REAL ESTATE
AND
REIT M&A

SELECTED ARTICLES AND MEMORANDA

WACHTELL, LIPTON, ROSEN & KATZ

DOCUMENT INDEX **TAB**

Robin Panovka and
Adam Emmerich

WACHTELL LIPTON (NEW YORK)

ADAM EMMERICH AND ROBIN PANOVKA

BY KATRINA DEWEY

ONE OF THE THINGS ABOUT LUNCHING at a fab place like Le Bernardin is that it's mind blowing. The art, the elegance, the service, the fish, Eric Ripert. A person could swoon even without a glass of wine.

But that's not really how business is done now, is it? What's way more fun is to paw one's way through one dish after another trying to keep up with two of the most dynamic and smartest partners around – the impossibly suave Adam Emmerich and the elegant Robin Panovka. They rule the REIT practice at Wachtell Lipton, which means they are the Rulers of REIT M&A, which is really big business. They are also noted global dealmakers and leading real estate strategists. Together, they helped Silverstein Properties redevelop the World Trade Center site after 9/11, in addition to advising leading REITs on their biggest deals and most complex and sensitive matters. Since the early '90s, they have been key players and innovators helping to fuel the growth and consolidation of REITs.

REIT legislation was signed by President Dwight Eisenhower in 1960, creating a vehicle that combined the best attributes of real estate and stock investment. Since then REITS have grown into a $2 trillion asset class, which is expected to continue its fast-paced growth in the next decade. In 2016, REITs were carved out as an 11th sector of the S&P 500.

If you're reading this sitting in an office building, it's likely owned by a REIT. If you're going to a shopping mall later, it's almost certainly owned by a REIT, and if it's less than full, it's probably being considered for a data center or an elder care facility. If you're talking on a cell phone, it's bouncing off a tower likely owned by a REIT. If you work in a big corporate headquarters, it's likely been sold to a REIT or is on its way. Real estate is so 1950s.

More salmon rillette, anyone? Yes, please.

Lawdragon: How did you get involved with REITS?

Robin Panovka: In the early '90s, REITs were starting to emerge, and it was clear to us that they were going to grow fast and consolidate into larger companies. That growth and consolidation - and the inevitable M&A and large-scale deal activity - seemed like an interesting opportunity for us at Wachtell Lipton. So Adam and I, along with our tax partner David Einhorn, formed our REIT M&A task force to focus on the area.

Adam O. Emmerich: We realized quickly that REIT M&A deals are best handled by a multi-disciplinary team with expertise in REITs and real estate, corporate law and public company M&A, and of course tax. The deals are complex, and we've found that we can best add value if we bring to bear all of these areas of expertise in a cohesive, seamless way. Our firm is structured perfectly for this kind of approach; we're flexible and we work well in teams focused on achieving the best results for our clients.

LD: What made REITs grow so quickly?

RP: REITs brought to the real estate markets something they desperately needed – liquidity, transparency and good corporate governance. Real estate is a capital intensive industry, so the logic of moving the industry from Main Street, so to speak, to Wall Street, was just too compelling not to work. REITs are, in essence, liquid real estate that generates a steady flow of dividends, which, particularly in the yield-starved world we still live in, is a very compelling idea.

LD: And why the consolidation into bigger companies?

AOE: Well, when we got started, the industry was incredibly fragmented, like many emerging industries. Think automakers in 1920. There were a large number of very small REITs, and the advantages of scale quickly became evident. One of the most important advantages is the lower cost of capital and the financial flexibility enjoyed by larger REITs. REIT combinations also deliver synergies, and often result in better run, more transparent, efficient and liquid vehicles.

LD: So how did you get started developing Wachtell's REIT M&A practice?

AOE: At the beginning we didn't know much about the area – we weren't really involved in regular REIT work or IPOs, so we started reading and getting educated. Then, as we gained expertise, we got to know key players in the space and started getting involved in deals.

RP: We were fortunate in that one of our first key clients in the space hired us to help them buy significant stakes

PHOTO BY: LAURA BARISONZI

AFTER WE ESTABLISHED OURSELVES IN THE SPACE AND DEVELOPED RELATIONSHIPS WITH KEY PLAYERS, DEALS FOLLOWED DEALS AT A VERY FAST PACE. IT'S BEEN A VERY PRODUCTIVE AND REWARDING PRACTICE AREA FOR THE FIRM, AND VERY INTERESTING. IN MANY CASES, WE REPRESENT THE CONSOLIDATOR IN A PARTICULAR SECTOR, AND HAVE HANDLED MANY DEALS FOR THEM AS THEY HAVE GROWN OVER THE YEARS.

in a number of REITs in different sectors over a couple of years, so we had the opportunity to learn about how the target companies were structured, figure out how they should be restructured and recapitalized, and get to know their boards and management teams, as well as the investment bankers and others working in the space. It was a great introduction.

LD: How did the practice evolve?

AOE: After we established ourselves in the space and developed relationships with key players, deals followed deals at a very fast pace. It's been a very productive and rewarding practice area for the firm, and very interesting. In many cases, we represent the consolidator in a particular sector, and have handled many deals for them as they have grown over the years. The deals started out fairly small when the industry was small, but at this point they are quite sizeable. For example, we just completed a $15 billion merger of two shopping center REITs, and over the last few years have handled many similarly sized mergers involving hundreds of billions of industrial, healthcare/senior housing, self-storage, office, mall, apartment, single-family homes and other real estate.

RP: In addition to mergers, we've also advised on several large REIT spin-offs – both REITs spinning off other REITs and regular businesses spinning out their real estate – as well as takeover and activist defenses, private equity buyouts, governance matters, and various strategic transactions. It's been busy.

LD: Are activists as much of a factor for REITs as other public companies?

AOE: Yes, increasingly so. REITs are increasingly being targeted, and it's important for REITs to be prepared, and to be in essence their own activists, generating ideas and considering alternatives. In most cases, activist attacks on REITs demonstrate short-term thinking and ideas that are already under consideration – like selling assets when the REIT is trading below the value of its assets – but once in a while the outsider's perspective can spotlight an interesting opportunity. So it has to be handled on a thoughtful, case by case basis.

LD: How are REIT mergers different than other mergers Wachtell handles?

RP: REITs have a number of unusual features that come into play in M&A deals, like the so-called UpREIT structure that utilizes an operating partnership, and so-called excess share ownership restrictions in REIT charters. And of course there are the REIT tax rules, which can have significant impacts and ripple effects on deals. REIT deals represent a marriage of real estate and corporate deal cultures, customs and technologies, as well as some different valuation and accounting metrics, so they can't be approached in a rigid corporate framework. And of course, the boards and CEOs often come from the entrepreneurial real estate world, which for me makes it a lot of fun.

LD: Are there hostile deals involving REITs?

AOE: Definitely. There are probably fewer hostile deals in REIT-land, largely because of the smaller takeover premiums that are typical of REIT transactions, but structurally REITs are no more takeover proof than any other public companies. The conventional wisdom that REITs are takeover proof is, well, conventionally wrong.

LD: What about the real estate that's owned by regular corporations, like headquarters buildings? How does that fit in with REITs?

RP: You're touching on an interesting area. We've been involved in a number of transactions in which corporate real estate has been moved into REITs – for example the spin of a gaming REIT out of a gaming company and the creation of a REIT to own and lease back retail properties – and we expect these kinds of transactions to continue. Companies that own significant real estate assets which aren't adequately valued by the market sometimes want to consider strategies to "unlock" the real estate value. There are a number of strategies to be considered, and in some cases creation of a REIT or a sale-leaseback might make sense.

LD: Have there been bumps in the road as the REIT industry has grown, or has it been a straight line?

AOE: The financial crisis was quite a big bump. REIT stocks joined the rest of the market in losing tremendous value, and that made their debt loads look heavy. But only one REIT filed for bankruptcy, and the REIT market fared much better than the private real estate market. In the end, the financial crisis probably strengthened the REIT industry, in that it caused REITs to recapitalize and showed the advantages of the REIT structure. REITs have now been battle-tested and emerged with flying colors.

LD: How has technological disruption affected REITs?

RP: As in other areas of the economy, there's been a tremendous impact and my guess is that we're just getting started. The so-called "bricks versus clicks" disruption has been most evident in the retail/shopping center sector, but it's having an impact everywhere. Just think Airbnb (hotels), WeWork and the mobile work force (office), not to mention self-driving cars, drone deliveries, altered reality and technologies we haven't even dreamed about. Some of the biggest and fastest growing REITs today are driven by technology, like cell tower REITs, data center REITs, and industrial/warehouse REITs that facilitate online shopping. REIT boards need to be nimble and keep an eye on these trends, now more than ever.

LD: What do you enjoy about the REIT M&A work?

AOE: For one thing, the fast-paced growth and innovation. Also the relationships we've formed with the leaders of REITs who we've been working with for many years. These are often remarkable people who founded the company or took it from nothing to an S&P 500 company. REITs are often incredibly flat, lean organizations, and that's a nice thing to deal with. It's a very dynamic, interesting practice.

RP: In many cases, we've been working with companies for more than a decade or even two, since they got started and made their first acquisition, so we have a real personal interest in them and their success.

LD: So what comes next for the REIT industry?

RP: It seems almost inevitable that the strong flow of properties into REITs, both in the U.S. and abroad, will continue, which obviously involves lots of deal activity. The U.S. REIT market is already over $1 trillion, and the European and Asian markets, which developed later, have already grown beyond $200 billion each. There's tremendous room for growth abroad, but even in the U.S. significant growth is expected, part of it from continuing consolidation by the existing leading REITs, part of it from fast-growing tech-REITS, and part from the expansion of REITs into new property types and the movement of corporate real estate into REITs. There is still a tremendous amount of real estate outside of REITs that might be better positioned in a REIT solution.

AOE: No question, we expect a steady flow of M&A deals as REITs continue to get bigger and consolidate their sectors. The 30 REITs now in the S&P 500 – up from zero 16 years ago, by the way – already have an average market cap of about $20 billion and represent 55% of the REIT market. The big are getting bigger, but still have tremendous runway.

LD: How does your work rebuilding the World Trade Center fit in with the REIT practice?

RP: It's really part of our broader strategic real estate practice. In addition to REIT M&A we advise on major development or city-building projects, joint ventures, private equity fund formations, and other high-stakes matters. Our firm spent many years working on the WTC rebuilding effort, starting days after 9/11, and we are proud of the role we played in this important effort and of course very gratified at the progress at the WTC and downtown.

May 6, 2020

"New" IRS Guidance Provides Relief from Dividend Payment Requirement for REITs

Taking a page from its financial-crisis playbook, the Internal Revenue Service has issued a welcome Revenue Procedure temporarily reducing, from 20% to 10%, the minimum required aggregate percentage of cash that publicly traded REITs must distribute to qualify for a 2017 safe harbor that treats an elective cash/stock distribution as a taxable dividend. This timely guidance provides much-needed relief to REITs that are struggling with some combination of sharply reduced income, COVID-19-related spending needs, dividend distribution requirements and debt maturities and other fixed obligations.

In response to the great financial crisis, the IRS created a safe harbor for elective cash/stock distributions paid by publicly traded REITs and RICs, permitting the amount of cash to be capped at 10% of the total dividend. Although this safe harbor was initially limited to distributions for taxable years ending on or before December 31, 2011, the IRS revisited the matter in 2017, when it effectively made the prior safe harbor permanent, albeit with a higher 20% cap and significantly more specific requirements on pro-ration mechanics.

This new guidance retains all of the other mechanical and procedural requirements of the 2017 safe harbor, but lowers the minimum required aggregate percentage of cash back to 10% from 20% for distributions declared on or after April 1, 2020 and on or before December 31, 2020.

While the circumstances facing REITs today vary broadly by property type and capital structure, each REIT is finding its own way through the pandemic and the destruction wrought on patterns of commerce and spending. This new IRS guidance provides another tool in the arsenal to weather the storm.

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April 28, 2020

REITs and COVID-19:
15 Key Issues for Boards as They Chart the Course Forward

Many REIT boards are now broadening their focus beyond the immediate firestorms unleashed by COVID-19, to longer-term risk-management and strategic planning issues that take account of the radically changed environment. Following is a list of 15 key issues to be considered with a 3-, 6- and 12-month lens, and beyond. Many boards have already considered these issues in crisis-mode, but it is essential to also reflect on them more broadly as we move into the next phase of response and as expectations for the recovery adjust to take account of the realities on the ground. Of course, the analysis around each of these issues will differ by sector, subsector and company, and there are unfortunately no one-size-fits-all answers:

1. Liquidity: Now that many credit lines have been drawn and other immediate liquidity enhancements implemented, how much runway does the company have in realistic worst-, best- and middle-cases; are additional liquidity measures necessary; when can/should credit lines be repaid; does the company have untapped collateral for cheaper secured financing; should asset sales be considered; should new equity be issued at some point; should a PIPE be considered; what government assistance might be available; and how much cash should the company keep on hand? Our firm's memo on preserving liquidity might be helpful in this regard.

2. Disclosure and Guidance: Given investors', the SEC's, proxy advisors' and other stakeholders' thirst for transparency and insights into the new environment, how best to communicate the impact of COVID-19 and changes in guidance, especially when visibility is so limited? Our firm's memo on upcoming earnings calls may be helpful in this regard.

3. Alterations to Properties and their Operation: As we move into the re-opening "dance," how best to protect the health and safety of employees, tenants, visitors and others. What physical and operational changes to the REIT's properties should be considered?

4. Dividends: What adjustments should be considered, as to amount, timing and stock component?

5. Rent Collections/Growth: The impact on April rent collections is now known, and boards will soon have data on May. What are the implications for collections in the coming months, and, as important, for rent growth/contraction going forward, especially in light of the possible contours of the recovery and resulting changes in supply and demand, tenant strength and ability to pay, potential tenant bankruptcies, ongoing COVID disruption and changes in the way in which we use and interact with various forms of real estate?

6. Lease Modifications: Will the rent deferrals and waivers negotiated so far result in more permanent lease restructurings, and what might those look like? Should any of the deferrals agreed to so far be treated as permanent relief?

7. Loan Modifications: What modifications should be sought in light of any covenant compliance and other issues? If lenders are being asked for relief or runway, what are the costs, and are they warranted? Are there alternatives in the market? Timing issues should also be monitored since many companies are working on modifications and lenders' bandwidth is being tested.

8. Cost Reductions: If cost reductions are or may become necessary, where should they be implemented? For example, are there assets encumbered by non-recourse debt that, given changes in NOI and values, may no longer be worth keeping (assuming no cross-default or other fallout)? Ground leases that should be terminated? Planned developments or re-developments that should be stalled? CapEx that should be deferred?

9. Ongoing Transactions/Construction: Most contracts have now been analyzed to identify issues relating to force majeure, operating and financial covenant compliance, MAC clauses, condemnation issues and the like. Now the question turns to how these issues will be managed and how they will play out. In many cases, a dose of pragmatism and long-term thinking will help in deciding which battles to fight and which to resolve quickly.

10. Stakeholders and Social Responsibility: REITs' responses to the crisis have demonstrated their commitment to the health, safety and welfare of their employees, tenants, communities and other stakeholders. An important question for boards is the extent to which social responsibility and sustainability measures undertaken so far, and perhaps additional measures, should be made permanent and woven into the fabric of the company.

11. Activism Preparedness: Given the precipitous drop in some REIT stock prices and accumulations by activists, it is often prudent to enhance stock surveillance and to consider putting a rights plan on the shelf (or in some circumstances adopting one), in addition to other steps discussed in our recent memo on preparing for threats in the COVID-19 environment.

12. Share Buybacks: The declines in many stock prices, in some cases far south of intrinsic value, will make it tempting to reinstate suspended programs or to initiate new ones, at some point. How and when to do so will be a complicated decision that will need to take account of many of the issues outlined above, as well as anti-buyback political and other cross-winds that have strengthened in the pandemic.

13. Relief/Insurance: Are there government relief programs available and appropriate for the company to tap into (either directly or indirectly through lenders or tenants)? What recovery might be available under business interruption or other insurance, recognizing that many policies have pandemic exclusions?

14. Digital Shift: The question has to be asked whether the pandemic has meaningfully and permanently accelerated the shift from bricks to clicks, what the realistic implications for the company's business model might be, and how the company should adjust. Clearly, some business models have performed better than others in this period, and there may be valuable lessons to be learned.

15. Going on Offense/M&A: It's too soon in most cases, but it may be worthwhile to consider when and how the window might open. Are there potential targets with whom a low-key dialogue should commence? What kind of dry powder might be needed?

In addition, boards must also continue to exercise their usual oversight duties (see our firm's memo with some general thoughts for the board), with extra attention on general risk management issues and on ensuring that the CEO is fully supported through the crisis and recovery.

Adam O. Emmerich   Robin Panovka

April 6, 2020

REIT M&A and Activism:
Preparing for Threats in the COVID-19 Environment

The precipitous drop in REIT stock prices has brought out the activists. While all REITs' first priority should be to focus on dealing with the immediate fallout from the COVID-19 crisis – including tenant, employee, operational, health and safety, liquidity and capital issues – it is also important to protect the enterprise from those who seek to take advantage of the situation. REITs would do well to freshen up their preparedness plans, including:

- Monitoring trading and ownership of the REIT's equity and debt securities (including options, credit default swaps and other derivative products to the extent possible), looking for accumulation or unusual activity by any activists, would-be acquirors or similar players.

- Reviewing (and, if appropriate, updating) structural defenses and governance profiles, including both conventional defenses and REIT-specific "excess share" ownership restrictions and unitholder rights. As discussed below, in most cases it would be prudent to get a rights plan ("poison pill") on the shelf, ready to adopt if circumstances warrant.

- Updating the board on best practices for responding to an activist or bidder, and assembling a team for rapid deployment.

- Taking a fresh look at the company's balance sheet and schedule of debt maturities and, if appropriate, exploring ways to increase liquidity, including drawing any available lines, new facilities, liability management, asset sales, workforce adjustments, and changes to payment and other practices.

- Considering the company's dividend policy, guidance, and COVID-19 disclosure, and their implications for short-termist investors.

- Assessing the risks to any NOLs and how they might be protected.

- Reviewing any Achilles' heels that the REIT might have and how they might be addressed, getting ahead of the activists.

- Engaging with shareholders on governance and strategy, including plans for dealing with the economic and other implications of COVID-19.

Myth and legend notwithstanding, REITs are not "takeover proof" and are susceptible to activist attacks, stealth accumulations, hostile takeover bids and proxy fights, just like other public companies. Although REITs have a number of specific structural features that may have defensive characteristics, discussed below, they should not allow their REIT status to give them a false sense of security.

REITs generally have so-called "ownership limitations" or "excess share" provisions in their charters designed to preserve their tax status. If properly implemented, these provisions generally do limit the accumulation of a large position and have a defensive effect. Indeed, some state statutes validate such charter ownership provisions, including for non-tax purposes, and some REITs have specifically disclosed that such provisions may be used for anti-takeover purposes. However, excess share provisions are largely untested as anti-takeover defenses and, in some cases, may be vulnerable because of their grounding in the tax code, or the specific manner in which they are written. In many cases, depending on their specific terms and other factors, they do offer strong protection against takeovers and activists, but they are unlikely to be more powerful or robust than other common takeover defenses such as a rights plan, and often may be less so.

A rights plan remains the single most effective device available to a board to enable the directors to discharge their fiduciary duties, deter stealth accumulations of controlling blocks of stock and maximize leverage regarding the timing and outcome of an unsolicited bid. Properly implemented rights plans can also address the opportunistic use of derivatives and structured economic exposure to a company, limit problematic "group" activity designed to change or influence control of a corporation, and address aggressive share acquisitions by activists.

That is not to say that we are advising all REITs to immediately adopt a rights plan. Rather, as discussed in our firm's recent memo, we would suggest that REITs consider preparing rights plans and putting them "on the shelf," ready for rapid deployment if and when advisable based on a nuanced assessment of the threat and the possible costs. Among the factors to be considered in deciding whether to adopt a rights plan will be how robust the REIT's excess share provision is, whether the rights plan would address the perceived threat, market and proxy advisor reaction, and overall strategy and market position.

Regardless of the specific tools to be deployed, advance preparation is essential. It can often make the difference between success and failure when under attack, in other times of stress or when fast action is necessary to avoid a serious problem. In light of the current uncertain and volatile environment, REIT management and boards of directors are well advised to redouble their efforts toward preparing for the various kinds of dangers we are currently witnessing in the REIT space.

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January 6, 2020

REIT M&A in 2020

REITs on the whole had a strong year in 2019, with robust growth, stock performance and deal activity. That said, not all sectors moved in tandem, and tech-disruption and activism continued to present challenges and opportunities for many companies. We offer some specific observations below that might be helpful as we enter the new decade:

1. Board Best Practices. A well-functioning, collegial board that speaks with one voice is essential to navigating the complexity of the evolving REIT markets, particularly when activists come knocking or extraordinary transactions are considered. Board dysfunction or division was a clear factor in a number of sub-optimal situations last year. Our firm's recent Some Thoughts for Boards of Directors in 2020 may be of interest in this regard.

2. Activism. Activists are increasingly part of the trigger for major REIT transactions or internal changes, more so than may be apparent from public reports. Managing proactively and reactively for activism is now a core part of the REIT landscape. Too often activists are attracted by the simplistic notion that a quick flip of the real estate at NAV will unlock value, without understanding the costs or complexity involved. Once in a while they shake things up with interesting ideas, but care should be taken not to allow activists to disrupt operations or long-term planning or dictate actions or results for the sake of short-term profits without regard to longer-term implications. Well-prepared boards have a variety of tools at their disposal for dealing with short-termist disruptors.

3. Shareholder Engagement. A handful of passive investors now own a third or more of the stock of many REITs. Understanding their perspective, and engaging with them, is an absolute necessity, and is best done well before a difficult vote. Activists know them well and visit them often; their voice should not be the only one heard. At the same time, actively managed funds are increasingly wielding their voting power and influence behind the scenes, and great care should be taken to maintain strong relationships and anticipate and resolve potential friction points with those investors who determine the trading price of the company's stock.

4. Proxy Contests. The rise of the "passive" investors, the influence of the proxy advisors, and evolving relationships among active managers, analysts and activists has given activists a relatively easy path to outright winning board seats – or influencing board composition and business strategy – even when they own a very small amount of stock. Boards should understand and plan for this, particularly where the activists seek just one or two board seats and various governance or other metrics show vulnerability.

5. Sale Processes. As a number of recent deals have shown, there is no one-size-fits-all approach for running a process that achieves the best results for shareholders. Each situation is different, and different paths to maximizing value will be attractive depending on the assets, bidders, capital sources, frictional costs, third party consents, blocking positions and other facts and circumstances at play in any particular situation.

6. Realistic Price Expectations. REITs interested in exploring strategic alternatives – and there are more of these than casual observers might suspect – should be careful to set (and ensure that their internal records are consistent with) realistic price expectations. Unquestioning belief in internal or third-party NAVs is often a recipe for confusion and disappointment – in the real world, many favorable transactions that are in the best interests of shareholders fall below theoretical NAV metrics.

7. Market Checks. 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.

8. Litigation. 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 and exposure controlled and kept to a minimum. The possibility of deal activism or bumpitrage – while far from rare – should equally not discourage the well-advised and well-prepared board.

9. Executive Compensation and Retention. Executive compensation and termination protection issues should be considered – by both buyers and sellers – early in any process to ensure retention of employees critical to a successful transaction. Regular review of change-in-control protections on a clear day – with no activists or transactions in sight – is always prudent, but swiftly moving events often require boards to be nimble and creative in maintaining management team focus, ensuring successful completion of transactions, and protecting against the downside of a busted deal. Compensation committees should remain current on their executive team's incentive and termination protections, as well as market practices, to be prepared for and be in a position to react quickly in the context of activist or transactional developments.

10. Deals. We expect the current trend of public-to-private arbitrage plays and, particularly in tech-driven sectors, public-to-public consolidation plays, to continue into 2020, with interest rates and political disruption being key wild cards.

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August 8, 2019

Use of Non-GAAP Measures Not Questioned in Recent Charges

Last week, government authorities charged Brixmor Property Group and certain of its former executives with a fraudulent scheme to manipulate a key non-GAAP accounting measure commonly used by REITs, Same Property Net Operating Income ("SP NOI"). In a criminal indictment and SEC Complaint, the government alleged that the former executives "engineer[ed] the numbers they needed" to convince the market that Brixmor had met performance expectations. These charges highlight the importance of consistent application of accounting principles, clear disclosure of methodologies employed and deviations from past practice, and ensuring a reporting culture built around integrity and forthrightness with the market, all of which are alleged to have been missing at Brixmor.

The allegations, if true, reflect plain-vanilla accounting fraud: the former executives intentionally manipulated a closely followed financial metric to mislead investors and analysts regarding the company's financial performance. In particular, the government has alleged that former executives made improper accounting adjustments with the aim of reporting false SP NOI Growth Rate figures. These allegedly false figures led investors to believe that Brixmor's SP NOI Growth Rate was stable and hit the "middle of its guidance range virtually every quarter." In fact, the responsible former executives allegedly knew that the rate had fluctuated wildly each quarter and was outside the guidance range in six of the nine quarters in the period under scrutiny. Among other things, the alleged accounting manipulations included improper timing for the recognition of revenue (in violation of GAAP), incorporating certain income into the SP NOI that the company repeatedly represented would be excluded from that metric, and improperly adjusting comparison period SP NOI numbers to make the SP NOI Growth Rate appear higher.

The SEC's complaint makes clear that it was not the use of non-GAAP metrics that the government found to be problematic, but the intentional manipulation of these metrics.

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April 4, 2019

REIT M&A and Consolidation:
Ten Predictions for the Next 24 Months

Below is our annual list of predictions discussed at yesterday's NYU REIT Conference:

1. Tech-REITs growth and consolidation will accelerate. Tech-REITs already represent four out of the ten biggest REITs, and with the roll-out of 5G, IoT and AI will be further turbo-charged.

2. The much-debated "NAV discounts" which drove several [misguided] activist campaigns last year have already flipped to premiums in a number of sectors, and we expect the trend to continue.

3. Take-privates will get harder as REIT valuations rise and arbitrage opportunities get harder to find, but will continue given the need to deploy the significant amounts of dry powder accumulated on the private side.

4. More public-to-public strategic deals will pencil out, driven in part by renewed CEO and board confidence (with obvious geo-political wild card caveats).

5. Founders who don't have viable succession plans will increasingly consider exiting through deals given the strong REIT markets.

6. A small number of PE players will continue to dominate take-privates of REITs over $5B, and club deals won't get any easier. Sale processes in this environment will continue to require artful structuring.

7. The complex bidding landscape and shallow big-bidder pools will result in more deals getting done with go-shops, window shops or initial (very) low-break fees.

8. Growth in the total market cap of U.S. REITs will continue, with REITs' aggregate equity market cap reaching $1.4 trillion by 2022.

9. Chinese capital will not return, but the impact will barely be felt.

10. Tech-disruption and opportunity will accelerate and continue to reshape REITs and their business models in unexpected ways.

Adam O. Emmerich   Robin Panovka

REIT M&A: Use and Overuse of Special Committees

Posted by Adam O. Emmerich, Robin Panovka, and William Savitt, Wachtell Lipton Rosen & Katz, on Thursday, February 21, 2019

Editor's note: Adam O. Emmerich, Robin Panovka, William Savitt, and Viktor Sapezhnikov are partners at Wachtell, Lipton, Rosen & Katz. This post is based on their Wachtell Lipton memorandum.

Special committees are often an indispensable tool in conflict transactions. In REIT management-buyout transactions, a well-functioning and well-advised committee can sometimes shield directors and managers from after-the-fact litigation exposure. But special committees are not one-size-fits-all, and can also be deployed to the detriment of a company and its shareholders. Forming a special committee when not required can needlessly hamper the operations of the company and its ability to transact, create rifts in the board and between the board and management, and burden the company with an inefficient decision-making structure that may be difficult to unwind. It is important, therefore, for REITs to carefully consider—when the specter of a real or potential conflict arises—whether a special committee is in fact the best approach, whether it is required at all, and whether recusal of conflicted directors or other safeguards are perhaps the better approach.

REIT management teams often stay the course through an M&A transaction and remain employed by the successor company after the deal. In such cases, it is not unusual for management to negotiate terms of employment with the transaction counterparty at some point during the deal, preferably towards the end when all material deal terms have been agreed. But while such negotiations can raise conflict issues, they do not necessarily mean that the entire transaction and surrounding process must or should be negotiated by a special committee. In many cases, simple recusal or other procedural safeguards may be more appropriate to address employment negotiations—leaving the full board to address matters for which there are no conflicts.

Where a special committee is properly deployed, the committee should exclude anyone with a direct or indirect interest in the transaction, and the committee should engage its own unconflicted legal and financial advisors. The committee should also be provided full negotiating power, including the power to reject any transaction. It should be constituted early in the process, before any material transaction terms are agreed, and have access to all relevant material information regarding the company and the proposed transaction.

Special committees should not be confused with transaction committees. Such committees are typically established for efficiency, not to deal with conflicts. Transaction committees can be particularly helpful when a deal is moving fast and requires a level of attention and speed that is impractical to expect from the full board. Transaction committees can—and often do—properly include the CEO and other management directors, and it is usually expected and required that material decisions will come back to the full board for final determination.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

REIT M&A in 2019

Posted by Adam O. Emmerich and Robin Panovka, Wachtell, Lipton, Rosen & Katz, on Friday, January 4, 2019

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, Mr. Panovka and colleagues at Wachtell Lipton.

As we enter the new year, we offer some thoughts based on hits and misses in 2018:

1. **Realistic Price Expectations are Key**. REITs interested in exploring strategic alternatives—and there are more of these than casual observers might suspect—should be careful to set (and ensure that their internal records are consistent with) realistic price expectations. Slavish belief in internal or third-party NAVs is often a recipe for confusion and disappointment—in the real world, many favorable transactions that are in the best interests of shareholders fall below artificial NAV metrics. As we have long pointed out, the NAVs bandied about with great authority are often nothing more than rough estimates based on limited data, are usually backward looking, fail to take frictional costs into account, and in many cases do not reflect fundamental value. As Green Street recently pointed out, "managers and boards with an NAV-or-bust mindset do a disservice to shareholders."

2. **Activism**. Activists are increasingly targeting REITs of all sizes and flavors, sometimes attracted by the simplistic idea of a quick flip of the real estate at NAV, without understanding the complexity involved. Once in a while they have interesting ideas which are worth considering, but care should be taken not to allow them to disrupt operations or long-term planning or to dictate actions or results for the sake of short-term profits. Well-prepared boards have a variety of tools at their disposal for dealing with short-termist disruptors.

3. **Sale Processes***.* As a number of recent deals have shown, there is no one-size-fits-all approach for running a process that achieves the best results for shareholders. Each situation is different, and different paths to maximizing value will be attractive depending on the assets, bidders, capital sources, frictional costs, third party consents, blocking positions and other facts and circumstances at play in the particular situation.

4. **Market Checks**. 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.

5. **Litigation**. 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 and exposure controlled and kept to a minimum. The possibility of deal activism or bumpitrage—while far from rare—should equally not discourage the well-advised and well-prepared board.

6. **Executive Compensation**. Executive retention and termination protection issues should be considered early in the process, preferably on a clear day.

7. **Arbitrage Mismatches**. Perhaps not surprisingly, the sectors that are often of least interest to private investors have the largest number of REITs interested in exploring an exit from the public markets. At the moment, this mismatch is creating too large a valuation gap for transactions to pencil out, and only time will tell whether the valuation gap will close in 2019. In some cases, particularly where there is concern about property obsolescence, we are not optimistic.

8. **Shareholder Engagement**. Passive investors now own a third or more of the stock of many REITs. Understanding the perspectives of these new "passive" behemoths and all shareholders, and engaging with them, is an absolute necessity, and is best done well before a difficult vote.

9. **Deals**. We expect the current trend of public-to-private arbitrage plays and, particularly in tech-driven sectors, public-to-public consolidation plays, to continue into 2019, with interest rates and political disruption being key wild cards.

As ever, predictions are hard—especially about the future. We expect 2019 will be full of surprises. Whatever those developments may be, a thorough appreciation and understanding of today's environment and the seismic changes that REITs and their shareholders have experienced in recent years will serve boards and managements well in responding nimbly to M&A opportunities.

December 11, 2018

Tenth Circuit Upholds Archstone Merger
Providing Useful Guidance on OP Unitholder Rights

The U.S. Court of Appeals for the Tenth Circuit has provided useful guidance on structuring UPREIT mergers. In [*Stender* v. *Archstone-Smith Operating Trust, et al.*](), the Court of Appeals affirmed summary judgment dismissing all remaining claims brought by operating partnership unitholders arising out of an UPREIT merger in which they had the option to sell their units or convert them into new units in the post-merger entity. The Court rejected the unitholders' claims that they were entitled to retain their existing units, that a class vote was required on the merger and that their reasonable expectations were thwarted by the merger.

This decision is the latest in a saga that has spanned more than a decade since Archstone was acquired in 2007. In that $22 billion transaction, nearly 99% of the votes cast by REIT shareholders were to approve the merger. No separate class vote of unitholders was conducted, but they were offered an election between the same premium cash consideration offered to REIT shareholders and a tax-deferred preferred unit alternative at market rates. Unsatisfied with these options, a class of unitholders filed suit alleging breaches of contract and fiduciary duty.

Relying on the Declaration of Trust that governed the relationship between OP unitholders and the operating partnership (which in this case was a trust), the Court of Appeals concluded that "the operating trust could merge and terminate the [OP] units in the process" because the merger complied with that contract's unambiguous terms. Thus, while "unitholders point[ed] out that they were entitled to a class vote on amendments" to the trust, since "nothing was amended until after the merger and the termination of [the OP] units," no class vote was required. The Court also rejected the unitholders' breach of fiduciary duty claims, holding that their "reasonable expectations were measured by their contractual rights" and the merger did not violate any of those rights.

The Tenth Circuit's decision shows a court's willingness to apply, as written, the contractual terms governing the rights of OP unitholders and to uphold an M&A transaction that was structured to comply with those terms.

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Harvard Law School Forum on
Corporate Governance and Financial Regulation

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.

March 23, 2018

Observations from the NYU REIT Symposium

Following are some observations[1] from this week's 23rd Annual NYU REIT Symposium, which included many of the top CEOs and thought leaders in the space, representing more than half the market cap of the industry:

1. Growth. Despite disappointing stock performance of late, the REIT industry continues to grow rapidly. Non-mortgage REITs now have an equity market cap of $1.1T and own assets valued north of $2T, yet still control only roughly 15% of U.S. commercial real estate and a smaller percentage of global assets. Lots of runway ...

2. NAV. NAV is a blunt instrument, to be used with care. NAVs are imprecise estimates by nature, are backwards-looking, and don't take account of frictional costs. A common misconception is that a public REIT cannot sell itself for less than NAV — while NAV is one metric to look at, the question for a REIT board considering a sale is how a price offered compares to the company's current and expected equity value, long term strategic plan and other strategic alternatives, and what is in the best interest of its shareholders.

3. Closing the NAV Gap. The many REITs trading at substantial discounts to guesstimated NAVs are attempting to close the gap in a number of different ways, from asset sales, share buybacks, deleveraging, development or sale of the company. They should also evaluate their executive compensation models to ensure that executives are appropriately incentivized in the current market.

4. Tech-REITs. Tech-driven REITs are in a turbo-charged category of their own. They already represent four of the ten biggest REITs.

5. Consolidation. The advantages of scale continue to drive consolidation. Some argued that one of the key advantages certain to increase the pace of consolidation is the ability to quickly harness new technologies across broad portfolios, providing tenants a superior product.

6. Privatizations. Privatizations are likely to pick up steam given the NAV gaps and the "maturity" of a good number of management teams and founders. In many cases, however, the large size or product type of a REIT (there are now 42 REITs with enterprise values over $10B, many much bigger) limits the number of potential bidders, which can be a serious impediment.

7. M&A Process. There is no one-size-fits-all process for M&A. Depending on the circumstances, a full auction, limited/soft auction, auction with a floor (à la EOP), or other process may make sense. Maryland and Delaware law give boards broad discretion to implement the process which they judge best to maximize shareholder value.

8. MBOs. In privatization transactions where management is part of the buy-out group it is important that procedures to address conflicts and to comply with enhanced disclosure requirements are put in place at the earliest stages of a transaction.

9. Activism. Activism is on the rise, especially by better capitalized players from outside the REIT space. The usual playbook applies.

10. Shareholder Engagement. REITs' shareholder base continues to evolve, with passive investors now owning 27% of the industry. Shareholder outreach, including to the passives, has never been more important.

Adam O. Emmerich　　　　Robin Panovka

[1] Of course, these observations reflect only our views and may or may not reflect the views of other participants at the Symposium.

January 2, 2018

REIT M&A, Activism and Governance – Ten Themes for 2018

Following are some of the key board-level themes we expect to continue playing out in 2018:

1. Consolidation. The steady aggregation of assets into larger REITs continues, not infrequently driven by activist pressure or technological disruption, but also by proactive strategic planning. Cross-border activity continues to be incremental and mostly episodic. REITs entering into deals should factor the potential for activist response into deal diligence and strategy.

2. Activism. Already a major factor in the retail sector (particularly with the recent entry of larger, non-REIT-dedicated activist funds), activist intervention is expected to expand to other REIT sectors, especially those with perceived NAV gaps, and to REITs with governance that doesn't comport with the expectations of the very large index investors that increasingly dominate the share registers of all REITs. Approaches for building thoughtful relationships with these investors that are focused on substance rather than check-the-box approaches are continuing to evolve.

3. Technological Change. Again most evident in the retail sector so far, but likely to expand to other sectors and potentially to require rethinking existing business models. This remains one of the key risks and opportunities to be managed by REIT boards. For the first time, four of the ten largest REITs are "tech-REITs".

4. Shareholder Outreach. Building strong relationships with major shareholders, a handful of whom are the biggest investors in most REITs and can determine the outcome of any vote – including in transactional or activist situations – has never been more important. Adverse proxy advisory firm recommendations will need to be managed effectively without letting ISS dictate what makes sense for the company. Most major institutional investors have made clear their commitment to a long term perspective and to a productive ongoing dialogue with senior REIT management and, as appropriate, directors.

5. Long Term Strategy. Regardless of the governance flavor of the day, the board's responsibility is to keep its eye on long-term strategy and value creation. Check-the-box governance prescriptions may affect various short-term "scores," but the board's core responsibility is to formulate and implement a long-term, sustainable strategy, vision, and corporate culture. Tone at the top matters.

6. Executive Compensation. Careful thought should be given to allowing board compensation committees greater discretion to reward outstanding performance, regardless of whether rigid mathematical targets are achieved. In too many cases, forces outside of the control of key executives, like macro trends that reduce TSRs, result in outperforming management teams being undercompensated. While the use of relative, rather than absolute, goals may be useful in this regard, outstanding REITs usually are a reflection of outstanding management, and a board's ability to attract, retain and motivate management should not be held hostage to rigid objective criteria.

