The Real Estate M&A and Private Equity Review

Editors
Adam Emmerich and Robin Panovka

Law Business Research

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EDITORS' PREFACE

Publicly traded real estate companies and real estate investment trusts (REITs), with help from real estate private equity, have transformed the global real estate markets over the past 20 years. Their principal innovation, and secret sauce, is '*liquid* real estate'. Unlike traditional property ownership, equity in publicly traded real estate vehicles is highly liquid and can be bought and sold in large volumes, literally in minutes, on numerous global exchanges.

Publicly traded real estate vehicles have an aggregate market capitalisation of over $1.6 trillion globally, including about $1 trillion in the United States and $200 to 300 billion in each of Europe and Asia. As public REITs and other vehicles have aggregated these properties and grown in scale and sophistication, so too have real estate-focused private equity funds, playing an important role catalysing hundreds of billions of dollars of REIT and real estate M&A transactions and IPOs.

Yet, despite the massive growth, the potential growth is far larger, both in long-standing REIT markets and in newer REIT jurisdictions where the trend is more nascent. With increasing development and urbanisation, the world is producing more and more institutional-grade properties, and a growing percentage of this expanding pool – an estimated $5 trillion, and counting, so far – will inevitably seek the advantages of liquidity by migrating to the publicly traded markets. The growth is expected to be both local and cross-border, with more than 40 countries already boasting REIT regimes.

REITs and other vehicles that hold liquid real estate have grown because they are often a superior vehicle for stabilised assets. Greater liquidity and transparency – and often superior governance – create demand from investors, resulting in a lower cost of capital and superior access to the capital markets. In addition to cheaper capital, REITs and other public vehicles benefit from efficiencies of scale, sophisticated management and flexible deal structures, to name just a few advantages. With these advantages, the global march of real estate to the public markets seems unstoppable.

This volume is a multinational guide for understanding and navigating the increasingly complex and dynamic world of liquid real estate and the transactions that produce it. The sea change in the markets has meant that major real estate transactions have migrated from 'Main Street' to 'Wall Street'. They now often take the form of mergers, acquisitions, takeovers, spin-offs and other corporate transactions conducted in the public markets for

both equity and debt. They have grown exponentially in complexity and sophistication, and increasingly represent cross-border multinational transactions fuelled by the now global real estate capital markets and M&A deal professionals. And they are often intermediated by international investment banks rather than local brokers, and financed with unsecured bonds or commercial mortgage-backed securities. In a fair number of cases they are instigated by private equity firms or similar catalysts, sometimes building portfolios to be taken public or sold to public real estate companies, and sometimes through buyouts of public real estate companies for repositioning or sale.

To create this volume, we have invited leading practitioners from around the globe to offer practical insights into what is going on around the conference table and in the markets in their jurisdiction, with an eye to cross-border trends and transactions. As will quickly become evident, the process of liquefying real estate, and the transactions that produce it, requires a melding of the legal principles, deal structures, cultures and financial models of traditional real estate, public company M&A and private equity. None of this, of course, happens in a vacuum, and the transactions often require expertise in tax, corporate and real estate law, not to mention securities laws and global capital markets. Each of our distinguished authors touches on these disciplines.

We hope this compilation of insight from our remarkable multinational authors produces clarity and transparency into this exciting world of 'liquid real estate' and helps to further fuel the growth of the sector.

Adam Emmerich and Robin Panovka
Wachtell, Lipton, Rosen & Katz
New York
August 2016

Chapter 20

UNITED STATES

Adam Emmerich, Robin Panovka and Matthew MacDonald[1]

I OVERVIEW OF THE MARKET

The REIT sector in the United States has expanded dramatically over the past two decades. Until the 'REIT Revolution' of the 1990s, private sources of capital dominated the US commercial real estate industry, and publicly traded real estate vehicles such as REITs played a relatively small role. The tables have now turned, and public REITs are dominant in a number of sectors and show every sign of continuing to grow.

