally unpersuasive. The awkward borrowing of property concepts to judge the validity of succession fees simply sidesteps the crucial inquiry into the adviser's potential conflict of interest. If courts allow advisers to orchestrate the appointment of successors who will pay the highest premiums,<sup>54</sup> the adviser's duty to recommend only the best successor will be forever interred.<sup>55</sup> Out of such a concern, the *Rosenfeld* court even went so far as to argue that it is immaterial whether the expectation of renewal enjoyed by the adviser is considered the fund's or the adviser's asset.<sup>56</sup> However, even if the adviser's contractual expectations are desig-

---

52. 254 F.2d at 646. Although the Ninth Circuit held that the advisory contract had terminated immediately upon the unapproved sale of control, see notes 46-47 *supra* and accompanying text, it is clear from the opinion that the adviser in fact continued to serve as the fund's adviser through the time of the proxy solicitation. *Id.*

The history of mutual funds has shown that the adviser's recommendation of a successor is virtually certain to be followed by the shareholders. See note 21 *supra* and accompanying text.

53. *Pepper v. Litton*, 308 U.S. 295, 311 (1939); *Kratzer v. Day*, 12 F.2d 724, 726 (9th Cir. 1926); *Clark v. First Nat'l Bank*, 219 Iowa 637, 259 N.W. 211 (1935); A. BERLE & M. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 237 (1932) (de facto control gives rise to same responsibility attendant upon actual control).

See also *RESTATEMENT OF CONTRACTS* § 569 (1932): "A bargain by an official or shareholder of a corporation for a consideration enuring to him personally to exercise or promise to exercise his powers in the management of the corporation in a particular way is illegal."

54. Shareholders who deem it in their interest to allow the adviser to select a successor and receive a succession fee may of course do so. See text accompanying note 108 *infra*.

55. It is conceivable that the successor picked by the incumbent will be both the highest bidder and the most qualified manager. In such a situation a succession fee might still be denied, because it would seem proper to require that the recipient of a succession fee show that it had selected the best adviser, and this burden of proving a negative—that there existed no more competent successor—could well be insuperable.

56. 445 F.2d at 1343. In *Ridley v. Continental Ill. Realty*, No. C 19550 (Los Angeles County Super. Ct., Jan. 22, 1974) (Notice of Intended Decision), discussed in note 58 *infra*, the court similarly indicated that succession fees should be treated as sales of influence rather than sales of property. But the court also utilized the same

nated a property interest, the succession fee need not necessarily be an *adviser* asset. Rather, the transferred property more likely represents the power to select an adviser in the first instance, a power inherently residing in the shareholders of the fund. Even though the shareholders permit their exercise of this power to be guided by the adviser, the succession fee may easily be deemed a fund asset.<sup>57</sup>

Because the Ninth Circuit incorrectly assumed that the fee constituted payment purely for an asset of the adviser, and because the court failed to perceive the defendant's ability to control the adviser's reappointment, the *ISI* case should not bar the application of *Rosenfeld's* fiduciary analysis to advisory succession fees in the REIT context.

### *REIT's: A Distinguishable Pattern of Adviser Succession?*

Can the *Rosenfeld* rule be limited to mutual funds, or at least held inapplicable to REIT's? In the recent case of *Ridley v. Continental Illinois Realty*,<sup>58</sup> the court, without elaboration, rejected the contention

---

reasoning to attack *Rosenfeld's* attempt to analogize succession fees to sales of fiduciary office. *Id.* at 27-28.

57. It is significant to note that the United States District Court for the Northern District of Illinois in *Kukman v. Baum*, which considered mutual fund adviser succession after *ISI* and *Rosenfeld*, agreed with *Rosenfeld* that under common law principles the mutual fund shareholders are entitled to any succession fee realized by its adviser. *Rosenfeld's* holding on this point, stated the court, was "so obviously correct" that no citations were needed to support it. 346 F. Supp. at 61. *Kukman's* adherence to *Rosenfeld* on this point is perhaps all the more impressive because it rejected the implied incorporation doctrine espoused by *Rosenfeld* and in this respect aligned itself with *ISI*. *Id.* at 62-65.

58. No. C 19550 (Los Angeles County Super. Ct., Jan. 22, 1974) (Notice of Intended Decision). Although the holding in this case does not decide whether REIT shareholders have a right to recover a succession fee from the trust's adviser, the case discusses some aspects of this issue in detail.

In *Ridley* the corporate adviser of an REIT was merged into its successor, contingent upon approval by the REIT shareholders of the successor's management contract. *Ridley*, one of the REIT's shareholders, brought suit on behalf of the trust against its adviser, alleging a breach of fiduciary duty. Urging application of the prophylactic rule of *Rosenfeld*, *Ridley* contended that any amount received by the adviser's shareholders in excess of the book value of its assets should be paid to the REIT. Despite the admitted applicability of the common law prohibition against a fiduciary's sale of its influence, the court recognized that the excess payments might also be attributed to factors other than the sale of influence. See note 15 *supra*. While acknowledging that some portion of the amount received *may* have been paid for the adviser's influence over the trust, the court focused on other alleged breaches of fiduciary duty in granting repayment of all fees received by the advisers during the period of malfeasance. *Id.* at 30-32. Among the breaches of duty which the court attributed to the adviser and its majority shareholder were: (1) disclosing confidential trust information during the merger negotiations; (2) permitting representatives of the aspiring successor to participate in meetings of the REIT's trustees; and (3)

that the fiduciary duties of REIT advisers were so distinguishable from those of mutual fund advisers as to preclude the application of *Rosenfeld* in the REIT context. Although the court acknowledged that differences exist between REIT and mutual fund advisers with respect to their regulation and function, it found that each bore substantially the same relationship to the investors whose funds they managed. There is no doubt that an REIT adviser, like a mutual fund adviser, is a fiduciary:<sup>59</sup> both exercise discretionary control over another's property in a relationship founded on the reliance and trust of that other person.<sup>60</sup> But REIT advisers and mutual fund advisers do not necessarily owe the same obligations to their respective beneficiaries, as the duties of a fiduciary vary according to the nature of the fiduciary relationship.<sup>61</sup>