7. Succession Planning. Few issues are more central to the board's long-term responsibilities than succession planning and implementation. A board will want to consider whether the successor CEO should be an insider or an outsider, whether the bench should be built out with an eye to succession, whether a "tournament approach" among two or more internal candidates is advantageous or whether it is best to pick a single candidate who can be groomed.

8. Board Quality. Board quality, including composition, is an increasingly important issue, with particular focus on relevant expertise, average tenure, diversity and, of course, independence, in addition to the baseline requirements of character and integrity. Quotas and other formulaic approaches are often a disservice to REITs, and in most cases it is better to implement a more nuanced evaluation of the ongoing needs of the company, the experience, expertise and contributions of existing board members, and opportunities to strengthen the current composition. Conveying to investors the board's strength, involvement and quality, including through the annual proxy statement and other means, will remain important.

9. MUTA and Other Matters Maryland. The preponderance of Maryland-incorporated REITs continues to be a source of both strength and scrutiny. Careful attention to ongoing developments in Maryland law, including their utility in the context of both friendly and contested acquisitions and activist engagements, is important for every Maryland REIT, as is careful monitoring of investor and governance advisor perspectives on the Maryland landscape.

10. Tax Reform. As laid out in our December 23 memo, the new tax law is expected to have far-reaching implications for domestic and multinational businesses as well as domestic and cross-border transactions, impacting the structure, pricing and, in some cases, viability of broad categories of deals. Of particular relevance to REITs, as a result of eligibility of REIT distributions for the new 20% deduction for pass through companies, REIT investors will benefit from an effective 29.6% rate on REIT ordinary income dividends, much lower than prior law rates of 39.6%, which is expected to have a number of ripple effects and potentially stimulate the growth of REITs.

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Harvard Law School Forum on Corporate Governance and Financial Regulation

Taking REITs Private

Posted by Adam O. Emmerich and Robin Panovka, Wachtell, Lipton, Rosen & Katz, on Wednesday, October 21, 2015

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With many REITs now trading at meaningful discounts to their net asset value, we are already seeing signs of an increase in REIT buyouts. Many of the drivers of the $100 billion-plus of public-to-private REIT M&A transactions that preceded the financial crisis are apparent again, including higher valuations in the private real estate markets than in the public REIT markets, highly liquid private markets that facilitate wholesale-to-retail executions, debt that is still both cheap and plentiful for certain transactions, large pools of low-cost private equity seeking deals (and willing to accept low cap rates), and a sizeable pipeline of REITs and REIT executives who are seeking a graceful exit. More recent trends such as the increasing interest of sovereign wealth funds and other sources of international capital in the U.S. real estate sector may also drive future REIT privatizations.

In recent months we have dusted off our public-to-private playbook, including some of the lessons from the last privatization wave:

1. Market Checks.

Boards of REITs considering a going-private transaction (or a sale of any kind) should bear in mind that while a pre-market check is not always required as a legal matter—particularly in Maryland, where many REITs are incorporated—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. Even when there is no explicit pre- or post-signing market-check or shopping period when selling a public REIT, the sale of every non-controlled public company will include a market test, if only through the absence of preclusive lock-up arrangements. Boards should carefully consider the alternatives—pre-signing full auction, limited auction, accepting a preemptive bid with a subsequent market check, go-shops, low break-fee deals (sometimes viewed as an auction with a floor), full-on accepting a blockbuster bid with a standard fiduciary out and break-fee, or combinations and variations on these options—and 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 an appropriate process was followed (including, as noted below, with regard to any conflicts of interest) and is demonstrable from the record.

2. Executive Compensation and Retention.

It is often important to private equity buyers to retain some or all of the target REIT's senior management. In constructing the best approval process for employment arrangements with the buyer, or retention arrangements with the target, entered into prior to the signing or closing of a transaction, it is important to distinguish between those situations where there is a management conflict of interest necessitating a special committee (discussed below) and routine retention arrangements, which may be approved by the target board or compensation committee in the ordinary course. Employment agreements between executives and a buyer negotiated after the major deal terms have been agreed and which do not affect the price to be paid to shareholders are common and perfectly acceptable, even if executed prior to or simultaneously with the definitive deal documents. From the buyer's standpoint these agreements should be carefully crafted to create the best possible 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). Equity compensation arrangements in a REIT which has been taken private typically will 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 market-check aspects of a deal.

3. Change of Control Employment Arrangements.

All public companies, including REITS, can and should address "change of control" protections well in advance of any potential transaction, before deal pressures mount, in order to create an environment that is best suited to maximizing shareholder value and retaining executive loyalty and focus when they are needed most. 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. 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 a fear of the impact of those transactions on their own financial situation, or to prefer a transaction involving the opportunity of continued employment over one—perhaps better for shareholders—in which there is no ongoing role for management. However, boards should also be aware of the scrutiny that shareholder advisory groups and activist investors give to change of control employment arrangements which provide for excessive severance, "single-trigger" payments (i.e., those made upon a change of control, irrespective of continued employment), or benefits which are, at the moment, out of public favor generally (such as gross-up payments relating to the "golden parachute" excise tax), and consider how best to balance these concerns with the needs of the company.

4. 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 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 public 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 a fixed-return preferred security or combination consideration including a mixture of cash and preferred securities. Issues to consider include the yield, windows for puts and calls, 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 which are profits interests for tax purposes (commonly known as "LTIP Units"), care must be taken to preserve the favorable tax attributes of those awards for the holders.

5. The CEO, the Board, Special Committees.

Any sale process should be overseen by the board, which should provide management with direction as to any process or potential process. 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 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 stockholder or unitholder 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.

6. Club Deals.

Successful club deals 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 renegade club members; lack of alignment with regard to bidding, operating or exit strategies; and excessively complex or impractical governance and bidding arrangements. On the sell-side, careful thought should be given to allowing clubbing with the board's consent, recognizing that, depending on the circumstances, the size of the deal and field of potential acquirors, a club prohibition could hurt as much or more than it helps.

7. Debt and Equity Bridges.

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 caps on guarantees provided by private equity firms are fairly standard in public-to-private REIT deals which typically 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, but they tend to be far more complicated in operation. Recent reverse break fees have been asymmetrical, exceeding (often substantially) the termination fees payable by the target. 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 the buyer's financing commitment.

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.

10. Litigation.

Nearly every REIT deal now 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.

ONLY DEATH, TAXES AND REITS ARE INEVITABLE

By Adam O. Emmerich and Robin Panovka[1]

One of the themes for NYU's 20th Anniversary REIT Symposium is that *"Only death, taxes, and REITs are inevitable."* We meant this only partly in jest. In light of the many advantages of the REIT structure, the dramatic growth of REITs over the last 20 years *was* inevitable. And looking forward, substantial continuing growth seems equally inevitable, not just in the sectors where REITs have been active so far, but also in new sectors and new markets.

Since the first NYU REIT Conference back in 1995, the "REIT Revolution" has transformed the commercial real estate industry. REITs now own a substantial portion of the institutional-grade real estate in the United States and several other markets, and are a major force in all sectors of the real estate industry. Back in 1995, REITs were more of a curiosity. The total enterprise value of all U.S. REITs was under $50 billion, there were just six REITs with a market capitalization of more than than $1 billion, and none over $2 billion.[2] Only 25 people showed up at the first NYU REIT Symposium, and no one was particularly surprised or discouraged by the turnout.

REITs now own a substantial portion of the institutional-grade real estate in the United States and several other markets, and are a major force in all sectors of the real estate industry.

The Last 20 Years

Fast-forward to our 20th annual conference. Attendance has increased from 25 to more than 700 participants, underscoring the dramatic trajectory in the industry. Today, REITs own approximately $1 trillion of commercial real estate assets.[3] There are 147 public-equity REITs with a value over $1 billion, 42 over $5 billion, and more than 20 REITs over $10 billion.[4] Twenty-one REITs are now included in the S&P 500.[5]

Progress has been swift outside the U.S. as well. REIT (or REIT-like) regimes exist in 37 countries,[6] a particularly impressive expansion given that the U.S. stood largely alone

[1] The authors are partners in the New York law firm Wachtell, Lipton, Rosen & Katz and cochairs of NYU's annual REIT Symposium. The authors gratefully acknowledge the assistance of their colleague, Matthew R. MacDonald, in preparing this article.

[2] NAREIT (data as of December 1, 1995).

[3] REIT.com, "Industry Data" (https://www.reit.com/investing/industry-data-research/industry-data) (as of December 31, 2014). Data includes both stock-exchange listed and non-listed REITs.

[4] NAREIT (data as of December 31, 2014).

[5] REIT.com "REITs in S&P Indexes" (https://www.reit.com/investing/investing-tools/reits-sp-indexes).

[6] European Public Real Estate Association (EPRA) (as of September 2014). EPRA also notes that two additional countries not included in this total are developing REIT or REIT-like legislation.

While the REIT universe in 1995 was largely confined to conventional commercial properties, REITs today extend across an array of nontraditional sectors, including telecommunications, timber, data storage, outdoor advertising, and gaming.

in 1995.[7] International REITs haven't grown at quite the pace of U.S. REITS, but have enjoyed their own run of success, with European and Asian REITs now having aggregate market capitalizations well north of $150 billion each.[8]

While the REIT universe in 1995 was largely confined to conventional commercial properties, REITs today extend across an array of nontraditional sectors, including telecommunications, timber, data storage, outdoor advertising, and gaming. Healthcare, self-storage, and technology-driven REITs today represent four of the 10 biggest REITs.[9] REIT governance has also come a long way and is now generally viewed as being on par with other public companies. Executive compensation at REITs is also consistent with the rest of corporate America.[10]

The benefits of the REIT structure — liquidity, transparency, governance, and superior access to capital chief among them — proved themselves in the 2008 financial crisis and its aftermath.

The benefits of the REIT structure – liquidity, transparency, governance, and superior access to capital chief among them — proved themselves in the 2008 financial crisis and its aftermath. Unlike their private peers, REITs suffered very few fatalities in the crisis, quickly recapitalized and de-levered, and then took advantage of opportunities to acquire cheap assets and grow. While REITs may have been somewhat over-levered in advance of the financial crisis, the governors built into the REIT markets ensured that debt levels remained well below the private markets,[11] and when equity values dropped, the capital markets barely flinched before stepping in to recapitalize. All told, REITs were battle-tested in the financial crisis and, despite some handwringing and share-price volatility, emerged stronger than ever, having learned lessons that will make them better prepared to handle the next downturn.

The Next 20 Years

So what lies ahead? In a word: growth. Now that REITs have matured through two recessions and the associated real estate cycles and have demonstrated their resiliency, continued migration of assets into public REITs and consolidation among REITs and other real estate companies seems very likely. While REITs have clearly covered substantial ground already, they still own only an estimated 15 percent of the commercial real estate in the U.S. and a much smaller percentage globally.[12] The

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[7] Australia instituted a REIT-like regime in 1985 and the Netherlands established one in 1969. By 1995, other countries like Belgium, Turkey, Brazil, and Canada were starting to establish their own REIT-like structures.

[8] Based on overall market capitalization for the FTSE EPRA/NAREIT Europe Index and Asia Pacific Index (as of December 31, 2014).

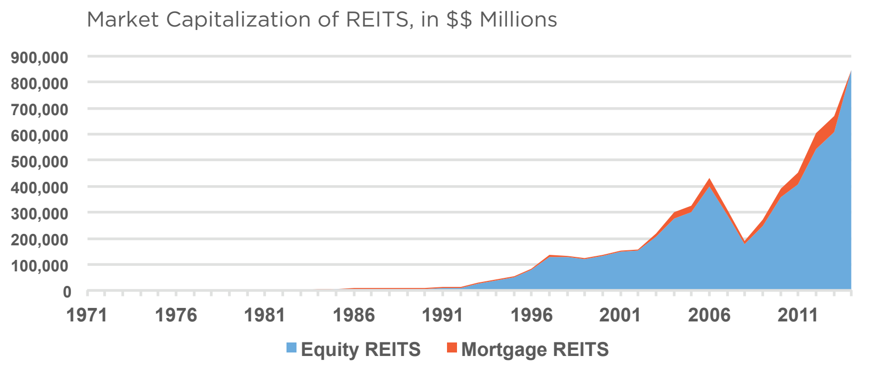
[9] Based on market capitalization at the end of 2014.

[10] Green Street Advisors, "Executive Compensation and Corporate Governance" (June 23, 2014).

[11] Stock-exchange listed REITs at the start of 2007 had a mean leverage ratio of 38.2 percent. Sun, L., Titman, S. D. and Twite, G. J. (2014), "REIT and Commercial Real Estate Returns: A Postmortem of the Financial Crisis," Real Estate Economics.

[12] REIT.com, "REITs and Conversions" (https://www.reit.com/investing/reit-basics/reits-and-conversions).

Since the Bottom of the Financial Crisis, Publicly Traded REITS Have Tripled Their Market Cap



Source: www.reit.com

commercial real estate market is vast, estimated at roughly $7 trillion in the U.S.,[13] as compared to $25 trillion for all U.S. publicly traded equities.[14]

Since the majority of real estate assets are still held in the highly fragmented private market, there is a continuing opportunity to build value by moving assets into the more liquid, transparent REIT sector. This is not to say that all commercial real estate will be consolidated into a handful of public mega-REITs in short order. The private markets, including private equity firms, will continue to play a significant role, particularly in less stable asset classes, development, or distress situations. And when REIT valuations are lower than private values or abundant cheap debt is available for leveraged buyouts, waves of privatizations will no doubt occur, similar to the nearly $80 billion in privatizations between 2004 and early 2007 that helped build the real estate bubble.[15] Indeed, arbitrage opportunities between public REITs and the private real estate markets are likely to continue to generate substantial transactional activity in both directions. But on the whole, the gravitational pull generated by REITs' incomparable liquidity and lower cost of capital will pull in more and more assets, particularly the stabilized institutional-grade assets that fit so well in the REIT solution.

In addition to the conventional assets that have historically populated most REITs, nontraditional real estate assets are also likely to contribute to the sector's growth. Just in the last few years, the market capitalization of nontraditional REITs has almost quadrupled — from $40 billion in 2011 to $152 billion in 2014.[16] There is, of course, risk of an IRS clampdown on some of the expanding definitions of real estate. We saw rumblings in that direction last year. However, as long as true real estate is involved, we do not foresee major stumbling blocks. The IRS' proposed clarification of the real property definition in the REIT rules may even encourage further REIT conversions now that there is increased certainty around which assets qualify for REIT status.

One of the other sources of potential REIT growth may be corporate real estate: the office buildings, plants, stores, warehouses, data centers, transportation hubs, healthcare facilities, and other properties owned by non-REIT public companies. Since these real estate assets are sometimes trapped within corporations, they may not be fully valued by the markets. As the technology for unlocking this value develops, it may make sense for corporations to consider REIT spin-offs (which can now be accomplished on a tax-free basis) in addition to sale-leasebacks, asset-

SINCE THE MAJORITY OF REAL ESTATE ASSETS ARE STILL HELD IN THE HIGHLY FRAGMENTED PRIVATE MARKET, THERE IS A CONTINUING OPPORTUNITY TO BUILD VALUE BY MOVING ASSETS INTO THE MORE LIQUID, TRANSPARENT REIT SECTOR.

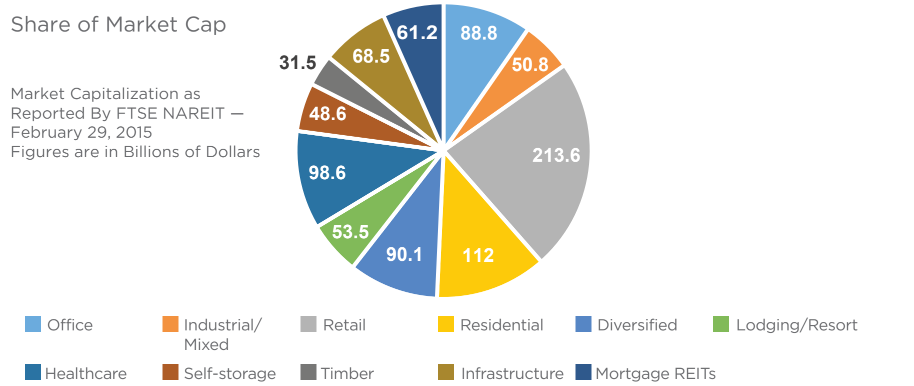
[13] Lazard Asset Management, "Understanding Real Estate's Value Proposition" (June 25, 2014).

[14] Dow Jones estimated market capitalization of U.S stock equities (February 28, 2015).

[15] "Privatization Wave Hits REITs," National Real Estate Investor (Feb. 1 2007), (http://nreionline.com/mag/privatization-wave-hits-reits).

[16] Ernst & Young: "Global Perspectives: 2014 REIT Report."

Major "Food Groups" Account for About One-Half of REIT Market Cap — Industry Is Spreading Its Influences Widely in 2015



based financing, and other mechanisms to maximize real estate value. Of course, there are both advantages and disadvantages to these kinds of transactions. They tend to be complex and time consuming and may not make sense in every situation. But as long as REIT valuation multiples remain robust compared to their corporate counterparts, transactions that unlock value by monetizing illiquid assets will continue to be a topic of discussion, especially since activist investors continue to suggest these techniques at an increasing array of targeted companies.

Another potential source of growth is globalization. Admittedly, however, with the exception of a few companies, talk of globalization has thus far generated far more smoke than fire. But this may be about to change. Interest by U.S. REITs in non-U.S. acquisitions is accelerating across several property sectors, fueled by high prices in the U.S. and perceived superior growth prospects abroad. Going the other way, despite the recent appreciation in American commercial real estate values, U.S. property remains attractive to international investors (such as sovereign wealth funds) seeking stable (albeit low) returns. At the same time, the growth of REITs in Europe and Asia raises the prospect of cross-border combinations, and with the increasing globalization of the capital markets truly multinational REITs may not be far away. Of course, frictional costs, cross-border tax leakage, and various

Avalon Ossining, courtesy of AvalonBay Communities, Inc.

complexities must be factored in and may slow the trend, along with market pressures for REITs to maintain focus on their core areas of expertise domestically.

Like private equity funds, non-traded REITs have proven to be useful incubators for public REITs and both may fuel future growth in the REIT space. In 2013 and 2014, the market saw roughly $35 billion and $20 billion of non-traded REIT liquidity events, which generally occurred through public listings or mergers into existing REITs. Longer term, it is unclear whether non-traded REITs will turn out to have been just a post-financial-crisis, low-interest-rate phenomenon or are here to stay. Tellingly, non-traded REIT fundraising was down roughly 20 percent in 2014 compared to the previous year, spurred in part by difficulties at leading non-traded platforms.

While, in general, larger, stronger REITs can be expected to acquire smaller REITs, there is also a trend for larger REITs to spin off or dispose of parts of their businesses. It sometimes makes sense for larger REITs to refocus on their core businesses or regions or on specific asset classes, or quality of assets, and REIT managers may decide to separate disparate business lines or reduce risk or leverage. The gravitational pull of larger REITs on smaller ones, combined with market pressure to spin out non-core or differentiated businesses, will likely continue to generate a dynamic market for corporate control.

As always, there are wildcards that could quickly change things. In the shorter term, an increase in interest rates would have a major impact. Longer term, tax law changes may target REITs or upend the landscape for corporate taxation more generally, complicating the conversion strategies of nontraditional real estate companies. And the impact of the Internet, e-commerce and other disruptive technologies could also have significant implications in retail and other sectors. It is too soon to tell exactly when and where change will come, but the impact on many property types is already clearly evident and we suspect still at an early stage. However, developing technology may also help REITs operate more efficiently as new tools help REITs manage their assets more effectively and improve their cost structures, and, enhance efficiency and business models. Technology may also boost some of the newer REIT sectors, like cell towers and data centers.

On the whole, the drivers of the REIT Revolution of the last 20 years continue to be very powerful and to point to more growth. To employ a nautical metaphor, REITs have the wind at their backs, with mostly fair skies ahead. The growth and maturity demonstrated since the first NYU REIT Symposium position REITs for further dramatic growth over the next 20 years and deepen their capability to weather future emerging economic fluctuations. ■

On the whole, the drivers of the REIT Revolution of the last 20 years continue to be very powerful and to point to more growth. To employ a nautical metaphor, REITs have the wind at their backs, with mostly fair skies ahead.

[17] Robert A. Stanger & Co.

[18] Robert A. Stanger & Co.

At Right: Housing development in Orange County, California.

September 16, 2015

Treasury Department Seeks to Curb "Cash-Rich" and REIT Spin-Offs

The Treasury Department and the Internal Revenue Service have announced (in Notice 2015-59) that they are studying issues related to the qualification of certain corporate distributions as tax-free under Section 355 of the Internal Revenue Code in situations involving substantial investment assets, reliance on relatively small active businesses, and REIT conversions. The IRS concurrently issued related guidance (Rev. Proc. 2015-43), adding such transactions to its ever-expanding list of areas on which it will not issue private letter rulings. While this expansion of the IRS's "no-rule" areas is not a statement of substantive law, these announcements may have a chilling effect on certain pending and proposed transactions.

Treasury and the IRS are most concerned with transactions that result in (1) the parent or the spun-off corporation owning substantial investment assets (*e.g.*, cash, stock or securities, or other assets held for investment) relative to its business assets and (2) one of the corporations having a significantly higher ratio of investment assets to non-investment assets than the other. Under its new policy, the IRS will no longer rule on any issue relating to the qualification of a distribution for tax-free treatment if, immediately thereafter, (1) the value of the investment assets held by either the parent or the spun-off corporation is two-thirds or more of the value of its total gross assets, (2) the value of the business assets relied upon by the parent or the spun-off corporation to satisfy the active trade or business requirement is less than 10 percent of the value of its investment assets, and (3) the ratio of the value of investment assets to non-investment assets of either corporation is three or more times such ratio of the other. Although the statute denies tax-free treatment only to "cash rich" split-offs, the IRS and Treasury are similarly concerned with "cash-rich" spin-offs. Yahoo-Alibaba type situations—where a very large percentage of the asset value of the parent or the spun-off corporation consists of a non-controlling stake in another publicly traded entity—appear to be directly targeted.

A related area of concern for the IRS and Treasury is the use of businesses having *de minimis* value relative to the corporation's total assets to satisfy the "active trade or business" requirement of Section 355. Under its new policy, which is similar to the ruling policy in effect prior to 2003, absent unique and compelling reasons, the IRS will no longer rule on any issue relating to the tax-free treatment of any distribution in which the value of the business assets relied on by either the parent or the spun-off corporation to satisfy the active trade or business requirement is less than five percent of the value of the total gross assets of such corporation. Smaller businesses frequently have been relied upon in situations in which an existing larger business technically does not qualify (*e.g.*, recently acquired assets or real estate activities of a REIT that are insufficiently "active").

Finally, Treasury and the IRS expressed concern over the increasing number of spin-offs involving the formation of REITs, in particular those in which good REIT assets are separated from an existing non-REIT enterprise to facilitate a REIT election by the parent or the spun-off corporation. In their view, these transactions raise the same policy concerns as the others described in the notice. Under its new policy, absent unique and compelling reasons, the IRS will no longer issue rulings on transactions in which the parent or the spun-off corporation becomes a REIT as part of the spin-off. Helpfully, the notice explicitly states that the above concerns are not present where both the parent and the spun-off corporation will be REITs, or where the parent corporation has been a REIT for a substantial period of time prior to the distribution, and that the IRS will continue to consider ruling on such transactions. The new guidance should provide a restraint on activist activity pressuring "PropCo/OpCo" separations.

Jodi J. Schwartz
Joshua M. Holmes
David B. Sturgeon

October 31, 2013

REIT M&A Update: Maryland Court Upholds Special Committee's Approval of Acquisition of REIT's External Manager

In an opinion issued last week, a Maryland court reinforced the importance of a robust, independent process in conflict transactions, dismissing with prejudice a shareholder challenge to the acquisition by the Cole REIT of an affiliated entity which had served as the REIT's external manager. The transaction had been reviewed and approved by a Special Committee of Cole's Board of Directors, composed of three independent directors. *Strub* v. *Cole Holdings Corporation, M.D. 24-C-13-001563 (October 22, 2013).*

In addressing allegations that the Cole board breached its fiduciary duties in approving the acquisition, the court reaffirmed Maryland's statutory principle that corporate directors will be presumed to have acted reasonably and in good faith, absent facts showing that they acted fraudulently, in their self-interest or with gross negligence. In this case, given the thorough process conducted by Cole's Special Committee, the plaintiffs could not allege the fraud, gross negligence or self-interest on the part of the independent directors necessary to overcome Maryland's statutory presumption.

The decision serves as a reminder of the value of an independent review process in conflict transactions, as well as of the reasoned deference that Maryland courts will grant the actions of independent directors of Maryland corporations.

Robin Panovka
William Savitt
Ronald C. Chen
Andrew J. Cheung
Donald P. Casey

12 April 2013

Is There a ‘New Normal’ for REIT M&A?

We participated in and attended NYU’s annual REIT M&A symposium, co-chaired by Wachtell Lipton. The conference, now in its 18th year, always features a stellar line-up of REIT CEOs, bankers, lawyers, investors and industry icons. This year’s event focused on M&A, the capital markets, the non traded REIT sector, foreign expansion, REIT conversions, the single family rental business and investment landscape.

Citi’s Take on Wachtell’s 7 Future Surprises for the Next 12-18 Months

Robin Panovka, Partner at Watchell, Lipton, Rosen & Katz, opened the event with 7 surprise predictions for the next 12-18 months for the REIT industry. We’ve added our thoughts to the predictions which are as follows:

1) ***REIT equity market cap will grow by $100bn, exceeding $600bn.*** Wachtell sees this driven by the continued acquisition of private portfolios by REITs, REIT conversions and more listing of non-traded REITs. This assumption seems quite reasonable given REIT’s current advantageous cost of capital and recent acquisition activity. In addition, with many large portfolios and companies across the various property sectors still in private hands, we will likely see a continuation of private owners sell to REITs, and also look to the public markets for IPOs.

2) ***Leverage use will increase as aversion to debt fades with the pendulum swinging back from the financial crisis.*** We believe REITs will be hesitant to increase leverage substantially given their experience in ‘08-09. However there is some “dry powder” for debt funded acquisitions given current ratios are low - net debt to EBITDA of ~7.1x and Debt/GAV of ~38%. Sound use of increased leverage – staggered term and rate – makes a lot of sense in our opinion. “Cheap” long term debt could become an important “asset” in a few years.

3) ***Fast pace migration of non-traded REITs into publically traded markets, with associated M&A, in order to take advantage of strong public REIT valuations***. With the amount of assets under management in the NTR sector, and deals already occurred (ARCT/O, RPAI, Cole/Sprit, Cole pending listing etc) – there is likely much more to come. However, it remains unclear whether non-traded REITs will be embraced by the dedicated REIT community. Key issues in our mind are alignment of interests and a clear value creation (vs. asset gathering) strategy. Internal management is critical and essential.

4) ***Slowdown in the pace of REITs conversion as the spreads seem to be decreasing.*** The increase in market multiples has certainly lowered the valuation spread – however, the spread remains large especially for those that own hard assets. It doesn’t help that many REIT conversions have seen a rapid rise in share prices, even though the long term value is unclear.

5) ***Increased REIT M&A, including possibly a return of privatization, in sectors trading below NAV or showing differentiation.*** Panel speakers at the conference tended to talk down prospects for REIT public to public M&A (see following section). With the recent rally in REIT securities and the majority of sectors trading at premiums to NAV, it is difficult to see an increase in privatizations, particularly when the overall REIT sector is trading at a premium to private market valuations. Never say never, which is why we include our views on potential M&A on pages 10-15 herein.

6) ***Activists losing credibility as flaws in 'short term-ism' become apparent as the pendulum swings back to focus on long term shareholder value**.* REIT sector activism has increased recently and has acted to highlight problems with the structure of certain REITs and self dealing. With the current rally in REIT shares, the probability of activism increasing has reduced significantly.

   We addressed the issue of activism in our March 22, 2013 Weekly REIT and Lodging Strategy - The Four Questions, where we asked *"Why has activism increased in REIT space recently, but historically it hasn't worked? Even so, who may be the next targets and why?* REITs, like the broad market, are trading near all-time highs, leaving investors searching for value amid a sector where many stocks trade at premiums. Given the underlying value of the real estate owned by the public REITs and the resulting valuation backstop in the private market, combined with a robust lending market, it makes sense for hedge funds to pursue companies that are clearly trading at substantial discounts. With the uptick in REIT conversions and the increased potential for M&A, the hedge fund community will likely continue to pay more attention to REITs. We have mentioned **BRE, DFT, ELS** and **PPS** as most ripe for activism. While **BRE** and **DFT** have had a variety of issues that have weighed on their stocks, **ELS** and **PPS** are both well run companies that simply trade at very large NAV discounts - that could be unlocked through activists or sales.

7) ***Trouble for Single Family REITs on the operational side.*** Wachtell had concerns that there may be problems for single family REITs on the operating side of the business. In our opinion, the jury is still out on the long term viability of single family REITs as a new institutional business. It remains to be seen if this was simply a trade on discounted housing prices, or if a long term business with attractive economics can be created with economies of scale. It does remain difficult to manage a substantial pool of assets across geographies.

REIT.com

Industry Observers Have Mixed Outlook on REIT M&A

1/17/2013 | By Carisa Chappell

Robin Panovka

A complex market filled with a combination of opportunity and uncertainty is shaping the outlook for mergers and acquisitions activity in 2013, according to industry observers.

Robin Panovka, co-head of real estate and REIT M&A at the law firm of Wachtell, Lipton, Rosen and Katz, said low interest rates and easy access to capital could fuel more deals. In addition, the velocity of deals gained momentum in late 2012, which may carry over into '13, according to Panovka.

"I don't have a sense that we'll have a massive increase in deal volumes this year, but there should be a healthy volume similar to 2012, perhaps better," he said. "Activity picked up quite a bit in the last quarter of 2012, and it shows every sign of continuing."

Jonathan Litt, managing principal of Land and Buildings Investment Management LLC, said he thinks 2012 ended up being an extraordinary year because of the Archstone transaction. Multifamily REITs AvalonBay Communities Inc. (NYSE: AVB) and Equity Residential (NYSE: EQR) joined forces to purchase Archstone Inc. from Lehman Brothers Holdings Inc. for $6.5 billion in cash and stock. With no major deals like Archstone or the 2011 merger of industrial REITs Prologis (NYSE: PLD) and AMB, Litt speculated that '13 would have a tough time living up to recent years.

"Absent [the Archstone deal, 2012] would have been more of an average year. So, I think the ability to top 2012 might prove difficult in terms of straight acquisitions," he said.

Panovka pointed to lingering uncertainty as a possible obstacle to REIT M&A deals in 2013, especially when it comes to major public-to-public transactions.

"There's still a sense that things are uncertain, so it's difficult to pull the trigger on transformative deals, even though many boards are beginning to understand that it might be a mistake to pass up the significant opportunities some REITs are seeing" he said.

Panovka said he expects public-private arbitrage plays to remain appealing to some companies: "As long as REITs are trading north of the private market valuations, they will be in a good position to continue to acquire privately owned assets and portfolios in accretive transactions. REITs are uniquely positioned to offer sellers both tax deferral and liquidity and have a number of other competitive advantages."

The best course for REITs with strong balance sheets and access to low-cost capital may be to take advantage of opportunities to buy private portfolios or weaker public peers, according to Panovka. At the same time, he said REITs face “unprecedented levels of pressure and engagement from activist and institutional shareholders” which in some cases can promote short-term thinking and stifle entrepreneurial instincts and long-term value creation.

“There’s too much focus from the activists on short-term results and not enough on the long-term best interest of the shareholders,” he said. “The pendulum has swung too far in that direction and hopefully will now swing back to the point where boards can really focus on long-term value creation and running their companies well.”

Litt advised investors to be on the lookout for potentially hostile takeovers. REITs with underperforming stocks could become targets for acquisition, he said. Litt and Panovka both encouraged REITs that don’t want to be acquired to prepare their defenses ahead of time.

“When you have great assets in great markets with a good management team and are trading a big discount, the management team should do something about it,” Litt said. “And if they don’t, they are going to see people chase them.”

Rebuilding the World Trade Center

by Larry A. Silverstein, Joseph C. Daniels, Robin Panovka, Seth Piasky, John Lieber

CORNELL REAL ESTATE REVIEW
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Robin Panovka

Robin Panovka is a partner at the law firm Wachtell, Lipton, Rosen & Katz, where he co-heads the firm's Real Estate and REIT Mergers and Acquisitions (M&A) group. His expertise is in cross border M&A, private equity, strategic transactions and corporate governance. Mr. Panovka has been active in many recent noteworthy M&A transactions in the REIT sector including representing AMB Property Corporation in the merger with ProLogis, and representing Ventas in its acquisition of National Health Properties. Since 2001 he has also played a crucial role in the redevelopment of the World Trade Center, as counsel to Silverstein Properties. He has been instrumental in negotiating the master development agreement and master plan for the redevelopment, the exchange of the Twin Towers' footprints for five adjacent office sites that enabled the redevelopment to proceed, and the multiple public-private arrangements for building and integrating the office towers, retail space, memorial, museum and infrastructure on the site.

Mr. Panovka is a frequent speaker and author on topics involving M&A, REITs and commercial real estate. Among other publications, he is co-author of "REITs: Mergers and Acquisitions," an article published by Law Journal Press. Mr. Panovka was born in Johannesburg, South Africa, lived in Israel for eleven years, and currently resides in Manhattan with his family. He holds honors degrees from Cornell University and Duke Law School and is a member of the New York Bar.

Cornell Real Estate Review Questions for Robin Panovka, Partner Wachtell Lipton Rosen & Katz

How did Wachtell Lipton first get involved in the rebuilding efforts?

Larry Silverstein hired us a few days after 9/11 to help him address the myriad issues that arose from the destruction of the World Trade Center, which he had taken over from the Port Authority just a few months before 9/11 under a 99-year lease. Our role initially included a heavy focus on the insurance claims. Our litigators developed the argument, which ultimately prevailed in court, that Silverstein was entitled to collect for "two occurrences" under some of the insurance policies. The insurance battle ultimately yielded $4.6 billion of insurance proceeds needed to rebuild. Our role also included representing Silverstein in negotiating a framework for the rebuilding effort, which was my primary focus. Our firm strongly supported Silverstein's mission to rebuild the Trade Center, and we dedicated a huge amount of time and energy toward the effort over the last 10 years.

What were the early days after 9/11 like, down at Ground Zero?

Initially, it was fairly chaotic, as you would expect given the traumatic events of 9/11. The federal government took over the site under its emergency powers., There were rescue and recovery attempts ongoing, and continuing concerns about security. There was also an understandable sense that Ground Zero belonged to the public and not to any one person or institution, that it was more than just land and buildings, and it seemed as if customary private property rights were suspended for a period. There were many strongly-held views about what should happen at the site, coming from many different stakeholders— property -- property owners, lessees, politicians, families of victims, the press and everyone else.

What was the process for resolving the uncertainty over what, if anything, should be rebuilt?

There was no clear process initially -- just lots of voices calling for different things, including a push by some for the government to take over the site permanently. What was needed in the midst of all the confusion was leadership, and Larry Silverstein quickly stepped in to provide it. From the very early days, Larry believed passionately in the importance of rebuilding as the appropriate response to the terrorist attacks, and he never wavered. Within weeks we formulated what became somewhat of a mantra—we -- we have the right, we have the responsibility, and we have the resources to rebuild—and – and it turned out to be an important force in shaping the debate. It sounded short and simple, but was actually a carefully constructed position, backed by legal, moral, political and financial analysis and strategic thinking. Each component—the -- the right (a reminder that there was a binding 99-year lease in place which gave Silverstein the right to rebuild), the responsibility (both moral and contractual) and the resources (a reference to the billions of dollars of insurance proceeds to which only Silverstein was entitled and which were essential to rebuilding)— was -- was carefully constructed to blunt arguments against Silverstein rebuilding.

Judging by the many volumes of documents involved, there must have been many agreements devoted to the rebuilding efforts. Do any stand out in particular?

There were a succession of important agreements, each more detailed and voluminous than its predecessor, including so-called Master Development Agreements that tied everything together, but if I were to pick one, it would be what we called the 12/1/03 "immediate swap" letter agreement. The "swap" agreement resolved what, at the time, towards the end of 2003, seemed like an impossible deadlock, and paved a path for rebuilding to proceed. It was a very short, unusual letter agreement which, in the stroke of a pen, or actually the stroke of a color-coded diagram, established the master plan for the site and created the blue print for all the agreements that followed.

How did this "immediate swap" agreement come about?

Long story short, by mid-2003, Larry Silverstein, the Port Authority, Governor Pataki and most stakeholders had generally agreed on two broad principles. First, that that the footprints of the Twin Towers, where so many lives had been lost, should become a memorial. And, second, that it was important to re-open the Manhattan street grid (including Greenwich Street) which had run through the site before the original World Trade Center had been built in the 1960's, but had been blocked by the "super-block" design of the original WTC. The reasons for re-establishing the grid and the related urban planning considerations is a whole separate topic for another day, but the important point here is that these two principles had taken hold and were strongly felt—don't -- don't build on the old footprints, and do re-open the grid.

There was just one problem. The entire legal regime for the site, Silverstein's 99-year lease and all the other ownership and leasehold stakes, were completely inconsistent with these two principles. In fact, the 99-year lease provided that Silverstein would rebuild the Twin Towers exactly where they had been pre-9/11, exactly where everyone agreed a memorial should be built. There was massive pressure. The Port Authority and Governor took the position that the pre-9/11 legal arrangements had to be thrown out, and that the whole situation was too complicated to sort through and renegotiate. Their positions was that we should just start with a clean page entirely controlled by government agencies and without any private interests. But Silverstein was, as always, passionate about rebuilding and we believed that stepping aside would be counter-productive and just lead to more delay.

Sounds like an impossible situation. How was it resolved?