US REITs today own more than $1.8 trillion of commercial real estate, and the industry's equity market capitalisation is close to $1 trillion.[2] There are now over 150 REITs in the United States with a market capitalisation over $1 billion, and 24 of those are over $10 billion.[3] Compare this to 1995, when the entire market capitalisation of the US REIT industry was just $57.5 billion, and there were only six REITs with a market capitalisation over $1 billion.[4]

In addition to growing in size, US REITs have also broadened their reach in terms of asset classes and have begun to expand geographically outside of the United States. While REITs traditionally owned office, multi-family, retail, industrial and lodging assets, today REITs extend across an array of non-traditional sectors, including telecommunications, timber, data storage, outdoor advertising and gaming.

Along with REITs, private equity funds have also become dominant institutional players in US commercial real estate over the past 20 years. At the sector's fundraising peak in

1 Adam Emmerich and Robin Panovka are partners and Matthew MacDonald is an associate at Wachtell, Lipton, Rosen & Katz.

2 NAREIT REITWatch (data as of 31 May 2016).

3 S&P CapitalIQ

4 NAREIT REITWatch

2008, real estate private equity funds raised over $130 billion per annum.[5] While fundraising following the 2008 financial crisis has not yet reached that level, private equity funds have continued to raise large amounts of capital (reaching $117 billion in 2015)[6] and have been the architects of some of the largest recent M&A deals in the real estate sector. While international institutional investors have had exposure to the US real estate sector for many years, sovereign wealth funds and other sources of international capital have demonstrated increased interest in the US real estate sector, including through joint ventures with US-based REITs and private equity funds. Foreign investors conducted $87.3 billion of real estate deals in the United States in 2015, up from less than $5 billion in 2009.[7]

II RECENT MARKET ACTIVITY

i M&A transactions

Recent REIT M&A activity has involved three major types of deals: (1) spin-offs by REITs of elements of their portfolios into newly created REITs; (2) mergers between REITs; and (3) transactions using the REIT structure to unlock the value of corporate-owned real estate.

Spin-offs

The rationale for typical REIT spin-offs is to provide the market with a more focused, targeted investment opportunity by separating elements of the parent company's property portfolio into a new, independent REIT. Major recent REIT spin-offs have included:

a Simon Property Group's spin-off of its shopping centre business and smaller malls into Washington Prime Group (May 2014);

b Vornado's spin-off of its shopping centre business into Urban Edge (January 2015); and

c Ventas' spin-off of its skilled nursing portfolio into Care Capital Properties (August 2015).

REIT mergers

REIT mergers may be motivated by the advantages of scale, including a potentially lower cost of capital, to benefit from synergies, or to garner other benefits of consolidation. Major recent REIT mergers have included:

a Essex Property Trust's acquisition of BRE Properties, creating a company with a market capitalisation of $15.4 billion (April 2014). BRE shareholders received consideration in the form of Essex stock as well as cash;

b Washington Prime Group's acquisition of Glimcher Realty Trust for $4.3 billion in stock and cash (January 2015). Glimcher shareholders received, for each Glimcher share, Washington Prime common stock and cash; and

5 *Wall Street Journal*, 'Investors Turn to Big Real-Estate Funds' (21 April 2015) (www.wsj.com/articles/investors-turn-to-big-real-estate-funds-1429645516).

6 Preqin Quarterly Real Estate Update, Q1 2016 (https://www.preqin.com/docs/quarterly/re/Preqin-Quarterly-Real-Estate-Update-Q1-2016.pdf).

7 *Bloomberg*, 'U.S. Real Estate to Draw More Foreigners in 2016, Survey Says' (4 January 2016) (www.bloomberg.com/news/articles/2016-01-04/u-s-real-estate-to-draw-more-foreigners-in-2016-survey-says).

c the stock-for-stock combination of Chambers Street Properties and Gramercy Property Trust, creating a company with an enterprise value of approximately $5.7 billion (December 2015). Gramercy stockholders received shares of Chambers Street for each share of Gramercy common stock they owned.