As pointed out above,<sup>62</sup> a comparison of the fiduciary relationships of both REIT and mutual fund advisers reveals numerous fundamental similarities. Both assume almost complete management of the enterprise, determine its investments, remain in office largely at will, and have power to determine a successor. But despite the significant similarities, several arguably important distinctions may exist between REIT and mutual fund advisers.

First, the history of the mutual fund industry reveals numerous instances of fund looting and shareholder abuse due to the sale of ad-

---

causing the REIT to give the surviving corporation certain warranties which had the potential of severely restricting the REIT's investment opportunities.

It seems that the court was wrong in not deciding the succession fee issue, as it represented an additional rather than an alternative ground for recovery. Influencing the choice of a successor breached a duty separate from those requiring nondisclosure of confidential information and the operation of the trust for the benefit of its shareholders. Moreover, although the court imposed a heavy penalty on the outgoing adviser by forcing it to repay substantial fees, the control premium its shareholders received represented a gain which did not come from the fees paid by the REIT. Thus, the principle which the court applied to justify repayment of the management fees—"that a fiduciary who gains personally at the expense of, or by reason of use or acquisition of an asset of, his principal, may be required to disgorge to his principal such gain," *id.* at 33—should be applicable to the succession fee as well.

59. Compare 4A POWELL 91573B[7] n.100 with *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191 (1963) and *Kukman v. Baum*, 346 F. Supp. 55, 61 (N.D. Ill. 1972) and *Brown v. Bullock*, 194 F. Supp. 207, 234 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

60. *E.g.*, *Schweickhardt v. Chessen*, 329 Ill. 637, 649, 161 N.E. 118, 123 (1928) ("A fiduciary relation . . . exists in all cases where confidence is reposed on the one side and a resulting superiority and influence on the other side arises therefrom"). See generally *Scott*, *supra* note 50, at 539.

61. It is obligatory to cite at this juncture perhaps the most often quoted words of Justice Frankfurter: "[T]o say that a man is a fiduciary only begins analysis. . . ." *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943).

62. See text accompanying notes 17-21 *supra*.

visory offices.<sup>63</sup> These abuses were responsible in large part for the enactment of the Investment Company Act of 1940.<sup>64</sup> The real estate investment trust field by contrast apparently has not witnessed such abuses, as evidenced by the lack of corresponding documentation or enactment of any remedial federal legislation. However, it would be naive to suggest that REIT advisers are peculiarly beyond temptation,<sup>65</sup> for the lack of documented abuses is quite likely a mere reflection of the relatively recent origin and growth of REIT's<sup>66</sup> and the fact that REIT's are only now beginning to experience the adverse economic circumstances<sup>67</sup> which frequently bring previously existing abusive practices to full public view.<sup>68</sup> Similarly, although Congress acknowledged the danger of mutual fund adviser misconduct by enacting remedial legislation which requires shareholder approval for all changes in advisory office, the more ancient learning of the common law, upon which *Rosenfeld* drew,<sup>69</sup> prohibits the sale of a fiduciary office even in the absence of a statutory shareholder approval requirement.<sup>70</sup> Most importantly, the rule of *Rosenfeld* was designed not

---

63. See SEC, PUBLIC POLICY REPORT 46; SEC, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. 279, 76th Cong., 1st Sess., pt. II, at 1918 (1939).

[A]fter investors have invested in investment companies on their faith in the reputation and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who have looted the assets of such companies or to other investment companies which have subjected the stockholders to grossly unfair plans of merger, consolidation, or other corporate re-adjustments. H.R. REP. NO. 2639, 76th Cong., 3d Sess. 9 (1940).

See S. REP. NO. 1775, 76th Cong., 3d Sess. at 7 (1940).

64. Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission . . . it is declared that the national public interest and the interest of investors are adversely affected . . . when control or management . . . [of investment companies] is transferred without the consent of their security holders . . . . Investment Company Act of 1940, §§ 1(b), 1(b)(6), 15 U.S.C. §§ 80a-1(b), -1(b)(6) (1970).

65. The need for government regulation of REIT's, especially to resolve conflict of interest problems, has been increasingly noted. Lynn, *Real Estate Investment Trusts: Problems and Prospects*, 31 *FORDHAM L. REV.* 73, 103 (1962); Remarks of S. Douglas Weil, *REAL ESTATE FINANCING; CONTEMPORARY TECHNIQUES* at 432 (Practising Law Institute 1973). Note, *supra* note 13, at 618 (discussing potential conflict of interest situations for REIT advisers). See also DICKEY, *supra* note 1, at 92.