Well, with this backdrop, after coming back from a summit one night where Silverstein had been given an ultimatum to either come up with a solution or step aside, Larry Silverstein, Marty Lipton, Janno Lieber and I sat down to try to come up with something. Marty pressed us to formulate a short and to-the-point

written proposal by the following morning, so that we could cut through the deadlock, show that the problem could in fact be solved, and start shaping people's thinking about the way forward. What we came up with was the idea of the "immediate swap", which we did in fact present to the Port Authority the following morning in the form of two short paragraphs and a color-coded diagram. Essentially what we said was that Silverstein would swap his leasehold for the Twin Towers—so -- so their footprints could become a memorial—for --for a leasehold on five adjacent sites surrounding the memorial, with development rights to build the same quality and amount of office space in the five towers as had existed in the Twin Towers before 9/11—" -- "10 million square feet of commercially viable Class A above-grade rentable office space ... [each with] an at-grade lobby". We slapped a three colored diagram on the back that showed what was transferred to the memorial in green, what went to Silverstein for office space in blue, and what would become a train station and infrastructure in yellow. And we agreed to some negotiating principles to fill in the details later, including that everyone would act reasonably and in good faith to negotiate all other issues. That was basically it. Every word was chosen carefully, but it was short and easy to understand. The key was that this was a final, binding agreement, not an aspirational letter of intent that may or may not be implemented. There was no turning back. Once the letter was signed on 12/1/03, the swap was immediately effective, the master plan for the site was legally adopted and final, and rebuilding could proceed. It was a risky move, but it was essential to resolving a paralyzing deadlock.

Were there other key breakthroughs? What about the deal to rebuild 7 World Trade Center?

There were many breakthroughs along the way— issues – issues arose frequently that threatened the project and needed to be resolved—but – but, yes, getting 7 WTC up, starting in 2002 when nothing else was moving at the site, was important because it showed that the WTC rebuilding effort wasn't hopelessly deadlocked and created a model for resolving future issues. 7 WTC was the last building to go down on 9/11 and fortunately no one died there, so it was less controversial to rebuild. In fact, there was a need to rebuild 7 quickly because its base included a ConEd power substation that was needed to power Lower Manhattan.

But there were two problems.

First, as I mentioned, the pre-9/11 7 World Trade Center had straddled Greenwich Street and completely blocked it, and there was a strong feeling by many people involved, including Larry Silverstein, that Greenwich Street should be re-opened and that, since the Master Plan had not yet been agreed upon, whatever was to be built at 7 should not interfere with the ultimate Master Plan. This was a simple proposition, but it was on a collision course with an equally simple fact. If the new 7 were to be built on only one side of Greenwich Street so as to re-open the street, the building's footprint would be too small to accommodate an office tower. The solution was to expand the footprint into another adjacent street, the NYC-owned Vesey Street, but here we ran into another "roadblock". While the City was willing to trade the required strip of Vesey Street for the re-opened Greenwich Street, it couldn't just convey the strip to Silverstein. Rather, a series of complex regulations needed to be addressed by having the required strip condemned, which was a court process that could be challenged and which carried various risks. There was no certainty it could be accomplished, and in any event, it would take much longer than circumstances allowed. We needed to build right away, and we couldn't wait for the condemnation. Never shy about taking calculated risk, Larry Silverstein stepped up and proceeded to build 7 on a strip of land he didn't own or lease, ultimately getting most of the building up by the time the strip was acquired. Luckily we never had to find out what would have happened if something were to have gone wrong.

The second problem was also caused by the need to rebuild quickly. The rebuilding of 7 included the ConEd power substation I mentioned earlier, in the first 77 feet, with the office tower directly above it. Construction was to be on a super-fast track, before the plans for the building were complete, and it was not possible to allocate costs between Con Ed and Silverstein in advance of building. There was no way to know how much of the foundation, elevator banks, façade and other elements was attributable to the office versus the substation until full plans and cost estimates were completed, and there was no time to wait for the final plans. So, given the urgent need to rebuild, Silverstein elected to proceed based on weekly agreements rather than wait until a comprehensive approach was possible. Each week during construction, Silverstein and Con Ed, with the help of the general contractor, Tishman Construction, entered into a weekly agreement allocating costs for the prior week and agreeing on what was to happen the following week. No one knew what would happen if we couldn't reach agreement the following week, but here again luckily we never had to find out.

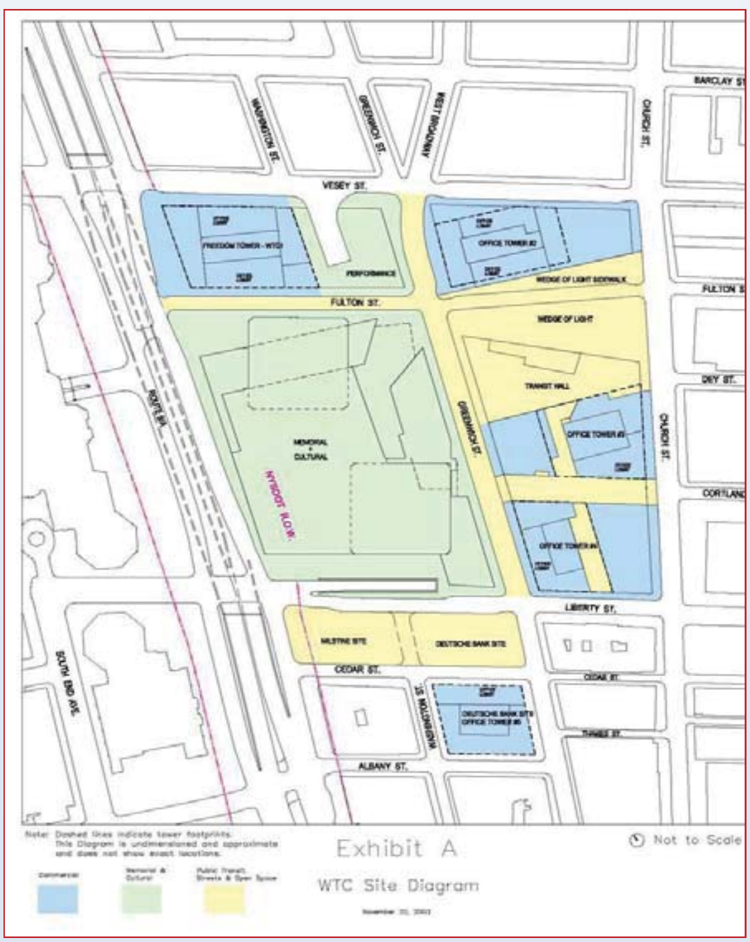

Exhibit A

WTC Site Diagram

Are there any lessons about negotiating that you've taken away from your experience at the Trade Center, thatCenter that perhaps might have broader applicability to other complex, multi-party negotiations?

It's hard to boil down ten years into one simple answer— – someday I'll write a book about all this—but – but I would emphasize the importance of arrangements that align parties interests and create long term incentive to perform (not so simple when you're dealing with as many diverse stakeholders and motivations as we had at the Trade Center); the importance of building trust and negotiating protocols among the negotiators; getting into the heads of counterparties in order to understand exactly what they are trying to achieve and to help them get there; understanding that in complex multi-party terrain like Ground Zero it's impossible to please everyone, to find the perfect solution or to draft the perfect agreement, so it's often wise to seek Pareto optimality and avoid getting bogged down trying to achieve perfection; trying to resolve disputes and deadlock relatively quickly before they spin out of control or spill into the press, by changing the dynamics or parties at the table, seeking third party intervention, by forming alliances or through PR; getting out ahead of complexity and shaping people's thinking with simple, bold proposals like the "immediate swap"; respecting "off the record" discussion; and avoiding ad hominem attacks if at all possible. Much of negotiation is art, not science, like judging when to stick to your guns and when to compromise, when to draw lines in the sand and when to roll with the punches, and the applicability of any rule will depend on the specific facts and circumstances.

What do you mean by negotiating protocols? Can you give us an example?

Two good examples were the related "resolve what you can and punt on the rest" and "no thumb on the scale" protocols that we established early on with the Port Authority negotiators. The idea was that at any given stage in the process we would resolve only what needed to be resolved and could be resolved at that time, with other issues deferred by articulating even-handed, broad principles for future negotiation. It was not possible, for example, to agree on all of the terms of redevelopment when we signed the 12/1/03 immediate swap letter—there r – there were too many moving pieces, too many unknown and unknowable facts—so -- so we had to proceed in incremental steps. It was understood that after each incremental step no one would try indirectly to influence the outcome of future negotiations, but rather that we would table the issue until it was ripe for resolution. Any attempt to slant drafting or facts on the ground in a way that would create future advantage, or any collateral agreement that would prematurely change the status quo, was an impermissible "thumb on the scale" entitling the other parties to cry foul. It took a lot of mutual respect and trust to make this work.

Any other general lessons from how the complexity and many obstacles in the way of rebuilding were overcome?

Many, but I would say that Silverstein's sheer determination and passion to rebuild, willingness to take huge (albeit calculated) risks to make it happen, and willingness to cooperate and compromise in order to craft solutions, were all critical ingredients. 7 World Trade Center might never have been built if Silverstein had not been willing to give up Greenwich Street and build on a week-to-week basis on a City street he didn't own, and the Master Plan might never have been adopted if Larry had not been willing to agree to the "immediate swap" in which he gave up well defined multi-billion dollar leases in exchange for a few (admittedly carefully crafted) paragraphs with a basic outline and principles for future negotiation.

June 6, 2011

Maryland Court Confirms Application of Business Judgment Rule
in All-Stock REIT Merger

A Maryland court last week confirmed that the business judgment rule applies to Maryland REITs and other Maryland companies in the context of stock-for-stock mergers, providing comfort to REIT boards that informed and well-advised directors will be granted substantial deference in entering into all-stock mergers. *In re Nationwide Health Properties, Inc. S'holder Litig.*, M.D. 24-C-11-001476 (May 31, 2011).

The Maryland corporate statute specifies that directors are not to be held to a higher duty or subjected to greater scrutiny for decisions relating to a change of control, but a 2009 case in Maryland's highest court extended common law fiduciary duties beyond the statute. The *NHP* plaintiffs argued that this created heightened, *Revlon*-like duties for directors of Maryland corporations even in stock transactions.

In the *NHP* case, the plaintiffs alleged that NHP's directors breached a common law duty to maximize the value received by NHP's shareholders by failing to conduct a full auction and by accepting a lower, but firm, offer over a higher but more speculative proposal. The Court squarely rejected this argument, holding that, under Maryland law, the decision by a board of directors to enter into a traditional stock-for-stock transaction with no sale of control is a managerial decision protected by the business judgment rule. The Maryland Court also dismissed as "wholly without merit" the plaintiffs' claim that inclusion of relatively standard deal protections in the merger agreement – a customary no-shop provision, information rights with regard to competing proposals, a matching right with respect to superior proposals and a reasonable termination fee – constituted a breach of the board's fiduciary duties.

By rejecting the application of *Revlon*-like duties in the context of an all-stock merger, the Maryland Court took the same approach as would apply under Delaware law, which has long held that a stock-for-stock merger between two public companies with no controlling stockholder does not constitute a change of control and thus will not trigger *Revlon* duties to auction the company.

Robin Panovka
Trevor S. Norwitz
William Savitt
Scott W. Golenbock

May 18, 2011

Sixth Circuit Upholds Tortious Interference Verdict Against Auction Loser's Overbid:
Over-bidder Must Reimburse Winner For Causing Price Bump

The U.S. Court of Appeals for the Sixth Circuit has affirmed a District Court judgment holding an interloper that breached its standstill agreement liable for tortious interference to the winning bidder in an auction. The interloper is required to pay the winner the incremental amount – over $100 million – that it took to secure shareholder approval for its deal, and may also be liable for punitive damages. In addition to providing important guidance on tortious interference claims in the M&A context, the case offers useful reminders for buyers, sellers and would-be over-bidders in the art of running, winning and "topping" an auction for a public company.

The case stems from a four-year old transaction in which, after our client Ventas won an auction to buy Sunrise REIT, losing bidder Health Care Property Investors ("HCP") went public with a topping bid at a 20% premium, even though this was prohibited by its standstill agreement with the target. The public announcement of the topping bid did not disclose that it was conditional or that it violated the standstill. Ventas demanded that Sunrise REIT enforce HCP's standstill agreement as required by the merger agreement. Both the Ontario trial and appellate courts ordered Sunrise REIT to do so, upholding a selling board's prerogative to structure an auction in a manner that the board believes will maximize shareholder value (including by requiring "best and final" offers from participants and agreeing to enforce a standstill obligation against a losing bidder).

Despite victory in the Ontario courts, Ventas had to increase its offer by $100 million to secure shareholder approval after HCP's announcement. Ventas sued HCP for tortious interference, alleging that HCP sabotaged its deal with a fraudulent announcement, and a federal jury in Kentucky agreed and awarded Ventas damages equal to the increased amount it had to pay. HCP appealed but the Sixth Circuit has now affirmed the judgment. The Court emphasized that tortious interference claims are held to an exacting standard, especially among competitors, requiring evidence of "significantly wrongful means." However in this case, the Court of Appeals agreed with the District Court that the standard was met, and also remanded the issue of punitive damages after finding that "the evidence suggests that HCP's public announcement of its offer was more than a simple breach of its Standstill Agreement with Sunrise, but instead was a fraudulent act designed to mislead the market and harm Ventas."

Although this outcome – as is usual in tortious interference cases – was heavily fact-dependent, it provides useful lessons and reminders for parties participating in public company auctions. Both buyers and sellers in auctions must pay careful attention to the precise terms of standstill obligations they sign, as well as the provisions of merger agreements regarding interlopers, including the enforcement of bidders' standstills. For parties seeking to "top" an announced transaction, this case sounds a loud warning to pay close attention to the "rules of the road" and to the provisions of any confidentiality, standstill or similar agreement they may have with the target.

It is of course also vital to ensure that all material information is disclosed when a competing proposal is announced. The Court emphasized that "the public interest in full and fair competition is furthered by imposing liability on a market player, such as HCP, for fraudulently leveraging a public market to sabotage a competitor, as liability for such conduct will deter similar future conduct and promote economic certainty in the marketplace."

Robin Panovka
Trevor S. Norwitz

May 11, 2009

Debt Buybacks Raise Unique Tax Issues for REITs

REITs that are considering repurchasing their debt at a discount should consider the taxable "phantom" cancellation of indebtedness income ("COD income") that will likely result and the potential UPREIT tax protection implications in order to avoid potentially costly surprises. This "phantom" COD income can impact the tax law requirement that REITs must distribute 90% of their taxable income as a taxable dividend (the "Distribution Requirement").

If a REIT buys back its debt at a discount, it will have non-cash COD income, generally in the amount of the discount. This can occur whether the REIT pays cash, issues new debt or uses its own stock to satisfy the outstanding debt if the amount of cash, adjusted issue price of the new debt or the fair market value of the stock is less than the amount of the debt being repurchased (and also can occur if a person related to the REIT acquires the REIT's debt at a discount). COD income must generally be included in taxable income (absent insolvency or bankruptcy at the time of the buyback). It is important to note that a REIT, unlike an individual, cannot exclude from its income any COD income that results from the cancellation of "qualified real property business indebtedness."

A REIT's COD income is not taken into account in determining whether a REIT satisfies the tax requirements mandating that certain percentages of a REIT's gross income be from specified sources. The tax rules also provide an exception from the Distribution Requirement for a REIT's "excess noncash income" (including COD income). However, the amount of excess noncash income is determined by a formula and may be significantly less than the amount of the REIT's actual noncash income. Moreover, even when a REIT's Distribution Requirement is reduced by the exclusion of excess noncash income, the REIT is taxable at regular corporate income tax rates on its undistributed income.

REITs generally should be able to take advantage of a new election that permits debtors with COD income in 2009 and 2010 to defer inclusion of such income. If the election is made, COD income that is generated in 2009 is deferred for 5 years (4 years if generated in 2010) and then included in income ratably over a five year period, with no attribute reduction (although related OID deductions are deferred). This election could help mitigate the effect of recognizing noncash COD income. In addition, under certain circumstances public REITs currently have the flexibility to satisfy the Distribution Requirement largely in stock. (*See* our memo of December 10, 2008.)

An UPREIT partnership also must be mindful of any tax protection agreements, which may require the partnership to maintain certain levels of debt to avoid triggering gain to protected partners who contributed properties and to indemnify the contributing partners for taxes (at times on a grossed up basis) if the partnership breaches the agreement. If applicable, the costs of those indemnities must also be weighed against the benefits of reducing debt.

David M. Einhorn
Adam O. Emmerich
Robin Panovka
Michele J. Alexander
David E. Shapiro

December 10, 2008

New IRS Guidance Provides Relief from
Dividend Payment Requirement for Cash-Starved REITs

The Internal Revenue Service today issued a welcome Revenue Procedure that temporarily permits publicly traded REITs to satisfy the tax requirement that they distribute at least 90% of their taxable income by offering their shareholders the election to receive the dividend in the form of cash or REIT stock. The Revenue Procedure permits the amount of cash to be capped at 10% of the total dividend. This timely guidance provides much needed relief to REITs that are struggling to raise the cash needed to meet the dividend distribution requirement and to retain cash for use in their business or to pay down debt.

Until now, a publicly traded REIT had the choice of paying the dividend in cash or seeking a private letter ruling from the IRS permitting it to pay the dividend by offering shareholders the choice of receiving either cash or stock, with the cash component generally permitted to be capped at 20% of the total dividend. The guidance contained in the Revenue Procedure extends only to distributions declared with respect to taxable years ending on or before December 31, 2009, and is effective with respect to distributions declared on or after January 1, 2008. In order for a stock distribution by a REIT to qualify for taxable dividend treatment under the Revenue Procedure, the following requirements must be met:

- The distribution must be with respect to the REIT's stock and the REIT's stock must be publicly traded on an established securities market in the United States.
- Each shareholder may elect to receive the entire dividend in either cash (subject to a cash limit) or stock of the REIT of equivalent value, provided that (1) the cash limit must not be less than 10% of the aggregate amount of the declared dividend and (2) if too many shareholders elect to receive only cash, each such shareholder must receive a *pro rata* amount of cash corresponding to his or her respective share of the aggregate dividend (and no shareholder electing to receive cash can receive less than 10% of his or her entire dividend in cash).

The Revenue Procedure also sets forth rules about how to calculate the number of shares to be received by shareholders, as well as how to treat shareholders participating in dividend reinvestment plans.

This new guidance should benefit the many cash-strapped and debt-maturity-facing public REITs that are trying to preserve cash for use in their operations or to pay down debt during the current deep freeze in the credit markets.

David M. Einhorn
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Robin Panovka
Michele J. Alexander

December 8, 2008

REIT M&A – Synthetic Ownership Arrangements Create Real Dangers

As structured forms of "synthetic" equity ownership – total return swaps, hedges and other contractual arrangements – have become increasingly popular armaments in the hands of hedge funds, corporate raiders and activist investors, corporate and regulatory tools are evolving to recognize that such arrangements can and should often be treated as equivalent to the ownership of the underlying shares, both for disclosure and for substantive purposes. This is true especially where direct or indirect counterparties to the synthetic or contractual arrangements actually acquire shares in the referenced company. Accordingly, those who might seek to acquire an economic interest in a REIT that would be prohibited by the REIT's excess share provision if acquired directly should assume that the excess share provision will equally prohibit clever subterfuge. Purchasers should not assume that optimistic and overly-aggressive interpretation of REITs' excess share provisions will withstand judicial scrutiny, and those who rely on them should be prepared to suffer the consequences.

In this connection, it should be borne in mind that many, if not most, REIT excess share provisions are written to be broader than the underlying IRS REIT qualification standards require, so as to avoid the complicated exercise of looking into the ownership and control of non-individual REIT shareholders. This has long been well disclosed and is perfectly sensible from both an administrative perspective and because it affords REITs protection from the dangerous and short-term self-interest that often motivates activist shareholders. Preventing the accumulation of large, potentially controlling, stakes in REITs and other public companies without allowing boards of directors the ability to negotiate with would-be controlling shareholders benefits and protects all shareholders. This is particularly true in the United States, where there are generally no mandatory offer, minimum price or other iron-clad remedies against oppressive or abusive share accumulations or squeeze-out or other similar transactions.

Given the potentially large tax costs to a REIT of being disqualified and the fact that REITs are generally required to enforce the provisions of their charters, a REIT that is aware of synthetic or other structured ownership or economic interests that could violate its excess share provision if the total number of shares to which the arrangements relate were owned directly should carefully evaluate whether it is compelled to act with respect to the potential violation of its charter restrictions. Among other actions, if the ownership restrictions in a REIT's charter are violated, the stock owned in excess of the limit (including any stock owned by a counterparty to a swap or other synthetic transaction) is automatically converted into excess stock and the economic upside of ownership of the stock is lost to the holder and any loss on the sale of the stock by the REIT for the former holder is borne by the former holder. In addition, the REIT may have other claims against the party who sought to obtain the economic benefit of ownership of the underlying shares.

Although written long before the proliferation of synthetic ownership arrangements in the market today, REIT excess share provisions are not toothless in the face of economic arrangements to indirectly acquire REIT shares that if carried out directly would clearly violate the excess share provisions. Would-be acquirors should proceed with extreme caution and REITs should act aggressively to enforce the terms of their excess share provisions against abusive accumulations.

David M. Einhorn
Adam O. Emmerich
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David E. Shapiro
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February 14, 2008

REIT Update:
Advance Preparation for Growing Threats

The current environment presents a range of threats to REITs. REIT stocks' almost unprecedented discount to estimated Net Asset Value (arguably 20-30% or more in some cases) makes them potentially attractive takeover targets. And, regardless of whether the discounts to NAV are real or only leading indicators of changes to come in underlying property valuations, as some believe, they are one of the key factors that is stimulating hedge funds and shareholder activists to push for a sale or strategic change in a growing list of companies. At the same time, difficulties in the credit markets and heightened scrutiny of REITs' balance sheets are creating liquidity concerns – sometimes quite extreme – for a growing number of REITs, particularly those with near-term debt maturities or creditors with "loan-to-own" motivations. Yet, while the credit markets continue to be extremely tight, there would appear to be plenty of both domestic and (in many cases especially) foreign equity available to fuel friendly and unfriendly investment. Whether responding to truly desperate credit circumstances (as in **Macklowe, Centro**) or merely to speculation and rumor (as in **General Growth**), or to something in between (as in **Glimcher**, **Cedar**, **One Liberty, American Land Lease**); whether dealing with a volatile mix of would-be buyers, shareholder activists and inside management (as in **Post**, **Maguire**); or instead acting pro-actively to achieve old-fashioned strategic combinations (as in **American Campus/GMH**), the REIT industry is today as active and diverse as ever, and significantly more dangerous for those who have not carefully prepared.

It is vitally important for REITs and their boards to carefully examine potential threats before they materialize, to take protective measures where appropriate, and to come up with contingency plans. The attached updated REIT Preparedness Checklist provides a roadmap for putting a REIT in the best possible position to respond to takeover threats (pg. 1), hedge fund and activist pressure (pg. 10), and liquidity concerns (pg. 14).

While each REIT would do well to create and implement a customized preparedness response plan and checklist based on its own particular situation and the likely potential threats it may face, the following action items are relevant to many REITs in the current environment:

- Monitor trading and ownership of the REIT's equity and debt securities (including options, credit default swaps and other derivative products to the extent possible), looking for accumulation by any potentially activist or threatening players. In the case of debt instruments, focus especially on the "fulcrum" security that loan-to-own distress buyers will likely target.

- Review (and if appropriate update) structural defenses, including both conventional defenses and REIT-specific "excess share" ownership restrictions and UPREIT unitholder rights, keeping in mind that REITs are no less vulnerable to unsolicited takeovers (and to proxy fights, and other varieties of unsolicited and activist tactics) than other public companies.

- Analyze the company's balance sheet in light of current lower asset valuations and market conditions, and, if appropriate, explore ways to de-lever, build financial flexibility and address upcoming maturities, including through potential asset sales.

- Consider capital markets activities such as buying the company's own debt or equity securities, exchange offers for substitute securities, recapitalizations and joint ventures to achieve the above goals, where such mechanisms are appropriate and feasible; do the necessary preparatory work and team-building to be able to move quickly in this area when opportunities present themselves.

- Review any Achilles' heels that the REIT might have and how they may be addressed, focusing in particular on embedded tax issues that could be used as leverage by agitators.

- Assess the company's debt covenants and other restrictions and, if appropriate, seek early amendment of covenants that could be triggered in a downturn, being willing to offer consideration for amendments; in all events be ready to move quickly in this regard.

Advance preparation can often make the difference between success and failure when under attack, in other times of stress or when fast action is necessary to avoid a serious problem. In light of the current uncertain and volatile environment, REIT management and boards of directors are well advised to redouble their efforts toward preparing for the various kinds of dangers we are currently witnessing in the REIT space.

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Takeover Preparedness Checklist[1]

I. Advance Preparation

1. Assemble Team to Deal with Takeovers

    a. Small group (2-5) of key officers plus lawyer, investment banker, proxy soliciting firm, and public relations firm

    b. Create war list of telephone numbers of the team

    c. Ensure ability to convene special meeting of board within 24 to 48 hours

    d. Continuing contact and periodic meetings are important

    e. A periodic "fire drill" is the best way to maintain a state of preparedness

2. Prepare Instructions for Dealing with:

    a. Press (both general press and trade publications)

    b. Stock Exchange

    c. Directors

    d. Employees

    e. Tenants/customers/suppliers

    f. Institutional investors and analysts

    g. Lending banks and bondholders

3. Review Structural Defenses, Consider Implementing Additional Defenses If Necessary

    a. Bear in mind:

        - In many cases a structural defense will be possible only if there has been careful advance preparation by the Company and its investment banker and counsel (see 7.

[1] In reviewing and implementing the checklist, it should be kept in mind that not all the items in the checklist are appropriate for every REIT, and that each REIT should develop its own customized checklist to address its particular threats.

and 8. below)

- While staggered election of the board of directors and

b. Review dividend policy, analyst and investor presentations and other financial public relations

super-majority merger votes or other shark repellents have proved not to be effective in defeating any-and-all cash tender offers, they may be effective in deterring the other types of takeovers (including proxy fights) and are worth having, if obtainable (but consider negative reaction of institutional investors).

- Structural defenses need to be reviewed in light of negative reactions from institutional investors and impact on corporate governance ratings and institutional voting services recommendations.

c. Charter and bylaw provisions

- Staggered board
- Ability of stockholders to act by written consent
- Advance notice provisions
- Ability of stockholders to call a special meeting
- Ability of stockholders to remove directors without cause
- Ability of stockholders to expand size of board and fill vacancies
- Supermajority voting provisions (fair price, etc.)
- Authorization of sufficient common and blank-check preferred stock
- Cumulative voting
- Preemptive rights
- Majority Voting (for the election of directors)
- Constituencies

d. “Poison pill”

e. Excess Share Provision

- In articles or bylaws?
- Look-through provision?
- Crafted as an anti-takeover defense as well as a REIT status defense?
- Appropriate disclosure to shareholders at time of adoption and in periodic disclosure? (critical to defensibility in the context of a transaction which does not threaten REIT status)
- Does board have the power to grant exemptions and waivers under certain conditions and to clarify ambiguities?

f. Control over joint ventures and institutional relationships

g. Change of control implications in material contracts – "Buy Sell" agreements, major leases, etc.

h. UPREITs

- Rights/veto powers of unit holders
- Tax Protection Agreements
- Fiduciary duty and conflict of interest issues
- Other structural and partnership agreement provisions

i. Structure of loan agreements and indentures

j. ESOP arrangements; plans to increase employee ownership

k. Options under state takeover laws

- Control share
- Business combination
- Fair price
- Pill validation
- Constituencies

- Long-term vs. short-term
- Disclosure

4. Consider Additional Advance Preparation

   a. Advance preparation of earnings projections and liquidation values for evaluation of takeover bid and alternative transactions

   b. Amendments to stock options, employment agreements, executive incentive plans and severance arrangements ("golden parachutes")

   c. Amendments to employee stock plans with respect to voting and accepting a tender offer

   d. Protection of overfunded pension plans

   e. White knight/white squire arrangements

5. Shareholder Relations

   a. Review dividend policy and other financial public relations

   b. Prepare fiduciary holders with respect to takeover tactics designed to panic them

   c. Monitor changes in institutional holdings on a regular basis

   d. Plan for contacts with institutional investors (including maintenance of an up-to-date list of holdings and contacts) and analysts and with media, regulatory agencies and political bodies

   e. Remain informed about activist institutional investors and about corporate governance and proxy issues

   f. Consider the role of arbitrageurs and hedge funds

6. Prepare Board of Directors to Deal with Takeovers

   a. Maintaining a unified board consensus on key strategic issues is essential to success

   b. Schedule periodic presentations by lawyers and investment bankers to familiarize directors with the takeover scene and the law and with their advisors

   c. Company may have policy of continuing as an independent entity

d. Company may have policy of not engaging in takeover discussions

e. Directors should refer all approaches to the CEO

f. Avoid being put in play; psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a takeover target

g. Review corporate governance guidelines and reconstitution of key committees

7. Preparation by Investment Banker

a. Maintain up to date due diligence file and analysis of off-balance sheet values

b. Consider recapitalization, spin-off and liquidation alternatives

c. Perform semi-annual review

d. Communication of material developments and regular contact is important

8. Preparation by Lawyer

a. Review structural defenses such as excess share provision and poison pill

b. Review charter and bylaws, ensure they reflect "state of the art"

c. Understand regulatory agency approvals for change of control

d. Consider impact of change of control on business

e. Consider disclosures that might cause a potential raider to look elsewhere

f. Consider recapitalization, spin-off and liquidation alternatives

g. Consider amendments to stock options, executive compensation and incentive arrangements and severance arrangements, and protection of pension plans

h. Consider ESOPs and other programs to increase employee ownership

i. Regular communication and periodic board presentations are important

9. Prepare CEO to Deal with Takeover Approaches

   a. The CEO should be the sole spokesperson for the Company on independence, merger and takeover

   b. Handling casual passes

   c. Handling offers

   d. Communications with officers and board of directors

   e. Company may have policy of not commenting upon takeover discussions and rumors

II. **Responding to Bidder Activity**

1. Types of Activity

   a. Accumulation in the market

   b. Casual pass/non-public bear hug

   c. Public offer/public bear hug

   d. Tender offer

   e. Proxy contest

2. Responses to Accumulation in the Market

   a. Monitor trading

   b. Maintain contact with specialist

   c. Look for bidder Schedule 13D and Hart-Scott-Rodino filings:

   d. Board has duty to prevent transfer of control without premium

   e. Monitor/combat disruption of executives, personnel, tenants, suppliers, etc.

   f. Monitor uncertainty in the market; change in shareholder profile

   g. Consider immediate responses to accumulation:

      - Poison pill can be structured so that flip-in takes effect at 10% to 15% threshold

      - Enforce excess share limitation

- Litigation
- Standstill agreement

3. <u>Antitrust Enforcement Policies</u>

   a. Hart-Scott is generally inapplicable in the REIT context

   b. Foreign Filings may be required

4. <u>Responses to Casual Passes/Non-Public Bear Hugs</u>

   a. No duty to discuss or negotiate

   b. No duty to disclose unless leak comes from within

   c. Response to any particular approach must be specially structured; team should confer to decide proper response

   d. Keep the board advised

5. <u>Response to Public Offers/Public Bear Hugs</u>

   a. No response other than "will call you back"

   b. Call war list and assemble team; inform directors

   c. Call special board meeting to consider bidder proposal

   d. No press release or statement other than "stop-look-and-listen"

   e. Consider trading halt (NYSE limits halt to short period)

   f. Determine whether to meet with raider (refusal to meet may be a negative factor in litigation)

   g. In a tender offer, Schedule 14 D-9 must be filed within 10 business days and must disclose:

      - Board's position (favor; oppose; neutral) and reasoning
      - Negotiations
      - Banker's opinion (optional)

Special Meeting of Board to Consider Offer

Board should be informed of the following:

- Board has no duty to accept or negotiate a takeover offer
- A premium over market is not necessarily a fair price; a fair price is not necessarily an adequate price
- The "just say no" response was approved in the Time Warner case and reaffirmed in the Paramount, Unitrin and continues to be good strategy and good law
- Where outside directors are a majority, there is no need for a special committee to deal with takeovers nor do the independent directors need separate board counsel
- Board must act in good faith and on a reasonable basis; business judgment rule applies to takeovers (modified rule applies in Delaware, where defensive action must be proportional to threat)
- Front-end-loaded, two-tier offers and partial offers present fairness issues which in and of themselves may warrant rejection and strong defensive action

Presentation:

- Management – budgets, financial position, real values (off-balance sheet values), new products, general outlook, timing
- Investment banker – opinion as to fairness or adequacy, assessment of bidder, quality of bidder's financing, state of the market and the economy, comparable acquisition premiums, timing
- Lawyer – terms and conditions of proposal, legality of takeover (antitrust, compliance with SEC disclosure requirements, regulatory approval of change of control, etc.), excess share issues, tax protection agreements and tax consequences generally, bidder's history, reasonable basis for board action

Board may consider:

- inadequacy of the bid

- nature and timing of the offer
- questions of illegality
- duties to unitholders
- tax consequences
- impact on constituents other than shareholders
- risk of non-consummation
- qualities of the securities being offered (if bid is not all cash)
- basic shareholder interests at stake, including the past actions of the bidder (greenmail, etc.)

III. **Strategic Alternatives**

Remaining Independent

"Just say no" defense is available as a legal matter, but may not be available in practice

- Refuse to waive excess share provision and/or redeem poison pill
- Wage proxy fight to keep control of board (if board is staggered, bidder cannot get control and redeem pill without two annual meetings)
- State law takeover defenses

Consider white squire arrangements

Consider actions which decrease the Company's attractiveness as a takeover target

- New acquisitions
- Asset sales or spin-off
- Share repurchases/self-tender
- Recapitalization

Joint Ventures and Strategic Alliances

- Strategic alliances are being pursued aggressively, often with significant control ramifications.
- These transactions raise complex tax, accounting and sale of control considerations, which must be carefully analyzed against the backdrop of alternate strategic options.
- The transactions often present all the complexities of a full acquisition with the added complexity of shared governance and the need to construct an inherently imperfect exit mechanism.
- Short-term objectives need to be carefully balanced against potential longer-term ramifications.

Sale of the Company

Options:

- Locate white knight
- LBO/MBO
- Auction
- Sell significant subsidiary or division ("crown jewel" or other)
- Negotiate with bidder
- Liquidate or Split-Up

Bear in mind: if a Delaware corporation and Revlon duties are triggered, board may not be able to reverse course

Activist Hedge Funds Checklist

Advance Preparation

1. Create Team to Deal with Hedge Fund Activism

   a. Basically the same team as the takeover response team: a small group (2-5) of key officers plus lawyer, investment banker, proxy soliciting firm, and public relations firm

   b. Continuing contact and periodic meetings of the team are important

   c. A periodic fire drill with the team is the best way to maintain a state of preparedness; the team should be familiar with the hedge funds that have made activist approaches and the tactics each has used

   d. Periodic updates of the REIT's board of trustees or directors

2. Shareholder Relations

   a. Monitor analyst, proxy advisors like ISS, activist institutions like CalPERS and TIAA-CREF, and media reports for opinions or facts that will attract the attention of attackers

   b. Be consistent with the REIT's basic strategic message

   c. Proactively address reasons for any shortfall versus peer benchmarks; anticipate key questions and challenges from analysts and activists, and be prepared with answers

   a. Monitor changes in hedge fund and institutional shareholder holdings on a regular basis; understand the shareholder base, including, to the extent practical, relationships among holders

   b. Maintain regular, close contact with major institutional investors

   c. Monitor ISS, CII, TIAA-CREF corporate governance policies in that activists try to "piggy-back" on process issues to bolster argument for short-term business changes

   d. Maintain up-to-date plans for contacts with media, regulatory agencies and political bodies

3. Prepare the Board of Directors to Deal with the Activist Situation

   a. Maintaining a unified board consensus on key strategic issues is essential

   a. Review dividend policy, analyst and investor presentations and other financial public relations

   to success; in large measure an attack by an activist hedge fund is an attempt to drive a wedge between the board and management by raising doubts about strategy and management performance

b. Recognize that not every situation requires a special committee, and do not be unduly influenced by the activists criticism of the board's independence

c. Directors must guard against subversion of the responsibilities of the full board by the activists or related parties and should refer all approaches to the CEO

d. Review basic strategy and evaluation of portfolio of properties with the board in light of possible arguments for share buybacks, asset sales, joint ventures, special dividends, sale of the company or other structural changes

e. Schedule periodic presentations by lawyers and investment bankers to familiarize directors with current activist environment

f. Avoid being put in play; recognize that psychological and perception factors may be more important than legal and financial factors in avoiding being singled out as a target

4. Monitor Trading

a. Stock watch service, Schedule 13F filings

b. Watch for Schedule 13D and Hart-Scott-Rodino Act filings

c. Monitor parallel trading and group activity (the activist "wolf pack")

Responding to an Activist Approach

1. Response to Non-Public Communication

a. No duty to discuss or negotiate

b. No duty to disclose unless leak comes from within

c. Response to any particular approach must be specially structured; team should confer to decide proper response

d. Keep board advised

2. Response to Public Communication

a. No response other than "will call you back" (no outright rejection; no substantive discussion—try to learn as much as possible by listening)

b. Assemble team; inform directors

c. Call special board meeting to meet with team and consider the communication

d. Determine board's response and whether to meet with attacker

e. Avoid mixed messages

f. Be prepared and willing to defend vigorously and attack the attackers

Credit Environment Checklist

1. Monitor trades in the company's debt (particularly at discounts). Focus on the "fulcrum" security that loan-to-own debt buyers will target – the security that in a restructuring would end up converting into equity in whole or part.

2. Keep current list of holders of debt and monitor their activities at other companies.

3. Consider buying the company's own debt – note that senior debt may restrict purchase of subordinated debt which is most likely to be of interest.

4. Formulate plan for upcoming debt maturities well in advance. Think broadly, including concepts such as debt tenders and exchanges for new securities.

5. Build flexibility into the system – the more alternatives the better.

6. Seek early amendment of any covenant that in a realistic worst-case scenario could trigger a debt default. Be prepared to pay a premium to the first 51% of holders to consent to an amendment.

7. Be aware that potential acquirers and activist debt investors may be participants in your bank debt, with access to materials distributed to bank lenders.

8. Consider de-leveraging, ASAP, through asset sales, recapitalizations, etc.

9. If going it alone won't work, consider identifying a partner who can work with the company to accomplish a consensual restructuring.

The communication, coordination, team building and scenario and other advance planning that are reflected in the Takeover Preparedness Checklist and Activist Hedge Funds Checklist above will also be applicable in the context of advance preparedness in this area and should be carefully tailored to the balance sheet and capital markets' situation of each REIT.

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THE AM LAW LIFETIME ACHIEVERS

UP FROM THE ASHES

It took Wachtell *and* Lipton, plus 70 of their lawyers, to help Larry Silverstein start rebuilding Ground Zero.

By Ben Hallman

The Biovail Botch: How a hedge fund suit became a law firm disaster.
What associates earn: A city-by-city report.

SILVERSTEIN'S ARMY

WACHTELL, LIPTON DEDICATED MORE LAWYERS TO HELPING
THAN TO ANY OTHER PROJECT IN ITS HISTORY. AFTER SIX YEARS
IS FINALLY BREAKING GROUND.