Separation of real estate assets

In situations where real estate owned by an operating non-real estate business would have a higher valuation if held in a REIT, or where separation of the real estate has other advantages, a company may consider strategies to unlock this value. REIT spin-offs and other separations are complex, and may or may not make sense depending on a variety of factors. Recent transactions of this kind include the following:

a Penn National Gaming separated its casino assets into a REIT, Gaming and Leisure Properties, which then leased most of these assets back to Penn National. Shares of the REIT were distributed to Penn National shareholders through a tax-free spin-off in November 2013.[8]

b Sears Holdings sold and leased back 235 of its owned retail assets to a newly created REIT, Seritage Growth Properties, and distributed rights to acquire shares of Seritage to Sears' shareholders in July 2015. The transaction allowed Sears to realise $2.7 billion in value for the assets, funded through the rights offering and financing on the assets.

c After Pinnacle Entertainment announced that it was planning a tax-free spin-off of its real estate assets, Gaming and Leisure Properties made an offer for Pinnacle's real estate assets. After adjustments to the offer and further negotiations between the parties, Pinnacle spun off its operating assets into a separate public company and merged with a subsidiary of Gaming and Leisure Properties in April 2016, and shareholders of Pinnacle received shares of both the new, spun-off operating company and Gaming and Leisure Properties.

ii Private equity transactions

Private equity firms have been increasingly active in real estate M&A, driven by large pools of capital seeking deals. In particular, factors such as higher valuations in the private real estate markets than in the public REIT markets, inexpensive and plentiful debt, and highly liquid private markets that facilitate exit opportunities have driven a number of REIT privatisations, including the following transactions:

a Blackstone purchased Excel Trust, which owned shopping centres and other retail assets, for about $2 billion in July 2015. The deal represented a 15 per cent premium for the target's stock, had a $25 million break fee (if the target terminated the transaction to take a superior proposal), and had a reverse break fee (payable by the acquirer in the event the deal was not completed under certain specified circumstances) of $250 million.

b Lone Star Funds acquired Home Properties, an apartment REIT, for $4.4 billion in October 2015. The deal represented a 9 per cent premium for the target's stock, had a $150 million break fee, and had a reverse break fee of $300 million.

8 Note that tax-free spin-offs of this nature are no longer permissible – see Section V, *infra*, for further information.

c Blackstone purchased Strategic Hotels and Resorts, an owner of luxury hotels, for approximately $6 billion in December 2015. The deal represented a 13 per cent premium for the target's stock, had a $100 million break fee, and had a reverse break fee of $400 million.

d Blackstone also acquired BioMed Realty Trust, which focused on office space for pharmaceutical and biotechnology companies, for $8 billion in January 2016. The deal represented a 24 per cent premium for the target's stock, had a $160 million break fee, and had a reverse break fee of $460 million.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs – structure and role in the market

In 1960, the Real Estate Investment Trust Act became law, creating the REIT structure in the United States. The policy objective of this legislation was to provide small investors the same tax-advantaged opportunities to invest in real estate that were available to institutional or high net-worth investors (who could acquire real estate directly or participate in pooled fund investments in real estate). Under the law, a business entity can elect to be taxed as a REIT (and avoid liability for entity-level US federal income tax) but must comply with an extensive array of restrictions to qualify for this tax-advantaged status. For example, in general a REIT must pay dividends to its shareholders of at least 90 per cent of its taxable income, at least 75 per cent of a REIT's total assets must consist of real estate assets, and a REIT must derive at least 75 per cent of its gross income from real estate-related income (such as rent from real property or interest on obligations secured by mortgages on real property).

These tax rules influence the structure and governance of REITs. In addition to the rules described above, the Internal Revenue Code requires that a REIT have no more than 50 per cent of its shares held by five or fewer individuals, commonly known as the '5/50 rule'. To ensure that the 5/50 rule is not violated, REITs customarily include provisions in their organisational documents restricting any shareholder – an individual or otherwise – from holding more than 10 per cent of their shares, with thresholds often set at a slightly lower percentage such as 9.8 per cent. If properly structured, these ownership limits (called 'excess share provisions') can also act as a takeover defence.[9] The consequences of violating an excess share provision can be severe, so it is essential for acquirors of REIT shares to understand and address the ownership limitations in the target REIT's charter, particularly in unsolicited transactions. Excess share provisions typically allow a REIT's board of directors to waive the limitation with respect to specific shareholders if the board is satisfied that such a waiver will not result in the violation of the 5/50 rule (or other relevant REIT qualification rules), allowing negotiated M&A transactions to proceed.