66. See note 1 *supra* and accompanying text.

67. See note 2 *supra* and accompanying text.

68. For example, Congress enacted the Securities Act of 1933 as a response to economic losses suffered by a large segment of the public due to fraudulent stock issuances. See, e.g., W. CARY, *supra* note 15, at 1295-96.

69. 445 F.2d at 1342. See notes 39-42 *supra* and accompanying text for the argument that the *Rosenfeld* court's imposition of a fiduciary duty on mutual fund advisers did not depend upon the fact that this common law duty had been incorporated into the Investment Holding Company Act of 1940.

70. In *Rosenfeld* the court further stated:

merely to remedy past abuse but to prevent the potential for abuse.<sup>71</sup>

A second possible distinction between REIT and mutual fund advisers is that an REIT adviser contracts, not directly with the beneficiaries as does a mutual fund adviser, but with the REIT trustees, because in the REIT, the trustees and not the beneficiaries act as legal owners and principals in conducting the trust's affairs.<sup>72</sup> Thus, the REIT trustee provides an additional check upon the influence of the REIT adviser. It follows that since the REIT shareholders are more insulated from the influence of the REIT adviser than are their counterparts in the mutual fund area,<sup>73</sup> the stringent fiduciary duty imposed upon mutual fund advisers is arguably unnecessary in the REIT context. The potential effect of this structural check on the influence of the REIT adviser is most apparent when one examines the investment process. Whereas mutual fund advisers are empowered to make investments on behalf of the fund,<sup>74</sup> the REIT adviser usually can only submit recommendations to the trustees who then accept or reject the proposed investment.<sup>75</sup> Despite this procedural difference, the REIT adviser plays an equally important role in the investment function. In practice the advisers of both mutual funds<sup>76</sup> and REIT's<sup>77</sup> have the power of initiative, since they determine in the first instance which investments appear worthwhile. Not only are REIT trustees thus restricted to a veto power, but also the need for prompt action in committing funds for real estate investment

---

Even ratification by the beneficiaries would not save a fiduciary from accountability for any amounts realized in dictating or influencing the choice of a successor unless this was secured with notice that the beneficiaries were entitled to the profit if they wished . . . , and it is questionable whether such ratification by a majority of the beneficiaries could bind others or the [fund] itself. 445 F.2d at 1343 (citations omitted).

71. "Experience has taught that, no matter how high-minded a particular fiduciary may be, the only certain way to insure full compliance with that duty is to eliminate any possibility of personal gain." 445 F.2d at 1342.

72. 4A POWELL ¶ 573A[16]. The trustees, as the trust's legal owners, are the proper parties to bring an action for the recovery of succession fees; but should they prove recalcitrant, a beneficiary can compel recovery by bringing an action directly against the advisor, joining the trustee as a defendant. Alternatively, the beneficiary may seek removal of the trustees for breach of trust in permitting the misappropriation of trust property. See G.G. & G.T. BOGERT, *LAW OF TRUSTS* §§ 160, 166 (1973); *RESTATEMENT (SECOND) OF TRUSTS* § 294 (1959).

73. See WHARTON STUDY, *supra* note 19, at 6-9.

74. See SEC PUBLIC POLICY REPORT 45-46.

75. See Remarks of Benito M. Lopez, Jr., *REAL ESTATE INVESTMENT TRUSTS* 1973, 21 (Practising Law Institute 1973) (sometimes an adviser is empowered to commit the trust to investments subject to limitations imposed by the trustees); cf. 3 Z. CAVITCH, *BUSINESS ORGANIZATIONS* § 44.06[1][c] (1963); 4A POWELL ¶ 573B[6][iii].

76. See note 74 *supra* and accompanying text.

77. See Schulkin, *supra* note 6, at 36.

suggests that trustee approval tends to be automatic.<sup>78</sup> While statistics have not been found, it seems logical in view of the adviser's influence and expertise that the trustees would rarely reject an adviser's proposed investment.

The aforementioned distinctions thus fail to diminish substantially the previously noted similarity between the fiduciary relationships of mutual fund and REIT advisers. It therefore appears that REIT shareholders need and deserve the same untainted judgment from an adviser as is required of mutual fund advisers under the *Rosenfeld* rule.

#### AVOIDING THE RULE IN *Rosenfeld*

##### *An Exception for Private Trusts—Or for Diversified Advisers?*

The defendants in *Rosenfeld* vainly argued that advisory succession fees should be allowed for the reason that controlling stock in banks or trust companies which administer private trusts may be sold at a profit.<sup>79</sup> Clearly these corporate trustees are classic fiduciaries who exercise significant control over the assets they manage. Nevertheless, the Second Circuit in dicta found that the duties owed by these corporate fiduciaries of private trusts were distinguishable from those owed by mutual fund advisers on the grounds that "[t]here is . . . no need to fear that the person who purchases the controlling interest [in such a corporate trustee] will pay the seller for exerting his influence to have the purchase approved by the beneficiaries of the trust."<sup>80</sup> Two reasons were given for this observation. First, since trustee fees are but a minute fraction of the income of a bank or trust company, the receipt of such fees is an insignificant incentive for the purchase of its controlling stock.<sup>81</sup> Second, as stated by the court, "A person who selects a bank or trust company as trustee must contem-

---

78. Some support for this inference may be drawn from the fact that most REIT's have found it advantageous to delegate investment authority to a special fast-acting trustee investment committee:

Typically, the REIT will establish an investment committee which is authorized to make investment decisions between sessions of the full board of trustees. Consequently, the REIT can take advantage of a worthwhile investment opportunity whenever it happens to arise. The common procedure is to have the investment committee meet to authorize the investments immediately following the decision by the adviser to recommend the investment to the REIT. It would also be wise for the Declaration of Trust to fully sanction conferences by telephone . . . . 3 Z. CAVITCH, *supra* note 75, at § 44.06[1][c] (footnote omitted).