LARRY SILVERSTEIN REBUILD AT GROUND ZERO

OF HEAVY FIGHTING, THE FIRM'S BIGGEST CLIENT

BY BEN HALLMAN

PHOTOGRAPH BY MICHAEL J.N. BOWLES

AT THE WORLD TRADE CENTER CONSTRUCTION SITE FROM LEFT:

PETER HEIN, BEN GERMANA, JONATHAN MOSES, ADAM EMMERICH, MARTIN LIPTON, LARRY SILVERSTEIN,

MARC WOLINSKY, BERNARD NUSSBAUM, ROBIN PANOVKA, HERBERT WACHTELL, ERIC ROTH, AND MICHAEL LEVY.

LARRY SILVERSTEIN ISN'T OFTEN AWAKE PAST 10 P.M., BUT FOR THIS, THE MARCH 14, 2006, MEETING THAT WOULD DETERMINE AT LONG LAST WHAT PART HE WOULD PLAY IN THE RECONSTRUCTION OF THE WORLD TRADE CENTER, HE WAS WILLING TO MAKE AN EXCEPTION.

Rebuilding was the developer's dream—and his right, according to his lawyers from Wachtell, Lipton, Rosen & Katz. But after the towers fell, New York city and state authorities seemed to have done everything possible to elbow him out of the way, even as Silverstein ponied up $100 million a year to rent a hole in the ground. Now, at almost midnight, he was huddled in a conference room in the Park Avenue offices of the Port Authority of New York and New Jersey, the quasi-governmental agency that had leased the Twin Towers to Silverstein in July 2001. Executives from his development company and his financial backers were there with him, as were Wachtell partners Martin Lipton and Robin Panovka. Silverstein ordered two cups of coffee. He was ready to stay up all night. "Let's get this thing done," he told the group.

Silverstein had missed his bedtime, but it was Port Authority and other government officials who were tired—of Silverstein, of his lawyers, and of what they would describe the next day as "bad faith" negotiating. When the Silverstein side returned to the table that night—either three or four hours late, depending on which side is telling the story—"everything that we thought we had settled was back on the table," says Kenneth Ringler, Jr., the Port Authority's executive director at the time. After several tense sidebar conversations, Ringler lost his cool. He stormed into the conference room occupied by the Silverstein team. "It's over," he said. "Send us your fucking rent check." Lipton followed Ringler out of the room, then returned a few moments later. "They're enraged," he said to the Silverstein team. "There's nothing we can do tonight." The men filed out. No one said much on the elevator ride down to the street. It had been a bad night, and with no deal in place, tomorrow would be worse.

Representing Larry Silverstein in his quest to rebuild at Ground Zero has been the most demanding project that Wachtell, Lipton has ever undertaken. Since 2001, 71 lawyers have worked 100 hours or more on World Trade Center matters, including a handful of partners who worked nearly full-time on the project—this at a firm with fewer than 200 lawyers and just 77 partners. It has also been Wachtell's most emotionally taxing representation. "I am not given to exhortatory messages," Herbert Wachtell wrote in a memo to his partners on the first anniversary of the terrorist attacks. "This is an exception." He continued: "Out of this horror, we have been given a tremendous privilege—to take a central role in bringing about the rebuilding of our city, to make it better than it was." As the late-night meeting at the Port Authority demonstrates, the dealmaking was never easy and an equitable outcome never certain. Negotiations with the Port Authority over who would rebuild at Ground Zero, and with the insurance companies that held billions of dollars needed to finance that construction, were contentious, at times bitter, and for all involved, exhausting. Those who worked on the land and insurance deals that will finally permit the rebuilding to begin—Silverstein executives, government officials, and scores of lawyers—say the agreements they signed in the past year were, hands down, the most complicated they have ever seen.

They also say that Wachtell partners—Lipton, Panovka, and Adam Emmerich on the real estate side; Herb Wachtell, Marc Wolinsky, Bernard Nussbaum, Peter Hein, and Eric Roth on the insurance litigation front—played a vital part, not just in providing the legal expertise expected of a top firm, but as hard-nosed negotiators whose clout bolstered Silverstein's position. "They were advisers, strategists, and negotiators," says John "Janno" Lieber, Silverstein's director of development for the 16-acre World Trade Center site. "They played every role."

WACHTELL IS THE WORLD'S PRE-eminent M&A firm, home to the richest lawyers in The Am Law 100—profits per partner were nearly $4 million in 2006—and some of the most secretive. This firm does not typically disclose much about itself or its work for clients. But at the behest of Silverstein, who sees the World Trade Center redevelopment as a historic moment, several Wachtell partners agreed to talk about all but the most confidential aspects of the deals. For Silverstein, they were willing to bend their rules. The developer, after all, is more than a client. He is also Herb Wachtell's best friend.

They met in September 1944 as freshmen at New York's High School of Music & Art, where Silverstein played drums and Wachtell played clarinet. They went to New York University together, double-dated together, and remained friends as they pursued separate careers: Wachtell as a renowned litigator and cofounder of the law firm that bears his name; Silverstein as a real estate developer best known for building 7 World Trade Center, across the street from the Twin Towers. By New York standards, Silverstein's portfolio of properties was modest; his deals typically pooled money from outside investors to buy properties he flipped quickly.

On September 7, 2001, the two friends and their wives had dinner at Wachtell's home in Sag Harbor, on Long Island. It had been a momentous year for Silverstein, and he was in the mood to celebrate. In January he had been hit by a drunk driver while crossing Madison Avenue. In the hospital, recovering from a broken pelvis, he asked his doctors to dial down the morphine long enough for him to make a dark-horse $3.2 billion bid on the World Trade Center, which the Port Authority was looking to unload. In July he signed a 99-year lease on the property, putting up just $14 million of his own money in the highly leveraged deal. (Silverstein's foes would later argue that his relatively small investment meant that he had little stake in the rebuilding.) Silverstein had dreamed of controlling the Twin Towers for years—he saw the buildings every day from his office—and told Wachtell that night at dinner that he had finally accomplished his biggest goal. "I felt like I had achieved the brass ring," he says.

Four days later, Al Qaeda hijackers crashed passenger planes into the towers, reducing them to a smoking ruin. Silverstein lost four employees in the attacks, which also destroyed 7 World Trade Center. On September 12 he called Lipton, and on the next day he met with Lipton and Wachtell in their midtown office. "I knew I needed superior counsel," Silverstein says. "I had always found Herb an exceptional intellect, and I knew Marty Lipton from our years serving together on the board of NYU's law school." Wachtell wanted to help, but knew it would mean a big commitment. In a 2002 article about the first stages of Silverstein's litigation with the insurers ["Double Indemnity," September 2002], Wachtell told *The American Lawyer* that after the September 13 emergency counseling session, he rounded up all the partners he could find for an impromptu firm meeting: "It was a firm issue—could we afford to take this on?" Ultimately, they decided to do it for two reasons. "Larry is my closest and oldest friend," Wachtell said. "And this was a civic thing—we felt an obligation to be involved in the rebuilding of the city." It was not a decision made lightly. Wachtell predicted "a mammoth drain on firm resources." He was right. The actual burdens "were greater than we ever anticipated," Wachtell says today.

MARTY LIPTON HELPED PERSUADE SILVERSTEIN TO GIVE UP THE FREEDOM TOWER (LEFT, IN AN ARTIST'S RENDERING) IN EXCHANGE FOR THREE OTHERS.

What started as one case—a fight with insurers over how much coverage they owed Silverstein when the World Trade Center was destroyed—quickly turned into a two-front campaign. Silverstein wanted to rebuild 10 million square feet of office space, the entirety of what he lost when the Twin Towers fell. This was a tough sell. Companies were fleeing Lower Manhattan, and there seemed to be little enthusiasm for an office project on par with the former World Trade Center. There was also opposition from victims' families, who felt the space should be dedicated as a memorial. But over the next few years, with the political backing of New York governor George Pataki, who also favored rebuilding, Silverstein and Wachtell won enough support for commercial redevelopment that most parties surrendered to the reality that some sort of office building, or buildings, would go up at Ground Zero. In 2003 the Lower Manhattan Development Corporation, created by Pataki and former mayor Rudolph Giuliani to coordinate rebuilding in Lower Manhattan, selected architect Daniel Libeskind's design for a new World Trade Center. Though his plan went through many permutations and redesigns after battles among different architects assigned to work on the project, the basics remained the same: There would be a new transportation hub and five new towers—four on the old World Trade Center property and a fifth on Liberty Street, on the site of the condemned Deutsche Bank Building. The gleaming centerpiece of the complex would be the 1,776-foot Freedom Tower, a 69-story office building capped by a spire resembling the massive TV tower atop the original 1 World Trade Center.

Yet even as the design work slowly progressed, the debate over who would build the structures remained stuck in the mud. From the beginning, officials at the Port Authority made it clear to Silverstein that they wanted him out of the reconstruction. They worried that he couldn't afford the job, that he would lose interest, that he would pocket the insurance money and go home, that he would prove a hindrance in the planning of the site. Silverstein's position, as articulated by his Wachtell lawyers—in meetings, publicly, whenever they had a chance—was that as leaseholder, Silverstein had the "right and obligation" to rebuild. It was a stalemate. Silverstein had the lease, the Port Authority owned the land, and when 2006 dawned, the two sides were still miles apart on a deal that would resolve the differences.

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In mid-December 2005 Pataki, who was weighing a presidential bid and wanted a World Trade Center deal on his resume, gave Silverstein and the Port Authority 90 days—until March 14—to come to an agreement. The Wachtell lawyers say they welcomed the deadline. "Sometimes it takes an outside force to break a deadlock," says real estate partner Panovka. The weeks that followed Pataki's ultimatum were grueling for Panovka and the rest of the Wachtell lawyers, who were in near-constant negotiations with Port Authority executives. At various times, practically every conceivable compromise was on the table, including a plan for Silverstein and the Port Authority to jointly build and operate the new World Trade Center. The five proposed towers were traded back and forth like baseball cards. Each side struggled over the innumerable details of a project that could ultimately cost $20 billion (Silverstein's estimate) or more. What percentage of the insurance proceeds would the Port Authority get? How much would Silverstein pay toward "common infrastructure" costs, such as the underpinning of the No. 1 subway line?

Even as the two sides narrowed their differences, the Freedom Tower remained an enormous obstacle. Silverstein didn't want to let it go. He had contributed to its planning and design—rescuing the tower, in his opinion, from designer Libeskind by bringing in his architect, David Childs. Silverstein's lawyers realized, however, that to get a deal made, he would have to give up the Freedom Tower. "It was like a child to him," Lieber says. "But economically it would be the most expensive building ever built, and there were questions about whether it could be leased." Lieber says it fell on him and Lipton to convince Silverstein to let go of the Freedom Tower. It was the right decision, they told him: If he surrendered the Freedom Tower, he could build three other towers, those that were planned for a reconstituted Greenwich Street. They would be closer to the new transportation hub, wouldn't carry the psychological burden of the Freedom Tower, and, as such, would be easier to lease. Silverstein finally relented.

With most of the pieces of a deal in place, the Wachtell lawyers were confident they would meet Pataki's deadline. At 8:30 on the morning of March 14, the Silverstein team sat down with Port Authority officials and John Cahill, Pataki's chief of staff, in the Port Authority's Park Avenue headquarters. They haggled over terms all day. When they broke for dinner, the Wachtell lawyers thought they were about to make a deal; only $50 million and a few issues, such as how to split revenue from the retail space, stood between Silverstein and the Port Authority. They went to Silverstein's Fifth Avenue office to discuss strategy and to meet with his financial backers. Silverstein, Lieber recalls, was in such a good mood that he ordered dinner for everyone from DB Bistro Moderne on Forty-fourth Street—a departure for the 76-year-old, who typically favors meals prepared by his long-serving company chef.

Panovka and Lipton, along with Silverstein, Lieber, and the financiers, returned to the Park Avenue office at, as they recall, around 9:30 or 10 P.M. They settled into a fifteenth-floor conference room. Silverstein ordered his coffee. They knew it was several hours after the Port Authority team expected them, Lieber says, but that was because they were working out critical details with Silverstein's backers. Whatever the explanation, the delay infuriated the Port Authority. Ringler, who says Silverstein's team actually didn't show up until 11 P.M., contends that

THE MAN THEY CALL "THE HAMMER"

RICK KOPSTEIN

SOMETIMES WHEN SOMETHING GETS STUCK and all the clever tools in your bag have failed, you need a hammer. Or, in the case of the World Trade Center insurance litigation, "The Hammer."

That was the nickname that New York superintendent of insurance Eric Dinallo earned earlier this decade when he worked as chief of investment protection for then–attorney general Eliot Spitzer. It was Dinallo's idea to examine the relationship between investment banks and investment analysts, and to use a little-known state law to begin the prosecutions that would lead to a sweeping, industrywide settlement.

After a stint in the private sector (including time as general counsel to insurance broker Willis Group Holdings Limited), Dinallo is working for Spitzer again, running one of the most important insurance regulating offices in the country. So far, he hasn't lost a step. "Remember, this is the guy who was Spitzer's lead prosecutor on financial business misbehavior," says John "Janno" Lieber, senior vice president of Larry Silverstein's World Trade Center Properties, LLC. "I think he sort of came into his new job looking for opportunities to make big things happen."

Thanks to his relationship with Spitzer, Dinallo has the autonomy—much more than insurance commissioners in the past—to take action. "I've worked with him for enough years that I know his judgment is sound," Spitzer says. "He has independence based on history between us." So when Dinallo found that the WTC insurance litigation was both ongoing and stalled, he decided to do something about it.

Sitting in his office months later, pink tie still tossed over his shoulder after a late Dunkin' Donuts breakfast, Dinallo grinned when asked about that decision. "I didn't tell anybody, I just called the meeting," Dinallo says. This was the meeting at which he threatened all the parties with damaging investigations unless they reached an agreement—a threat he would later refer to as the "sword of Damocles."

Despite the swagger, Dinallo's success in breaking through the deadlock came as much from his legal chops as his boldness. Since graduating from the New York University School of Law in 1990, Dinallo says, he has learned from legal heavyweights who also understood public service. These have included, most notably, Arthur Liman of Paul, Weiss, Rifkind, Wharton & Garrison, for whom Dinallo worked as an associate after clerking for Judge David Ebel of the U.S. Court of Appeals for the Tenth Circuit in Denver; and longtime Manhattan district attorney Robert Morgenthau, whom Dinallo served as an assistant D.A. from 1995 to 1999. And, of course, Governor Spitzer.

Through these relationships, Dinallo has gained an understanding of how legal and political issues go hand in hand. "Eric is excellent at taking a legal issue and figuring out what its real-world consequences are, and taking a real-world issue and figuring out how to fit it in a legal box," says Michele Hirshman, Spitzer's chief deputy as AG and now a Paul, Weiss partner.

Five weeks of Dinallo's pounding brought the insurance case to the brink of settlement. Then "The Hammer" engaged even more powerful weaponry, bringing in Spitzer—with whom Dinallo debated the WTC case via speakerphone—for the final stage of negotiations.

Now, with the WTC project moving forward, Dinallo is moving on to new challenges. "I'm not surprised that Eric got it done," Spitzer says, "even though I was amazed that anybody could get it done."

Pity the poor nail.

—TIM FERNHOLZ

Silverstein proceeded to backtrack on several already-agreed-upon points. The Silverstein side, not surprisingly, says the Port Authority was to blame for the breakdown in communications: The agency, they say, had never handled a real estate deal of this size or complexity, and its bureaucracy was cumbersome; in addition to Ringler, the governors of New York and New Jersey and a board of directors all have a say in agency matters. When Ringler marched into the Port Authority's conference room, cursing and insisting that negotiations were over, the Silverstein team knew they had exhausted their welcome.

The key, Panovka says, was a rule they called "no finger on the scale": Each problem had to be handled in turn, without influencing all the other outstanding issues. The parties couldn't write an agreement on one issue in a way that gave them an advantage on another issue. Take, for example, design. The two sides agreed that the buildings would be "substantially similar" to the Twin Towers in terms of space—10 million square feet of office space in five office towers in the locations plotted by Libeskind in his master plan for the site. But all the design specifics, including such important details as the allocation of street-level retail space, were put off until later. Similarly, critically important cost allocations involving hundreds of millions of dollars were put off until the design was complete. "In a normal real estate deal, this would be insanity," Panovka says. But "agreeing to agree," he says, was the only way the lawyers could avoid getting buried under a mountain of details.

AFTER NEGOTIATIONS FELL APART, PORT AUTHORITY EXECUTIVES REFUSED TO TALK TO SILVERSTEIN. BUT THE SITUATION WASN'T QUITE SO BLEAK: WACHTELL LAWYERS QUIETLY RESTARTED THEIR DIALOGUE WITH THE AGENCY.

As the developer and his Wachtell lawyers left the building, Port Authority officials were hitting the phones, calling reporters. The next day, Silverstein held a press conference to explain his position, but it was clear who had won the public relations battle. Silverstein received a thrashing from all quarters. Pataki issued a statement saying that Silverstein had "betrayed the public trust and that of all New Yorkers." *The New York Times* also weighed in: "The terms were overly generous to Mr. Silverstein, and he was very lucky to get them," said a March 17 editorial. "But at the last minute, Mr. Silverstein and his team made a new set of demands that seem to have been intended to scuttle the bargaining."

For all the blustery press conferences on both sides, the situation behind the scenes wasn't quite so bleak. Within a few weeks of the March 14 debacle, Lipton and Panovka restarted the dialogue with Ringler and with Darrell Buchbinder, the general counsel of the Port Authority. In a typical negotiation, principals meet with principals, and lawyers meet with lawyers, but the acrimony between Silverstein and the Port Authority hadn't faded. Agency officials refused to talk to the developer, or to anyone at Silverstein Properties, Inc. Though Silverstein considered the cold shoulder unprofessional, he told the Wachtell team to proceed: "I said, 'Guys, let's close the damn deal.' "

Fortunately, they didn't have to start from scratch. With the basics of who would build what decided, the two sides progressed with a protocol of negotiation that the lawyers had developed before the talks abruptly ended.

On the evening of April 25, Panovka, who had been at his older daughter's school play, turned on his BlackBerry. He had messages marked "urgent" from Buchbinder and Ringler. The Port Authority wanted to finalize a deal that night: Buchbinder was nearly finished with a draft of an agreement to show the Wachtell partner. Panovka rushed to his office and began negotiating by phone. Early the next morning, six weeks after the blowup, the two sides signed a conceptual real estate framework. In just seven pages, by agreeing to agree later on thousands of details, Wachtell and the Port Authority lawyers laid out the terms of the deal. Silverstein would indeed give up the Freedom Tower, though he would remain a consultant on the project. He would surrender 43.5 percent of the proceeds he recovered from his insurers to the Port Authority, and would contribute $140 million in common infrastructure costs for the rebuilding of the site. In return, Silverstein received the right to build three towers on Greenwich Street, each nearly as tall as the Empire State Building—in all, 6.2 million square feet of office space, of which the Port Authority and the City of New York agreed to lease a total of 1.2 million square feet. He also won access to $2.6 billion in tax-free bonds allocated by the federal government to encourage rebuilding in Lower Manhattan. To allay the fears of officials who questioned Silverstein's ability to pay for his part of the rebuilding, he committed to begin work on two new towers as soon as the Port Authority finished digging out and fortifying a "bathtub" to prevent flooding on the east side of the property. He also agreed to pay steep penalties if he didn't meet certain construction deadlines.

Port Authority general counsel Buchbinder declined to comment on the negotiations, but others had high praise for the work the lawyers did. "Marty never lost his touch and never lost his cool," says former Pataki chief of staff Cahill, who was at the Port Authority the night of the fireworks. Of Panovka, he says that "he came with the reputation of being honest and direct" and that he was "instrumental in fashioning a deal." Even Ringler, the former Port Authority executive director, has kind words for the Wachtell lawyers, with whom he continued to talk through a long summer, finalizing the more than 200 agreements—seven double binders' worth—that eventually documented the deal. "Wachtell knows how to negotiate," he says. "And Lipton is one of the few people Silverstein will listen to on occasion."

WITH A LAND DEAL IN HIS POCKET, Silverstein was ready to rebuild, but he was short $2 billion in insurance money—and his lawyers at Wachtell were having a hard time collecting. Silverstein is magnanimous, for the most part, about his former adversaries. But he doesn't conceal his contempt for the insurance companies. "We tried to settle," he says. "We didn't want to litigate. We said, 'Please help us get this done.' "

When Silverstein leased the World Trade Center, he took out $3.5 billion in insurance, the most ever purchased for a single office complex, from 25 different companies. After September 11, Herb Wachtell came up with a theory that would potentially double Silverstein's recovery from those insurers. Because the attack on the World Trade Center involved two planes and two towers, Wachtell argued that two discrete, insurable events had occurred. Silverstein, in Wachtell's theory, was due twice his policy limits—$7 billion—from his insurers.

The insurers, predictably, didn't see it that way. The dispute quickly became rancorous and in 2004 wound up in a courtroom. Two federal juries essentially divided Silverstein's insurers into two categories: Underwriters that used a boilerplate contract provided by Silverstein's insurance broker were liable for just one occurence; those that did not use the broker's form owed Silverstein coverage for two occurrences. The verdicts limited Silverstein's potential payout to about $4.68 billion.

Of that total, Silverstein had been able to collect only $2.55 billion, enough to pay his rent and pay his lawyers, but not enough to secure the type of financing needed to build three buildings that could cost $7 billion or more, plus infrastructure costs. Eight carriers—a group that included Allianz SE, Swiss Reinsurance Company, and The Travelers Companies, Inc.—were still liable for up to $2.1 billion. And that money remained out of Silverstein's reach. The insurers insisted after the 2004 trials that Silverstein hadn't proved the replacement value of the Twin Towers: the cost in today's dollars to build two brand-new towers exactly like the ones that had been brought down. The appraisal process to determine that amount had begun in September 2004. Three arbitrators were to decide the hypothetical question of how much it would have cost to build the World Trade Center, as it was originally constructed, on September 11, 2001. Wachtell partner Peter Hein led a team through 100 days of hearings to determine that cost, down to the last screw. It was an arduous process. John Gross, a partner at Proskauer Rose, which served as cocounsel with Wachtell on the appraisal, describes it as a "litigation within a litigation" and as "an extraordinarily intense, detailed proceeding." The insurers' lawyers even disputed how much hypothetical depreciation to subtract from the value of the hypothetical structure. But until the appraisal process was complete, the insurance companies argued, there could be no reckoning of what they owed.

WACHTELL'S MARC WOLINSKY WANTED STATE INSURANCE COMMISSIONER ERIC DINALLO TO BREAK THE DEADLOCK BETWEEN SILVERSTEIN AND HIS INSURERS. DINALLO OBLIGED. "HE TOOK THE BAIT," SAYS WOLINSKY.

Silverstein, meanwhile, refused to give up a claim for prejudgment interest that could have added $500 million to his insurance recovery. Discussions between counsel for the insurers and Wachtell litigation partner Marc Wolinsky, who'd taken the lead for Silverstein after the two trials, were going nowhere; insurers felt that in Wolinsky, the intractable Silverstein had an equally stubborn advocate. A resolution seemed years away.

Then, in late January 2007, Wolinsky met with Eric Dinallo, the acting New York State insurance commissioner (he was confirmed to the office a few months later). The meeting was about a related issue: The U.S. branch of one of the World Trade Center insurers, Royal Indemnity Company, which owed up to $250 million, was involved in a liquidation proceeding in Delaware, and Wolinsky had been fighting to make sure the Delaware agency overseeing the matter enforced the terms of the carrier's settlement with Silverstein. At the end of the meeting with Dinallo, Wolinsky says, he gave the commissioner an update on the World Trade Center litigation. He told him that five years after the attacks, Silverstein was still waiting for more than $2 billion from his insurers. Wolinsky was hoping that Dinallo would jump into the dispute, and Dinallo obliged.

"He took the bait," Wolinsky says.

Dinallo, a former general counsel of Willis Group Holdings Limited, the insurance broker, had worked for Governor Eliot Spitzer when Spitzer was attorney general, and had been in office for only a few weeks [see "The Man They Call 'The Hammer,' " page 88]. "I didn't know the magnitude of the amounts to be paid," Dinallo says. Wolinsky says he was eager to bring the commissioner up to speed: "I had to convince Dinallo that we really were due the money we were claiming, so I had to educate him and his staff of the substance of five-and-a- half years of litigation."

On March 22, two months after his meeting with Wolinsky, Dinallo summoned representatives from the insurance companies and from Silverstein Properties to his office on Beaver Street in Lower Manhattan. He felt the lawyers were stuck in a "litigation posture," so he directed his remarks to the executives. James Corcoran, a former New York insurance commissioner who represented Zurich American Insurance Company at the meeting, says Dinallo made the right decision. "There were too many chefs, too many people" in the negotiations, he says. "If you put trial lawyers in a room, they do what trial lawyers do. Management has to manage the company, not the lawyers."

Dinallo told the executives that their failure to resolve the insurance dispute was "a black eye" and "a disgrace" to the entire industry. And he wasn't afraid, he said, to use the power of his office. If the insurers didn't settle with Silverstein within the next four weeks, Dinallo warned, he might investigate all of their insurance claims–handling practices. Nor did he spare the Silverstein representatives at the meeting, Wolinksy and Lieber. If there were an investigation, Dinallo said, his office would also look at whether Silverstein had made inflated claims. Says Robert Easton, Dinallo's general counsel: "We wanted to make it clear that the agency wasn't in anyone's pocket, that we were not put up to it by influential persons, but that this was something that the agency would look at because it was bad for New York, bad for the industry."

Still, Wachtell welcomed Dinallo's involvement—with a real estate agreement in place, Silverstein needed money sooner rather than later to secure the financing for the three towers on Greenwich Street. The insurance companies, at least some of them, were less pleased. Accounts differ, but one observer at the March 22 meeting says the insurance executives were "stunned" by what the commissioner had to say. (Harvey Kurzweil, a partner at Dewey Ballantine who represented Travelers, downplays the impact of Dinallo's speech. Travelers had done nothing wrong and had nothing to fear from a threatened investigation, he says.)

After the meeting with Dinallo, executives from Zurich American, which owed Silverstein about $53 million, approached Wolinsky. They wanted to settle right away (citing a confidentiality agreement, the parties declined to specify the settlement amount). Over the next several weeks, other insurers followed. Dinallo would bring insurance representatives into his office and park them in separate conference rooms from the Wachtell lawyers. Then he'd engage in what he calls "shuttle diplomacy," racing from one conference room to another. Gradually, the parties whittled away their differences on dollar amounts.

Negotiations with one insurer, Allianz SE of Germany, were particularly thorny, so when Wolinsky got a call from a reinsurer associated with Allianz, asking him to come to Switzerland for a meeting, he readily complied. It was an unusual situation. SCOR, the Paris-based reinsurer, wasn't licensed to do business in New York State, and so had paid Allianz to serve as its proxy in selling insurance to Silverstein in 2001. Allianz's own share was relatively small: It owed Silverstein only about $155 million, of which half had been paid. This put Allianz in the awkward position of negotiating on behalf of an entity with a far greater exposure than its own—SCOR was on the hook for $709 million, and still owed up to $475 million—and contributed to Allianz's reluctance to make a deal. (Allianz was afraid SCOR would sue if it made a deal without that approval, which, in fact, is exactly what happened several months later.)

Wolinsky's meeting in Switzerland proved bizarre. (Wolinsky declined to discuss the meeting, citing a confidentiality agreement. This account comes from sources involved in the negotiations who either heard about what was happening at the time, or learned about it later.) After a red-eye flight, he and Michael Levy, Silverstein's chief financial officer, along with Albert Rosenblatt, a retired New York State Court of Appeals judge appointed to mediate the dispute, met three SCOR executives, including Denis Kessler, the carrier's chief executive, over lunch in a nearly empty dining room at Baur au Lac, a five-star hotel on Lake Zurich. The two sides had a cordial discussion and then, after about an hour and a half, the SCOR executives excused themselves. They said they just needed some time to confer and would be back soon. An hour passed. Then two. It was a beautiful spring day, so Wolinsky, Levy, and Rosenblatt took a walk around the hotel. Wolinsky called and e-mailed the SCOR people. No response. Rosenblatt, described as typically mild-mannered, grew increasingly agitated. He had reserved conference rooms for the day and had come to the meeting expecting to referee a deal. Around midnight, Wolinsky sent a final e-mail. If you don't come back, we're getting on a plane tomorrow morning for New York, he wrote. But the SCOR negotiators had beaten the Wachtell partner to the punch. After leaving the lunch, they went to the airport and flew home to Paris. It was a technique unique in the annals of business history: the pretending-to-go-to-the-next-room-but-really-flying-home-to-France dodge. (Allianz declined to comment, and SCOR didn't respond to a request to comment.)

Wolinsky called to tell Dinallo what had happened. "It was the low point," Dinallo says. But as with the breakdown at the Port Authority a year earlier in the real estate negotiations, the impasse didn't last long. Dinallo's shuttle diplomacy resumed. Wolinsky, accustomed to holding his cards close to his chest, slowly revealed them to the mediators in Dinallo's office.

"Wolinsky is a great strategist," Easton says. "In dealing with the department he had an overall game plan that didn't always dovetail with the superintendent, and I would at times feel frustrated. He had a sense about what numbers were reasonable, but getting him to admit those numbers to us was no small feat."

Finally, Dinallo's office orchestrated a breakthrough: Silverstein agreed to retreat, mostly, from his demand for prejudgment interest. The carriers felt sufficiently assured that insurance money would pay for reconstruction that they agreed to give up litigating the issue of replacement costs. Travelers, which owed up to $187 million, agreed to settle, followed by Swiss Re, which had potential liability of $658 million. (Swiss Re's settlement was particularly important, Easton says, because the carrier had won a favorable district court ruling that said it didn't owe Silverstein a cash value replacement, but that it only had to pay replacement costs as they were incurred.) The other insurers slowly fell into line. The four-week deadline came and went, but Dinallo allowed an extension.

Allianz and the French reinsurer SCOR—they of the Swiss disappearing act—were the last holdouts. The sticking point, Wolinsky says, was Allianz's position on assignability. If Silverstein or the Port Authority were to sell one or more of their properties, would the insurance proceeds also transfer? Could Silverstein bring in an equity partner to share construction costs? Like the other insurers, Allianz wanted assurances that the insurance money would be spent on buildings, that it wouldn't simply go into Larry Silverstein's bank account.

The talks were stuck. It was time to call the governor.

On May 22 Dinallo briefed Eliot Spitzer on the impasse. Spitzer put on his lawyer hat and dived in. "It was fun to push [Dinallo] and make sure that we were right and challenge some of the thinking," Spitzer says. "It's different from negotiating in a more purely political context, which is what being governor is all about." If Dinallo held the stick, Spitzer offered the carrot. He told Allianz that he welcomed its business in New York. He also came up with a partial solution to the assignability deadlock, Wolinsky says. The Port Authority could freely assign insurance money to another party if it wanted to sell or lease the structures it controlled. Silverstein could assign insurance money only from one part of the project to another; if he sold one or two of his buildings, he could use the insurance proceeds only to build the remaining towers. Wolinsky negotiated for the final piece of the deal: Silverstein had no interest in selling, he says, but he might want to bring in an equity partner to help with costs. He argued, and won, the right to transfer insurance dollars to that partner. Allianz, in return, would be the only insurer that would pay its burden in installments.

That evening, Wolinsky called Silverstein as the developer was leaving a concert. "I explained where we were, and Larry said, 'Great, go for it.' " Wolinsky and Levy stayed awake all night working out the details. Wolinsky likes to use an old-fashioned calculator, the kind with the tape spooling out, and as the night progressed, he tallied up the dollar figures. When the Allianz agreement was final, he punched in a final number. The total: $1,999,988,800. They were shooting for an even $2 billion, but came up $12,000 short. "Close enough," Wolinsky says. Everyone at Wachtell who worked on the deal would later get a copy of that tape, enclosed in a Lucite cube.

On May 23 Spitzer called a press conference to announce a deal. The Silverstein team, along with Allianz executives and lawyers from Zelle, Hofmann, Voelbel, Mason & Gette, were put together beforehand in a holding room. "Silverstein and the insurance guys were struggling to make small talk after years of the most hard-fought and sometimes personal disputes," says one of the lawyers in attendance. "It was a very human ending."

LARRY SILVERSTEIN STILL DOESN'T like to stay up past 10 P.M., but for this, a July 24 celebratory dinner to mark the end of nearly six years of litigation and negotiations, he was willing to make another exception. First, though, a photo shoot. He was chauffeured past a gate and guards into the deep pit in Lower Manhattan that since September 11, 2001, has been known as Ground Zero. Now, littered with bulldozers and cranes, and with the skeleton of the Freedom Tower rising out of the ground, it looked more like a construction site than it did sacred ground. Waiting for him, making one last appearance on behalf of their client, were ten Wachtell partners grumping good-naturedly in the way that men do when they are made to stand still for too long. Silverstein hopped out of his car and started working the crowd, shaking hands. He had a big smile on his face—and why not? The brass ring wasn't out of reach after all.

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November 29, 2007

Unlocking Real Estate Value through Corporate Restructurings

Carrefour's announcement that it plans to create a separate publicly-held real estate holding company for 60% of its real estate assets (valued at €20 to €24 billion) underscores the growing trend for retailers and other businesses to restructure in order to unlock the value of their properties. Carrefour, the world's second biggest retailer, will lease the properties back from the real estate holding company and will sell a 20% stake in the real estate company through an initial public offering that is expected to raise about €3 billion. Carrefour's retention of an 80% stake is designed to help ensure that it will retain control over the real estate.

Significant real estate value may be trapped in retailers and other real-estate-intensive companies, unable to be maximized because of tax, accounting or market constraints. For one thing, real estate is often carried by companies at depreciated "book value," which can be well below current market value, especially with assets that have been held for a long time. In addition, ownership of real estate by regular corporations is often less efficient from a tax perspective than ownership by a REIT or other pass-through vehicle that avoids double taxation. And in some cases, trading multiples for REITs and other public real estate companies may exceed the multiples for the operating businesses that own the real estate, so the full value of that real estate is not recognized while it is retained by its corporate owner.

Restructurings like the transaction planned by Carrefour can unlock a part of the trapped value. In addition to raising cash, often an important goal, such restructurings can improve a company's balance sheet and financial performance, and can enhance management's focus on the company's core business. Such restructurings can take many forms, starting with the relatively simple Carrefour structure (also employed by Casino, one of Carrefour's competitors) and running through a series of more exotic alternatives. One approach that has met with success in the U.S. timber industry is conversion of the company into a REIT that drops its active business into a taxable REIT subsidiary. Another approach involves a tax-free spin-off of a corporation that either operates the active businesses or owns the real estate and elects to be taxed as a REIT. And there are a panoply of other strategies that may be employed depending on the particular facts and business goals, such as leveraged partnerships and installment sales.

In most cases, a key factor – in addition to unlocking value – is ensuring that after the restructuring the company retains the right to continue to use the real estate and sufficient control over the properties to properly and confidently operate its business for the long term. Typically, the restructured company will lease the properties back at fair-market rents, but greater control may often be necessary. Carrefour's plan to retain 80% of its newly formed real estate company, in contrast to Casino's retention of only 44% of the real estate company it spun off, was clearly designed to ensure greater long term control. In addition to such cross-ownership structures, other means for retaining control include repurchase options and rights of first refusal or first offer with respect to the properties, as well as interlocking boards and executive teams. Not surprisingly, the greater the ties and controls over the separated real estate company, the greater the likely hit to its value. Determining the right level of control is therefore a delicate balancing act and will depend in part on a careful analysis of the tax consequences of the transaction.

Of course, restructurings to maximize real estate value are not for everyone. In some cases the benefits are illusory or the numbers may show an economic detriment in light of the particular circumstances. In other cases, tax obstacles may be too great (for example, excessive retained earnings and profits may make a REIT conversion too expensive because of the required taxable dividend), the resulting loss of control (however small) may be too risky as a business matter, or the costs or other risks may outweigh any anticipated benefits. Each company and situation must be evaluated based on the specific facts, circumstances and risks involved, with a careful weighing of the strategic significance of long term ownership of properties against the anticipated financial or other benefits.

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August 23, 2006

REITs Are Not Takeover Proof – the Public Storage/Shurgard Case Study

We have been saying for some time, most recently in our memo from last August (copy attached), that REITs are not takeover proof, myth and legend notwithstanding. The closing yesterday of Public Storage's successful takeover of Shurgard makes the case more eloquently – and decisively – and should finally put to rest any lingering misconceptions about whether it is possible to acquire a REIT on an unsolicited basis.

Public Storage had privately approached Shurgard several times to discuss a potential business combination and was repeatedly rebuffed. Most recently, in July 2005, Public Storage proposed a stock-for-stock combination at a significant premium to market prices. Although this proposal was also quickly rejected as inadequate by the Shurgard board, Public Storage did not back down. Public Storage made its proposal public, and pressed its case to the Shurgard shareholders through one-on-one meetings and through press releases and public statements. Ultimately, the resulting shareholder pressure and compelling logic of the combination led the Shurgard board to announce that it was exploring strategic alternatives. In the end, Shurgard's exploration process culminated in a merger with Public Storage, which valued Shurgard at about $5.5 billion. The transaction provided Shurgard shareholders a 39% premium to Shurgard's undisturbed stock price plus the opportunity to benefit from the upside potential of the combined company.

The Public Storage/Shurgard transaction is indicative of larger trends in the REIT market. The extraordinary liquidity in the real estate capital markets, combined with the differential between private and public market values and the low interest rate environment, among other factors, have brought an increase in the frequency and seriousness of unsolicited proposals, hedge fund activity, private equity club deals for large targets, and topping bids after announced deals. The attempts to derail the sale of Town & Country, even though unsuccessful, illustrated that even REITs that are committed to announced transactions are not immune to takeover attempts. REITs are increasingly being subjected to the same dynamics and pressures that exist in the broader market for corporate control.

REIT management and boards of directors are well advised to study the market environment in which they now operate, to engage in advance planning and takeover preparedness reviews in order to be able to respond rapidly and appropriately as circumstances may dictate, and to pay careful attention to deal protection measures in friendly transactions.

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August 18, 2005

REITs Are Not Takeover Proof

A popular misconception is that REITs are by their nature "takeover proof." This is simply not the case. Although REITs have a number of defenses at their disposal, as we have long pointed out there is nothing inherent in the REIT structure that makes REITs any less vulnerable to unsolicited offers than other public companies. As with publicly traded corporations generally, REITs and their boards of directors must be well-briefed on the M&A market, plan carefully for the possibility of an unsolicited takeover approach, and be prepared to respond with flexibility, realism and creativity to the unexpected.