In addition to these tax complexities, the structure of REITs can often differ from that of a typical public company, since many REITs, called 'UPREITs',[10] include partnership entities in their corporate structure. UPREITs, are REITs that hold their assets and conduct business through an operating partnership in which the REIT is the general partner. Holders of units in a REIT's operating partnership generally have the right to exchange their units

9 For further discussion of the anti-takeover implications of excess share provisions, see Section IV.iii, *infra*.

10 Short for 'umbrella partnership real estate investment trusts'.

for REIT shares or cash (at the election of the REIT). REITs generally choose the UPREIT structure because of the tax advantages that such a structure provides, discussed further in Section IV.v, *infra*.

ii Real estate PE firms – footprint and structure

Real estate private equity funds aggregate investor capital to generate returns through the acquisition, ownership, and sale of real property assets or interests in such assets, and are also active in the origination and trading of real estate debt. Private equity fund managers may choose a particular area of geographical focus, property type, or investment strategy. Core funds tend to invest in stable assets, such as office properties with high-credit-quality tenants located in major urban areas. Opportunistic funds use more leverage and take on higher-risk opportunities (such as developing new buildings or repositioning distressed or poorly capitalised assets). Blackstone, a firm with a leading real estate private equity business, describes the strategy of its opportunistic funds simply as 'buy it, fix it, sell it'[11] – indicating how such funds acquire distressed properties or underperforming REITs and then use their asset management personnel to stabilise these assets or companies prior to sale. Value-added funds tend to adopt strategies and have risk profiles that fall between core and opportunistic funds, and may focus on geographies outside of the largest urban areas.[12] Private equity transactions are often driven by arbitrage opportunities between the public and private markets. When REIT valuations are high relative to the private real estate market, private equity funds may focus on aggregating portfolios that are then sold to REITs (or taken public as REITs). When the reverse is true, and REITs are undervalued relative to the private real estate market, private equity funds may work to take REITs private.

Real estate private equity funds are often structured as Delaware limited liability companies or limited partnerships. Investors commit to provide a specified amount of capital to these funds, as (and when) needed to make acquisitions. Typically, fund managers are compensated with management fees (generally a fixed percentage of the fund's assets under management) and performance fees. These performance fees are generally structured in a waterfall format, under which investors must achieve a specified minimum return (a 'hurdle rate'), before the fund managers earn performance fees. Once the hurdle rate is met, the manager generally earns carried interest (a percentage of overall gains) above the threshold. Private equity fee structures are complex, and can involve tiered hurdle rates, discounts for initial investors, scaled-back management fees or clawbacks of excess carried interest in the later stages of a fund's lifecycle.[13]

11 Blackstone, www.blackstone.com/the-firm/asset-management/real-estate.

12 This investment style overview is based on the categories used by the National Council of Real Estate Fiduciaries (NCREIF).

13 See §1.07 of *Private Equity Funds: Business Structure and Operations*, James M Schell, Kristine M Koren and Pamela Lawrence Endreny (Law Journal Press, 2016).

IV TRANSACTIONS

i Legal frameworks and deal structures

REIT M&A transactions are often structured as triangular mergers. In a triangular merger, the acquiring REIT forms a wholly owned subsidiary (a 'merger sub'), and the target REIT merges with this merger sub. Following the merger, the target REIT becomes a wholly owned subsidiary of the acquirer, which generally allows the target's liabilities to remain at the level of the subsidiary. If the merger sub is the surviving entity in the transaction, the structure is known as a 'forward triangular merger'. If the target REIT is the surviving corporation, it is called a 'reverse triangular merger'. Reverse triangular mergers have a lower likelihood of triggering third-party consent rights in contracts of the target REIT, since the target remains in existence following the merger. The decision to choose a forward or reverse triangular merger structure can depend on these contractual concerns as well as tax issues.

While asset purchases can be an alternative mechanism of acquiring a REIT, and are sometimes considered, the direct transfer of legal ownership of real estate is complex and time-consuming, resulting in considerable transaction costs (including transfer taxes) and sometimes requiring lender or other third party consents.