See also 4A POWELL ¶ 573B[6][iii].

79. 445 F.2d at 1346-47 n.13.

80. *Id.*

81. *Id.*



plate that a change in control of the corporate trustee may occur during the life of the trust."<sup>82</sup> This dicta suggests some possible arguments which might be raised in the REIT context, especially by a bank or a similarly diversified corporate adviser as justification for the retention of a succession fee.<sup>83</sup>

Reading this exception expansively, it could be contended that the *Rosenfeld* rule applies only to a "pure" succession fee for services rendered and not to a sale of a controlling interest in a corporate REIT adviser.<sup>84</sup> This argument was rejected as to mutual fund advisers, however, in *Kukman v. Baum*.<sup>85</sup> In *Kukman* controlling stock in a corporation which advised three mutual funds was sold at a profit, whereupon the advisory contract was reinstated.<sup>86</sup> Even though the adviser's investment policy and managerial personnel did not change following the sale of control, the United States District Court for the Northern District of Illinois stated in dicta that *Rosenfeld's* common law fiduciary duty should apply to the sale of a controlling interest in a corporate adviser.<sup>87</sup> The important issue, observed the court, is not the method by which adviser succession is procured,<sup>88</sup> but rather whether the results produce the same danger of adviser conflict of interest.<sup>89</sup>

Despite the broad language in *Kukman*, the distinction between sale of control in a corporate adviser and receipt of an outright succession fee gains more credence if the adviser is a large, diversified enterprise which receives only a "minute fraction" of its income from

---

82. *Id.*

83. Banks such as Bank of America, Chase Manhattan, Union Bank, and Wells Fargo have all sponsored REIT's. Meyer & Sprayregen, *supra* note 1, at 82.

84. *Rosenfeld* expressly states no opinion as to whether its rule is applicable to a succession fee received upon sale of control. 445 F.2d at 1346. The Second Circuit noted that *ISI*, which had permitted a succession fee, involved a sale of control; but the court distinguished *ISI* on the technical ground that in *ISI* the SEC proceeded under a different section of the Investment Company Act than did the plaintiffs in *Rosenfeld*. However, the *Rosenfeld* court did carefully suggest that its decision might be applicable to sale of control situations. *Id.*

85. 346 F. Supp. 55 (N.D. Ill. 1972).

86. 346 F. Supp. at 56-59. *Kukman* actually involved two sales of control, the first from a group of individual shareholders to a corporation which subsequently resold the stock. *Id.* at 56.

87. *Id.* at 61. While *Kukman* found *Rosenfeld* indistinguishable on its facts, *Kukman* reached a different result by rejecting *Rosenfeld's* conclusion that the common law principles denying a succession fee were impliedly incorporated into the Investment Company Act. *Id.* at 62-65. See notes 40-42 *supra* and accompanying text. No mention is made in *Kukman* of whether a claim asserted under state law would have been successful or whether state law had been preempted. See note 40 *supra*.

88. These methods are outlined in note 15 *supra*.

89. See 346 F. Supp. at 61.

managing an REIT.<sup>90</sup> Arguably, the succession fee would be too small relative to the whole transaction to influence the motivations of either the buyer or the seller. One would not be likely to sell control of a large, diversified corporation merely to capitalize on the possibility of retaining a succession fee which would constitute only a small fraction of the corporation's total value. Therefore, as the number of persons to whom the adviser owes a fiduciary duty increases, the less practical it is to expect that, upon sale of control of that adviser, the seller should be required to consider solely what is best for any particular beneficiary;<sup>91</sup> and as the adviser's other sources of income increase, there becomes less of an incentive for the adviser to seek profit by violating his fiduciary duty to the REIT's shareholders.

If the sale of a controlling interest in a large, diversified REIT *does* violate a duty, identifying that part of the purchase price which represents a succession fee would be difficult.<sup>92</sup> But the mere difficulty of ascertaining the proper amount of recovery should not completely bar application of *Rosenfeld's* prophylactic rule.<sup>93</sup> For although the Investment Company Act provides some safeguards for mutual fund shareholders, there is no statutory requirement that sale of control in an REIT adviser automatically terminates the advisory contract. Moreover, even where a termination-upon-agreement provision is expressly included in the advisory agreement,<sup>94</sup> such a provision may provide only illusory shareholder protection, because as was demonstrated by the facts of the *ISI* case,<sup>95</sup> it can be evaded.

---

90. It may have been appropriate for *Kukman* to have addressed this problem. The adviser in that case, in addition to advising three mutual funds, also managed investment portfolios for others. Defendants' Memorandum for Summary Judgment at 18. The defendants contended that a sale of control was distinguishable from the form of succession in *Rosenfeld* on the ground that the corporation and not its shareholders is the fiduciary. *Id.* at 53. The common law of trusts has generally viewed the corporate entity as the fiduciary. BOGERT, *supra* note 72, at § 531.

91. The adviser with numerous beneficiaries might argue that its primary duty is to pick the most competent successor to advise *all* the beneficiaries as a class.