Extrapolation from the very few instances in which REITs have been the subject of unsuccessful takeover bids is not a good predictive tool. The sample is too small and involves a variety of special situations and circumstances. Recent successful REIT takeover defenses hinged not on REIT-specific issues but rather on the opposition of a significant number of shareholders to an inadequate bid, shareholder preference for an alternative transaction, or other unique circumstances. The broader universe of public companies that have experienced unsolicited bids is a better framework for understanding current takeover dynamics. The lesson from that broader universe is that few companies are takeover proof; boards must be prepared for the eventuality of a possible takeover approach, and be realistic and well-advised about the legal and market realities of unsolicited bids.

REITs generally have so-called "ownership limitations" or "excess share" provisions in their charters designed to preserve their tax benefits. If properly implemented, these provisions can and generally do serve as a form of takeover defense. Indeed, some state statutes validate such charter ownership provisions, including for non-tax purposes, and some REITs have specifically disclosed that such provisions may be used for anti-takeover purposes. However, excess share provisions are largely untested as anti-takeover defenses and may be inherently vulnerable because of their grounding in the tax code, or the specific manner in which they are drafted. Indeed, some ownership limitation provisions even *require* a board to exempt an acquiror who so requests unless the board makes a determination that the exemption would jeopardize REIT qualification. The bottom line is that ownership limitation provisions – even when specifically authorized by statute or designed for anti-takeover purposes – are unlikely to be more powerful or robust than other common takeover defenses such as a rights plan, and may often be less so. It would be unwise to assume that such provisions or REIT status more generally will provide immunity from the normal operation of the market for corporate control, particularly in the context of non-coercive, fully financed offers.

When an unsolicited takeover approach is received, directors of REITs and other target corporations have a central role in evaluating any proposed transaction and the alternatives available to the corporation. The role is an active one, however, and not one that can be premised on anything other than a clear-eyed view of the realities today facing public companies – including REITs – in the takeover context. These include importantly the current attitudes of the large institutional shareholders, and the willingness of shareholders to act aggressively with respect to boards of directors, at annual meetings, and between annual meetings. Absent special circumstances, inside ownership or show-stopper defenses, a board which is faced with a *bona* *fide* transaction, proposed by a determined suitor, and desired by shareholders, but which offers no alternative transaction or corporate transformation, will come under intense pressure.

Failure of publicly traded corporations to prepare for a takeover attempt exposes the company and reduces the company's ability to control its own destiny. Boards of both potential targets and acquirors need to assemble a team of trusted advisors, plan in advance for possible takeovers, and be realistic about the legal and market dynamics for widely held REITs.

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May 5, 2006

Hostile Takeovers of REITs

Our article on Hostile Takeovers of REITs, just published in the Wharton Real Estate Review, is attached and may be of interest. The article debunks the myth that REITs are takeover-proof and explains that REITs are in fact no less vulnerable to hostile takeovers than other public companies. Potential target REITs and potential acquirors of REITs are well advised to understand the current realities of the marketplace for corporate control.

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Hostile Takeovers of REITs

Debunking the myth that

REITs are takeover-proof.

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REAL ESTATE investment trusts (REITs) have become mainstream investment vehicles. Together with increased liquidity, greater access to capital markets, and the broader investor base that comes with being public—and higher visibility, S&P 500 membership, and growing acceptance in individual and institutional portfolios—REITs now also feel the full pressures of the public markets, and the sharp demands of shareholders for accountability and, often, change. Like all public companies, publicly traded REITs are ultimately controlled by their shareholders and are subject to all the pressures that play out elsewhere on the corporate landscape, including unsolicited takeovers and proxy fights for control.

But REITs are no more defenseless in the face of hostile advances than other publicly traded companies. The tools and defenses available to directors of all public companies to resist abusive takeover tactics and suboptimal transactions are equally available to REIT trustees and directors. These techniques include shareholder rights plans (also called "poison pills"), and staggered boards of directors, which prevents the entire board of directors being replaced in a single year. In addition, the REIT arsenal may also include further defenses unique to the REIT form, such as "excess share" ownership restrictions and umbrella partnership or "UPREIT" consent rights, which are discussed further below.

With all these tools, however, the bottom-line reality should not be overlooked: REITs are not takeover-proof. On the contrary, while REIT-specific devices may sometimes complicate takeover strategies for a hostile acquirer, REITs are as vulnerable to hostile takeovers as other public companies. Indeed, in some cases they may be more vulnerable than their non-REIT counterparts because of excessive and misguided reliance on REIT-specific, tax-based defenses that—while helpful when properly deployed—are often inadequate as takeover defenses. As shown below, public REITs are subject to the same economic and shareholder pressures that drive the market for corporate control in other sectors, and the notion that REITs are takeover-proof must therefore be rejected as (dangerous) myth. Accordingly, we emphasize the pre-takeover preparations that REIT trustees and directors can (and should) make to ensure their ability to protect the interests of all shareholders in a complex and changing consolidation environment.

THE ERA OF CONSOLIDATION

Public REITs have come of age. The value of assets held by publicly traded U.S. REITs today stands at around $500 billion, up from $125 billion in 1996. The industry's aggregate equity market capitalization exceeds $290 billion and the daily trading volume of public REITs exceeds $1.5 billion. On average, a REIT has gone public in the United States once every 40 days over the past ten years, raising more than $236 billion in initial and secondary offerings. And while REITs in the 1990s were much criticized for their governance, in 2005 the REIT sector earned an Institutional Shareholder Services average score of 65.2, compared to an all-sector average of 51.2.

If the decade 1990-2000 sealed the era of the "corporatization" and securitization of real estate, the driving force behind the current decade has been REIT consolidation. The last ten years have seen more than eighty multi-million-dollar public REIT merger transactions with a total value in the $100 billion range. The trend towards fewer, larger REITs with an ever-increasing share of the institutional quality property market is confirmed by increasing M&A activity in the sector. Over the last decade, the average capitalization of REITs has increased nearly six-fold, from $274 million to $1.5 billion, and the number of REITs with a capitalization of more than $1 billion has grown from ten to eighty-two.

The last two years have seen transactions unprecedented in size for the sector, including General Growth's acquisition of Rouse for more than $12 billion in cash and debt, and ProLogis' $5 billion acquisition of Catellus to create the world's largest network of distribution facilities. From June to November 2005, there was an average of one major REIT transaction per month including: ING Clarion Partners taking Gables Residential private; Camden's acquisition of Summit; Brandywine's deal to buy Prentiss; Public Storage's hostile (and ultimately successful) bid for Shurgard; DRA Advisors LLC's acquisition of CRT Properties; ProLogis' acquisition of Catellus; General Electric's deal to buy Arden and to sell part of the Arden portfolio to Trizec; Morgan Stanley's acquisition of AMLI Residential; and the acquisition by Morgan Stanley and Onex of Town and Country. This consolidation has produced more than a dozen REITs with a market capitalization in excess of $4 billion. The consolidation wave, combined with the costs of Sarbanes-Oxley compliance and other public company burdens, has caused the number of REITs with a market capitalization below $100 million to dwindle from eighty-five to fourteen. But with close to two hundred publicly traded REITs in the NAREIT Index, and one hundred and sixty REITs currently trading on the New York Stock Exchange, the consolidation wave may still be in its infancy.

In addition to consensual transactions, consolidation pressures have resulted in hostile takeover activity in the REIT sector, including the successful bid by Public Storage for Shurgard; Simon/Westfield's failed bid for Taubman in 2003; Sam Zell's Manufactured Home Communities' unsuccessful bid to derail the Chateau-ROC merger, which was defeated as a result of a restructuring of the Chateau-ROC transaction; Apollo's derailment of a transaction between the Santa Anita paired-share REIT and Colony Capital, which resulted in a fourth-party interloper, MediTrust, ultimately outbidding Apollo (which ironically had in the meantime partnered with Colony) and entering into a transaction with Santa Anita; Patriot American's successful bid to derail a transaction between the Bay Meadows-Cal Jockey paired-share REIT and Hudson Bay, which resulted in the Patriot-Bay Meadows merger; Wilshire REIT's hostile bid for Imperial Credit; and Gotham's attempt to oust the First Union board. In addition, the last few years have seen a large number of non-public approaches (in the form of so-called private "bear hug" letters) that continue to simmer under the market's surface.

THE HOSTILE THREAT

Public companies, including publicly traded REITs, thus face constant exposure to hostile takeover attempts. There are two basic weapons in the hostile arsenal—the tender offer and the proxy fight—and they can be deployed separately or in tandem.

In a hostile tender offer, the raider offers to purchase the outstanding shares of the target's stock for a premium to market, with the closing of the offer typically contingent on the tender of a minimum percentage of the target's outstanding stock and/or other conditions. While there are a number of possible responses to a hostile tender offer, the core defense is the shareholder rights plan—colloquially known as a "poison pill," or just "the pill"—that results in the issuance of a large number of new shares to all holders except the raider in the event an acquirer's holdings exceed a pre-set threshold, thereby making the transaction prohibitively dilutive. Significantly, rights plans hold out the threat of drastic and permanent economic loss to the potential acquirer, and thus operate as a powerful deterrent on would-be raiders.

In a proxy contest, the raider nominates a slate of insurgent directors committed to support a change in management, and then seeks sufficiently broad shareholder support to elect its candidates at annual director elections. Bidders whose tender offers are blocked by a poison pill often launch proxy contests, with the promise that their slate of directors will "redeem" the pill—that is, nullify its effect as to the tender offer—in the event they are elected. While there are a number of structural defenses against a potential proxy fight, the core defense is the staggered board; that is, a provision in the corporate charter that directors will be elected in successive annual classes rather than all each year, which provision requires an insurgent to elect slates at two or more successive annual meetings in order to seize control of the company.

These threats are well known, and the basic defenses are battle-tested and highly effective. But the defenses are not impregnable. For example, it is not clear whether and under what circumstances a board facing a hostile bid may be required to redeem a rights plan to allow a bid to proceed. To be sure, Delaware courts have made clear that a board can "just say no" to an unsolicited threat in a variety of circumstances. (See *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1152 (Del. 1989); *Paramount Communications v. QVC Network, Inc.,* 637 A.2d 34, 43 n.13 (Del. 1994).) But it cannot be ruled out that courts would require a board to redeem a pill under certain circumstances, and so simple reliance on a rights plan is not an adequate response to a hostile offer. Moreover, directors may find themselves under considerable pressure to accede to a hostile offer (irrespective of whether the majority of the board faced a reelection fight), and, under any circumstances, an unconditional, fully funded, all-cash premium bid may be very difficult for a board to resist as a practical matter.

Given the constant threat of a hostile bid, there is no substitute for active and engaged board attention to takeover issues. As elaborated below, directors must be aware of the possibility of hostile activity on an ongoing preventive basis. And in the event a bid emerges, directors must be prepared to respond promptly and with discipline in what will, by definition, be a fast-moving and challenging environment.

EXCESS SHARE PROVISIONS

Advance preparation is critical to managing a takeover situation for all public companies. This truism holds equally well for publicly traded REITs, notwithstanding the widespread (but erroneous) belief that REITs enjoy special and inherent takeover defenses. We survey below two REIT-specific issues responsible for the myth of REIT impenetrability: the "excess share provision" found in almost all REITs; and the UPREIT form that is often (and mistakenly) thought to provide talismanic protection against hostile activity. As the analysis below shows, public REITs are as exposed to takeover activity as any other public company, and, accordingly, REIT directors must consider the same proactive prophylactic steps as their non-REIT public company counterparts.

Excess share provisions (sometimes called "ownership limitations") generally restrict the number of shares that any REIT shareholder can own to 9.9 percent (or some lesser percentage) of the shares outstanding. These provisions are included in the articles of incorporation of most REITs and serve the central purpose of ensuring compliance with the so-called "5/50 rule" of the Internal Revenue Code, which prohibits five or fewer individuals from owning in excess of 50 percent of the shares of a REIT during the last half of the REIT's taxable year. Under a standard excess share provision, any shares acquired by a shareholder in excess of the ownership threshold are stripped of excess voting rights or any right to receive dividends until the excess shares are transferred to a holder who can own them without violating the ownership restriction. A purported acquirer who exceeds the percentage cannot vote, receive dividends on, or otherwise enjoy any benefits of ownership of the "excess share." Any such shares are thereafter disposed of by an "excess shares trustee"; when the trustee sells the excess shares, the acquirer receives the price it paid or the sale proceeds, whichever is less. The purported acquirer loses the entire economic benefit, (but not the risk of loss) of share ownership, as well as the ability to vote the shares.

The typical excess share provision grants the REIT's board the discretion to waive (or increase to a stated higher limit) the limitation with respect to particular acquirers, so long as the board, usually after consulting with outside legal counsel, is satisfied that the acquirer is not an individual for purposes of Section 542(a)(2) of the Code—that is, that the acquirer is a corporation, partnership, estate, trust or any other non-"individual" to whom the 5/50 rule's "look-through" provision would apply and the board obtains sufficient assurances that no individual's beneficial ownership of stock through the acquirer will violate the ownership limit. The REIT as a whole is thus protected from the adverse tax consequences that would flow from any violation of the 5/50 rule, but the board retains the power to waive the excess share provision in an appropriate circumstance. Many REITs set the ownership limitation at 9.9 percent, which is the highest threshold that mathematically ensures compliance with the 5/50 rule assuming no substantial ownership blocks in excess of 10 percent already exist. The bar can, however, and when one or more holders own more than 10 percent *must* be set lower in order to achieve the basic purpose of ensuring the tax benefits of REIT status.

If properly drafted and implemented, an excess share provision can and probably will serve as a form of takeover defense. Indeed, some state statutes specifically validate such charter ownership provisions, including for purposes beyond the preservation of tax benefits, and some REITs have specifically disclosed that their excess share provision may be used for anti-takeover purposes. Excess share provisions thus have a role to play as part of a REIT's overall takeover defense strategy.

But the fact that REITs have excess share provisions does not mean that they are immune from hostile attack and have no need for a rights plan and other structural defenses. On the contrary, excess share provisions are largely untested as anti-takeover devices and may be inherently vulnerable because of their grounding in the tax code. While the case law and statutes of Maryland (where most REITs are incorporated) provide some support for the use of an excess share provision to deter a coercive bid, courts have yet to determine whether such provisions may be used to block a transaction that does not threaten a REIT's target status. And it goes without saying that a fast-moving, high-stakes control contest is not the time to find out whether one's core defense is legally secure. The poison pill, on the other hand, has been judicially validated in a variety of contexts in major commercial jurisdictions across the country.

Moreover, excess share provisions typically act simply as a temporary bar to voting and dividend rights until the excess shares are transferred to purchasers who do not exceed the ownership limit, whereas poison pills threaten permanent and punitive dilution to the acquirer. Accordingly, excess share provisions do not have the same deterrent effect as a shareholder rights plan; this lesser risk and punishment has a smaller deterrent effect and, in the right (or wrong) circumstances, may entice a bold acquirer to "blow through" the limit. Another relative weakness in excess share provisions lies in the REIT board's flexibility to waive the excess share provision after it has been violated. Properly drafted rights plans cannot be redeemed after they have been triggered, which increases their deterrent effect and avoids placing the board under intolerable pressure in the heat of a contest for control. Finally, the excess share provision confers no additional protection against the real-world pressure on a board to consider waiving protection in the face of a premium hostile bid, as a board can under certain circumstances dismantle either device—the pill and the ownership limitation—at its discretion, and unsolicited suitors can be expected to attempt to force the board to do so. Ownership limitation provisions, even when specifically authorized by statute or designed for anti-takeover purposes, are thus unlikely to be as powerful as other common takeover defenses such as a rights plan, and in many circumstances may prove far less robust.

Additionally, if an excess share provision is to provide even minimal protection, it must be properly conceived and implemented. In fact, many provisions contain unclear and counterproductive features. Some ownership limitation provisions affirmatively require a board to exempt an acquirer who so requests unless the board makes a determination that the exemption would jeopardize REIT qualification under the tax law. Another common drafting shortcoming is lack of clarity about whether the ownership restrictions operate on a "look-through" or entity-level basis. Entity-level excess share limitations are obviously more effective than "look-through" provisions (which explicitly or, rather more frequently, implicitly appear designed only to guard against violations of the 5/50 rule). A further source of confusion is the drafting practice of cross-referencing REIT charter provisions to the tax code. In many cases, the scope of the cross-reference is ambiguous, and the ambiguity can be exploited by a hostile acquirer seeking to attack the provision in the course of a control contest with the argument that the excess share provision should be understood to reference the 5/50 rule. Such ambiguity can be costly: when Manufactured Home Communities attempted to break up the merger between Chateau and ROC Communities, it argued in court that Chateau's ownership limitation was a pure look-through provision that did not prevent its acquisition of Chateau's stock. Although the case was settled before the court decided it, the ambiguity in Chateau's excess share provision gave Manufactured Home an additional argument that careful drafting might have eliminated.

UPREIT STRUCTURES

In an UPREIT structure, the real estate holdings of the REIT are owned through a partnership in which the real estate's former owners (often called "sponsors") are limited partners and the REIT is the general partner and also holds a limited partnership interest. The UPREIT structure is an effective tax deferral mechanism for REIT sponsors or others who own low-basis real estate that has been contributed to the REIT. While contribution of real estate directly to a REIT in exchange for stock is generally a taxable transaction, contribution of the real estate to a REIT's operating partnership in exchange for limited partner units (called OP Units) is tax-free and defers recognition of the built-in gain. Of course, the deferred gain will be recognized when the sponsors sell or convert their OP Units (including in connection with a cash takeover) and in various other circumstances. OP Units are generally convertible by the unit-holder at any time, into stock of the REIT or cash, at the election of the REIT.

Despite common beliefs to the contrary, the UPREIT form provides no special protection against an unwanted suitor. To be sure, some UPREITS—like some public companies—have founding or sponsoring unit-holders whose economic position is sufficiently large that they have the mathematical or practical ability to block any transaction (including, of course, a change-in-control transaction) that requires a shareholder vote. This was the case in the 2003 contest between Simon Properties and Taubman, where Simon offered what was then an above-market price for Taubman shares that the Taubman board (correctly, as hindsight has confirmed) resisted as inadequate. The Taubman family owned some 30 percent of the REIT's outstanding voting power (and a corresponding economic interest), and the transaction proposed by Simon required 67 percent of the vote. Thus, as a practical matter, the Taubmans exercised an effective veto over the proposed transaction. Such governance structures—in which the voting rights of each of the UPREIT's classes of equity (stock and units) are directly proportional to their relative economic value and are exercised at a single level to elect the REIT's board—are inherently fair and appropriate. There can be no question that the exercise of voting power by a sponsoring, founding or otherwise substantial unit-holder in such circumstances is reasonable. Such unit-holders plainly have an important stake in the affairs of the UPREITs they own, and any notion that the tax deferral such unit-holders enjoy requires their disenfranchisement would have as little basis in logic or fairness as would the suggestion that Bill Gates or Warren Buffett should have no voting rights in Microsoft or Berkshire Hathaway simply because their shares have a low basis.

In other UPREITs, sponsoring unit-holders have taken care to protect their interests by providing contractually for disproportionate voting rights or selective consent rights with respect to certain exceptional transactions. Such arrangements reflect bargained-for economic benefits for the sponsoring unit-holder; they should be respected by courts, and unit-holders should be able to rely upon them as a legal and practical matter.

It is thus true that some UPREITs include large and powerful unit-holders who may have either a sufficiently large economic and voting position in the UPREIT to block any unwanted takeover, or specific contractual consent rights over extraordinary transactions, or both. While this point is true as a matter of historical generality, it would be error to conclude that UPREITs (still less REITs generally) are thereby immunized against hostile activity. Indeed, in the context of a widely held UPREIT (where the sponsor no longer has a blocking economic position or other veto right), the entity will be as vulnerable to hostile attack as any other public company. Moreover, even where an UPREIT sponsor maintains a sufficiently large economic stake to block any unsolicited bid, or retains a contractual veto over extraordinary transactions, the sponsor may be subject to tremendous pressure to consent to a transaction that enjoys wide support among public holders, and particularly so where the economic ownership stake is small, regardless of the contractual entitlements. Thus, the same forces that would bear down on the economically dominant holder in any public company whose interests, economic and otherwise, may not be perfectly congruent with the public at large—think again of Bill Gates and Warren Buffet—are equally at work in the UPREIT context. Put simply, there is no magic in the UPREIT form that wards off unwanted suitors.

TAKEOVER PREPAREDNESS

Although REITs have a number of defenses at their disposal, there is nothing inherent in the REIT structure that makes REITs any less vulnerable to unsolicited offers than other public companies. The key for REITs, as with other companies, is to deploy the tools at hand effectively; there is no substitute for advance preparation to achieve this goal. When an unsolicited takeover approach is received, directors of REITs and other target corporations have a central role in evaluating any proposed transaction and the alternatives available to the corporation. The board must respond actively to any threat, however, and must take account of the realities today facing public companies—including REITs—in the takeover context. These include the current attitudes of the large institutional shareholders and the willingness of shareholders to act aggressively with respect to boards of directors, at and between annual meetings. Absent special circumstances, inside ownership or showstopper defenses, a board facing a bona fide transaction proposed by a determined suitor and desired by shareholders will come under intense pressure from the market.

Like all public companies, REITs should make advance preparations to respond to a hostile bid. The well-prepared REIT will have a team in place to deal with unsolicited initiatives; will have developed clear instructions for directors and employees in the face of a bid; and will undertake a periodic review of structural defenses. In many cases, a structural defense will be possible only if there has been careful advance preparation by the REIT and its legal and financial advisors. The most fundamental structural decision will often be whether to implement a rights plan, which, as elaborated above, provides a potential target with substantial and judicially tested protection from unsolicited bids. These structural issues should be examined with care by REIT directors, in concert with their financial and legal advisors, before any threat of takeover activity emerges.

Excess share provisions should also be considered in a REIT's advance takeover preparedness review. For the reasons set forth above, an excess share provision can never substitute for a shareholder rights plan, but such provisions can serve as a useful defensive supplement. Significantly, excess share provisions can apply at lower ownership levels than rights plans, which rarely have triggers below 10 percent or more of a company's stock, and often have triggers of 15 percent or 20 percent; they can therefore deter accumulations at lower levels. To achieve these supplemental protective benefits, however, an excess share provision should be drafted and implemented with care: it should appear in the articles of incorporation rather than the bylaws, and should be drafted to make crystal clear that the ownership restrictions operate on an entity-level (not look-through) basis. Drafters should take care when employing the common practice of cross-referencing excess share provisions to the tax code, as the scope of such cross-references may prove ambiguous in a subsequent court test.

REIT boards should also take care to publicly disclose the anti-takeover purpose and effect of the excess share provision. Appropriate disclosure to shareholders at time of adoption and periodically thereafter will fortify the argument that the provision has a role to play in the context of a control contest and will help defeat the argument, sure to be advanced by unsolicited suitors, that the excess share provision should be limited to transactions that threaten the REIT's tax status. Finally, excess share provisions should be drafted to clarify that the power to grant exemptions and waivers is discretionary with the board. This drafting precaution will weaken any potential argument that the board is required to grant an exemption in favor of a hostile bidder if its ultimate judgment is that such an exemption would be imprudent. By attending to these precautions in advance, a REIT maximizes the likelihood that its excess share provision will prove useful in the event a hostile bid materializes.

REITs should also consider additional takeover preparedness options under state takeover laws. In the important case of Maryland REITs, for example, the state's control share and fair price statutes and the constituency provisions in the Maryland Unsolicited Takeover Act permit directors confronted with a potential acquisition of control of the corporation to consider the interests of the corporation's shareholders, employees, customers, creditors, suppliers and communities in which the corporation is located or does business. Under the constituency provision, directors may reject an offer because of the effect that the acquisition would have on non-stockholder stakeholders or may accept a lower priced offer that the directors believe is more favorable to all of the company's constituencies. These are potentially powerful tools in a takeover contest, and REITs should therefore consider thoroughly and in advance the various interests and stakeholders that they serve.

An important additional part of takeover preparedness is an advance strategy for monitoring and responding to the first signs of potential bidder activity, including market accumulations by potential raiders and casual, non-public expressions of interest. The appropriate monitoring activity and preparatory steps will vary in every case, and REITs will generally benefit by working with their advisors to develop an anticipatory takeover response plan.

In the event that a hostile bid materializes, directors generally retain the ability to "just say no" that is, to conclude, after careful and fully informed deliberation, that the proposed transaction is not in the best interests of the entity and its shareholders and that the company is simply not for sale. The "just say no" response to a hostile bid was approved in the Time Warner case and reaffirmed in subsequent decisions. It continues to be good strategy and good law. But while the "just say no" defense may be available as a legal matter, it may not always be a practical option as a control contest unfolds in the market. Accordingly, any REIT under a hostile attack should, in addition to relying on structural defenses, consider actions that decrease its attractiveness as a takeover target, including making acquisitions (for example, to create antitrust problems for a hostile bidder or to increase the size of the potential transaction for the bidder); conducting asset sales or spin-offs of assets that may be desirable to the acquirer; initiating share repurchases or self-tenders; liquidating; issuing targeted stock; or effecting a recapitalization. Here again, these options should be preliminarily developed in advance, in cooperation with legal and financial advisors, to ensure their maximum efficacy.

Whatever measures are taken to protect against unwanted bids, careful board process and regular communication between the company's offers and the board is critical. The CEO should be the sole spokesperson for the company on independence, merger and takeover matters. The company's response to any particular approach must be specially structured and a team of officers and outside advisors should confer to decide on a proper response. In all cases, the board must deliberate with care and ultimately act in good faith and on an informed, reasonable basis. There is no one-size-fits-all prescription for complying with a board's open-ended fiduciary obligations in the context of a control contest, but boards may generally consider the following factors in analyzing an offer: the adequacy—or inadequacy—of the bid; the nature and timing of the offer; questions of illegality; duties to unit-holders; the impact on constituents other than shareholders (provided that consideration of such other constituents is permissible under local law); the risk of non-consummation; the qualities of the securities being offered (if bid is not all cash); and the basic shareholder interests at stake. Ultimately, a diligent, well-informed board—one that takes careful account of these considerations and all others that present themselves in the unique circumstances of an actual control contest, in an appropriately deliberate manner and with the advice of experienced counselors—will be credited with due exercise of good judgment in the event its conduct is later challenged.

CONCLUSION

Healthy fundamentals and strong private market valuations of underlying real estate assets mean that the REIT industry remains ripe for takeover activity. In this environment, REIT directors would be well-advised to re-examine strategic plans and review their takeover response preparations. Contrary to the conventional wisdom, excess share ownership limitations are not a silver bullet against unwanted takeover activity and, indeed, are generally less effective than a rights plan because of (among other things) their grounding in the tax laws and their relatively unthreatening punitive effect.

Properly deployed, the takeover preparedness guidelines set forth above will help protect a REIT against abusive takeover tactics, increase the REIT's ability to control its own destiny, and, in appropriate circumstances, allow directors to negotiate the best possible deal for the REIT and all of its shareholders and unitholders. In reviewing and implementing these recommendations, it should be kept in mind that not all of these guidelines are appropriate for every REIT. Takeover defense is an art, not a science. It is essential to adopt and keep current effective defenses in advance of any danger, to be able to adopt new defenses quickly and to be flexible in responding to changing takeover tactics. There is simply no substitute for advance preparation.

The views expressed herein are not necessarily the views of Wachtell, Lipton, Rosen & Katz.

August 18, 2005

REITs Are Not Takeover Proof

A popular misconception is that REITs are by their nature "takeover proof." This is simply not the case. Although REITs have a number of defenses at their disposal, as we have long pointed out there is nothing inherent in the REIT structure that makes REITs any less vulnerable to unsolicited offers than other public companies. As with publicly traded corporations generally, REITs and their board of directors must be well-briefed on the M&A market, plan carefully for the possibility of an unsolicited takeover approach, and be prepared to respond with flexibility, realism and creativity to the unexpected.

Extrapolation from the very few instances in which REITs have been the subject of unsuccessful takeover bids is not a good predictive tool. The sample is too small and involves a variety of special situations and circumstances. Recent successful REIT takeover defenses hinged not on REIT-specific issues but rather on the opposition of a significant number of shareholders to an inadequate bid, shareholder preference for an alternative transaction, or other unique circumstances. The broader universe of public companies that have experienced unsolicited bids is a better framework for understanding current takeover dynamics. The lesson from that broader universe is that few companies are takeover proof; boards must be prepared for the eventuality of a possible takeover approach, and be realistic and well-advised about the legal and market realities of unsolicited bids.

REITs generally have so-called "ownership limitations" or "excess share" provisions in their charters designed to preserve their tax benefits. If properly implemented, these provisions can and generally do serve as a form of takeover defense. Indeed, some state statutes validate such charter ownership provisions, including for non-tax purposes, and some REITs have specifically disclosed that such provisions may be used for anti-takeover purposes. However, excess share provisions are largely untested as anti-takeover defenses and may be inherently vulnerable because of their grounding in the tax code, or the specific manner in which they are drafted. Indeed, some ownership limitation provisions even *require* a board to exempt an acquiror who so requests unless the board makes a determination that the exemption would jeopardize REIT qualification. The bottom line is that ownership limitation provisions – even when specifically authorized by statute or designed for anti-takeover purposes – are unlikely to be more powerful or robust than other common takeover defenses such as a rights plan, and may often be less so. It would be unwise to assume that such provisions or REIT status more generally will provide immunity from the normal operation of the market for corporate control, particularly in the context of non-coercive, fully financed offers.

When an unsolicited takeover approach is received, directors of REITs and other target corporations have a central role in evaluating any proposed transaction and the alternatives available to the corporation. The role is an active one, however, and not one that can be premised on anything other than a clear-eyed view of the realities today facing public companies – including REITs – in the takeover context. These include importantly the current attitudes of the large institutional shareholders, and the willingness of shareholders to act aggressively with respect to boards of directors, at annual meetings, and between annual meetings. Absent special circumstances, inside ownership or show-stopper defenses, a board which is faced with a *bona fide* transaction, proposed by a determined suitor, and desired by shareholders, but which offers no alternative transaction or corporate transformation, will come under intense pressure.

Failure of publicly traded corporations to prepare for a takeover attempt exposes the company and reduces the company's ability to control its own destiny. Boards of both potential targets and acquirors need to assemble a team of trusted advisors, plan in advance for possible takeovers, and be realistic about the legal and market dynamics for widely held REITs.

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June 16, 2005

Post-SOX Issues for REITs Linked to Operating Companies are Overstated

The unsolicited bid for Universal Health Realty Income Trust (UHT) has raised questions about whether a "linked" REIT – created when a company distributes its real estate to a newly formed REIT and then leases the real estate back – is viable in today's post-Sarbanes-Oxley world, particularly if significant control and leverage are retained over the REIT. UHT's critics argue that it charges unfairly low rents to its affiliated tenant, and that the close ties between UHT and its affiliate are anachronistic. The critics may be right or wrong on UHT's particular facts, but there is certainly no need to throw the baby out with the bathwater. Rather, while these criticisms make clear that all such structures need to be carefully considered, documented and disclosed, they do not change the fact that, if properly structured, linked REIT vehicles are perfectly viable in today's environment and may present an attractive option for real estate-intensive companies that are seeking to reduce their real estate exposure.

Over the past decade or so, a number of real estate-intensive operating companies have reduced their real estate exposure by distributing their real estate holdings to a linked REIT. In addition to the familiar benefits of sale-leaseback transactions – tax advantages, streamlining of the balance sheet, capital raising at favorable rates given currently low capitalization rates, ability to focus on core businesses, possibly higher return on equity by taking capital out of real estate – linked REITs enable the operator to retain a level of control over the real estate which is often critical to the success of real estate-intensive companies such as hospital operators, restaurant chains, lodging companies, prison operators, timber companies, retailers and others. Whether such a transaction takes the form of an operating company transferring its real estate to a new REIT and then leasing the properties back or an operating company retaining its real estate, becoming a REIT, and transferring its operating business to a new operating company that leases the real estate from the REIT, various links and cross-controls are generally put in place to tie or "link" the two companies together, so that the operating company will have an acceptable level of control over the properties. Examples of such transactions include Wackenhut Corrections Corporation's formation of the linked Correctional Properties Trust, AMC Entertainment Inc.'s formation of the linked Entertainment Properties Trust, and Host Marriott Corporation's conversion into a REIT after distributing its operating business to the linked Crestline Capital Corporation.

The key to establishing the links between the operating company and the REIT that provide the desired level of control over the REIT and its real estate is careful up-front structuring and disclosure, including "pre-negotiation" of as many potential issues as possible. Careful consideration should be given to tax, governance and operational issues in selecting the appropriate mix of cross-ownership and control, board and officer overlap, ownership limitations and advance takeover preparations, as well as lease terms, including purchase options, extension options, rights of first refusal to purchase or lease and the like. As for conflicts that inevitably arise following the separation despite the best planning, depending on the exact nature of the post-transaction linkages, use of special committees, independent directors or officers and other safeguards to deal with such ongoing issues may be advisable.

Other alternatives are available to companies seeking to reduce their real estate exposure. As we have noted in the past, formation of an UPREIT under a non-REIT operating company, more conventional forms of financing, and sale-leasebacks with unaffiliated triple net REITs can frequently achieve many of the desired goals and should be considered. Whichever course is pursued, careful advance planning is necessary to achieving the desired goals.

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FOCUS ON REITs

CRITICISM OF REITs GOES TOO FAR – SELLING OUT OR MERGING ISN'T ALWAYS BEST FOR SHAREHOLDERS

by Adam O. Emmerich & Robin Panovka

One of the latest fashions in the popular REIT press is to bash indiscriminately the management and directors of REITs that seek to remain independent or explore alter-natives in the face of a potential merger or other strategic transaction. A recent REIT M&A transaction, for example, drew comments from one analyst to the effect that "it is very rare to be associated with a REIT management team that holds its responsibilities to shareholders in such high regard" and, in similar vein, a statement from a different commentator that "doing the right thing for [REIT] shareholders shouldn't be noteworthy, but it is." Similarly, REITs' adoption of shareholder rights plans (so-called "poison pills"), common in the rest of corporate America, has prompted some REIT commentators to argue that the credibility of the REIT industry is being damaged by the adoption of "unnecessary" and "anti-shareholder" measures.

These attacks go too far. They are based on a flawed perception that any resistance to a sale of the company is not in the best interests of shareholders. In reality, the ability to resist and negotiate can often be advantageous to the shareholders, and a sale – even at a seemingly attractive price – can mean a less favorable result for share-holders than pursuing the REIT's long-term strategic objectives.

An analysis of the impact of rights plans is instructive. Rights plans protect against takeover abuses, give companies and their shareholders and boards of directors breathing room in which to make decisions on potential takeovers, and strengthen the ability of the board of directors of a target to fulfill its fiduciary duties. Studies have shown, over and over again, that "poison pills ... are reliably associated with higher takeover premiums for selling shareholders, both unconditionally and conditional on a successful takeover ... Antitakeover measures increase the bargaining position of tar-get firms, but they do not prevent many transactions."[1] As a result, rights plans have become a familiar part of the landscape in corporate America, having been adopted by over 2,300 public companies, including at least 45 percent of the Fortune 500 Companies. But despite the empirical evidence, in the eyes of some popular REIT commentators, rights plans are still too often viewed as tools to entrench management and make REITs takeover proof, at the cost of shareholders.

One of the myths that has contributed to the perception that REITs that adopt rights plans are taking excessive anti-shareholder action is the notion that REITs are "bullet proof" by virtue of their built-in 9.8 percent (or lower) share ownership limitations. REITs, the argument goes, are inherently well-fortified, and the adoption of rights plans on top of their ownership limits makes them far more difficult to take over than non-REIT public companies. The argument is fundamentally flawed – as we have long argued, REITs with rights plans are no more "takeover proof" than other public companies with rights plans. In reality, REITs' share ownership limitations are largely untested as anti-takeover defenses and may be inherently vulnerable because of their grounding in the tax code. Moreover, the consequences of violating a typical share ownership limitation are less draconian than the consequences of violating rights plans and they therefore have a weaker deterrent effect.

Excessive skepticism as to the motives of REIT executives is unfair and can force a "short term" mentality on executives that is ultimately harmful to shareholders and to the REIT industry. Certainly, there are bad apples in the REIT industry, as there are in other industries, but it is a mistake to extrapolate too quickly and to condemn the entire industry for taking actions which are in fact in the interests of shareholders and are entirely consistent with mainstream corporate governance practices outside the REIT area.RE125.**RE125**

NOTES

1. "Poison or placebo? Evidence on the deterrence and wealth effects of modern anti-takeover measures." Robert Comment and G. William Schwert, *Journal of Financial Economics*. Vol.39 (1995), pp.3-43.

ABOUT OUR FEATURED COLUMNISTS

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<u>REIT M&A TRANSACTIONS – PECULIARITIES AND COMPLICATIONS</u>

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During the last decade, real estate investment trusts (REITS) have claimed an ever-increasing share of the U.S. commercial real estate market. Publicly traded REITs' equity market capitalization has grown from $8.7 billion in 1990[1] to roughly $140 billion by the end of 1998,[2] a more than 25-fold increase, with REIT debt rising from $10 billion in 1992 to $400 Trillion in 1998.[3] Yet, REITs still own less than 10% of the commercial real estate in the United States.[4] The REIT revolution is still young, and, despite the recent bear market in REIT stocks and the resulting privatization trend, many expect REITs to claim as much as 30% of the roughly $4 trillion of U.S. commercial real estate within ten to fifteen years.[5] Considering that a REIT market in that range would represent as much as 10% to 15% of all publicly traded equities in the United States,[6] it is easy to understand the interest surrounding REIT growth, particularly on Wall Street. Certainly, the markets for publicly traded real estate equities have recently suffered through a period of relative doldrums, but the underlying trends towards greater transparency and public ownership remain nascent, and promise to continue their long-term growth.

The emergence of REITs and the continuing consolidation of the real estate markets has meant, and will increasingly mean, significant merger and acquisition activity involving publicly traded REITS. While merger and acquisition (M&A) transactions involving public REITs have much in common with M&A transactions involving other public companies, the special tax rules applicable to REITs and other peculiarities tend to complicate REIT transactions, often in unexpected ways. Business and strategic objectives typical of other industries often face friction in the REIT world**,** in both friendly and unsolicited transactions.

After sketching the various forms taken by REITs and REIT-based real estate investment vehicles, we focus on the measures available to REITs to deter unsolicited takeover bids and compare the relative validity and efficacy as takeover defenses of REITs' traditional charter-based ownership restrictions versus shareholder rights plans (poison pills or pills). We then examine the special conflict of interest issues that arise in change of control transactions involving UPREITs (REITs linked with operating partnerships). Next, we outline a number of additional complications that the REIT structure and its special qualification rules may create for

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1 *See* National Association for Real Estate Investment Trusts (NAREIT), Annual Market Capitalization: Equity Market Capitalization Outstanding (last modified Dec. 31, 1999), *available in* http://www.nareit.com/research/marketcap.htm.