For REITs structured as UPREITs, parties must consider the best way to combine the operating partnerships of the merging REITs. The partnerships can be combined through a direct merger, through triangular merger structures, or can be left as separate subsidiaries of the parent REIT. Typically, the governing agreements of the operating partnership inform the structuring decision, with key factors including the consent rights of the operating partnership unit holders over REIT-level transactions and the redemption and conversion mechanics that will apply to unit holders following a merger.

In the context of evaluating a merger proposal, REIT directors owe fiduciary duties to the firm and its shareholders, consistent with general corporate law principles. REIT directors are subject to two primary fiduciary duties: the duty of care and the duty of loyalty. To satisfy his or her duty of care, a REIT director must make well-informed decisions based on appropriate knowledge and advice, if necessary. To satisfy the duty of loyalty, a REIT director must act in good faith and in the interests of the shareholders and the REIT (as opposed to his or her personal interest).

Courts in Delaware, where many US firms are incorporated, will review directors' compliance with their duties based on standards that vary based on the situation in which directorial decision-making occurs. The 'business judgement rule' is the default standard of judicial review applying to the actions of directors, under which the business decision-making of a director generally does not give rise to personal liability. However, higher judicial standards apply in situations when a company is being sold. In particular, '*Revlon* duties' apply under Delaware law in the context of a corporate change of control. When a company is engaged in a transaction that may result in a sale, '[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company'. While there is no single blueprint a board must follow in a *Revlon* context, in general, *Revlon* duties require that the board work to maximise the sale price of the business. However, in Maryland, where many REITs are incorporated, a director is not subject to greater scrutiny in a change-of-control context, a significant divergence from Delaware law.[14]

14 Md. Code Ann. Corps. & Ass'ns. §2-405.1(f).

Any REIT sale process should be overseen by the company's board, which should provide management with direction as to any process or potential process. In an auction context, careful consideration should be given to including the right mix of potential bidders to maximise value. Strategic bidders often will have different views of value than financial bidders, since they may be able to capitalise on synergies not otherwise available to financial bidders or because an acquisition fulfils a strategic need or, conversely, because of constraints on their ability to utilise cheap leverage.

Whenever a buyer seeks to retain some or all of the target REIT's senior management, it will be essential to ensure that critical decisions – including the method of sale, selection of bidders, deal protections, access to due diligence materials, and negotiation of the price and other deal terms – fully involve unconflicted directors. In situations going beyond a straightforward desire by the buyer to retain current senior management (for instance when a management team or affiliated stockholder or unit holder seeks out a private equity buyer to submit a joint bid to acquire the company, or in other circumstances presenting more complicated or extensive conflicts), the best way to address the conflict may be to establish a special committee. In situations where directors are also operating partnership unit holders, the board should consider any possible differing interests as between unit holders and shareholders. When a special committee is formed, it should be firmly in control of the process, retain the services of independent legal and financial advisers, and have a clearly defined role, the ability to negotiate independently, and the power to say no. The best way to address conflicts will always depend on the circumstances, however, and care should be taken not to reflexively establish formalistic special committees or otherwise implement drastic measures that end up hurting the process by, for example, depriving the board and bidders of critical access to key executives and their base of knowledge and experience or creating the impression of conflict where it does not truly exist.

Once a merger agreement is signed, federal securities laws impose disclosure requirements with regard to the transaction. A proxy statement is used to provide stockholders with information about the merger, and this proxy statement can be combined with a registration statement for securities used as consideration in the transaction (if any). The SEC may review this registration statement and request changes, a process that may influence the timing of closing.

ii Acquisition agreement terms

Consideration

In a REIT merger, target stockholders receive cash, securities or a mixture of both. When stockholders are receiving stock, the value of the consideration may fluctuate based on the market value of the acquirer's stock in the time period between signing and closing, depending on the specifics of the exchange mechanism. Parties can use a number of techniques to address this risk, including pricing structures based on the average price of the acquirer's stock over a period of time or termination rights triggered by a decline in the acquirer's stock price.

Representations and warranties

The representations and warranties in REIT merger agreements generally resemble those of other public company merger agreements (and do not include the very detailed property-level representations that are common in real estate asset purchases). Instead, an acquirer will often rely on broad representations and a REIT's financial statements and public filings (and will typically get representations relating to their accuracy). The representations and warranties

in a REIT merger agreement will serve as a guide for due diligence, as a risk-allocation mechanism, and as a set of preconditions for closing. Representations relating to the tax status of the REIT are particularly important to ensure that the REIT complies with applicable tax regulations (both before and after the transaction).