92. See generally Note, *Fiduciary Requirements*, *supra* note 22, at 663-65.

93. Cf. 11 S. WILLISTON, *CONTRACTS* § 1342 (Jaeger, 3d ed. 1968).

94. At least some, and probably most, REIT advisory contracts provide for automatic termination if the adviser attempts to "assign" the contract. See 4A POWELL ¶ 573B[6][b][iv]. Query whether such a provision could be construed to apply to all forms of advisory succession or whether as a matter of the common law of contracts only more direct forms of adviser assignment are prohibited. See Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(4) (1970) (broadly defining assignment to include sale of control); 4 A. CORBIN, *CONTRACTS* § 865 (1951) (contracts for personal services involving skill and judgment are not assignable).

95. See note 52 *supra* and accompanying text.

Nor are REIT shareholders statutorily required to approve the successor.<sup>96</sup> Where these features are absent, or ineffective, neither the trustees nor the shareholders may have an immediate check upon advisory succession.<sup>97</sup>

Even if control in a large, diversified corporate adviser is generally sold without regard to the value of the attendant advisory contract, the purchaser is likely to be the highest overall bidder rather than the most qualified adviser. If the succession fee is truly insignificant to the parties, advisory succession can be accomplished by an alternative method producing less risk to the REIT shareholders. For instance, it could be required that the advisory position and all elements of control over that position, such as offices and directorships, be completely relinquished before the sale, or that the adviser recommend a new adviser controlled by parties other than the purchasers of its controlling interest.<sup>98</sup> In either event, open competition for the vacated position might be created, thereby resulting in a benefit to the shareholders in the form of more profitable investment advice or lower management fees.<sup>99</sup> Thus, while there may be less incentive for abdication of fiduciary duty when the succession occurs as a sale of control in a large, diversified corporate adviser, this should not exempt such transactions from *Rosenfeld's* general prohibi-

---

96. See 3 Z. CAVITCH, *supra* note 75, at § 44.07. For an example of a typical declaration of trust which leaves the selection of an adviser to the discretion of the trustees, see REAL ESTATE INVESTMENT TRUSTS 1973, 37 (Practising Law Institute 1973).

97. Such safeguards may also fail because some or all of the trustees and the remaining shareholders may not know that the controlling stock in the adviser has been sold. Depending upon the terms of the trust agreement and advisory contract, the shareholders may have the power to remove the trustees at any time by majority vote and the trustees may have the power to terminate the advisory agreement at any time. However, even under such a carefully worded contract, before the shareholders could remove an adviser they did not want, they would first have to learn about the sale of control, call a shareholders' meeting, vote to remove the trustees, elect new trustees, and, as would probably be prudent, arrange for a new adviser.

98. In the absence of such a provision, it could almost always be contended that a succession fee was included in the purchase price paid for controlling interest in a corporate REIT adviser. The plaintiff shareholders in *ISI* contended that any amount above a corporate adviser's net asset value constituted a succession fee. 254 F.2d at 647. See note 15 *supra*.

99. If a prospective adviser is willing to pay a succession fee to the incumbent, it would probably be willing to pay a like amount to the trust, see *Sterrett* 211, perhaps in the form of lower advisory fees if not as a direct lump sum payment.

If the result of denying succession fees was to increase shareholder profits, a collateral benefit to the increased fairness to shareholders might be the investment of additional capital in REIT's, thereby forwarding a major Congressional purpose for enacting favorable REIT tax treatment—providing additional capital for the construction industry. H.R. REP. No. 2020, 86th Cong., 2d Sess. 3-4 (1960).

tion of advisory succession fees.<sup>100</sup>

### *Contractual Exculpation for Succession Fees*

For the REIT adviser that wishes to receive a succession fee, a more promising approach than seeking a common law loophole would be to create a contractual loophole by means of an exculpatory clause.<sup>101</sup> Accordingly, since *Rosenfeld*, some advisory contracts have contained provisions explicitly stating that REIT shareholders do not have any interest in the proceeds from the sale of the adviser's shares.<sup>102</sup> Although such exculpatory clauses can relieve a fiduciary of liability,<sup>103</sup> courts will generally not give them effect unless certain conditions are met. First, exculpatory provisions are strictly construed against the fiduciary; to be effective, the provision relied upon must clearly describe the act to be excused and the extent to which liability is relieved.<sup>104</sup> Thus, a provision which permitted a succession fee upon sale of the adviser's controlling shares would probably not permit a succession fee obtained by any other means.<sup>105</sup> Second, an exculpatory provision will not be given effect if it is against public policy.<sup>106</sup> Since retention of a succession fee allows the adviser, while operating under a conflict of interests, to influence the appointment of his successor, the trust is unnecessarily jeopardized if the trustees gratuitously permit a succession fee.<sup>107</sup> Of course, if the *shareholders* knowingly and freely approve even a gratuitous succession fee provision, it does not violate public policy: absent harm to another, the shareholders may treat their own property as they wish.<sup>108</sup>

---

100. The desired weight to be given shareholder protection increases when it is considered that the principal investors in REIT's are small shareholders who are senior citizens. A survey of REIT shareholders conducted early in 1972 disclosed that 78% were individuals and 61% owned less than 300 shares each. Buffington, *supra* note 1, at 276.

101. *But see* Remarks of Fredric J. Klink, *supra* note 40, at 187 ("Whether that kind of a boot strap is effective is debatable.").