2 *See* NAREIT, January 1999 NAREIT Summary Performance Numbers, *available in* http://www.nareit.com/research/sum9901.PDF.

3 *See* Isles of Stability: When Dot.com Mania Dies, Property Stocks Will Gain, Says Legendary Investor, Interview by Jonathan R. Laing with Sam Zell (Dec. 27, 1999) <http:// www.interactive.wsj.com>.

4 *See* NAREIT, 1998 INDUSTRY STATISTICS 5 (1998) (including both equity and mortgage interests) (applicable pages on file with *The Business Lawyer*, University of Maryland School of Law).

5 *See*, *e.g.*, Mark O. Decker, *The Modern Real Estate Investment Trust Industry, in* REAL ESTATE INVESTMENT TRUSTS 3, 7 (Richard T. Garrigan & John F.C. Parsons eds., 1998).

6 Total U.S. equity market capitalization is approximately $12.5 trillion. *See* Greg Steinmetz, *U.S. Firms, Honed in Huge Home Market, Are Poised to Pounce in the New Europe,* WALL ST. J., Jan. 4, 1999, at A5.

friendly M&A transactions. Finally, we consider various REIT tax qualification rules likely to raise issues for prospective acquirers of REIT shares.

I. BACKGROUND

A. REITs

In 1960, the first REIT legislation[7] was passed in order to provide small investors the same tax-advantaged investment opportunities with respect to pooled fund investments in real estate as then existed with respect to pooled fund investments in securities through mutual funds.[8] Like mutual funds, REITs are entitled to a dividends paid deduction and generally are subject to tax only on undistributed income.[9] As a result, investors in REITs are generally subject to only a single level of tax with respect to their investments.

In order to qualify as a REIT, an entity must satisfy detailed organizational and operational rules.[10] As a consequence of the special rules applicable to REITS, acquisitions of REIT shares (whether or not consensual), and placements of significant blocks of REIT stock with a domestic or foreign investor, can raise significant tax and nontax issues. In part to address these issues, REIT charters typically contain various ownership limitations. These limitations, unfortunately, far from simplifying matters, raise their own set of complex issues, which are discussed below.

B. UPREITs

The UPREIT[11] structure is a relatively new variant of the traditional REIT structure. In a typical UPREIT, the REIT holds all of its assets and conducts its business through an operating partnership. Owners of real estate transfer their ownership interests to the operating partnership in exchange for limited partner interests (operating partnership units or OP Units) in the partnership. The sole general partner of the operating partnership is usually a newly organized REIT that, in exchange for the general Partner interest, contributes to the operating partnership cash raised in an initial public offering of its shares. The limited partners have the right to exchange their OP Units for REIT shares, typically on a one unit for one share basis or, at the REIT's option, for cash of equal value. Future acquisitions by the operating partnership generally can also be made on a tax-deferred basis using OP Units as acquisition currency.

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7 *See* Real Estate Investment Trust Act of 1960, Pub. L. 86-779, § 10(a), 74 Stat. 998, 1003 (codified as I.R.C. §§ 856-858 (1994 & Supp. III 1997)).

8 *See* H.R. Rep. No. 86-2020, at 3 (1960); Rev. Rul. 89-130, 1989-2 C.B. 117.

9 *See* I.R.C. § 857(b)(1)(B) (1994). Unless otherwise noted, all references herein to "the Code" are references to the Internal Revenue Code of 1986, as amended, and references to "section" or citations to "I.R.C. §" are references to sections of the Code. References to "Regulation §" or "Reg. §" and citations to "Treas. Reg. §" are to the Treasury Regulations promulgated under the Code.

10 *See id.* § 856 (1994 & Supp. III 1997).

11 The term "UPREIT" is an acronym for "umbrella partnership REIT."

The popularity of the UPREIT form is owed to the ability of the contributing property owners to defer all or most of any gain realized on the contribution of appreciated real estate to the operating partnership.[12] In contrast, contributions by individuals or partnerships directly to the REIT in exchange for stock generally do not to qualify for tax deferral.[13] Of course, upon conversion of OP Units into REIT stock or cash, the deferred gain is realized.

The tax advantages of UPREITs do not come without costs. The UPREIT structure can create complex conflicts of interest between the directors of the REIT and the limited partners, which are often heightened in the context of change of control transactions, primarily because of the differing tax positions of REIT shareholders and the OP Unitholders. Although the precise contours of REIT directors' duties in these conflict situations have not yet been tested, the potential conflicts may be mitigated through various procedural safeguards discussed below.[14]

C. DownREITs

In order to compete effectively with UPREITs in property acquisitions, traditional REITs often mimic the UPREIT structure by creating operating, partnerships that acquire and hold assets separate and apart from the REITs' other assets.[15] Creation of the operating partnerships gives traditional REITs an acquisition currency limited partner interests in the operating partnerships) similar to UPREIT OP Units. REITs that hold assets both at the REIT level and through one or more operating partnerships are commonly referred to as "DownREITs."[16] As is the case with UPREITS, the DownREIT structure can give rise to thorny conflict of interest issues in the context of change of control transactions which, again, are discussed below.[17]

II. THE USE OF SHAREHOLDER RIGHTS PLANS AND SHARE OWNERSHIP LIMITATION PROVISIONS TO DEFEND AGAINST TAKEOVERS

As the number of REITs and the size of their holdings have increased, so too has M&A activity in the REIT market, both solicited activity and so-called "hostile" activity. With many REITs currently trading at discounts to their net asset values and with the current instabil-

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12 *See* I.R.C. § 721. *See generally* John P. Napoli & John E Smith, *Emerging Issues in UPREIT Transactions*, 26 J. REAL EST. TAX'N 87 (1999) (exploring some of the tax and business issues involved in an UPREIT's acquisition of real estate in exchange for OP Units).

13 *See* I.R.C. § 351(a), (e). Acquisitions taking the form of reorganizations within the meaning of § 368(a) are beyond the scope of this paper. See *infra* note 102 for a brief discussion of structural alternatives for REIT mergers and acquisitions.

14 *See infra* notes 100-09 and accompanying text.

15 *See* Glenn L. Carpenter & Gary B. Sabin, *DownREITs: Now Everyone Can Do Tax-Free Exchanges,* REIT REP., Spring 1996, at 9, 9.

16 *See* Glenn L. Carpenter, *DownREIT Strategy*, REIT REP., Spring 1996, at 10, 10.

17 *See infra* notes 100-09 and accompanying text.

ity in the REIT capital markets, unsolicited transactions are expected to increase. Many analysts believe that large scale consolidation, voluntary and involuntary, is inevitable in the REIT and real estate industries.

The most common advance takeover defense utilized by REITs is an ownership limitation coupled with an "excess share provision." The provisions are typically adopted as part of a REIT's articles of incorporation and usually restrict the number of shares that any shareholder can own to 9.8% or some lesser percentage.[18] The ostensible purpose of the provisions is to ensure compliance with the so-called "5/50 rule" of the Code, which prohibits five or fewer individuals from owning in the aggregate in excess of 50% of the value of the shares of a REIT during the last half of the REIT's taxable year.[19] In the case of REITs in which a founding individual owned more than 10% of the stock at the time the excess share provision was adopted, the ownership limit for other shareholders is typically set at a lower percentage, designed to ensure compliance with the 5/50 rule even after taking into account the founder's interest.[20] Under a typical provision, any shares acquired by a shareholder in excess of the 9.8% or lower ownership limit become "excess shares" that are transferred to a trust for the benefit of a charity so that the purported acquiror obtains no voting rights or right to receive dividends on the shares.[21] Importantly, the 5/50 rule operates on a "look-through" basis, so that only individuals[22]—not corporations, partnerships or other entities — are restricted in their ownership.[23] The rule "looks through" entities and focuses instead on the individuals who own them.

The key to the effectiveness of the excess share provisions as a takeover defense is that they typically do not incorporate the "look-through" mechanism of the 5/50 rule. Instead, the provisions are usually worded so as to restrict any entity from acquiring in excess of the stat-

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18 *See* James M. Lowy, *REITS*: *1999 Strategies for Financing and Growth in a Challenging Market,* in REAL ESTATE INVESTMENT TRUSTS, at 87, 103 (PLI Corp. Law & Practice Course Handbook Series No. 1137, 1999).

19 The "5/50 rule" is one of the REIT qualification requirements of' § 856(a) of the Code. *See* I.R.C. § 856(a)(6), (h)(1)(a) (1994 & Supp. III 1997) (excluding from the definition of REIT entities which are closely held pursuant to the stock ownership provisions of I.R.C.

20 *See Lowy, supra* note 18, at 103 ("In some REIT's that are created by converting existing partnerships or corporations which have owners that own significant percentages of the outstanding interests, the ownership limitation for other shareholders may be as low as 2%.").

21 The trustee of the excess shares trust is usually required to sell the excess shares and distribute to the purported acquiror the lesser of the net sale proceeds or the acquiror's cost for the shares. Dividends and any increases in value are paid to the designated charity. Through this mechanism, the purported acquiror receives no economic or voting benefit from its purchase. *See generally* Priv. Ltr. Rul. 96-27-017 (Apr. 5, 1996) (discussing the workings and tax implications of excess shares trusts); Priv. Ltr. Rul. 95-34-022 (May 31, 1995) (same). *See also* PETER M. FASS ET AL., REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 4.02 [6][b], at 4-13 to - 15 (1998) (discussing other issues raised by excess shares trusts).

22 *See infra* note 25 and accompanying text for the meaning of "individuals" for this purpose.

23 The "look-through" mechanism is incorporated into the 5/50 rule through the application of § 544(a)(1) of the Code, which provides that " [s] tock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries." I.R.C. § 544(a)(1) (1994).

ed maximum percentage of shares. Thus, the typical excess share provision would thwart a hostile acquisition of a REIT because the acquiror would be prevented from acquiring more than the maximum stated number of shares, even though, under the tax laws, such an acquisition would not threaten the target's REIT status because of the Code's look-through provisions.[24]

Recognizing "excess share" provisions' broad applicability, the provisions typically grant the REIT's board of directors the discretion to waive the limitation with respect to particular acquirers if the board is satisfied (through an opinion of counsel or a ruling from the Internal Revenue Service (Service), for example) that the acquiror is not an individual for purposes of section 542(a)(2) of the Code[25] (i.e., that the acquiror is a corporation, partnership, estate, trust or any other non-"individual" as to whom the 5/50 rule's look-through would apply) and the board obtains such representations and undertakings from the acquiror as it deems to be reasonably necessary to ascertain that no individual's beneficial ownership of stock through the acquiror will violate the ownership limit.

In light of the excess share provisions' anti-takeover effect, a hostile acquiror would be expected to seek to have the provision set aside or nullified as a condition to its offer. As with rights plans, the key question facing a target's board is whether or at what point the board has a duty to waive the excess share provision in the face of a hostile takeover offer. The law is not well settled on this issue. Although there is Maryland[26] case law to support the use of an excess share provision as a means of deterring a coercive bid,[27] there is little guidance as to the permissibility of using an excess share provision to block an all-cash, non-coercive tender offer, and there is a yet-unanswered question regarding the defensibility of using an excess share provision to block a transaction that does not threaten the target's REIT status.[28] As explained below, much will likely depend on the disclosure made with respect to the excess share provision at the time of adoption.[29] If the excess share provision was submitted to the target's shareholders as a device to protect REIT status and not as an anti-takeover device, then its use when no threat

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24 Indeed, some REITs' ownership restrictions go farther still by applying their ownership limits to "groups" as defined under § 13(d)(3) of the Securities Exchange Act of 1934. *See* 15 U.S.C. § 75m(d)(3) (1994). Section 13(d)(3) of the Act defines a "group" as "two or more persons act[ing] as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer." *Id*.

25 I.R.C. § 542(a)(2).

26 Throughout this Article, we pay special attention to Maryland law, because most REITs are incorporated in Maryland. *See* Jay L. Bernstein, *REIT Merger Issue Online, in* REITS USING FINANCIAL AND LEGAL TECHNIQUES TO CAPITALIZE ON THE EXPLODING MARKET, at 281, 286 (PLI Corp. Law & Practice Course Handbook Series No. 1016, 1997).

27 *See* Realty Acquisition Corp. v. Property Trust of Am., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,245, at 96,083 (D. Md. Oct. 27, 1989). The court applied the business judgment rule to uphold the target's reliance on an excess share provision, largely because the offer being deterred was a coercive tender offer, precisely the sort of offer the excess share provision was designed to deter.

28 For a discussion of recent Maryland statutory developments relating to this issue, see *infra* note 49 and accompanying text.

29 *See infra* note 50 and accompanying text.

is posed to REIT status is likely to trigger vigorous objections. Conversely, the greater the disclosure of the anti-takeover purpose of the provision, the more likely the provision to withstand attack. Needless to say, the untested nature of excess share provisions and the many yet-to-be answered questions they raise is a source of concern when analyzing the reliability of the provisions as takeover shields.

An oft-debated issue in the context of hostile REIT transactions is just how effective REITs' "excess share provisions" are as takeover defenses, and how they compare to rights plans, or "poison pills." The answer in short, as explained more fully below, is that unlike poison pills, excess share ownership limitations are largely untested as takeover defenses and, in any event, are unlikely to prove as effective as pills.[30] Excess share provisions can serve as a useful supplement to, but are not a substitute for, a properly drafted shareholder rights plan.[31]

A. <u>Shareholders Rights Plans and Excess Share Provisions Compared</u>

Properly drafted rights plans are widely recognized as the most effective device yet developed to protect against abusive takeover tactics and inadequate bids. Over 1700 public companies have adopted pills, including half of the Fortune 500 and Business Week 1000 companies, 60% of the S&P 500 companies, and about two-thirds of the Fortune 200 companies.[32] REITS, too, are increasingly including pills in their takeover defense preparations, with some 47 REITs adopting pills in 1998 and 1999.[33]

1. <u>The Advantages of Poison Pills Over Excess Share Provisions</u>

REITs that adopt pills do so with good reason. Pills enjoy a number of advantages over entity-level excess share provisions. First, pills are well understood by most courts and have been battle-tested or statutorily endorsed in most major jurisdictions. In contrast, as discussed below, the judicial authority on the legitimacy of the defensive use of excess share provisions is scant, conflicting, and based upon provisions that differ in a number of signif-

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30 *See infra* notes 32-73 and accompanying text.

31 In 1998 alone, 31 REITs instituted shareholder rights plans. *See* Barbara Martinez, *REIT Interest: Poison Pills Take Precedence at Many Firms*, WALL ST. J., Jan. 27, 1999, at B10. Currently, 60 of the 208 REITs have poison pills in place. Email from Danielle Endreny, NAREIT, to David Kahan, Summer Associate, Wachtell, Lipton, Rosen & Katz (Nov. 10, 1999) [hereinafter Poison Pills List] (on file with *The Business Lawyer*, the University of Maryland School of Law) (attaching a list of REITs with poison pills).

32 *See* Edward Herlihy et al., *Financial Institutions—Mergers and Acquisitions 1996: Another Successful Round of Consolidation and Capital Management, in* FINANCIAL INSTITUTIONS MERGERS & ACQUISITIONS, at 251, 360 (PLI Corp. Law & Practice Course Handbook Series No. B4-7179, 1997); Lee Meyerson, *Breaking Up an Existing Deal—The Art of "Deal-Jumping," in* FINANCIAL INSTITUTIONS MERGERS & ACQUISITIONS, at 639,673 (PLI Corp. Law & Practice Course Handbook Series No. B4-7179, 1996); Martin Lipton, *Poison Pills Update,* M&A LAW., July/Aug. 1997, at 3, 3.

33 *See* Gilbert G. Menna & Michael S. Turner, *PEIT Mergers, Going Private and DeREITing Activities in the Real Estate Securities Industry, in* REITS: 1999 STRATEGIES FOR FINANCING AND GROWTH IN A CHALLENGING MARKET, at 291, 320-231 (PLI Corp. Law & Practice Course Handbook Series No. 1137, 1999) (listing the dates of adoption of all poison pills adopted through May 1999). The Menna and Turner piece in addition to individual research using the Poison Pills List, *supra* note 31, led to the figure of 47 REITs.

icant respects from contemporary provisions.

Second, even if excess share provisions do, in the end, survive judicial scrutiny, the typical excess share provision is still less effective than a pill for a number of reasons. First, unlike pills, excess share provisions do not hold out the clear threat of drastic, permanent economic loss to the acquiror. Excess shares provisions merely serve to deprive the acquiror of the benefits of ownership[34] and may result in an economic loss if the stock price declines before the excess shares are sold. This lesser risk and punishment has a smaller (though admittedly significant) deterrent effect and, in the right (or wrong) circumstances, may not deter the bold acquiror from "blowing through" the limit.[35] A second relative weakness in typical excess share provisions lies in the REIT board's flexibility to waive the excess share provision after it has been violated. Properly drafted pills cannot be redeemed after they have been triggered — which increases their deterrent effect and avoids placing the board under intolerable pressure. Moreover, in light of a board's power to waive applicability of its excess share provision, the provision is unlikely to prove more protective than a pill because, in the final analysis, a court's determination of when a board has a duty to waive applicability of an excess share provision is likely to mirror its determination of when a board has a duty to redeem a pill. As with a pill, the key question will be whether, or at what point, the board has a duty to waive the excess share provision in the face of a hostile takeover offer.[36]

Third, poison pills enjoy an advantage over excess share provisions because they can more easily be implemented on short notice. Because excess share provisions are found in REITs' charters, their implementation and modification requires a shareholder vote.[37] By contrast, a rights plan is implemented by the dividend of the rights to shareholders, a REIT's board can therefore quickly and easily adopt a pill without any requirement of a shareholder vote.[38]

Fourth, pills typically are triggered upon acquisitions at substantially higher acquisition levels (15% to 20%) than are excess share provisions (9.8% or less).[39] Moreover, un-

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[34] *See supra* notes 18-25 and accompanying text.

[35] That is, a would-be acquiror may purchase a quantity of shares in excess of the ownership in hopes of pressuring the REIT's board to waive the provision or of obtaining a favorable judicial decision regarding the provision's enforceability.

[36] Note, however, that in Maryland, recent legislation establishes that a board has no duty to "[a]uthorize the corporation to redeem any rights under, modify, or render inapplicable, a stockholders rights plan." MD. CODE ANN., CORPS. & ASS'NS § 2-405-1(d)(2) (1999).

[37] REIT boards of directors that have tried to adopt bylaws that provide more restrictive share ownership limitations than contained in their charters have been unsuccessful in enforcing the limitations against hostile acquirors. *See infra* notes 59-68 and accompanying text.

[38] In order to qualify as a REIT for federal income tax purposes, the REIT's shares must be transferable. *See* I.R.C. § 856(a)(2) (1994); *see also infra* notes 166-76 and accompanying text (applying the transferability requirement to ownership limits and excess share provisions).

[39] *See* Mark Gerstein, *Legal and Other Planning Issues in Assessing and Effecting Exit Strategies for the Privately-Held Company, in* ADVANCED DOING DEALS: A STRATEGIC APPROACH TO COMPLETING THE TRANSACTION, at 187, 219 (PLI Corp. Law & Practice Course Handbook Series No. 1055, 1998).

like excess share provisions, which declare transfers to or from an acquiror who owns shares in excess of the ownership limit void *ab initio,* pills do not by their terms prohibit the transfer of shares to or from an acquiror who holds shares in excess of the trigger level. For these reasons, pills do not raise issues regarding the transferability of a REIT's shares.[40]

Although not a substitute for a pill, an excess share provision can be useful as a supplement to a pill, serving as one more potentially complex hurdle for hostile acquirers. In addition, because, as noted, excess share provisions often apply at lower ownership levels than pills, they can deter accumulations at lower levels.[41] It is important, therefore, to ensure that a REIT's excess share provision is drafted and adopted in a way that maximizes its defensive potentials.[42]

2. The Uncertainties Surrounding Enforcement of Excess Share Provisions in REIT Charters as Defensive Measures

As discussed above, an effective (for defensive purposes) excess share provision must reach the ownership of stock by entities, even though only share accumulations by individuals actually jeopardize REIT status under the Code.[43] One of the potential difficulties in relying on REITs' typical entity-level ownership limitations as defenses against unsolicited takeover bids turns on a point so fundamental that it is often overlooked: An entity-level ownership restriction cannot do its work if it is not recognized as an entity-level restriction or, put differently, if it is or can be interpreted as a "look-through" provision. The problem is that it is not always apparent on the face of a charter ownership restriction, or even the provision read in conjunction with public U.S. Securities and Exchange Commission (SEC) filings that describe it, whether the restriction operates on an entity level or a pure "look-through" basis.

Ownership limitations are usually drafted in a manner that limits a "Person's" "Beneficial Ownership" of the REIT's shares to a stated percentage. Consider the following typical definition of "Beneficial Ownership," in which "Person" is defined broadly to include individuals, corporations, partnerships, etc.:

> "Beneficial Ownership" shall mean ownership of Stock by a Person who is or would be treated as an owner of such shares of Stock either directly or indirectly pursuant to section 542(a)(2) of the Code, taking into account, for this purpose, constructive ownership determined under section 544 of the Code, as modified by section 856(h)(1)(B) of the Code.

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40 *See infra* notes 167-77 and accompanying text (discussing how limits on transferability of REIT shares can under certain circumstances jeopardize REIT status).

41 *See supra* notes 18-23 and accompanying text.

42 Conversely, a rights plan may indirectly serve to maintain a REIT's compliance with the 5/50 Rule by deterring persons or affiliated or other groups from acquiring shares in amount beyond the plan's trigger level.

43 *See supra* notes 22-24 and accompanying text.

At this point the reader should be prepared to step through the looking glass and join Alice because the above provision can be interpreted as either a look-through limitation or an entity-level limitation.

The interpretive difference centers around the determination of whether "a Person . . . is or would be treated as an owner of Shares . . . under section 542(a)(2) of the Code." As previously discussed in connection with the 5/50 Rule, section 542(a)(2) seeks to determine whether more than 50% of a corporation's stock is held by or for not more than five "individuals."[44] Recall that section 542(a)(2) expands the definition of "individual" to include certain organizations and trusts. One could claim that the above provision is a look-through because of the reference in the definition of "Beneficial Ownership" to "a Person who is or would be treated as an owner . . . pursuant to section 542(a)(2)." As noted earlier, section 542(a)(2) is the look-through rule of the Code that searches for ownership by a "Person" that is treated as an individual.[45]

Alternatively, the reference can be interpreted as creating a hypothetical in which the inquiry is whether the "Person," whether or not an "individual," would be treated as an owner of shares under section 542(a)(2) without regard to any provision in section 542(a)(2) that looks through entities to ascertain the ownership by "individuals." This interpretation appears to be more consistent with the authors' understanding of common practice and with the purposes of the entity-level ownership limitation provisions. Still, the ambiguity remains and potentially could be exploited by a hostile acquiror who seeks to have an ownership limitation set aside or nullified.[46]

Indeed, just such an interpretive issue took center stage in the Chateau/ROC transaction when Manufactured Home Communities, Inc. (MHC) made an offer to acquire all of the common stock of Chateau in an attempt to break up a planned merger between Chateau and ROC.[47] MHC's tender offer was subject to several conditions, including the condition that it be

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44 *See* I.R.C. § 542(a)(2) (1994); *see also supra* note 25 and accompanying text.

45 *See supra* note 25 and accompanying text.

46 The authors faced just this interpretative issue in connection with a REIT that had provided a significant investor with an interpretation of its charter provision that varied from the interpretation given to an earlier investor.

47 For information on the Chateau/ROC transaction, see Complaint, Chateau Properties, Inc. v. Manufactured Home Communities, Inc. (D. Md. 1996) (on file with *The Business Lawyer*, University of Maryland School of Law); Response including Answer, Verified Counterclaims, and Third Party Complaint, Chateau Properties, Inc. v. Manufactured Home Communities, Inc. (D. Md. 1996) (on file with *The Business Lawyer*, University of Maryland School of Law); PR Newswire Association, Inc., *Chateau Properties Announces Second Quarter Results; Funds from Operations Increased 10 Percent on a Per Share/Op Unit Basis*, Aug. 6, 1996, *available in* LEXIS, News Library, Wire Service Stories File; PR Newswire Association, Inc., *MHC Files Suit Against Chateau, Seeks Immediate Hearing*, Sept. 25, 1996, *available* in LEXIS, News Library, Wire Service Stories File; PR Newswire Association, Inc., *MHC Proposes Merger with Chateau*, Aug. 19, 1996, *available in* LEXIS, News Library, Wire Service Stories File; PR Newswire Association, Inc., *MHC Responds to Chateau/ROC Announcement*, Sept. 19, 1996, *available* in LEXIS, News Library, Wire Service Stories File; PR Newswire Association, Inc., *ROC Communities, Inc. (RCI) Announces Board Approval of Amended Merger Agreement with Chateau Properties*, Sept. 18, 1996, *available* in LEXIS, News Library, Wire Service Stories File; Chateau Properties, Inc., Schedule 14D-1 (1996), *available in* <http://www.sec.gov/Archives/edgar/data/912393/0000950124-96-003857.txt>; Chateau

(footnote continued)

satisfied that none of the shares of Chateau that it was to acquire would be "Excess Stock" under Chateau's charter. MHC indicated it would be satisfied that this condition was met if the Chateau board of directors agreed with its interpretation that, because MHC's acquisition would not result in the loss of Chateau's status as a REIT, the Excess Stock provision did not prohibit the acquisition.

Chateau's charter was typical of most REIT charters and provided that no "Person" could "Beneficially Own" common shares in excess of the applicable "Ownership Limit," set at 7% of its common stock. Chateau's charter gave its board of directors discretion to exempt purchases from the ownership limitation under certain circumstances.

In response to MHC's tender offer, Chateau, *inter alia*, sought a declaratory judgment that (i) MHC's purchase of Chateau's common stock would violate the Excess Stock provisions of Chateau's charter, and (ii) Chateau's board was not required to exempt the purchase of its stock pursuant to MHC's tender offer from the ownership limitations contained in its charter. Chateau argued that its ownership limitations would prevent MHC's purchase because MHC was a "Person" and MHC's tender offer for 100% of Chateau's common stock was clearly in excess of the 7% limit contained in its charter.

MHC countered by arguing that Chateau's board was improperly relying on the 7% ownership limitation in its charter. MHC argued that the limitation should be interpreted in accordance with its purpose — to preserve Chateau's status as a REIT. MHC went on to point out that in various public documents Chateau had stated that the ownership restrictions were designed to preserve its status as a REIT. MHC argued that the references to the various Code sections and the public disclosures led to the conclusion that Chateau, in its charter, had adopted a look-through restriction that would not be violated by its purchase in the tender offer because

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(footnote continued)

Properties, Inc., Schedule 14D-9 (1996), *available in* <http://www.sec.gov/Archives/edgar/data/912393/0000950009-96-000428.txt>; Chateau Properties, Inc., Schedule 14D-9A (1996), *available in* <http://www.sec.gov/Archives/edgar/data/912393/0000950009-96-000429.txt>; Chateau Properties, Inc., Form S-4 (1996), *available in* <http://www.sec.gov/Archives/edgar/data/912393/0000912057-96-030148.txt>; Letter from Manufactured Home Communities, Inc. to John A. Boll, Chairman of the Board, Chateau Properties, Inc. (Aug. 16, 1996) (on file with *The Business Lawyer*, University of Maryland School of Law); Press Release, MHC Proposes Merger with Chateau (August 19, 1996) (on file with *The Business Lawyer,* University of Maryland School of Law); ROC Communities, Inc., Notice of Special Meeting of Stockholders and Joint Proxy Statement/Prospectus (1996) (on file with *The Business Lawyer*, University of Maryland School of Law); ROC Communities, Inc., Schedule 13D/A (1996), *available in* <http://www.sec.gov/Archives/edgar/data/906325/0000950009-96-000413.txt>.

MHC did not have any 7% individual shareholders.[48] Unfortunately, the issue was never judicially resolved because the case was settled before a decision was handed down.[49]

Although the Chateau/ROC/MHC contest did not result in any judicial guidance on the interpretation of excess share provisions, it does offer an important lesson for a REIT that wishes to adopt an entity-level excess share provision in part for defensive purposes. In what is a common mistake with respect to excess share provisions, Chateau failed to make adequate public disclosure of the provision's anti-takeover purpose and effect. REITs should take pains not to leave hostile acquirers with an argument that their shareholders never approved use of the provision to defend against acquisitions that do not threaten REIT status. To that end, a REIT that wishes to enforce an entity-level restriction should clearly state in its prospectus or proxy statement that the restriction may have the effect of preventing a change of control, which does not threaten REIT status.[50]

Even well drafted excess share provisions, which are clearly intended to apply to entity-level ownership, are not certain to survive judicial scrutiny. An unsolicited suitor can be expected to seek to have a target REIT's excess share provision set aside, or the target's board ordered to grant a waiver for its transaction, by arguing that all such provisions should be limited to transactions that threaten the target's REIT tax status, relying on the fact that such a concern was the original motivation for excess share provisions and remains the ostensible primary purpose for them.

Judicial guidance analyzing the defensibility of an excess share provision is scant. There are, however, three cases that have dealt with the subject. The most significant case is

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48 Interestingly, Chateau did not argue that MHC's interpretation could render ineffective that provision in its charter designed to insure that it satisfies the 100 shareholder test. Under the tax rules, a REIT must have at least 100 actual shareholders. *See* I.R.C. § 856(a)(5) (1994 & Supp. III 1997). Chateau's charter voided any transfer that, if effective, would result in its stock being "Beneficially Owned" by fewer than 100 Persons. If, as MHC argued, the definition of "Beneficially Owned" called for a look-through analysis to determine ownership by individuals, the acquisition of all of Chateau's stock by a widely held corporation or partnership would violate neither the charter's Ownership Limitation nor the charter's provision that was designed to insure that Chateau has 100 actual shareholders. This latter violation could jeopardize Chateau's tax status.

49 As discussed below, Maryland law now expressly allows a REIT charter to include transferability and ownership restrictions designed to preserve the REIT's tax status or "for any other purpose." MD. CODE ANN., CORPS. & ASS'NS §§ 2-105(a)(11), 8-203(a)(5) (1999); *see infra* note 70 and accompanying text. Even if, however, such other purposes are judicially determined to include defense against unsolicited takeover bids, the interpretive issues discussed in this Article will remain, as will issues concerning the circumstances, if any, in which the REIT's board may be required to waive any such restriction.

50 For an example of such a statement, see Boston Properties, Inc., Form S-11/A, S.E.C. File No. 333-41449 Jan. 23, 1998), *available in* <http://www.sec.gov/Archives/edgar/data/ 1037540/0000927016-98-000180.txt>, which states that the purpose of Boston Properties' ownership limit is to protect the REIT's tax status and "to otherwise protect the Company from the consequences of a concentration of ownership among its stockholders." *Id*. at 103. The prospectus further discloses that the "Ownership Limit may have the effect of precluding acquisition of control of the Company." *Id*. at 104. The "Risk Factors" section of the prospectus notes that the ownership limit so operates even with respect to transactions that "involve a premium price for the Common Stock or otherwise be in the best interests of the Company's stockholders." *Id*. at 6.

Realty Acquisition Corp. v. Property Trust of America,[51] in which a federal district court applying Maryland law upheld Property Trust of America's (PTA) refusal to waive its excess share provision in the face of a hostile partial tender offer by Realty Acquisition Corp. (RAC).[52] RAC had expressly conditioned its partial tender offer on the court's invalidation of PTA's excess share provision, poison pill, and other defenses. RAC argued that the failure of PTA's trustees to exempt RAC from PTA's 9.8% ownership limit was contrary to PTA's declaration of trust (the equivalent of a corporate charter) and, in addition, constituted a breach of the trustees' fiduciary duty.[53] The court rejected RAC's first assertion by pointing out that the declaration of trust *permitted*, but did not require, the trustees to exempt from the ownership limit acquirers who provide evidence and assurances acceptable to the trustees that the REIT status of PTA would not be jeopardized by their stock ownership.[54] The court appeared, however, to ground its decision on the fact that the offer was a partial offer, the type of offer PTA had stated the excess share provision was aimed at deterring in the proxy statement proposing the provision.[55] In rejecting RAC's breach of fiduciary duty argument, the court applied the business judgment rule without any heightened scrutiny to the case,[56] and stated, "[i]n the present case, there is no evidence that [PTA's] trustees acted with 'gross or culpable negligence' in refusing to exempt [RAC] from the ownership limit or that the trustees' conduct was in any way fraudulent."[57]

The two earlier cases that addressed excess share provisions found them to be invalid on the facts of the cases. The holdings are, however, of limited utility for addressing the viability of provisions adopted by shareholders prior to any takeover threat because in both cases, the provision was adopted by the board of directors in response to a takeover threat, and the directors were found to have exceeded their authority. In *Pacific Realty Trust v. APC Investments, Inc.*,[58] the trustees of Pacific Realty Trust (PacTrust) adopted an excess share bylaw provision, without shareholder approval, in an effort to block a partial tender offer by APC Investments, Inc. (APCI). The Oregon Court of Appeals held that the excess share bylaw provision

51 [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,245, at 96,083 (D. Md. Oct. 27, 1989).

52 *See id.* at 96,083.

53 *See id.* at 96,082.

54 *See id.* at 96,082-83.

55 *See id.* at 96,083.

56 The so-called "business judgment rule" is shorthand for the deference courts typically show to boards of directors when action taken by the board is challenged in a judicial proceeding. The rule has a number of well developed and well known exceptions, particularly those crafted in the context of judicial review of decisions taken in the context of transformative transactions such as a sale or merger of the company, or as a response to unsolicited takeover offers. Most of these doctrines have been developed in Delaware; while Maryland has adopted certain statutes which render some of this Delaware case law irrelevant in Maryland, the overall contours of Maryland courts' approach to the entire area remains somewhat unknown in light of those courts' relatively small experience in the area.

57 *Realty Acquisition Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 96,083 (citation omitted).

58 651 P.2d 163 (Or. Ct. App. 1982).

was invalid because its adoption by the trustees without shareholder approval exceeded the authority granted to the trustees by PacTrust's declaration of trust.[59]

Although the *Pacific Realty Trust* holding would appear to be limited to the specific fact pattern in the case, the court's analysis of the breadth of PacTrust's excess share provision, which appears to have been a fairly typical provision,[60] is instructive. Section 6.17 of PacTrust's declaration contained a very general provision that, without specifying a percentage limit on ownership, gave the trustees the power to redeem shares or prevent their transfer if the trustees were of the good-faith opinion that any concentrated ownership of shares threatened PacTrust's qualification as a REIT under section 856 of the Code.[61] In explaining its view that the bylaws' excess share provision was more restrictive than section 6.17 of the declaration, the court pointed out that the excess share provision exceeded what was necessary to protect REIT status and quoted with approval the following example provided by APCI:

> "Assume that the five largest individual shareholders of PacTrust own in the aggregate 30% of the outstanding shares, with A owning 9%, B owning 8%, C owning 6%, D owning 4%, and E owning 3%. A purchases an additional 2% of the outstanding shares. Under section 6.17, the trustees are not empowered to affect [sic] that transfer, because they cannot in good faith conclude that it would disqualify the trust as a REIT. Under the Internal Revenue Code, to maintain REIT status, the five largest individual shareholders cannot own more than 50%; in this example, the resulting 32% that would be owned by the five largest shareholders after A's purchase is clearly less than 50%, and thus, in the words of section 6.17, the purchase would not 'disqualify the Trust as a Real Estate Investment Trust.'
>
> "However, under [the excess share bylaw provision], the trustees would declare null and void the purchase of 1.2% of the 2% of outstanding shares that were the subject of the transaction, since [sic] A could not own more than 9.8% of the outstanding shares, even where there is no threat to REIT status."[62]

Similarly, in *San Francisco Real Estate Investors v. Real Estate Investment Trust of America*,[63] the court concluded that the adoption by the trustees of the Real Estate Investment Trust of America (REITA) of an excess share bylaw provision, which was more restrictive than the general provision of the target's declaration of trust, effectively repealed the declaration's provision without the requisite shareholder approval.[64] The court therefore granted a preliminary injunction against the enforcement of the excess share provision to block the acquiror's takeover

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59 *See id.* at 167.

60 The bylaw restricted ownership to 9.8% on an entity-level basis.

61 *See Pacific Realty Trust*, 651 P.2d at 167; *see also* I.R.C. § 856(a)(5) (1994 & Supp. III 1997) (enumerating the requirements for REIT status).

62 *Pacific Realty Trust*, 651 P.2d at 166 n.4.

63 701 F.2d 1000 (1st Cir. 1983).

64 *See id.* at 1005.

attempt.[65] Interestingly, the court noted that although it had no occasion to address whether the adopted excess share provision was a "manipulative device,"[66] it did have a concern "over the possibility that business enterprises . . . may, by internal bylaws or charter amendments, insulate themselves from takeover efforts."[67]

The excess share provisions adopted by many of the REITs formed in recent years differ in a number of important respects from the PTA, PacTrust and REITA excess share provisions. Unlike the PacTrust and REITA provisions, modern excess share provisions are usually adopted by the shareholders in the articles of incorporation, thus blunting any argument that the adoption of the provision is beyond the scope of the directors' authority. Second, unlike the PTA provisions, modern provisions frequently are not limited to coercive tender offers and would appear to apply to cash tender offers for all outstanding shares. Third, many prospectuses of modern REITs describe the excess share provision as a device that is intended to protect the REIT's status under section 856 of the Code and which may have the *incidental or collateral effect* of deterring takeovers, rather than describing them, as did the PTA proxy statement, as having been *designed* to protect against takeovers.[68] Finally, none of these three cases considered a more restrictive modern provision that imposes ownership limits on "groups," as defined in section 13(d)(3) of the Securities Exchange Act of 1934, as well as persons and individuals.[69] Modern excess share provisions incorporating some or all of these features are likely to be tested in the coming consolidation wave, particularly in instances where the excess share provisions are used to thwart non-coercive cash offers for 100% of the stock of the REIT or transactions, which that do not threaten the REIT status of the target.

Recent legislation in Maryland is aimed at helping REITs that wish to adopt excess share provisions in that it specifically permits the inclusion of transferability restrictions in charters "*for any purpose,* including restrictions designed to permit a corporation to qualify as: (i) [a] real estate investment trust under the Internal Revenue Code," but it is too soon to tell how these issues will be resolved in real cases.[70] Delaware, too, has recently adopted legislation which expands the scope of permissible charter restrictions on ownership.[71]

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65 *See id.* at 1007.

66 *Id.* at 1007.

67 *Id.* at 1007 n.10.

68 See *supra* note 50 for an example of language typical of contemporary disclosure statements.

69 *See* 15 U.S.C. § 78m(d) (1994); *see also supra* note 24.