Covenants

Covenants govern the actions of both the target and acquirer in the period between the signing of the merger agreement and the closing of the merger. In general, these covenants restrict the actions of the target (to prevent significant changes in the business being acquired) and commit the parties to take the steps necessary to close the transaction.

A target will generally agree to conduct its business 'in the ordinary course' consistent with its past practices. However, since this standard can be vague, a merger agreement typically contains a number of specific restrictions, which can include prohibitions on acquisitions, dispositions, material capital investments, or major changes in compensation policies (among other restrictions), unless the acquiring party consents. The target will also typically agree to avoid actions that will compromise its REIT tax status.

In addition to these restrictions on the target, both parties will agree to covenants that bind them to take certain actions necessary to close the transaction. For example, the parties may agree to coordinate on securities filings associated with the transaction, work to acquire third-party consents, and apply for regulatory approvals that may be necessary. Unlike many public-company mergers, antitrust approval is generally not required for US REIT transactions.

Deal protection, termination and break fees

Merger agreements typically also contain provisions governing stockholder approval, fiduciary duty outs and deal protections. A merger agreement would typically require a target's board of directors to conduct a stockholder vote on the transaction, and may also require the board of directors to recommend the transaction to stockholders. In addition, there may be covenants preventing the target from soliciting or facilitating competing bids from other parties (called 'no shop' provisions). However, when covenants such as these are included, a 'fiduciary out' is common, which allows the target's board of directors to change its recommendation or engage with competing bidders should such actions be required by the board's fiduciary duties. Given the importance of these provisions, they are often heavily negotiated.

A merger agreement will contain provisions indicating when either party can walk away from the deal. These provisions may be triggered by an uncurable breach of the merger agreement, failure to obtain shareholder approval, or the failure to close the deal by a specified date. Should an agreement be terminated under certain circumstances (such as pursuant to a fiduciary out in order to accept a superior proposal), the target may have to pay a break-up fee or expense reimbursement fee to the acquirer. Reverse break-up fees (payable by the buyer in the event of certain termination events) are common in private equity deals, and operate much like a traditional real estate deposit. Recent reverse break fees have been asymmetrical, generally exceeding the termination fees payable by the target.

Closing conditions

In general, closing conditions provide a list of events that must occur (or be waived) before the transaction is consummated. For example, closing conditions may include stockholder approval (or approval of unit holders, if necessary), or receipt of necessary consents. In

addition, one condition may involve a 'bring-down' of certain representations and warranties, which requires that the representations and warranties made at signing are also true at closing. Other closing conditions may involve the absence of a material adverse change in the target.

Indemnification

Indemnification provisions address the rights of each party to recover damages from the other party in the event of a breach of the merger agreement. Generally, such provisions are not available when the target will cease to exist as a separate, independent entity following the transaction (such as in a merger involving the target). However, they are common when the seller continues to operate after the closing (such as in the context of an asset sale). A party may agree to indemnify the other party for breaches of the representations, warranties and covenants in the merger agreement that survive post-closing. These indemnification obligations may be subject to caps (limiting the indemnifying party's liability) or thresholds (under which indemnification obligations are not triggered unless a liability reaches a certain size).

iii Hostile transactions

Although REITs have a number of defences at their disposal, REITs are still vulnerable to unsolicited offers. The excess share provisions of most REITs can and generally do serve as a form of takeover defence, and many REITs specifically disclose that such provisions may be used for anti-takeover purposes. However, excess share provisions are relatively untested as anti-takeover defences and may be vulnerable because of their grounding in the tax code, or the specific manner in which they are drafted. Excess share provisions – even when designed for anti-takeover purposes – are unlikely to be more powerful or robust than other common takeover defences such as a rights plan, and may often be less so. While hostile takeovers are not common in a REIT context, they have occurred. For example, in 2006, Public Storage successfully completed a hostile takeover of Shurgard, and interlopers making unsolicited bids designed to top announced mergers are rather common.