102. *Id.* at 187. For an example of such an exculpatory clause see REAL ESTATE INVESTMENT TRUSTS 1973, 58-59 (Practising Law Institute 1973).

103. RESTATEMENT (SECOND) OF TRUSTS § 222 (1959).

104. 3 A. SCOTT, THE LAW OF TRUSTS § 222.2 (3d ed. 1967).

105. For the means by which a succession fee may be realized, see note 15 *supra*.

106. A. SCOTT, *supra* note 104, at § 222.3.

107. *See* RESTATEMENT, *supra* note 103, at § 222.2.

108. *See* A. SCOTT, *supra* note 104, at § 216. Similarly, subsequent ratification by the beneficiaries, if made knowingly and willfully precludes a fiduciary's liability for breach of trust. *Id.* § 218. For support of the statement that knowledge and willfulness are essential to the validity of such a ratification, see note 70 *supra*.

An example of a provision in a trust agreement requiring the trustees to insert an exculpatory clause in the advisory agreement may be found in REAL ESTATE IN-

A more difficult public policy question is presented where it can be shown that the *trustees*, without specific shareholder approval, received valuable consideration *on behalf of the trust* in exchange for the agreement to the exculpatory clause. In support of such an exculpatory provision, it can be argued that the trustees pursuant to their management powers may reasonably choose to augment the trust by accepting a sum certain for exposing it to a risk which may never occur. Whether such conduct breaches the trustees' duty of care and loyalty cannot be ascertained without analysis of all the relevant factors, such as the value of the consideration received, the apparent likelihood and result of adviser succession, the personal interests of the trustees in inserting such a provision, and existing contractual modification of the trustees' duties.<sup>109</sup> Since an exculpatory provision is likely to be inserted at the insistence of the adviser, not only may the trustees be liable for breaching their duty of discretion or loyalty by inserting such a clause, but also the adviser may be liable for its participation in the trustees' breach of duty.<sup>110</sup> Thus, while an exculpatory clause permitting succession fees inserted without shareholder approval may be valid, disputes over the legality of succession fees can best be avoided by obtaining express shareholder approval of such clauses.

#### A FAIRNESS TEST AS AN ALTERNATIVE APPROACH

The preceding sections of this Note indicate that it is appropriate, absent an exculpatory clause, to prevent all succession fees as a means of avoiding any adverse effects on an REIT when its adviser

---

VESTMENT TRUSTS 1973, 37 (Practising Law Institute 1973).

See also *Ridley v. Continental Ill. Realty*, No. C 19550 (Los Angeles County Super. Ct., Jan. 22, 1974) (Notice of Intended Decision). In *Ridley*, the shareholders ratified certain of the adviser's actions which were otherwise in violation of fiduciary obligations. Ratification was ineffective because full disclosure of the underlying facts was absent.

109. A trustee in managing the trust must utilize "the care, skill, prudence, and diligence of an ordinarily prudent businessman engaged in similar business affairs and with objectives similar to those of the trust in question." BOGERT, *supra* note 72, at § 541. However, this duty of care like the adviser's fiduciary duty discussed above, may be modified by an exculpatory clause. *Id.* § 542. A typical exculpatory clause for REIT trustees relieves them of liability except for bad faith, willful misconduct, and gross negligence. Remarks of Fredric J. Klink, *supra* note 40, at 178. 3 Z. CAVTCH, *supra* note 75, at § 44.06[1][f].

110. If inducing the trustees to insert the exculpatory clause breaches the adviser's duty to the trust, the adviser cannot assert that the clause is valid. See BOGERT, *supra* note 72, at § 167. See also RESTATEMENT, *supra* note 103, at § 326: "A third person who, although not a transferee of trust property, has notice that the trustee is committing a breach of trust and participates therein is liable to the beneficiary for any loss caused by the breach of trust."

acts in this conflict of interest situation. A different approach to judging whether profits from succession should be allowed REIT advisers is exemplified by the policy statements of the Midwest Securities Commissioners Association (MSCA) regarding REIT's.<sup>111</sup> Although even the member states of the MSCA are not required to adopt its statements of policy,<sup>112</sup> these statements have served as models for many blue sky regulations dealing specifically with REIT's,<sup>113</sup> and as such they are probably the most important current influence on positive law dealing specifically with the fiduciary relationship of REIT advisers.<sup>114</sup>

The MSCA's most recent statement of policy of REIT's was adopted on July 16, 1970, almost a year prior to the Second Circuit's decision in *Rosenfeld*.<sup>115</sup> Thus, it is not surprising that this statement of policy does not specifically address the conflict of interest situation giving rise to succession fees.<sup>116</sup> However, the 1970 statement contains a broad "Self Dealing" section which appears to be aimed at

111. For a brief description of the MSCA see 1 BLUE SKY L. REP. ¶ 4751 (1969).

112. Even if these statements are not incorporated into a state's regulations, they affect industry practice because they are the view of the MSCA. Remarks of Edward J. McAniff, REAL ESTATE INVESTMENT TRUSTS 80 (Practising Law Institute 1970).

113. "[I]t may be assumed that the Statement of Policy will be utilized to some extent by each of the member states in any legislation they may adopt." 3 Z. CAVITCH *supra* note 75, at § 44.07[3][b][i].

