Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

REIT M&A in a Complex Market

Posted by Adam O. Emmerich and Robin Panovka, Wachtell, Lipton, Rosen & Katz, on Saturday, June 23, 2018

Editor's note: Adam O. Emmerich and Robin Panovka are partners and leaders of the REIT M&A practice at Wachtell Lipton Rosen & Katz. This post is based on a Wachtell Lipton memorandum authored by Mr. Emmerich and Mr. Panovka.

We offer some quick observations from recent REIT deal activity, with a more fulsome discussion in our attached updated playbook:

1. N A V are the three most misunderstood letters in the REIT lexicon, often viewed doubly incorrectly as both a floor for what a sale process should yield, and an indicator of opportunities for activists. A REIT's so-called NAV is merely an estimate (best viewed as a range), is backward looking, typically fails to account for frictional costs, and may, in many cases, not reflect fundamental value.
2. Activist pressure, or its threat, is often a driver, but should never be allowed to dictate results, particularly where short-termism is at play.
3. Frictional costs can vary widely from deal to deal, depending on tax protection agreements, debt breakage, transfer taxes, severance, litigation and other issues. This should be top of the list in due diligence.
4. Auction bidder pools vary in depth depending on the asset class and complexity involved, with some strategic buyers exercising caution, and with the larger PE firms and sovereign funds focusing rather selectively, particularly in light of unusual uncertainty around underlying value in certain asset classes. Most PE firms and sovereign funds are unwilling or unable to take down the larger or even mid-size REITs without clubbing, which obviously adds a layer of complexity and execution risk.
5. Post-deal market checks can be an attractive tool for maximizing value, providing the benefits of an "auction with a floor." A no-shop coupled with a two-tiered break fee (low for an initial period and then climbing to market) is sometimes a helpful compromise between go-shops and high-break-fee no-shops. Negotiating the right balance of deal protections while preserving the ability to fulfill fiduciary duties is especially important as topping bids are increasingly considered and made.
6. Deal litigation continues to be largely inevitable, but should not be allowed to wag the dog. If a process is properly managed, the courts will afford boards wide latitude to determine how best to maximize shareholder value, with litigation/settlement costs controlled and kept to a minimum.
7. Executive retention and termination protection issues should be considered early in the process, preferably on a clear day.

1. **Market Checks**. The sale of every non controlled public company will include a market test of some kind, whether pre- or post-signing of the merger agreement, even if only through the absence of preclusive lock-up arrangements, but a pre-deal auction is not required in every case, and may, in some cases, be counter-productive. The decision of how to conduct a sale process and on what basis to strike a deal is probably the most intensely reviewed decision a board can make, and it is important that boards carefully consider the alternatives, from a pre-signing full auction, limited or soft auction, accepting a preemptive bid with a subsequent market check, go-shops, low break-fee deals (sometimes viewed as an auction with a floor), break fees that ratchet up after an initial period with a low fee, to full-on accepting a blockbuster bid with a standard fiduciary out and break fee, or combinations and variations on these options. Negotiating the right balance of deal protections and flexibility is especially important as topping bids are increasingly considered and made. There is no one-size-fits-all answer, and it is up to each board to determine which course is most likely to enhance shareholder value under the relevant circumstances. Boards should also consider, in evaluating their options, how to best communicate the rationale for their chosen strategy to shareholders in order to facilitate shareholder approval. Courts in both Maryland and Delaware will generally respect the board's decision if the record demonstrates that an appropriate process was followed (including, as noted below, with regard to any conflicts of interest).
2. **The CEO, the Board, Special Committees**. Any sale process should be overseen by the board, which should provide management with direction. In most circumstances, it is proper for the CEO or other senior management to explore whether there are attractive private equity options, among others, that the board should consider, but management should take care not to get too far out over their skis (as demonstrated by some spectacular recent flameouts). 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 equityholder 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 unitholders, the board should consider any possible differing interests as between unitholders 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 advisors, 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.
3. **Special Considerations for UPREIT Transactions**. Acquisitions involving UPREITs present their own unique set of challenges that can make or break the deal. Tax protection agreements (designed to perpetuate a contributing operating partnership