More recently, activist investors have successfully instigated changes of control at REITs, including, for example, the campaign against the CommonWealth REIT (now Equity Commonwealth) in 2014. Activists may also pressure REIT boards to consider a sale of the company, particularly if there is a large spread between the market value of the REIT and the net value of its assets.

iv Financing considerations

In structuring a transaction (and considering the optimal financing strategy), REIT acquirers must consider both the implications of a transaction on the debt of the target as well as the effects on the acquirer's debt. A transaction may violate change-of-control provisions or covenants in existing debt, or these covenants may create operating difficulties (such as restrictions on asset transfers after closing). Prepayment costs or other fees triggered by the transaction may be substantial, and a careful review of debt documents should occur in conjunction with a planned transaction.

For REITs, after closing, financing can occur at the entity level (in the form of preferred stock or senior or subordinated notes) or at the property level (generally mortgage loans secured by a REIT's assets, which may include issuance of commercial mortgage backed securities). The conditions of any financing commitments for a REIT acquisition should be carefully scrutinised by both the buyer and seller, to eliminate any discrepancies between the closing conditions in the merger agreement and the financing commitments.

v Tax considerations

Given the complexity of tax rules that govern REITs, the tax implications of a transaction are among the most important structuring considerations in a REIT M&A deal. In particular, parties must ensure that the transaction does not create any REIT qualification issues. Depending on the structure of a transaction, the consideration involved in the deal may be wholly or partially taxable to the target REIT or its shareholders, or it may be tax-free (assuming appropriate regulatory and judicial requirements are satisfied). However, transaction structure may also affect the tax basis of the target REIT's assets (specifically, whether the tax basis in such assets is 'stepped-up' following the transaction).

For transactions involving UPREITs, parties must also consider the tax consequences on operating partnership unit holders (especially since the interests of unit holders and shareholders can be different). The UPREIT structure allows REITs to provide property owners the ability to transfer properties to the REIT in a tax-deferred manner, a significant advantage for UPREITs. When property owners transfer a property to the UPREIT and receive partnership units in exchange, owners can defer taxation relating to gains realised on the contribution of this appreciated real estate. As a result, operating partnership unit holders often have tax protection agreements in place (designed to perpetuate a contributing operating partnership unit holder's tax deferral by requiring tax gross-ups if the contributed property is sold or if certain other actions are taken that would accelerate gain recognition to the contributing operating partnership unit holder). This may influence transaction structure at the level of the operating partnership, and can frustrate plans to sell some or all of the assets of an acquired portfolio.

vi Cross-border complications and solutions

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) can create challenges for international investors considering an investment in US real estate. In general, FIRPTA can subject foreign owners of US real property (or interests in certain entities holding US real property) to taxation on gain recognised on the disposition of such property or interests. While dispositions of interests in a REIT can implicate FIRPTA, certain important exceptions may apply. For example, should a REIT be domestically controlled (that is, with under 50 per cent of the value of its shares held directly or indirectly by non-US holders), FIRPTA does not apply to the disposition of shares of such REIT by non-US holders. A similar exception applies to dispositions of stock of a publicly traded REIT by a non-US holder, as long as such holder has not owned more than a specified percentage of the stock during a certain time period.

Acquisition of high-profile real estate assets may be politically controversial, particularly in situations where the acquirer is sponsored by a foreign government entity (such as a sovereign wealth fund). Appropriate communications strategies and partnerships with local players should be considered as strategies to address political implications. Consequently, international investors in the United States often enter into joint venture agreements with local companies to facilitate their entry into the marketplace. While the structuring of these joint ventures can be complex, they have the advantages of allowing foreign investors to leverage the expertise of local companies that are familiar with the local markets.

From a regulatory standpoint, the Committee on Foreign Investment in the United States (CFIUS) can review acquisitions in the United States by non-US acquirers (including real estate acquisitions), but it is unlikely that CFIUS review will affect typical real estate transactions. In addition, a transaction involving a foreign acquirer may implicate US

securities laws (if, for example, a foreign company is issuing shares as consideration in a transaction), and the disclosure requirements of these laws and any ongoing compliance costs they may impose should be considered.