Nine states have modeled their blue sky regulations after an MSCA statement of policy. See 1 BLUE SKY L. REP. (Alas.) ¶ 6046 (1972); 1 BLUE SKY L. REP. (Cal.) ¶ 8625 (1972); 2 BLUE SKY L. REP. (Iowa) ¶ 18,636 (1971); 2 BLUE SKY L. REP. (Mo.) ¶ 28,606 (1972); 3 BLUE SKY L. REP. (S.D.) ¶ 44,629 (1972); 3 BLUE SKY L. REP. (Tenn.) ¶ 45,626 (1967); 3 BLUE SKY L. REP. (Tex.) ¶ 46,661 (1967); 3 BLUE SKY L. REP. (Wash.) ¶¶ 50,641, 50,650 (1972); 3 BLUE SKY L. REP. (Wis.) ¶ 57,732 (1970).

Five other states have also enacted blue sky regulations dealing expressly with REIT's. See 1 BLUE SKY L. REP. (Fla.) ¶ 13,613 (1972); 1 BLUE SKY L. REP. (Idaho) ¶¶ 15,701, 15,713 (1970); 2 BLUE SKY L. REP. (Mich.) ¶ 25,640 (1972); 2 BLUE SKY L. REP. (Miss.) ¶ 27,941 (1964); 3 BLUE SKY L. REP. (Va.) ¶ 49,614 (1972).

114. See Remarks of Charles A. Goldstein, REAL ESTATE FINANCING: CONTEMPORARY TECHNIQUES 433 (Practising Law Institute 1973) (noting that blue sky laws appear to provide the only specific state regulation of REIT's); Wheat & Armstrong, *supra* note 39, at 925-26.

The Real Estate Advisory Committee of the SEC has recommended that a study be conducted of REIT's to formulate proposals for specific REIT regulation by the SEC. DICKEY, *supra* note 1, at 93-94.

115. 1 BLUE SKY L. REP. ¶ 4801 (1971). This statement supersedes earlier statements of policy and their revisions, which presently provide the pattern for regulations in some states. For some of these earlier statements see *id.* ¶¶ 4751-58 (1969). The North American Securities Administrators Association, Inc., has also adopted the 1970 Statement. *Id.* ¶ 4801.

116. See Remarks of Thomas Nelson, REAL ESTATE INVESTMENT TRUSTS 107-08, 112-13 (Practising Law Institute 1970).

various forms of adviser profiteering in conflict of interest situations: "No . . . adviser . . . shall . . . receive any commission or other remuneration, directly or indirectly, in connection with the purchase or sale of trust assets . . . ." <sup>117</sup> However, this section proceeds further to permit an adviser's purchase or sale of trust assets if certain conditions are satisfied. First, the transaction must be "fair and reasonable to the shareholders."<sup>118</sup> Furthermore, it must be at a price "not exceeding the fair value thereof as determined by independent appraisal."<sup>119</sup> And lastly, it must be approved "by a majority of the trustees, including a majority of the independent trustees."<sup>120</sup>

Some textual difficulty exists in reading the MSCA statement of policy as applicable to succession fees.<sup>121</sup> Nevertheless, regardless of

---

117. 1970 Statement ¶ B.

118. *Id.*

119. *Id.*

120. *Id.* By "independent trustee" the MSCA statement of policy means trustees who are not affiliated with the adviser or any organization affiliated with the adviser. The MSCA further requires that a majority of the trustees be unaffiliated and that all trustees be elected annually. *Id.* ¶ A.

An earlier MSCA statement of policy contained substantially the same broad prohibition against adviser self-dealing but did not contain these exemption provisions. 1 BLUE SKY L. REP. ¶ 4754 (1969) ("No . . . adviser . . . may . . . receive a commission or other remuneration, directly or indirectly, in connection with the disposal or acquisition of trust assets"). This provision still appears in some state regulations. *See, e.g.*, 3 BLUE SKY L. REP. (Tex.) ¶ 46,661 (1967). Hence, this earlier formulation against adviser self dealing, by not allowing any exceptions, provided perhaps a more persuasive basis than the 1970 Statement for contending that succession fees should not be allowed.

121. For the initial prohibition of the self dealing section to be applicable to succession fees, it must be held that the adviser has sold a "trust asset." As pointed out earlier, the Ninth Circuit in *ISI* rejected the contention that any asset of the trust had been sold in the transfer of control of the adviser. *See* text accompanying notes 48, 54-57 *supra*. Nevertheless, the penultimate sentence of the self dealing section suggests that this section's prohibition extends to transactions not involving the sale of assets. That sentence reads: "All such transactions *and all other transactions* in which any such persons have any direct or indirect interest shall be approved by a majority of the trustees, including a majority of the independent trustees." 1970 Statement ¶ B (emphasis added). "All such transactions" refers to purchases or sales of trust assets, whereas "all other transactions" seems to be a dragnet provision. The statement of policy gives no indication what these "other transactions" might be; but by including all transactions in which the adviser has a direct or indirect interest, and which, by implication, affect the trust in some way, the provision would appear to apply to a succession fee contract between an outgoing adviser and an incoming one. Thus, a succession fee would be permissible only if approved by a majority of the trustees, including a majority of the independent trustees. (The independent appraisal and fair and reasonable requirements do not apply to "other transactions.") Precisely what must be approved is unclear. For instance, it could be argued that the actual contract between the outgoing and incoming adviser must be approved by the trustees, since approval of the incoming adviser's contract would not constitute approval by the trus-

whether it actually so applies, the important question raised is whether courts should apply the general prohibition of succession fees stemming from *Rosenfeld* or disallow succession fees only if they are "unfair" to the shareholders.<sup>122</sup>

As an abstract proposition, it is unobjectionable to allow an REIT adviser a "fair and reasonable" succession fee: where there is no danger to the shareholders, the adviser could be permitted to be compensated for any risk that was taken in organizing the trust or any goodwill which had accrued to it in the course of a successful advisory relationship.<sup>123</sup> With trustee approval and a prior independent appraisal of the value of these factors, a court would not have to rely upon the adviser's own judgment as to what was fair. Similarly, continued use of expert appraisal might develop helpful guidelines for judicially assessing the fairness of a succession fee.