unitholder's tax deferral by requiring tax gross-ups if the contributed property is sold), and more general unitholder protections enshrined in the operating partnership's governing documents, can increase frictional costs and frustrate plans to "slice and dice" the acquired portfolio through rapid sale of some or all of the assets. Careful thought must be given both to any unitholder voting, notice, or consent rights that might be triggered by the acquisition and to the form of consideration to be offered in the transaction to unitholders who prefer to extend their tax deferral by rolling over their equity rather than taking the cash consideration offered to REIT shareholders. In private equity acquisitions, there is no surviving publicly held equity, so the flexibility and protections previously available through conversion of operating partnership units into stock or its cash equivalent often must be replaced with a security that satisfies the unitholders' needs. For example, unitholders may be offered an option to elect to receive a fixed-return preferred security or a combination of consideration including a mixture of cash and preferred securities. Issues to consider include the yield, windows for puts and calls and redemption rights, voting rights (if any), and continuing tax protection arrangements (no sale or refinancing of certain assets, the ability to guarantee debt, etc.). Along the same lines, if executives and other employees hold equity compensation awards in the form of operating partnership units that are profits interests for tax purposes (commonly known as "LTIP Units"), consideration should be given to preserving the favorable tax attributes of those awards for the holders.

4. **Change of Control Protections**. All public companies, including REITs, can and should address "change of control" protections for their management teams well in advance of any potential transaction, before deal pressures mount. Properly-structured change of control protections are both legal and proper, and serve to align the interests of key decision makers with the interests of shareholders, creating an environment that is best suited to retaining executive loyalty and focus when they are needed most. It is not in the interests of public REITs or their shareholders for senior management to have an incentive to avoid shareholder value-creating transactions out of concern for the impact of those transactions on their own personal situations. However, boards should also be aware that shareholder advisory groups and activist investors scrutinize change of control employment arrangements that provide for "single-trigger" payments (*i.e.*, those made upon a change of control, irrespective of continued employment), "problematic" severance (*e.g.*, cash payments exceeding three times base salary *plus* a bonus amount) or other benefits which are, at least at the moment, out of favor, and consider how best to balance these concerns with the needs of the company. One particularly sensitive area, which requires careful navigation, is how best to address the impact of the so-called "golden parachute" or "280G" excise tax regime, which if applicable, can have unintended punitive consequences for executives.
5. **Executive Retention and Post-Closing Arrangements**. It is often important to private equity and other buyers to retain some or all of the target REIT's senior management. In constructing the approval process for pre-closing retention arrangements at the target company, and/or post-closing employment arrangements with the buyer, it is important to distinguish between (1) those situations where there is a management conflict of interest necessitating a special committee (discussed below) and (2) routine retention and termination protection arrangements, which may be approved by the target board or compensation committee in the ordinary course of the transaction. Employment and equity compensation agreements that are negotiated between executives and a buyer after the major deal terms have been agreed, and which do not affect the price to be paid to shareholders, whether entered into before the signing of the definitive agreement for,

or closing of, a transaction, are not unusual. From the buyer's standpoint, these agreements are typically crafted to create post-closing alignment between the buyer and the executives, both on the downside (by requiring a rollover of significant equity and/or a cash investment) and on the upside (through promote structures and other compensation mechanisms). Post-closing equity compensation arrangements in a REIT that has been taken private typically may be more heavily weighted than when the REIT was public toward performance-based vesting and payout, and less toward being earned solely based on continued service. On the sell side, consideration should be given to ensuring that any management arrangements are compatible with the fiduciary-out or marketcheck aspects of a deal.