V CORPORATE REAL ESTATE

In situations where corporate-owned real estate would have a higher market value if transferred outside of the company (whether to a REIT or a private owner) or where a company's real estate is underutilised or represents 'trapped' value, companies may consider a variety of transactions to unlock the value of their real estate. Such transactions are complex and time-consuming, and may or may not make sense depending on the circumstances. They often have operational implications (particularly where the company no longer has direct control of its real estate), and it is often the case that simpler transactions, like borrowing against the real estate, might better achieve the corporate purpose. Common strategies include sale-leasebacks, joint ventures, or borrowing against the value of the assets with mortgage financing.

Recent tax law changes have complicated these transactions. In the past, corporations with valuable real estate could transfer the assets to a newly formed REIT, spin off the REIT on a tax-free basis to the corporation's stockholders, and enter into a lease agreement with the REIT. However, tax-free REIT spin-offs by US corporations have been prohibited by recent legislation (although such spin-offs by REITs are still permissible). While this change removes one tool used to unlock real estate value, other techniques are still available – for example, taxable spin-offs are still permitted.

VI OUTLOOK

Continued M&A activity is expected among public REITs, both in terms of acquisitions by larger, stronger sector leaders and spin-offs by REITs of their non-core assets. An increasingly vocal group of REIT activists is likely to continue to push for M&A activity, particularly in the case of REITs that trade at a discount to their net asset value. High levels of available private capital, along with easy access to financing, is also likely to continue to spur additional public-to-private transactions driven by private equity buyers. The trend of unlocking corporate real estate value through transactions using the REIT structure will likely continue, although such activity is expected to slow because of the recent restrictions on the use of tax-free REIT spin-offs.

In the short term, adjustments to US tax law, potentially increasing interest rates, or a downturn in the broader commercial real estate market may complicate the outlook for real estate M&A; but in the long term, the liquidity, transparency, and access to capital in the public US real estate market makes the growth of REITs seem inevitable.

Appendix 1

ABOUT THE AUTHORS

ADAM EMMERICH

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Adam Emmerich practises in Wachtell Lipton's corporate department, focusing primarily on mergers and acquisitions, particularly in the REIT and publicly traded real estate areas, as well as on corporate governance and securities law matters. His practice has included a broad and varied representation of public and private corporations and other entities in a variety of industries throughout the United States and globally, in connection with mergers and acquisitions, divestitures, spin-offs, joint ventures and financing transactions. He also has extensive experience in takeover defence. Mr Emmerich is recognised as one of the 500 leading lawyers in America by *Lawdragon*, as one of the world's leading M&A lawyers in *Chambers*, as an expert in each of M&A, corporate governance and M&A in the real estate field by *Who's Who Legal*, and as an expert both in M&A and in corporate governance by Euromoney Institutional Investor's *Expert Guides*.

ROBIN PANOVKA

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Robin Panovka co-heads Wachtell Lipton's real estate and REIT M&A groups. He focuses on M&A and strategic transactions across the real estate, REIT, hospitality, gaming and private equity sectors, and also advises on general cross-border M&A and large-scale projects including the redevelopment of the World Trade Center in Manhattan. Mr Panovka has been named one of the *Lawdragon* 500 Leading Lawyers in the United States, and is consistently ranked as one of the leading REIT and real estate M&A lawyers by *Chambers*, *The Legal 500*, *Who's Who Legal* and similar publications. He was recently described in *Chambers* as 'the dean of US REIT M&A'. He is the co-author of 'REITs: Mergers and Acquisitions', a leading treatise published by Law Journal Press, co-chair of the NYU REIT Center, and has served as an adjunct professor at Columbia Business School.

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Matthew MacDonald is an associate in the corporate department of Wachtell Lipton. He received a JD *summa cum laude* from the University of Pennsylvania Law School, where he was a member of the Order of the Coif, senior editor of the *University of Pennsylvania Law Review*, and was awarded the Barenkopf Scholarship (given to the student with the best academic record after the first two years of the JD programme). He also received an MBA from the Wharton School at the University of Pennsylvania, where he was awarded Director's List honours. Previously, he completed his bachelor's degree *cum laude* at Princeton University. Before joining the firm, Mr MacDonald worked at Fidelity Investments, as a member of its internal strategy consulting team, and at Bain Capital, as part of its venture capital and growth equity fund.

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