70 MD. CODE ANN., CORPS. & ASS'NS § 2-105(a)(11)(1999) (emphasis added); *see also id*. § 8-203(a)(5) (allowing same scope of transferability restrictions in the declarations of trust of Maryland REITs organized as trusts). No judicial decision has yet construed § 2-105 or § 8-203.

71 *See* 72 Del. Laws 123 (1999) (to be codified at DEL. CODE ANN. tit. 8, § 202(d)(1)(iii)) (expanding the list of reasons that are "conclusively presumed" to demonstrate that the restriction is "reasonable" to include any provision designed to enable a corporation to maintain its REIT status). New § 202(e) also applies the list of permissible restrictions to those on "ownership," as opposed to merely those on "transfer." It should be noted, however, that the new Delaware language does not provide clear guidance to courts as to whether it is presumptively

(footnote continued)

In sum, the success of the argument that a REIT's excess share provision should not apply to a transaction that does not cause the loss of REIT status will likely depend at least in part on the target REIT's public disclosure with respect to its excess share provision. The acquiror's case will likely be bolstered by disclosure that the excess share provision was adopted merely as a device to protect REIT status.[72] Conversely, if the disclosure also made clear that the provision has an anti-takeover purpose and effect, the acquiror's argument is less likely to be sustained. Although there is support in Maryland for use of an excess share provision to deter a coercive bid,[73] there is little guidance concerning the use of an excess share provision to block an all-cash, non-coercive tender offer, and it is uncertain whether an excess share provision can be used to block a transaction that does not threaten the target's REIT status. By contrast, the courts of most U.S. jurisdictions have approved the use of poison pills as a defensive measure and have developed an established body of case law dealing with poison pills.[74]

B. Tension Between the REIT Rules and the Mechanics of Poison Pills

In the preceding section, the authors discussed why a properly drafted rights plan provides a stronger and more reliable deterrent to unwanted takeover bids than does an excess share provision. At this point, special emphasis should be placed on the qualification "properly drafted" — in certain circumstances, a poison pill may unexpectedly operate in a manner that calls into question the ability to satisfy the REIT qualification rules. To appreciate the issues involved, it will be helpful first to review the precise mechanics of rights plans.

1. Background

As noted earlier, upon the adoption of a rights plan, a corporation distributes, as a dividend, one "Right" for each outstanding share of its common stock. The Rights are initially redeemable for a nominal amount, usually $.01 per Right, and become unredeemable upon the occurrence of certain events. Initially, the Rights are deemed to be part of and cannot trade separately from the stock with respect to which the Rights were issued, nor can they be exercised. The Rights generally expire after ten years.

(footnote continued)

reasonable to draft a provision that, while ostensibly designed to satisfy the statutory goal of REIT qualification, is overinclusive and reaches entities. This lack of guidance illustrates the ambiguities regarding enforcement of excess share provisions.

72 Recognition that a REIT's ownership limitation operates on an entity-level basis is not inconsistent with the argument that it is designed solely to protect REIT status. Because of' the difficulty in monitoring ownership by attribution, a REIT that did not intend to use an excess share provision defensively might still adopt an entity-level ownership limit as the most practicable and cost effective means of insuring compliance with the 5/50 Rule. This argument**,** however, may make it difficult to refuse to grant a waiver in connection with an acquisition that clearly does not jeopardize REIT status.

73 *See* Realty Acquisition Corp. v. Property Trust of Am., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,245, at 96,082-83 (D. Md. Oct. 27, 1989).

74 *See, e.g.,* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1378 (Del. 1995) (noting that the adoption of poison pills is appropriate in certain defensive circumstances); Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049, 1056 (Del. Ch. 1988) (using a detailed test to determine the validity of a poison pill).

The Rights separate from the stock, are physically distributed (Distribution), and become exercisable on the Distribution Date. The Distribution Date is either (i) the date that a person or group of affiliated or associated persons (Acquiror) acquires a target level, say 20% or more, of the issuer's stock, or (ii) ten days after an Acquiror announces its intention to commence or in fact commences a tender offer that would result in such Acquiror's ownership of stock at or above the target level.[75] The initial exercise price for a Right is typically set at three to five times the issuer's current market price. The exercise price does not change until the Rights "flip-in" or "flip-over" as described below.

Rights typically have both "flip-in" and "flip-over" features. The flip-in feature is designed to discourage creeping accumulations of stock.[76] If an Acquiror acquires the target level of stock, the Rights flip-in and each holder of a Right, other than the Acquiror or a person who acquires the Right from an Acquiror, is able to purchase at the exercise price a number of shares of stock of the issuer having a then current market price equal to twice the exercise price.[77]

To protect against squeeze-out mergers, Rights flip-over after a merger or sale of 50% or more of the corporation's assets or earnings power.[78] After a flip-over event, the Rights entitle holders, other than the Acquiror or a person who acquires the Right from an Acquiror, to purchase stock of the Acquiror with a current market value equal to twice the exercise price.[79]

The Service has ruled that the adoption of a Rights Plan is a non-event for federal income tax purposes.[80] The Service did not, however, offer any explanation or analysis to support its ruling that the issuance of Rights "does not constitute the distribution of stock or property by *X* to its shareholders, an exchange of property or stock (either taxable or nontaxable), or any other event giving rise to the realization of gross income by any taxpayer."[81] Revenue Ruling

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75 Issues concerning the consequences of the Rights separation and Distribution are overwhelmingly academic because, despite the popularity of pills and the many waves of takeover activity, Rights have not separated and been Distributed. Given the severe economic consequences to an Acquiror, unsolicited offers are always conditioned on the redemption of the Rights or their neutralization.

76 *See* Edward D. Herlihy & David A. Katz, *Developments in Takeover Tactics and Defense*, *in* CONTESTS FOR CORPORATE CONTROL 1991, at 7, 82-83 (PLI Corp. Law & Practice Course Handbook Series No. 731, 1991) (describing flip-in and flip-over provisions).

77 *See id*.

78 *See id.*

79 For example, in a flip-in or flip-over, if Rights had an exercise price of $160 and the poisoned stock had a market value of $40, the holder could purchase eight shares of stock with an aggregate market value of $320 for $160.

80 *See* Rev. Rul. 90-11, 1990-1 C.B. 10.

81 *Id*. The Committee on Corporations of the New York State Bar Association's Tax Section, in its Report on the Taxation of Shareholder Rights Plans (Rights Plan Report), offered six different tax characterizations for the adoption of a Rights Plan. COMMITTEE ON CORPORATIONS, NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON THE TAXATION OF SHAREHOLDER RIGHTS PLANS (JULY 25, 1988), *reprinted in* TAX NOTES TODAY, Aug. 1, 1988, *available in* Westlaw, 88 TNT 157-22. Of the six, only one would have created immediate tax and, given

(footnote continued)

90-11 expressly stated that it did not address the tax consequences of any redemption of the Rights, or of any transaction involving Rights subsequent to the Rights separating from the stock.[82]

2. Impact of a Distribution of Rights on a REIT's Non-Closely Held Status

Although it is extremely unlikely to occur, a key initial question and planning issue for a REIT adopting a Rights Plan concerns the tax consequences if a Distribution Date occurs and Rights separate from the stock and are distributed.[83] If the separation and Distribution create the potential for adverse tax consequences for the REIT or its shareholders (other than the Acquiror) or both, the technical utility of the Right may be diminished because it may be possible to imagine that a very aggressive Acquiror may not be fully deterred by the presence of a poison pill if its triggering would also poison the REIT by creating adverse consequences for it and its shareholders.

The first issue faced by a REIT if Rights separate concerns the impact of the separation under the 5/50 Rule. If the Rights constitute options under section 544(a)(3),[84] each holder of an exercisable Right would be treated as owning the stock that can be acquired on the exercise of the Right. Because most options are out-of-the-money at the time of grant, the mere fact that a Right may be out of the money when it is distributed, because it has not flipped-in or flipped-over, would not lead to the conclusion that it is not an option or prevent the holder from being treated as a shareholder for purposes of the 5/50 Rule.[85] Although the Rights generally

(footnote continued)

the conclusion in Revenue Ruling 90-11, that taxable characterization can be ruled out as the basis for the ruling. The Rights Plan Report notes:

> The adoption of a Rights Plan could be characterized in at least six different ways, namely, (1**)** a non-event because of the contingencies precedent to separation and flip-in, (2) an addition of a new term to the issuer's stock that does not rise to the level of a deemed exchange of "old" stock for "new" stock, (3) a promise on the part of the issuer to pay, or the declaration of a dividend to be paid, in the future, (4) an addition of a term to the issuer's stock that is treated as an exchange of "old" stock (which does not incorporate the Right) for "new" stock (which does), (5) a distribution of the Rights as an item of property separate from the stock and (6) an exchange of old stock for a package consisting of new stock and separate Rights.

Id.

82 *See* Rev. Rul. 90-11, 1990-1 C.B. 10.

83 The model Rights Plan recommended by the New York law firm of Wachtell, Lipton, Rosen & Katz provides for a ten-day window period after the Distribution Date in which the separated Rights may be redeemed for a nominal price. Not all Rights Plans have such a window period. It is uncertain whether a Distribution for federal income tax purposes occurs when the redemption right lapses, the Rights separate, or both. The model plan also permits the board of directors to defer the Distribution unless the Distribution Date occurred by reason of an actual purchase.

84 I.R.C. § 544(a)(3) (1994).

85 *See* Rev. Rul. 68-601, 1968-2 C.B. 124.

would be viewed as options if the issuer were a regular corporation, the reason why Rights would not be treated as "options" in a particular REIT shareholder's hands is discussed below.

After the Rights flip-in or flip-over, the Rights may not be exercised by any Acquiror or a person who acquires a Right that was at any time owned by an Acquiror. Assuming that the Distribution occurs as a result of an Acquiror owning shares in excess of the target level for the Rights, the actual Distribution of exercisable Rights that occurs upon separation is not pro rata.[86] The non-pro rata distribution of the Rights means that the proportionate ownership of the non-Acquiror shareholders in the REIT will increase (because they will be treated as owning the shares they can acquire by exercising the option) and the proportionate ownership of the Acquiror in the stock of the REIT will decrease (because the Acquiror cannot exercise the option, its ownership will be diluted). The potential impact of such ownership shifts on the 5/50 Rule when Rights are distributed and as a result of future trading must be carefully considered.

Example

> Assume that REIT X has 1000 shares of common stock outstanding and that five individuals each own 9% (90 shares/1000) of those shares (collectively the "9% Shareholders"). As a result of a widely held Acquiror's acquisition of 20% (200 shares/1000) of REIT X, the 9% Shareholders and the other non-Acquiror shareholders each receive exercisable Rights to purchase eight additional shares for each share of REIT X they own. Assuming an actual purchase of 20% of the shares and not just a tender offer, the Rights flip-in and are "in the money." As a result of the flip-in event and the fact that section 544(a)(3) treats option holders as shareholders for purposes of applying the 5/50 Rule, the aggregate beneficial ownership (after giving effect to the options) of REIT's non-Acquiror shareholders increases from 80% to 97.3% with the 9% Shareholders aggregate ownership increasing from 45% to approximately 55% (4050/7400). Indeed, if one assumes that only the 9% shareholders exercise options and count only their shares as outstanding, the aggregate ownership increases to 88%.[87]

Unless (i) REIT X's charter treats some of the shares owned by the 9% Shareholders as "excess shares," (ii) the Rights Plan contains other provisions to prevent the application of the option rule, or (iii) as argued below, the Rights are not viewed to be options in the hands of a holder if it such a view could result in ownership in excess of REIT X's ownership limitation, the cumulative impact of the Rights separation on REIT X could be disqualification.[88]

Consider also the following variation on the facts in the above example. Assume that Acquiror does not purchase 20% or more of REIT shares, but instead launches both a tender

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[86] A Distribution that occurs because of the commencement of a tender offer that, if completed, would result in an Acquiror owning shares in excess of the target level would be made to all shareholders and thus would be pro rata.

[87] This may well be the appropriate method. *See* Treas. Reg. § 1.544-1(b)(4) (as amended in 1964).

[88] Ownership shifts could also cause rent to be disqualified as related tenant income or cause a loss of domestically-controlled REIT status. *See infra* notes 135-66 and accompanying text.

offer and a proxy fight to replace the board of directors with directors who will redeem the Rights. Even if the REIT's board of directors does not act to prevent a Distribution and a Distribution occurs, it would be pro rata because every shareholder would receive Rights (that are out-of-the-money).

If Rights are options and the ownership limitation and excess share provisions of the REIT are triggered,[89] the impact of those conclusions on beneficially owned shares (which include shares under option) of the 9% Shareholders must be considered. Most ownership limitation and excess share provisions have rules that apply when the event causing the ownership limit to be exceeded is a "transfer" of the REIT's shares or some other non-transfer event. Those special provisions could treat as excess the shares that are the subject of the option. When the shares that are the subject of the option are the REIT's unissued shares, the application of that rule is problematic. If the 9% Shareholders are members of the founding family for REIT X, and the effect of REIT X's excess share provisions could be to reduce the number of voting shares owned by those key shareholders, those events would possibly increase Acquiror's chances of prevailing in the proxy contest and hence its takeover bid.[90] Obviously, such excess share treatment is not the goal REIT X is trying to achieve.

In this example, it is extremely doubtful that Rights are "options" in the hands of 9% Shareholders because the REIT's excess share provisions will prevent such shareholders from actually obtaining the optioned shares or any of the economic benefits, such as dividends and capital appreciation, associated with share ownership. The Service has ruled that in order for ownership of the underlying stock to be attributable to the holder of an option, that holder must have the unilateral right to acquire the stock at the holder's election and free from all contingencies.[91] If the REIT's excess share provision is valid, then the exercise of Rights by a 9% shareholder will constitute an attempted transfer in violation of the REIT's charter. Depending on the specifics of the charter provision, the attempted transfer likely will be declared void *ab initio* and the shares will become excess shares that are held in trust for the exclusive benefit of a charity.[92] Because of the REIT's charter provision designed to ensure compliance with the 5/50 rule,[93] a 9% Shareholder does not have a unilateral right to acquire the stock subject to the Rights at such shareholder's election; the acquisition of such shares is subject to the contingency that their transfer would not violate the 5/50 Rule. Because a 9% shareholder would not be able to obtain any shares by virtue of the Rights, such shares should not be attributable to such shareholder for purposes of the 5/50 Rule.

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89 Whether and how the ownership limitations and excess share provisions would apply would depend on the particular provisions.

90 The tax cost to the 9% Shareholders of treating what may be low basis REIT shares as excess must also be considered. In any event, because the board will be charged with interpreting the charter and will therefore consider the charter's purpose, this interpretation is not likely.

91 *See* Rev. Rul. 68-601, 1968-2 C.B. 124; *see also* Rev. Rul. 89-64, 1989-1 C.B. 91; IRS Field Service Advice 199915007 (Apr. 16, 1999), *available in* 1998 FSA LEXIS 29.

92 *See supra* note 21 and accompanying text (describing the workings of an excess shares trust).

93 *See supra* notes 18-23 and accompanying text.

There may be other reasons specific to a REIT's charter which would prevent the Rights from being deemed options. For instance, if the Rights were treated as options and as a result the REIT's charter would cause some shares of a Right holder to be excessed, so that the Right holder's ownership percentage of the REIT could not increase, then the Rights should not be treated as options to acquire additional shares. Second, if the REIT's charter operated in a manner that caused the very shares to be issued by the REIT on exercise of the Right to be excess shares, it is equally doubtful that the Right would be treated as an option in the hands of the 9% Shareholder because such shareholder could never own the shares.[94]

If a REIT has any concern over the workings of its excess share provisions, the Rights Plan could be crafted in a manner that makes Rights non-exercisable in the hands of a shareholder if and to the extent that exercise would (i) result in an individual shareholder being treated as owning more than 9.8% of the REIT determined on the basis applicable to the 5/50 Rule, (ii) otherwise cause REIT disqualification, or (iii) create excess shares. The period of non-exercisability could terminate when the Rights are transferred to a person that could exercise the Rights without creating a more than 9.8% individual shareholder or when exercise would not cause the previously described ownership problems.[95]

3. Impact of a Separation of Rights on the REIT Income Distribution Requirement

A further potential tax complication for a REIT caused by a separation and Distribution of the Rights in conjunction with a flip-in or flip-over concerns the tax characterization of the Distribution. Assuming that a distribution for tax purposes occurs on the Distribution Date,[96] the Distribution would carry with it earnings and profits. Because the Distribution is not pro rata to all shareholders, it might not qualify for the dividends paid deduction.[97] In order to qualify as a REIT, a REIT's annual deduction for dividends paid must equal or exceed 95% (90% starting with taxable years beginning after December 31, 2000) of its real estate trust taxable income (REIT-TI).[98] Because a "dividend" is a distribution out of earnings and profits, it has been sug-

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94 On this point, a private letter ruling on the related issue of "excess OP units" (i.e., operating partnership units in an UPREIT, which, if exchanged by their holder for REIT shares, would result in a violation of the REIT ownership limitations) may be instructive. The Service has ruled that exchangeable OP units generally would be treated as "options" under § 544(a)(3), but excess OP units would not count as such because, under the terms of the REIT charter there considered, the OP units lose their exchange rights when they become excess. *See* Priv. Ltr. Rul. 96-27-017 (Apr. 5, 1996). This ruling could be read to support the more general proposition that an option on a REIT's share will not be treated as an "option" under § 544(a)(3) if the REIT's charter operates to deprive the option holder of the economic and voting benefits of the option. On this reading, if the shares to be issued on exercise of a Right will be excessed, the Right would not be a § 544(a)(3) option. *See* I.R.C. § 544(a)(3) (1994).

95 The fact that a non-exercisable transferable Right provides the holder with some of the economic benefits of share ownership should not cause the Rights to be treated as stock. It is not unusual for options to be transferable.

96 The distribution for federal income tax purposes may occur on termination of the REIT's right to redeem the Rights and not on the date of the Distribution. *See supra* note 83.

97 *See* I.R.C. § 562(c).

98 *See id.* § 857(a)(1)(A)(i). The REIT Modernization Act of 1999, enacted into law on December 17, 1999, as part of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, § 556, starting

(footnote continued)

gested that if the Rights Distribution carries out earnings and profits, but does not qualify for the dividends paid deduction, the REIT may be unable to qualify as a REIT if the Distribution of the Rights carries out so much of its earnings and profits that it cannot distribute 95% (90% starting with taxable years beginning after December 31, 2000) of its REIT-TI as a deductible dividend.[99] Section 857(d)(1), however, appears to resolve the qualification problem, however, by providing that a REIT's current earnings and profits are not reduced by any amount, which is not allowable in computing its taxable income.[100] Accordingly, the Distribution of the Rights (even if viewed as a preferential dividend) would not carry out the REIT's earnings and profits, and the REIT should be able to meet its distribution obligation.

Although the operation of a rights plan may thus have unexpected effects on a REIT's compliance with the qualification rules, these effects can be avoided through careful drafting and coordination of the rights plan with the charter's excess share provisions. Likewise, careful drafting and coordination will also be necessary to ensure that OP Unitholders will not be inadvertently diluted upon the exercise of a pill, through issuance of rights to the OP Unitholders or otherwise.

III. UPREIT AND DOWNREIT COMPLICATIONS IN M&A TRANSACTIONS

Takeovers of UPREITs and DownREITs present a number of unusual issues largely attributable to the complex interrelationships inherent in the REIT/operating partnership structure explained above.[101] In particular, special consideration must be given to the rights and treatment of the OP Unitholders and to the ultimate treatment to be afforded to the operating partnership itself in any change of control transaction. These issues will often be of paramount importance in structuring the transaction[102] because of the significant tax burden that could result to the OP Unitholders from certain transactions. For example, the dissolution of the operating partnership, the repayment of the operating partnership's debt or the sale of the operating partnership's assets could each trigger the very taxes on the limited partners' built-in gain that the

(footnote continued)

with any REIT taxable year beginning after December 31, 2000, reduces a REITs annual distribution requirement from 95% to 90%.

99 *See* Fass ET AL., *supra* note 21, § 5.09[3], at 5-56 to -58.

100 *See* I.R.C. § 857(d)(1).

101 *See supra* notes 11-17 and accompanying text. For an excellent discussion of federal income tax issues and alternatives in reorganizations involving REITs and UPREITS, see generally Marshall E. Eisenberg, *Mergers and Acquisitions in an UPREIT/DownREIT World,* 74 TAXES 993 (1996).

102 There are a number of structural alternatives that can be employed in mergers or acquisitions of UPREITS. For example, two UPREITs could merge through the separate mergers of the two corporate general partners (the REITS) and of the two operating partnerships; a REIT or an UPREIT could acquire or merge with an UPREIT without acquiring or merging with the target UPREIT's operating partnership; or the assets of an UPREIT could be contributed to the acquiror UPREIT's operating partnership in exchange for OP Units in a § 721 transaction. *See* I.R.C. § 721.

UPREIT[103] structure was designed to defer. Because of the sensitivity of these issues, the partnership agreement for the operating partnership may provide the OP Unitholders veto rights over such transactions as well as over change of control transactions. And, of course, the fact that the OP Unitholders are often also significant shareholders, directors, or officers of the REIT will tend to add special emphasis to the OP Unitholders' concerns and thus sharpen conflict of interest issues.

A. Resolving Conflicts of Interests Between REIT Shareholders and Limited Partners: Where does an UPREIT Board's Paramount Fiduciary Duty Lie?

The dilemma raised for an UPREIT's board of directors when the interests of REIT shareholders and limited partners are adverse was brought to light in the attempt, discussed earlier, by Manufactured Home Communities, Inc. to break up the friendly stock merger between ROC and Chateau, an UPREIT.[104] One central issue to the litigation surrounding the Chateau takeover battle was the extent to which directors of a REIT (some of whom are also OP Unitholders) may, or must, take into account the interests of the OP Unitholders in addition to the interests of the REIT stockholders.[105] Put differently, the issue is how a REIT board, some of whose members are also OP Unitholders, should act when a takeover transaction gives rise to a conflict between the interests of the Unitholders and the interests of the shareholders. The board of the REIT obviously owes a duty to the REIT's shareholders, but, at the same time, the REIT, as general partner of the operating partnership, owes a fiduciary duty to the Unitholders.[106] The pivotal questions are which duty the REIT's board should consider paramount and how to reconcile the duties. Although the law provides little guidance on this point, there is good reason to believe the courts will hold that the duty to shareholders is paramount and that, in a case of conflict, the board may only consider the claims of the OP Unitholders in determining the course of action that will ultimately be best for shareholders, including taking into account potential liability of the REIT to the OP Unitholders for breach of duty.

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[103] For the purpose of economy, we will henceforth refer only to UPREITs, but the issues discussed apply equally to DownREITs.

[104] *See supra* notes 47-48 and accompanying text.

[105] *See* Chadwick M. Cornell, Comment, *REITs and UPREITs: Pushing the Corporate Law Envelope*, 145 U. Pa. L. Rev. 1565, 1588-91 (1997) (discussing this and other conflicts raised in the Chateau/ROC/MHC contest).

[106] Different states have adopted different approaches to the question of which constituencies the Board may consider in deciding how to deal with potential acquisitions of the company. While the traditional common-law approach emphasized board loyalty to shareholders, many states have passes "nonshareholder constituency statutes" that allow the Board to consider other groups. See James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97 (1991), for an overview and evaluation of such statutes. Recently enacted Maryland legislation allows REITs to adopt charter provisions that empower the Board to "consider the effect of the potential acquisition of control on: (i) [s]hareholders, employees, suppliers, customers, and creditors of the trust; and (ii) [c]ommunities in which offices or other establishments of the trust are located." MD. CODE ANN., CORPS. & ASS'NS § 8-202(b)(2) (1999).

The oft-quoted *In re USACafes, L.P Litigation*[107] decision held that the directors of a corporate general partner owe the limited partners a direct fiduciary duty.[108] The extent of this duty, however, is unclear. In *USACafes*, the court applied this duty to prevent directors of a corporate general partner from engaging in obvious self-dealing, stating that directors' duty to limited partners is not necessarily coterminous with that owed by the directors to shareholders.[109] Subsequent case law has not provided much guidance on this issue. It is possible, perhaps even likely, therefore, that courts will view the duty directors owe limited partners as limited to avoid overreaching or unfair dealing with the limited partners.

Despite the absence of definitive legal guidelines, some general observations can be made. First, both the limited partnership and the corporation are long-established legal forms that are governed by familiar and well developed bodies of case law. By structuring their enterprise as an UPREIT, the sponsors, in effect, made certain decisions about the legal principles and rights and obligations that would control. Given this choice, a court may well adopt a formalistic approach and hold that directors owe a fiduciary duty only to the shareholders, and that the sole recourse of OP Unitholders (absent self-dealing on the directors' part) is against the REIT as general partner.

The courts will likely recognize that the REIT itself, as general partner of the operating partnership, owes duties to the partnership and is subject to potential liability for its acts as general partner. Thus, if a particular transaction would constitute a breach of duty by the REIT to the OP Unitholders, it is virtually certain that courts would find it appropriate for the directors to consider the impact on shareholders of the risk of ensuing litigation from the OP Unitholders. Directors could reasonably conclude that a transaction otherwise in the best interest of the shareholders should not be entered into in light of the corporation's interest in avoiding the expenses and liability associated with such litigation. In the UPREIT context, one possible basis for a breach of fiduciary duty claim against the REIT by the OP Unitholders could be that the transaction is unfavorable to the OP Unitholders given their tax circumstances. Given the absence of definitive case law, although it may be argued that a general partner is entitled to disregard the individual and likely differing tax circumstances of each of the limited partners, which courts have determined to be the case when dealing with corporations and their shareholders, the threat of such a claim may not necessarily be ruled out as completely lacking a rational basis.

B. <u>Dealing With Potential Internal Board Conflicts Arising From Board Composition in UPREITS and DownREITS</u>

Given that directors will probably not be permitted to take into account the interests of OP Unitholders *as* limited partners, a board of directors must also then address the conflict of board members who themselves are OP Unitholders and who therefore have an interest in the transaction (by hypothesis different from the interest of shareholders). When will it be ap-

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[107] 600 A.2d 43 (Del. Ch. 1991).

[108] *See id.* at 49.

[109] *See id*.

propriate to establish a special committee to determine the appropriate course of action? When must or should the interested directors recuse themselves?

In cases where a majority of directors are also OP Unitholders, the existence of a special committee will blunt, almost certainly fatally, the allegation that the board was improperly tainted by conflict of interest and eliminate the alleged conflict as a basis to apply a standard of review more stringent than the business judgment rule.[110]

If one or more (but less than a majority of) directors hold OP Units, the directors who hold OP Units should, at a minimum, disclose their holdings to the remaining directors if they wish to engage in the decision-making process. Alternatively, they may consider refraining from the decision-making process altogether. The particular facts and circumstances of each transaction will determine whether it is more prudent to avoid any entanglement by OP Unit holding directors in decisions relating to extraordinary transactions. In many cases, such participation may be perfectly appropriate and, indeed, beneficial, particularly if the individuals in question are highly knowledgeable as to the business or plans of the UPREIT. In other circumstances, the board may determine that recusal from all or a portion of the decision-making process is simpler and decreases the likelihood that a court will subject the board to a standard higher than the business judgment rule.

In all cases, the crucial question is whether a court will evaluate directors' conduct under the business judgment rule or find that it falls within the ambit of higher scrutiny.[111] Absent a particularized showing of *actual* conflict of a majority of the board, and assuming that the interest of a minority of the board as OP Unitholders is known to the other directors (as it almost certainly would be), generally the interests of some directors as OP Unitholders should not *per se* remove board action from the ambit of the business judgment rule.[112] Courts will, however, be alert to circumstances in which action is taken or foregone to the benefit of the OP Unitholders and the detriment of the shareholders, and they will be inclined to examine carefully *how* the alleged conflict actually presented the director with incentives to act other than in the interest of the shareholders. The more influential the conflicted directors, the greater the likelihood of enhanced scrutiny.

Directors and other actors in an UPREIT change-of-control transaction should therefore be aware that the judicial approach to UPREIT conflicts of interest remains to be determined and should maintain a high degree of vigilance in any circumstance where the interests of OP Unitholders and shareholders might differ in change of control or other transactions.

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110 *See, e.g.,* Weinberger v. UOP, Inc., 457 A.2d 701, 709 & n.7 (Del. 1983) (citations omitted), *aff'd*, 497 A.2d 792 (Del. 1985).

111 This question, however, should not arise in Maryland, where recent legislation provides that director actions in response to a potential acquisition "may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director." MD. CODE ANN., CORPS. & ASS'NS § 2-405.1(f)(2).

112 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993) (holding that to disqualify a corporate director from the protection of business judgment rule, there must be evidence of disloyalty, and that a showing of self-interest alone is insufficient), *modified*, 3636 A.2d 956 (Del. 1994).

Careful thought should be given in such circumstances to recusal of conflicted directors, to the establishment of a special committee, and to the duties of the various actors.

C. Potential Anti-Takeover Effects of the Operating Partnership Structure

The UPREIT structure may also provide a target with an anti-takeover defense. As noted above, OP Unitholders typically have the right to put their limited partnership units in the operating partnership to the REIT general partner. Generally, the consideration for the limited partner units can be paid in the form of either cash or REIT stock at the REIT's election. Either way, given the often significant limited partner interests of the sponsors, the put rights offer sponsors a possible weapon against uninvited takeover attempts — albeit one that sponsors may be reluctant to exercise because doing so would generally trigger recognition of their built-in gains.[113] However, even when such potential tax consequences deter sponsors from exercising their rights, the uninvited bidder will often be unaware of the degree of the sponsor's reluctance and may therefore remain deterred by the threat of an exercise of the rights.

UPREIT operating partnership agreements sometimes give sponsors additional rights that could be used to thwart or deter a takeover of the REIT, such as the right, as OP Unitholders, to veto certain transactions (e.g., a sale of all or substantially all of the REIT's assets in a taxable transaction or a merger of the REIT with another entity unless the operating partnership is included in such transaction).[114] Such rights are generally limited, however, because of strong market pressures in the context of REIT IPOs to eliminate conflicts of interest between the OP Unitholders and the public shareholders of the REIT, or at least to limit the OP Unitholders' sway over the REIT. In any event, hostile acquirers may challenge the exercise or potential exercise of these limited partner rights, arguing that the OP Unitholder/sponsors have a duty not to veto a transaction which is in the best interest of the shareholders. Again, the level and nature of the public disclosure concerning such rights will likely influence the court's decision.

Given the limitations of relying solely on their special structural characteristics as a defense against coercive offers, UPREITs, like traditional REITs, should give serious consideration to adopting a shareholder rights plan when evaluating their takeover preparedness.

IV. PECULIARITIES IN STRUCTURING AND EXECUTING REIT COMBINATIONS

As noted above, the complexities of the tax and other rules applicable to REITs give rise to a number of unique takeover defenses. These same rules can create dangerous pitfalls for the unwary friendly acquiror or merger partner. Below, we detail some of the more important complications that the tax law introduces into structuring and executing REIT combinations, in addition to those addressed above.

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[113] The exchange of OP Units for stock of the REIT will generally be taxable. *See* I.R.C. §1001.

[114] *See*, *e.g.*, Irvine Apartment Communities, Form 10-K, Exhibit 3.5, § 7.3(E) (filed Mar. 31, 1998) (Second Amended and Restated Agreement of Limited Partnership of Irvine Apartment Communities, L.P., Jan. 20, 1998), *available in* <http://www.sec.gov/edgar/Archives/edgar/data/912084/0000892569-98-000903.txt>.

A. Issues Raised by De-Controlled Subsidiaries

For tax reasons, management companies employed by REITs are typically set up as "de-controlled subsidiaries," meaning that substantially all of the economic interests in the companies are owned by the REIT but, because of the requirements of currently effective section 856(c) of the Code,[115] at least 90% of the voting securities of the companies are held by the REIT's sponsors or management. Occasionally, the management company is owned mostly by the REIT's sponsors and/or an employee stock ownership plan (ESOP) and is not a subsidiary of the REIT. In either case, a REIT acquiror will typically want to ensure that it gains control over the management company and should therefore consider making its offer contingent on the transfer of the voting stock in the target's management subsidiary to the acquiror. Management or sponsor control of the stock of the company managing the target's properties, of course, makes a hostile acquisition more difficult. The recently enacted REIT Modernization Act will likely reduce the complexity created by service-company subsidiaries by liberalizing the rules governing taxable REIT subsidiaries and, effective 2001, allowing REITs in some cases to own up to 100% of taxable subsidiaries that provide services to REIT tenants and others.[116]

B. Friction Between Deal Protections and the REIT Rules

Merger agreements frequently provide that under certain circumstances a party that fails to consummate the merger must pay a breakup fee to the other party. The receipt of the fee is income to the recipient. Accordingly, a REIT that receives such a fee must take it into account in determining whether it satisfies the gross income tests contained in section 856(c).[117] Given the limited 5% basket available to a REIT to generate nonqualifying income, there is a realistic chance that receipt of the fee, if it is nonqualifying income could result in its disqualification. In order to protect its status as a REIT, in the event the fee becomes payable, a REIT typically will include a savings clause in the contract that reduces the amount of the fee that would be paid to it in the year in which it first becomes payable to the maximum amount that it can receive without causing it to be disqualified. Typically, any excess of the fee provided for and the amount that is paid after application of the savings clause gets carried over for a period and is paid in the future.

The key tax questions a REIT is faced with in drafting the provision on the breakup fee concern the length of the carryover and the circumstances that trigger payment of the excess being carried over. The period and circumstances must be fixed in a manner that will not result in the accrual of the excess fee and its inclusion in the REIT's taxable income prior to the occurrence of the circumstances that trigger payment. On the conservative side of the issue, a REIT can condition the payment of the portion of the fee being carried over on the receipt of a

115 I.R.C. § 856 (1994 & Supp. III 1997). Currently, a REIT cannot hold more than 10% of the voting stock of a corporation. *See id.* § 856(c)(4)(B) (Supp. III 1997). As noted in the text, these restrictions will be relaxed for taxable years beginning after December 31, 2000. *See infra* note 116 and accompanying text.

116 The REIT Modernization Act is part of the Ticket to Work and Work Incentives Improvement Act of 1999, enacted into law December 17, 1999, Pub. L. No. 106-170, §§ 542, 543, 546.

117 *See* I.R.C. § 856(c)(2)-(3) (1994 & Supp. III 1997).

ruling from the Service or possibly an opinion of counsel that the resulting income will count as "good" REIT income. This is viewed as so unlikely by many advisors that it amounts to a virtual give-up of the excess. Alternatively, future payment of the excess can be conditioned on the REIT's ability to receive that amount paid without violating the gross income tests for the year of payment.

If the alternative provision is chosen with an extended multiyear carryover period, receipt of at least part of the excess payment is likely. However, that increased likelihood raises questions about the need to accrue the fee. Under the "all events test" of section 451, income is not accrued unless (i) all the events have occurred which fix the right to receive it, and (ii) the amount can be determined with reasonable accuracy.[118] Because the amount of the breakup fee that the REIT will be able to receive in any given carryover year without being disqualified (like the year in which the event potentially giving rise to the payment of the fee) will vary from year to year, the right to receive any fee income is uncertain. As a result, because the REIT has no right to the fee income unless it satisfies a condition precedent (i.e., the receipt will not cause disqualification), the all events test would not be met with respect to the portion of the fee that would be carried over under the alternative provision.[119] This argument can, however, be stretched beyond its breaking point. If, at the time of the initial payment, the multiyear carryover period were extended indefinitely, or until such time as the REIT was able to absorb the entire amount of the fee without violating the gross income test, then a strong argument could be made that the all events test was satisfied and the income would have to be accrued in that taxable year. On balance, a carryover period of three to five years in which to soak up the excess seems like a reasonable compromise, although no direct authority exists.

A REIT may be able to avoid these complications in a proposed merger with another REIT by structuring the payment of the breakup fee in a manner that generates "good" qualifying income rather than "bad" nonqualifying income. Consider a transaction in which the REIT, instead of becoming entitled to a breakup fee in the event the merger is not consummated for certain reasons, acquires of options to acquire stock in the defaulting REIT that become exercisable in the event the merger does not occur for certain reasons. For the purposes of satisfying the gross income test of section 856(c), gain from the sale or disposition of stock in other REITs is considered "good" income.[120] Furthermore, under section 1234, gain attributable to the sale of an option is treated as gain from the sale of the underlying property.[121] Thus, whether the options are exercised and the acquired REIT shares sold at a gain or the options themselves are sold at a gain, the gain to the REIT should be treated like gain on the sale of REIT shares, generating qualified capital gain income. The net effect of compensating the rejected merger partner in options instead of cash may be to convert "bad" nonqualifying income into "good" real estate flavored capital gain.

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118 *See* Treas. Reg. § 1.451-1(a) (as amended in 1999).

119 *See, e.g.*, Worden v. Commissioner, 2 F.3d 359 (10th Cir. 1993); Tech. Adv. Mem. 96-38-002 (June 3, 1996).

120 *See* I.R.C. § 856(c)(3)(D).

121 *See id.* § 1234(a)(1) (1994). Cash settled options are treated in the same manner. *See id.* § 1234(c)(2).

C. Post-Acquisition Pruning

Finally, rules restricting dispositions of REIT assets may interfere with otherwise desirable post-acquisition pruning of acquired assets. The prohibited sales rules provide a strong deterrent to such transactions, imposing a stiff 100% tax on the net income from certain prohibited transactions.[122] These rules, however, apply only to the sale or disposition of section 1221(1) property that is not foreclosure property, namely property held primarily for sale to customers in the ordinary course of a trade or business.[123] In addition, certain transactions will be exempt from this tax if they qualify under the safe harbor provisions of section 857(b)(6)(C).[124]

In order for a sale or disposition to be exempted, three principal requirements must be met. First, the REIT must have held the property for the production of rental income for at least four years.[125] Second, the aggregate expenditures includible in the property's basis made during the four years prior to its sale must be less than 30% of the net sales price.[126] Third, a REIT cannot have made more than seven such sales during a taxable year unless the aggregate bases of all the properties sold is less than 10% of REIT's aggregate bases in its entire portfolio of properties.[127] Thus, although possibilities for post-acquisition tailoring of the acquired assets exist, some flexibility in that regard may be lost due to the prohibited sales rules.

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122 *See id.* § 857(b)(6)(A).

123 *See id.* § 1221(1).

124 *See id.* § 857 (b)(6)(C) (1994 & Supp. III 1997).

125 *See id.* § 857(b)(6)(C)(i) (1994).

126 *See id.* § 857(b)(6)(C)(ii).

127 *See id.* § 857(b)(6)(C)(iii) (1994 & Supp. III 1997). The Service's position on whether § 1031 like-kind exchanges count for this purpose is unclear. *See* Priv. Ltr. Rul. 91-23-042 (Mar. 12, 1991) (expressing no opinion as to tax consequences of transactions under § 1031).