6. **Club Deals**. Some of the smaller private equity firms and sovereign wealth funds have shown a preference to team up in bidding for REITs, particularly the larger targets. Club deals of this kind require careful management of a number of buy-side complications, particularly the danger of a club bid being dragged down by its weakest member, defections by some club members, lack of alignment with regard to bidding, operating or exit strategies, and excessively complex or impractical governance and bidding arrangements. On the sellside, careful thought should be given to allowing clubbing with the board's consent, recognizing that, depending on the size of the deal and field of potential acquirors and other circumstances, a club prohibition could hurt as much or more than it helps. That said, selling boards and bankers are often leery of dealing with complicated clubs, and all else being equal would prefer to transact with larger, fully-financed players that can take down the target on their own.
7. **Debt and Equity Commitments**. The conditionality of bridge and other financing commitments should be carefully scrutinized by the selling board and the private equity buyer, and should inform negotiations around reverse break fees (discussed below). The goal, of course, is to eliminate any daylight between the closing conditions in the merger agreement and the financing commitments. In light of the strong bargaining power of private equity borrowers and the favorable debt markets, market MACs, diligence conditions and the usual extensive list of contingencies in lender forms can often be eliminated.
8. **Reverse Break Fees and Capped Guarantees**. Reverse break-up fees and guarantees provided by private equity firms are fairly standard in public-to-private REIT deals, which often involve reverse termination fees, or liquidated damages provisions, of roughly 7-10% of overall transaction value. In some ways, these provisions represent a regression to traditional real estate deposits and liquidated damages provisions in lieu of specific performance, but they tend to be far more complicated in operation. Such reverse break fees are typically asymmetrical, exceeding (often substantially) the termination fees payable by the target (which are limited by fiduciary-law constraints). From the selling board's perspective, careful thought should be given to the odds and consequences of a failed deal and the limited recourse available in such circumstances. The reputation and track record of the private equity shop will be relevant, as will be the conditionality of any financing commitments obtained by the buyer.
9. **Strategic v. Financial**. In an auction context, careful consideration should be given to including the right mix of potential bidders to maximize value. Strategic bidders often will have different views of value than financial bidders, since they may be able to capitalize on synergies not otherwise available to financial bidders or because an acquisition fulfills a strategic need or, conversely, because of constraints on their ability to utilize cheap leverage and concerns about dilution. These considerations need to be weighed against concerns with providing confidential information to a competitor and the fact that strategic

bidders sometimes need a longer time to conduct diligence and decide on a process. Strategic bidders whose stock has been performing poorly may also be constrained in their ability to pay up for a target, both because of difficulty raising the equity for a cash bid and because of the potentially dilutive effect of a stock bid, which may in any event be unattractive to the seller.

10. **Litigation**. Nearly every REIT deal still attracts shareholder litigation and take-private transactions are an especially attractive target for the stockholder plaintiffs' bar. What this means is that a selling board's actions, including its decisions with respect to all the issues outlined above, are likely to face post-signing scrutiny in court. Careful and well-documented board and committee processes are therefore critical in these deals, because they allow bidders, sellers and trustees to minimize the costs and risks of litigation and in many cases obtain favorable settlements or early dismissal when the inevitable lawsuits materialize. If properly handled, deal litigation should not be an impediment to a deal that has been structured through a well-conceived process with a proper record, and should not be allowed to wag the dog.
11. **Timing Is Everything**. When a deal makes sense, it will generally be prudent to move quickly to resolve issues and get the deal done. Circumstances change, and time has a way of creating economic, business and other issues that kill deals. The longer a deal takes, the greater the risk of leaks and their inevitable ripple effects on the market, employees, tenants, lenders and others. Conversely, if a particular deal or exploration of strategic alternatives is not feasible or prudent, boards will also be wise to reach that conclusion quickly so as not to waste management bandwidth and board energy or risk losing focus on the business on account of deal distractions. A deal that doesn't make sense today may come back as the landscape develops—so it is important to update analyses promptly and consider re-engaging if circumstances change.