But enthusiasm for the fairness standard dampens upon analysis of the results achieved in other areas of fiduciary regulation.<sup>124</sup> Requiring a court to determine what is fair in a complex business situation frequently calls for a difficult, subjective evaluation. Realizing that a high degree of subjectivity is involved, a court may too often hesitate to upset a transaction and too readily defer to the judgment of others.<sup>125</sup> For example, in a great majority of derivative suits brought by minority shareholders contending that controlling shareholders have paid themselves salaries in excess of a fair and reasonable compensation, courts defer to the "business judgment" of those who set their own salaries.<sup>126</sup> Therefore, in applying a fairness test to advisory succession fees the courts would be likely to strike down only those fees which patently and egregiously exceeded a reasonable estimate. As a result the advisory office would continue to be regularly transferred to the

---

tees of the outgoing adviser's retention of the succession fee. Cf. Brief for Plaintiffs/Appellants at 34-36, *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971).

122. It has been suggested that a fairness test of this type should be applied to the allowability of succession fees for mutual fund advisers. See Note, *Common Law Prophylactic Rule*, *supra* note 22, at 1164-65; 46 N.Y.U.L. REV. 1029, 1040-42 (1971).

123. See note 15 *supra* and accompanying text. For a discussion of the propriety of rewarding entrepreneurial risk by mutual fund advisers and the feasibility of using management fees rather than succession fees as the proper compensation vehicle, see Sterrett 266-73.

124. See Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35, 57 (1966).

125. See F. O'NEAL & J. DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: "SQUEEZE-OUTS" IN SMALL ENTERPRISES* §§ 3.06, 8.02 (1961).

126. See Note, *Executive Compensation in Close Corporations: The Need for a Modified Judicial Approach to the Reasonableness Test*, 1972 DUKE L.J. 1251, 1263-69.



highest bidder and not necessarily to the most qualified successor.

Even if the courts were willing to apply a fairness test rigorously in this setting, neither prior independent appraisal nor trustee approval seem likely to cure the defects of the fairness test. For a court to require prior independent appraisal as a matter of common law would apparently be an unprecedented and unlikely step. Even if appraisal were worth the cost involved, appraisal works best when there exists some established market from which to extrapolate, and it is doubtful whether a meaningful market for REIT adviser succession could be established.<sup>127</sup> In addition, trustee approval as contemplated by the MSCA would be effective only if a court were first willing to require that REIT's have independent trustees.<sup>128</sup> At present, however, REIT advisers seem to dominate even these financially uninterested trustees.<sup>129</sup>

While a fairness test rather than a flat prohibition now governs the permissibility of fiduciary profits in many self dealing situations in corporate law,<sup>130</sup> the change from the prophylactic rule to the permissive one has been accomplished cautiously and only after considerable experience showed the prophylactic rule to be too impractical.<sup>131</sup> It would be premature to adopt a fairness test and its inherent limitations in protecting REIT shareholders at this time. However, if it can be established that practical considerations tend to make a prophylactic rule forbidding succession fees unworkable, especially with regard to large, diversified advisers, the fairness test may develop into a preferable rule of law, particularly if legislation or regulations are adopted to increase shareholder protection in REIT's.

---

127. See note 15 *supra* describing the different means by which advisory succession can occur. The adviser's control over approval of a successor can prevent the formation of a market. The SEC has warned that in the sale of an adviser "competition cannot be relied upon to provide the necessary safeguards because the management's control over the fund is sufficiently strong so that the prospective successors to the relationship will bid for the favor of the existing management rather than for the favor of the fund and its shareholders." SEC PUBLIC POLICY REPORT at 151.

128. Existence of independent trustees in REIT's is required by the MSCA in paragraph A of the 1970 Statement. "A majority of the trustees shall not be affiliated with the adviser of the trust or any organization affiliated with the adviser of the trust." But in the states which do not have such a blue sky requirement no independent trustees are required. See Remarks of Benito M. Lopez, Jr., *supra* note 75, at 24. It has been stated that normally only a bare majority of REIT trustees are independent. See note 8 *supra*.

129. See notes 8-12 *supra* and accompanying text.

130. "[R]eview of legal history in this area seems to demonstrate that the courts have progressed from condemnation, to toleration, to encouragement of conflict of interest." Marsh, *supra* note 124, at 57.

131. See *id.* at 36-48.

## CONCLUSION

Analysis of the common law principles relied upon in *Rosenfeld* to prohibit a mutual fund adviser from realizing a succession fee justifies the denial of succession fees to REIT advisers as well. However, if it can be convincingly demonstrated that this prophylactic rule is impractical in the context of REIT operations, it should be replaced by a rule which allows only fair and reasonable succession fees. In the meantime, an REIT adviser can safely receive a succession fee only if it has obtained the knowing and voluntary consent of the shareholders.