V. ADDITIONAL TAX AND TAX-BASED IMPEDIMENTS TO ACQUISITIONS OF REIT SHARES[128]

The "5/50 rule" and "excess share provisions" discussed above are not the only tax and tax-based impediments to acquisitions of REIT shares. The Code and, frequently, REIT charters, also contain restrictions relating to domestic control status, income from related tenants, and transferability issues separate and apart from the 5/50 rule. Any acquisition of REIT shares or other corporate transaction involving a REIT must take careful account of these limitations because the consequences of a violation can be dire.

A. Charter Restrictions that Protect a REIT from Being Closely Held or Having Fewer than 100 Shareholders

Not only, as described above, will an entity fail to qualify as a REIT for federal income tax purposes if its shares are "closely held" in violation of the 5/50 rule, it will also fail to qualify as a REIT if its shares are owned by fewer than 100 shareholders.[129] We have already discussed how REITs, in order to prevent transactions from causing the loss of REIT status, adopt charter provisions to limit share ownership and how those protective charter provisions create a significant obstacle for a potential acquiror.[130] A person[131] seeking to acquire a significant or controlling block of REIT shares must also consider charter provisions the REIT has adopted to prevent share accumulations that could result in its shares becoming held by fewer than 100 shareholders.[132]

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[128] In order to fully appreciate some of the tax and nontax issues that arise in REIT change of control transactions and in connection with the acquisition of REIT shares by a foreign or domestic investor, it is necessary to keep in mind the tax requirements for qualification as a REIT. A REIT is purely a creature of the tax law and, generally, a corporation, trust, or association may qualify as a REIT if: (i) it is managed by one or more trustees or directors; (ii) its beneficial ownership is evidenced by transferable shares or transferable certificates of beneficial interest; (iii) it would be taxable as a domestic corporation but for its taxation as a REIT; (iv) it is not a financial institution or insurance company; (v) it is owned by at least 100 persons; (vi) it is not "closely held," i.e., no more than 50% of the value of its stock may be owned by five or fewer "individual" shareholders at any time during the last half of its taxable year; (vii) it elects (or continues in effect a pre-existing election) to be taxed as a REIT; and (viii) it satisfies the detailed asset and income tests contained in § 856(c). *See* I.R.C. § 856(a). In addition, in order to be taxed as a REIT, an entity must also meet the distribution requirement contained in § 857 and must not have any undistributed earnings or profits accumulated in years which the entity was not a REIT. *See id.* § 857(a)(2) (Supp. III 1997).

[129] *See id.* § 856(a)(5)-(6) (1994 & Supp. III 1997).

[130] *See supra* notes 18-31 and accompanying text.

[131] As used herein, unless otherwise noted, the term "person" means a person as defined in § 7701(a)(1), which includes "an individual, a trust, estate, partnership, association, company or corporation." I.R.C. § 7701(a)(1) (1994).

[132] Regulation § 1.856-1(d)(2) states that charter or bylaw provisions that permit the directors to refuse to transfer shares if the directors believe in good faith that the transfer would cause the loss of REIT status do not render the REIT's shares nontransferable in violation of Section 856(a)(2). *See* Treas. Reg. § 1856-1(d)(2) (as amended in 1981); *see also* I.R.C. § 856(a)(2) This Regulation has been applied to typical excess share provisions in a number of private letter rulings. *See, e.g.*, Priv. Ltr. Rul. 96-27-017 (Apr. 5, 1996); Priv. Ltr. Rul. 95-52-047

(footnote continued)

In contrast to the "5/50 rule," the 100 shareholder requirement is not a significant impediment to share accumulations primarily for two reasons. First, a REIT need only pass the 100 shareholder test during at least 335 days out of a tax year of twelve months.[133] Second, every shareholder, including a shareholder who owns only a small amount of non-voting stock, counts toward the 100 shareholder minimum.[134] An acquiror of a REIT, therefore, typically has a window period in which it can place a small number of shares with third parties (often employees of the acquiror or charities) and thereby satisfy the 100 shareholder requirement. Thus, careful planning can generally solve problems raised by charter provisions preventing accumulations that would result in the REIT not satisfying the 100 shareholders requirement. It remains important, of course, that the existence of such a charter provision not be overlooked.

B. Charter Restrictions that Preserve a REIT's Status as a "Domestically-Controlled REIT"

Another form of ownership restriction sometimes found in REIT charters prohibits ownership transfers that would cause the REIT to fail to qualify as a "domestically-controlled REIT" within the meaning of section 897(h)(4)(B).[135] "Domestically-controlled" status carries particular significance for non-U.S. shareholders because it exempts gains on sales of such a REIT's shares from the rigors of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[136] A REIT is domestically-controlled if, at all times during the preceding five years, less than 50% of the value of its stock was held "directly or indirectly" by foreign persons.[137]

FIRPTA treats the gain or loss of a non-resident alien or a foreign corporation from the disposition of a "United States real property interest" (USRPI) as effectively connected to a U.S. trade or business,[138] and hence subject to U.S. income tax.[139] In addition, transfer*ees*

(footnote continued)

(Sept. 29, 1995); Priv. Ltr. Rul. 95-34-022 (May. 31, 1995). The issue of whether the use of very expensive ownership limitations can cause a REIT's shares to be considered nontransferable in violation of Section 856(a)(2) is considered *infra* notes 168-77 and accompanying text.

[133] *See* I.R.C. § 856(b).

[134] *See*, *e.g.*, Priv. Ltr. Rul. 83-42-016 (July 13, 1983). The Internal Revenue Service is apparently no longer issuing rulings that a shareholder whose ownership interest in the REIT is nominal counts as a shareholder for the 100 shareholder requirement. The 100 shareholder requirement, nevertheless, is not difficult to satisfy, and there is no support in the Code or the Regulations for ignoring nominal unrestricted share ownership by a bona fide shareholder.

[135] *See* I.R.C. § 897(h)(4)(B).

[136] *See id.* §§ 897, 6039C.

[137] *See id.* § 897(h)(4)(B).

[138] *See id.* § 897(a).

[139] *See id.* §§ 871(b) (imposing U.S. income tax liability on nonresident aliens for effectively connected income), *id.* 882(a) (same for foreign corporations).

who acquire USRPIs from a foreign person are required to collect a FIRPTA withholding tax of up to 10% of the *amount realized* on the sale.[140]

Because USRPIs include interests in corporations 50% of whose assets by fair market value consist of USRPIs (U.S. real property holding corporations or USRPHCs),[141] REIT shares would potentially lie within FIRPTA's scope. The act, however, expressly excepts domestically-controlled REITs from its coverage.[142] Sales of stock of a domestically-controlled REIT by a foreign person are therefore not subject to U.S. income tax or FIRPTA withholding.[143] As a result, foreign investors who seek to invest in U.S. real estate[144] gain important tax advantages by indirectly investing in such real estate through a domestically-controlled REIT. Because of their different focus, charter provisions designed to preserve a REIT's domestically-controlled status can apply and void a share acquisition that does not otherwise exceed the REIT's general ownership limitations.

Given the importance of domestically-controlled status to foreign investors who contemplate making significant investments in a REIT, it is often necessary to determine the percentage of a REIT's stock owned by foreign persons.[145] However, even when the facts are known, this determination may be difficult because issues arise over whether particular shares are or were "held directly or indirectly" by a foreign person.[146] The following example illustrates the problem of indirect holdings:

Example

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[140] *See id.* § 1445(a). Any tax withheld under § 1445(a) is credited against the amount of income tax due from the foreign transferor. *See* Treas. Reg. § 1.1445-1(f)(1) (as amended in 1995).

[141] *See* I.R.C. § 897(c)(1)(A)(ii), (c)(2).

[142] *See id.* § 897(h)(2). There are two other important exceptions. Stock of a REIT that is regularly traded on an established securities market is only treated as a USRPI in the hands of an investor that held more than 5 percent of such class of stock at some time during the preceding 5-year period. *See id.* § 897(c)(3). In addition, since a USRPI does not include an interest solely as a creditor, a so-called mortgage REIT may not be a USRPHC. *generally id.* § 897(c). Accordingly, interests in a mortgage REIT may also escape USRPI status.

[143] *See id.* §§ 897(h)(2), 1445(a); Treas. Reg. § 1.897-1(c)(2)(i) (as amended in 1975), *id.* § 1.1445-2(c)(1) (as amended in 1988).

[144] A not insignificant investment clientele: "Approximately 5 to 10 percent of the common shares of the largest institutionally favored U.S. REITs are held by foreign investors…." John F.C. Parsons, *REITs and Institutional Investors*, in REAL ESTATE INVESTMENT TRUSTS 413, 422 (Richard T. Garrigan & John F.C. Parsons eds., 1998).

[145] Indeed, under certain circumstances a domestic corporation must (upon request from a foreign person owning an interest in it) inform such owner whether the interest constitutes a USRPI. *See* Treas. Reg. § 1.897-2(h) (as amended in 1987).

[146] Section 897(h)(4)(B) refers to shares that are directly and indirectly "held" and not to shares that are directly and indirectly "owned." In this instance the difference does not appear to be substantive. *See* I.R.C. § 897(h)(4)(B).

> Assume that a real estate investment trust organized in Maryland (U.S. REIT) has a charter provision that voids transfers to the extent it would cause the REIT to lose its status as a domestically-controlled REIT. Assume that widely held foreign corporation (FC) directly owns 44% by value of U.S. REIT and that a Delaware corporation (DC) that is wholly owned by foreign individual A (FI-A) has as its sole asset 5% by value of the stock of U.S. REIT. Foreign individual B (FI-B) wishes to acquire 5% by value of the stock of U.S. REIT. Assuming that no other foreign person owns a direct or indirect interest in U.S. REIT, will the acquisition by FI-B cause U.S. REIT to cease being domestically-controlled and will U.S. REIT's charter cause all or part of FI-B purported acquisition of U.S. REIT shares to be void?

The answers depend, of course, on whether FI-A holds "indirectly" the U.S. REIT shares that are directly owned by FI-A's wholly owned corporation. Unfortunately, the Code does not define when stock is held indirectly by a foreign person for purposes of determining whether a REIT is domestically-controlled,[147] and the tax law in general provides no clear answer as to when stock is treated as being held or owned "indirectly."[148] What then is the meaning of stock held indirectly for purposes of section 897(h)?

The Regulations under section 897 simply repeat the Code's definition of domestically-controlled without defining indirect ownership, but adds that: "[f]or purposes of this determination the actual owners of stock, as determined under § 1.857-8, must be taken into account."[149] Regulation section 1.857-8 provides some interpretive help by stating that the actual owner of a REIT's stock is the person who is required to include in gross income in such person's returns the dividends received on the stock.[150] The reference to Regulation section 1.857-8 is highly suggestive that for this purpose the indirect holders are those holders who are the actual owners under Regulation section 1.857-8.

Pursuant to Regulation section 1.857-8, DC in our example is the actual owner of U.S. REIT stock. The conclusion that DC is the actual owner of' the U.S. REIT stock does not necessarily mean that FI-A does not hold indirectly through DC the U.S. REIT stock actually owned by DC. The fact that the Code generally resorts to specific constructive ownership rules to attribute a corporate entity's ownership to its shareholders, however, supports the view that

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147 *See id.* § 897(h). The attribution rules of § 318 are not made applicable to the determination of whether a REIT is domestically-controlled. Unless the attribution rules of § 318 are expressly made applicable, they do not apply. *See id.* 318(a).

148 *See* Monte A. Jackel & Glenn E. Dance, *Indirect Ownership Through A Partnership: What Does It Mean*?, 70 TAX NOTES 91, 95-96 (1996) (discussing rulings in which the Service has found indirect ownership by attribution despite the lack of any expressly applicable constructive ownership provision of the Code).

149 Treas. Reg. § 1.897-1(c)(2)(i) (as amended in 1975).

150 *See id.* § 1.857-8(b) (as amended in 1981).

indirect ownership does not generally look through corporations,[151] though the meaning under general tax rules of the term "indirect," as applied to ownership, is unclear.[152]

While there would seem to be no clear policy reason to treat a foreign person as holding indirectly interests in a REIT owned by a domestic corporation that is fully subject to U.S. taxation, the language of section 897 is not as clear as it could be in this regard. Indeed, the policy behind the decision to treat domestically-controlled REITs differently at all is obscure.[153]

Going back to the example, FI-B should be able to purchase 5% of U.S. REIT stock without causing U.S. REIT to lose its status as a domestically-controlled REIT.[154] Admittedly, one's faith in the conclusion likely has more to do with the lack of any clear policy reason

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151 Professors Bittker and Eustice, in commenting on the terminology on "actual," "direct," and "indirect" ownership in the context of § 318, explain:

> "Actual stock ownership" is referred to in various provisions of §318 as stock owned "directly or indirectly," i.e., stock titled in the name of the owner (direct ownership) or held by an agent (indirect ownership). "Indirect ownership," therefore, does not mean ownership by attribution ... otherwise, reattribution would occur by virtue of this phrase in all cases and not by virtue of §318(a)(5), which provides reattribution in most, but not all, cases.

BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.02[1], at 9-11 & n.40 (6th ed. 1996).

152 *See* Jackel & Dance, *supra* note 148, at 95-96.

153 While it may be possible for direct and indirect foreign holders to cause the REIT to elect or forgo an election under § 857(b)(3)(C) to treat part of a distribution as capital gain, the ability to control the election concerning the character of the distribution is not likely to be of significant benefit to foreign shareholders under FIRPTA. *See* I.R.C. § 857(b)(3)(C) (1994). Section 897(h)(1) treats distributions to a REIT's foreign shareholders as gain recognized by the shareholder on the sale or exchange of a USRPI to the extent the distribution is attributable to the REIT's gain on sales or exchanges of USRPIs, apparently without regard to whether the REIT elects to treat the distribution as capital gain dividend. *See id.* § 897(h)(1). Moreover, as a result of the Taxpayer Relief Act of 1997, a REIT may retain capital gain proceeds but must pay a REIT level tax and pass through a tax credit to its shareholders under the newly enacted § 857(b)(3)(D). *See id.* § 857(b)(3)(D) (Supp. III 1997). Thus, it does not appear that foreign persons can dispose of USRPIs through a non-domestically-controlled REIT without incurring U.S. income tax liability either directly, upon receipt of distributions attributable to gain on dispositions of USRPIs, or indirectly, by way of a REIT-level capital gains tax.

The legislative history of FIRPTA provides little guidance on this question. In what may be a clue, the U.S. House of Representatives reported its concerns that under prior law a foreign investor actually engaged in a U.S. real estate business could avoid U.S. capital gains taxes by selling property on an installment basis so as to receive income in a later year in which the gain would not be effectively connected with a U.S. trade or business, or through like-kind exchanges of U.S. real property for foreign property. *See* H.R. REP. NO. 96-1167, at 509-10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 5526, 5872-73. One might speculate that Congress believed these types of manipulations to be less likely in the case of domestically-controlled REITs. The only House or Senate report that expressly mentions the domestically-control REIT, however, exception does not comment on its rationale. *See* H.R. CONF. REP. NO. 96-1479 (1980), *reprinted in* 1980 U.S.C.C.A.N. 5903.

154 Although the answer should be the same, a "harder" case would involve a 49% foreign owner of a REIT that creates a wholly-owned domestic subsidiary exclusively to hold an additional 2% interest in that REIT.

to find otherwise than with the strength of the textual analysis.[155] Ideally, the Service should clarify the meaning of "indirectly" as used in section 897(h) as well as in other sections, because the concept of indirect ownership permeates the Code and Regulations and lacks any consistent, clearly articulated meaning.[156]

C. Charter Restrictions that Prevent Related Tenant Rent Income

A REIT's charter may also contain provisions that limit an acquiror's ability to acquire the REIT's shares if the acquisition would result in "related tenant rent."[157] As noted above, qualification as a REIT requires ongoing compliance with certain income and assets tests.[158] The applicable income tests require, among other matters, a REIT's income to consist almost entirely of real estate related items of income, such as "rents from real property" as defined in Section 856(d), and other forms of passive income.[159] Not all rental income qualifies as rents from real property. Section 856(d)(2)(B) provides generally that rents from real property do not include any amount received directly or indirectly from certain related tenants — roughly speaking, tenants 10% or more of whose vote or value is actually or constructively owned by the REIT.[160]

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155 Lesser problems with the meaning of direct and indirect ownership arise under § 856(d) in connection with the calculation of "rents from real property." *See* I.R.C. § 856(d) (1994 & Supp. III 1997). The term "rents from real property" does not include amounts received by the REIT from any person if the REIT owns, "directly or indirectly," ten percent or more of the total combined voting power or of the total number of all shares of all classes of such person. *See id.* § 856(d)(2)(B) (1994). For this purpose, the constructive ownership rules of § 318 are expressly made applicable, with certain modifications, to determinations of share ownership. *See id.* § 856(d)(5) (1994 & Supp. III 1997); *see also id* § 318. Although the use of language calling for the use of both constructive ownership and indirect ownership suggests that the terms are not coextensive, the Regulations applicable to § 856(d) strongly suggest otherwise. In that regard, Regulation § 1.856-4(b)(7) provides that for purposes of § 856(d)(2) (relating to rents received from related tenants) and § 856(d)(3) (relating to the determination of whether a person is an independent contractor) "direct or indirect" ownership is determined using the rules of § 318. *See* Treas. Reg. § 1.856-(b)(7) (as amended in 1981). No similar provision is contained in the Regulations under § 897.

156 Section 269 uses the term "indirectly" in a manner similar to that of § 897(h), but § 269 serves a very special purpose. *Compare* I.R.C. § 897(h) (1994) *with id.* § 269. Section 269 generally allows the Service to disallow, *inter alia*, net operating loss carryovers if a person acquires "directly or indirectly" control of a corporation for the purpose of avoiding tax, where control is the ownership of stock possessing at least 50% of the voting power or value of all classes of stock. *See id.* § 269(a). The fact that in § 269(a) the term "indirectly" modifies "acquires," a verb, should not make a substantive difference. In 1980, the Service ruled that the attribution rules of § 318 did not apply to § 269, but indicated, without citation of authority, that a corporation that owned 45% of a holding company indirectly owned 45% of each of the holding company's subsidiaries. *See* Rev. Rul. 80-46, 1980-1 C.B. 62. Based on Rev. Rul. 80-46, the Service, at least for purposes of § 269, views the acquisition of the stock of a parent company as an indirect acquisition of the stock of its direct subsidiaries.

157 *See* I.R.C. § 856(d)(2)(B).

158 *See id.* § 856(c) (1994 & Supp. III 1997).

159 *See id.*

160 A tenant is related to the REIT if the REIT owns, directly or indirectly, either (i) stock of such tenant possessing 10% or more of the total combined voting power of all classes of stock entitled to vote, (ii) 10% or more of the total number of all classes of stock of such tenant, or (iii) if the tenant is not a corporation, an interest of 10%

(footnote continued)

Unwittingly receiving related tenant income is a distinct possibility, for in determining the ownership of stock, assets or net profits of a tenant, the constructive ownership rules of section 318 apply with greatly expanded reach. Section 856(d)(5) replaces section 318's 50% ownership threshold for attribution to and from corporations with a much lower 10% trigger.[161] Moreover, the Regulations under section 856 indicate that related tenant income includes rents received indirectly from subtenants, thus further complicating the task of monitoring compliance with the rule.[162]

While the Code is silent as to whether the necessary ownership must be present at the time the rent is accrued or received, the Regulations provide that rent from real property "does not include any amounts received or accrued, directly or indirectly, from any person in which the real estate investment trust owns, *at any time during the taxable year*, the specified percentage or number of shares of stock (or interest in the assets or net profits) of that person."[163] Read literally, even if the relationship is established on the first day of the twelfth month of a REIT's tax year, the rent received by the REIT during the prior eleven months of the year and before the relationship existed is "bad." This appears to be so even if the related person is no longer a tenant on the date on which REIT acquires the specified interest in that person.[164] Despite the absence of a clear policy rationale for such a literal interpretation, [165] the Regulation's

(footnote continued)

or more in the assets or net profits of such tenant. *See id.* § 856(d)(2)(B) (1994). Because the determination of the amount of stock owned by the REIT takes into account the constructive ownership rules of § 318, the REIT is treated as owning (among other shares) the stock owned by an owner of 10% or more of the REIT's stock. *See id.* § 318(a); *id.* § 856(d)(5) (1994 & Supp. III 1997).

161 *See id.* § 856(d)(5). Because the constructive ownership rules of § 318 are quite different from those of § 544 that apply for purposes of the 5/50 Rule, an acquiror may accumulate the requisite 10% ownership for purposes of the related tenant rules without exceeding a numerically smaller general share ownership limitation that uses § 544 constructive ownership rules. For example, § 544 does not contain constructive ownership rules that attribute stock owned by individuals to entities, but § 318 does have such rules. *Compare id.* § 318(a)(3), *with id.* § 544.

162 *See, e.g.*, Treas. Reg. § 1.856-4(b)(4) (as amended in 1981).

163 *Id.* (emphasis added).

164 For example, suppose A owns a 10% interest in REIT tenant B Corp., but no interest in the REIT from January through November. On November 30, the B Corp.'s lease with the REIT terminates and is not renewed. On December 1, A, still owning 10% of B Corp., acquires a 10% interest in the REIT. Because by attribution the REIT owns the specified percentage of B Corp. in December, a literal reading of the Treas. Reg. § 1.856-4(b)(4) could result in disqualification of all rent received by the REIT from B Corp. for the year, *even though B Corp. is no longer a tenant of the REIT in December.*

165 What policy is the Regulation protecting? The Code may reflect the congressional policy that a REIT can only earn income from defined activities and should not be able to indirectly receive income earned by a 10% owned entity engaged in a business that the REIT could not engage in directly. *See* H.R. REP. NO. 86-2020, at 4 (1960). Alternatively, this rule may be a backstop to the requirement that a REIT be a passive investor and the belief that an ownership of 10% or more of a tenant might make the REIT too active. Similarly, it has been suggested that the asset diversification requirement contained in Section 856(c)(5)(B) that prohibits a REIT from owning 10% or more of the voting securities of any corporation "may reflect a policy that a REIT cannot carry on indirectly through an

(footnote continued)

onerous reporting requirements appear to support it. Regulation § 1.856-4(b)(4) mandates that a REIT that receives "directly or indirectly, any amount of rent from any person in which it owns any proprietary interest" shall file with its return for the taxable year a schedule setting forth the name and address of any such person, the amount of rent received, and the highest percentage interest in the person owned by the REIT at any time during the taxable year.[166] No request is made for the dates on which the person was a tenant of the REIT or the date on which REIT owned its highest percentage interest. The Regulation thus appears to be a case of overly broad drafting. Given that the nature of a REIT's income is a qualification issue on which the REIT would have the burden of proof in a dispute with the Service, the Treasury should reevaluate the related tenant income Regulation with due consideration to the policy to be served and the difficulty of self-monitoring compliance.

D. Transferability Issues

The beneficial ownership of a REIT must be evidenced by transferable shares or transferable certificates of beneficial interest.[167] As noted earlier, a typical excess share provision prohibits transfers of shares that would result in the transferee holding an amount of stock in excess of the ownership limit contained in the REIT's charter and declares any purported such transfer void *ab initio*.[168] Do such restrictions render the REIT's shares non-transferable in violation of the REIT qualification rules? How far can you go in using ownership limitations to protect against unsolicited takeovers and share accumulations?

The Code and Regulations provide no explanation for the transferability requirement. Many REIT advisors believe the requirement that a REIT's shares be transferable is a holdover from the time when REITs had to be organized as unincorporated trusts or associations under local law.[169] Nevertheless, the requirement of transferable shares remains and its parameters have not been fleshed out. Despite the number of private letter rulings dealing with the transferable shares issue,[170] little in the way of "authority" or explanation exists as to what this

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(footnote continued)

affiliate activities in which it could not engage directly." *See* John A. Corry, *Stapled Stock—Time for a New Look*, 36 TAX L. REV. 167, 178-79 (1981).

166 *See* Treas. Reg. § 1.856-4(b)(4).

167 *See* I.R.C. § 856(a)(2) (1994).

168 *See supra* note 40 and accompanying text.

169 Prior to the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, a REIT could not be organized as a corporation.

170 Because transferability of shares is a condition for qualification as a REIT, REITs frequently seek the protection of a private letter ruling with respect to their share ownership limitations and excess share provisions. Accordingly, a large number of repetitive rulings concerning ownership limitations and "excess shares" provisions have been issued. *See, e.g.*, Priv. Ltr. Rul. 95-52-047 (Sept. 29, 1995) (holding that "[t]he Ownership Restrictions will not cause Company to fail to satisfy the requirement imposed by section 856(a)(2) of the Code that beneficial ownership of a REIT must be evidenced by transferable shares"); Priv. Ltr. Rul. 92-05-030 (Nov. 5, 1991). Priv. Ltr. Rul. 92-05-030 held that

(footnote continued)

requirement means. Because the transferable shares requirement is a REIT qualification issue, REITs are justifiably cautious.

Treasury regulations and private rulings do at least confirm that transfer and ownership restrictions designed to protect REIT status do not cause the shares to be nontransferable in violation of section 856(a)(2).[171] Although the Service has ruled that certain restrictions on transferability that are not necessary to preserve REIT status do not cause a REIT's shares to be nontransferable, such rulings do not explain the reason for the rule, the policy behind it, or contain any standard that can be applied to determine when shares are not transferable.[172]

For instance, in private letter rulings on restricted stock plans, the Service has distinguished between transfer restrictions that apply to shares issued to employees as compensation and those that apply to shares issued to investors.[173] In those rulings, the Service has indicated that the requirement that REIT shares be transferable was intended to inure to the benefit of small investors.[174] Reasoning that the restrictions on the small percentage of stock issued to employees will not affect the ability of investors to transfer the REIT's shares on the stock ex-

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(footnote continued)

> [i]f (1) any person attempts to acquire shares in contravention of the restrictions contained in the Articles, (2) those restrictions are set aside by a final court order, and, (3) the Company meets the stock ownership requirement of section 542(a)(2), then the transfer will be considered effective, and the Company will be closely held within the meaning of 856(a)(6).

In order to receive such rulings, REITs have been representing to the Service that the charter provisions concerning ownership limits and excess shares are enforceable under applicable state law and that the REIT will enforce the restrictions. While not entirely free from doubt, excess share provisions that limit only individual ownership to that necessary to protect REIT status are generally believed to be enforceable as a matter of corporate law. Charter provisions that impose transfer restrictions beyond those necessary to protect REIT status, however, have not been fully tested in the courts, though there may be some legislative authority for their enforcement under Maryland law. *See supra* note 70 and accompanying text.

171 Regulation § 1.856-1(d)(2) provides:

> Provisions in the trust instrument or corporate charter or by laws which permit the trustee or directors to redeem shares or to refuse to transfer shares in any case where the trustee or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a real estate investment trust will not render the shares "nontransferable."

Treas. Reg. § 1.856-1(d)(2) (as amended in 1981); *see also* Priv. Ltr. Rul. 96-27-017 (Apr. 5, 1996) (applying the Regulation); Priv. Ltr. Rul. 95-52-047 (Sept. 29, 1995) (same); Priv. Ltr. Rul. 95-34-022 (Aug. 25, 1995) (same).

172 The Service has ruled that the use of restricted stock as compensation does not cause a REIT's shares to be nontransferable. *See* Priv. Ltr. Rul. 97-47-034 (Aug. 25, 1997); Priv. Ltr. Rul. 96-31-018 (May 3, 1996); Priv. Ltr. Rul. 95-34-022 (May 31, 1995); Priv. Ltr. Rul. 94-40-026 (July 11, 1994). The Service has also ruled that sale restrictions imposed by the securities laws do not cause a REIT's shares to be nontransferable. *See* Priv. Ltr. Rul. 96-30-016 (Apr. 26, 1996). In addition, the Service has ruled that restrictions to protect the status of a REIT as "domestically-controlled" (within the meaning of § 897(h)(4)(B)) do not cause the REIT's shares to be nontransferable. *See id.*

173 *See, e.g.*, Priv. Ltr. Rul. 97-47-034 (Aug. 25, 1997).

174 *See id.*

change, the Service has ruled that the restrictions on employee stock do not render a REIT's shares non-transferable.[175]

In another private letter ruling, a REIT had adopted an ownership limit of 3.9%.[176] The letter ruling pointed out that after the adoption of the 3.9% ownership limit, the REIT's shares would continue to trade on the NASDAQ National Market System and that, based on prevailing market prices, 3.9% of the REIT's shares represented an investment of $10,000,000. As a matter of common sense, shares should be considered transferable if investors have the ability to freely trade REIT shares in blocks of up to $10,000,000 on the NASDAQ.

Nothing in the foregoing private ruling should be read to imply that trading on the NASDAQ may be insufficient to demonstrate that shares are transferable if the ownership limit translates into a dollar amount investment that is less than the $10,000,000 block described in the private ruling. Instead, the private ruling should be read to express the sensible conclusion that the transferability requirement is intended to be for the benefit of small investors and that limited share transfer restrictions on significant blocks of shares are permissible. Nevertheless, the ruling does not resolve this issue.

Viewed from the perspective of the typical small investor for whom REITs were intended to provide real estate investment opportunities, the usual ownership limitations and excess shares provisions do not render shares nontransferable. Rather, such provisions at most may operate to change the intended transferee to the excess shares trust and to limit somewhat the class of potential large transferees. Only in extreme cases could one argue that such provisions cause shares to be nontransferable. Nevertheless, many important questions thus remain open. Could a REIT's charter raise transferability issues if it contains ownership limitations that far exceed the limits necessary to protect REIT status?[177] Must all of the REIT's shares be transferable or only some percentage? Can a REIT whose shares (or a substantial percentage thereof) trade on a national exchange ever fail the transferability requirement?

While the answers to some transferable shares questions may appear to be clear (with varying degrees of clarity) to REIT tax advisors, the lack of authority and a clear understanding of the policy behind the requirement would make it difficult to marshal authority to support the perceived answer if challenged by the Service. Until the Service articulates a standard for applying the requirement, REITs should proceed with a degree of caution in crafting overly broad defensive entity-level ownership limitations.

VI. CONCLUSION

The increasing "corporatization" and securitization of commercial real estate in the United States is changing the way in which real estate is bought and sold, and corporate-style M&A transactions involving REITs and other real estate operating companies, including hostile takeovers, are becoming increasingly prevalent. While REIT M&A transactions are similar to

175 *See id.*

176 *See* Priv. Ltr. Rul. 89-21-067 (Feb. 28, 1989).

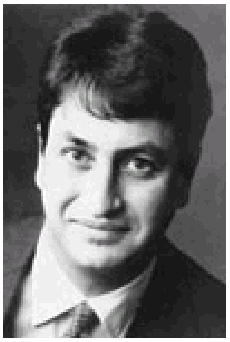
177 E.g., "group" level ownership limits. *See supra* notes 43-73 and accompanying text.

non-REIT transactions in many respects, they do raise a number of unusual obstacles and issues, largely because of REIT's unique tax situation. Careful planning and analysis will generally be critical to any successful transaction.

FOCUS ON REITs

TAKING REITS PRIVATE

by Robin Panovka



Talk of taking REITs private continues despite the recent rebound in equity REIT stocks. Many smaller REITs have been left out of the multiple expansion being enjoyed by their larger peers and continue to explore strategic alternatives. While the renewed strength of the large cap REITs increases the possibility of selling out to a large competitor (who now can more easily manage a stock-for-stock transaction or perhaps even a cash deal), the option of going private is often an attractive alternative, particularly because of the continued healthy valuations in the private real estate markets. And from the perspective of financing sources, the gap between the Wall Street valuations for REITs and the private market values of the assets held by REITs presents an obvious opportunity. These dynamics have resulted in a number of successful LBO transactions in the REIT sector, and will likely result in additional activity.

While the idea of taking a REIT private is relatively simple, execution is often complex, in that it involves weaving through a number of business and legal constraints. Recent LBO activity in the REIT market and broader experience from other sectors provide a number of useful guidelines which should be kept in mind when evaluating a potential going private transaction involving a REIT:

- **Pricing Considerations.**
  It is important to understand at the outset that procedural constraints (outlined below), competition from other bidders, the value demanded by shareholders as an inducement to approve a transaction, and transaction expenses typically will push up the cost of the deal to a number which is not too far off from real value. Bargain basement bids (measured by real value, not just current stock price) usually attract competition, litigation, and other scrutiny, and are unlikely to succeed in their initial form.

- **Inability to Control Outcome.**
  Once the LBO process is initiated, the process often takes on a life of its own and the initiators (management and its financing sources) will likely lose control and be unable to assure a particular outcome. Management-led buy-outs typically result in auctions in which third-party bidders have the opportunity to compete with the insider group on a "level playing field." Also, importantly, the ultimate decision of whether to consummate any particular transaction and with whom generally rests in the hands of the shareholders.

- **Managing Conflicts of Interest.**
  LBOs and other going private transactions which involve management or members of the board of directors necessarily raise potential conflicts of interest. In the UPREIT context, there is an additional layer of conflicts because of the potentially divergent interests of the OP Unitholders and the shareholders. Procedures must be implemented to ensure that potential conflicts do not taint the "fairness" of the transaction and result in shareholder litigation which has the potential to derail the – transaction or expose the participants to liability.

As a practical matter, this usually means that it is advisable to have the transaction evaluated and negotiated by a special committee of directors who do not have a financial interest in the proposed LBO. In order to provide the desired legal protection, the special committee should have independent financial and legal advisors, be well informed, and have the ability and bargaining power to negotiate on behalf of the public shareholders.

- **Enhanced Disclosure.**
  Extensive disclosure is required by Rule 13e-3 under the Securities Exchange Act – particularly with regard to contacts and negotiations leading up to the transaction – where the acquiror group includes management or any other affiliate of the target REIT.

- **REIT Rules.**
  In any transaction involving a REIT, consideration should be given early on to the impact of the special tax rules that apply to REITs and to the target REIT's charter provisions that are designed to preserve its REIT tax status. In that regard, careful thought must be given to the decision to continue the target's status as a REIT or to operate it as a taxable real estate company. The entity's ability to service its debt after the going private transaction and still satisfy the REIT income distribution requirement and the tax consequences of the loss of REIT status must be analyzed.

Properly planned and executed going private transactions, of course, often do succeed and yield the expected benefits. It is important, however, to set realistic expectations at the outset and to exercise care in threading through the legal, regulatory, and market challenges.**REI**

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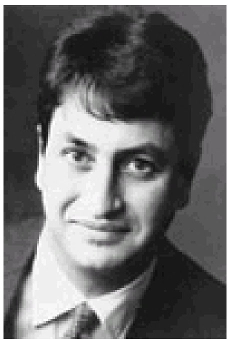
FOCUS ON REITs

PUBLIC REAL ESTATE COMPANIES' ADVANTAGES WILL OVERPOWER THE REIT BEAR MARKET

by Robin Panovka



The current REIT-related news centers on the day-to-day performance of REIT stocks, the excessive restrictions imposed by the REIT rules, methods for retaining and compensating REIT executives, and predictions for when the REIT bear market will end. Often forgotten, however, as the REIT industry licks its bear market wounds, are the *long-term* advantages of publicly traded, corporate real estate operating companies, or REOCs. For all of their shortcomings and maturational problems, publicly-traded REITs represent a new breed of investment vehicles that have noteworthy virtues and fundamental advantages over many of the older methods of investing in real estate.

Take, for example, the perspective of the individual investor who bought interests in syndicated limited partnerships in the 1980's and whose plight is once again making news. There can be little doubt that the public REIT or REOC offers individual investors more liquidity, better governance and accountability of management, and better reporting and transparency than the syndicated limited partnership structure.

And the same is often true from the perspective of institutional investors. Take the admittedly crude example of an institutional investor based somewhere in the Midwest who would like to allocate some funds to office buildings in the Southeast. The investor now has a choice between investing in the publicly-traded stock of any number of REITs which focus on the sector or utilizing one of the various private market alternatives that has historically been available. Investing in the public stock will often prove advantageous for a number of reasons:

- Instant access to information required to make the investment decision — SEC filings on the REIT that provide detailed information, including audited financials, can be pulled off the internet in seconds.
- Speed of execution and liquidity – depending on the size of the investment, the stock can be purchased and sold almost instantly with a few clicks of a mouse.
- Assurance of getting future reports on a regular basis – public companies are required to file with the SEC publicly available quarterly reports, including financials, and to disclose all material events.
- Tried-and-true public company corporate governance structure — while certainly not perfect, the governance structure that has evolved in corporate America is relatively well-defined, gives the shareholders a clear voice, and provides mechanisms for aligning the interests of management with those of the shareholders.
- Comfort that the various Wall Street watchdogs (analysts, rating agencies, investment banks and the financial press) will be keeping an eye on the REIT.

- Efficiency and lower transaction costs — when buying real estate through investment in publicly traded stock, there is no need to negotiate joint-venture agreements and other contracts; hire lawyers and ground-level consultants; perform costly ground-level due diligence; develop new business relationships; hire a staff; open offices; or incur frictional costs of entry and exit (transfer taxes, title insurance premiums, etc.), all potential aspects of direct investment in real estate. In addition, in the case of foreign investors, FIRPTA taxes typically can be avoided.

There will always be an active private real estate investment sector (as there is in non-real estate capital intensive industries that have long been public), and some investors will continue to shy away from investments in public REITs and REOCs because of the view that such investments do not provide the sought-after diversification from stock market investments historically provided by real estate investments (the jury will be out for some time as to this debate). But on balance, despite the recent setbacks, public REITs' and REOCs' roles as investment vehicles will continue to grow as their advantages to investors converge with the inescapable logic of providing the capital intensive real estate industry with access to the public capital markets.**REI**

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REITs and Rights Plans

Criticism of REITs that adopt rights plans is simply misplaced.

By Adam O. Emmerich and Robin Panovka

A growing number of REITs have joined much of the rest of corporate America in adopting shareholder rights plans (so-called poison pills). The trend has resulted in criticism from shareholder activists and commentators who have argued that the credibility of the REIT industry is being damaged by the adoption of "unnecessary" and "anti-shareholder" measures. Clearly, the concern that REITs unequivocally demonstrate that they are committed to shareholder value maximization—and that they have distanced themselves from the more unsavory management/developer-centered viewpoint of the private real estate markets—is appropriate and an important focus as the public REIT marketplace matures. However, the criticism of REITs that adopt rights plans, which protect and ensure equal treatment for all REIT shareholders, is simply misplaced.

The simple facts about rights plans were clearly laid out in Georgeson's November 1997 study (point your browser to the firm's Web site at www.georgeson.com), which found that: (1) premiums paid to acquire target companies with poison pills were, on average, 8 percentage points higher than premiums paid for target companies that did not have poison pills; (2) the presence of a poison pill at a target company did not increase the likelihood of the defeat of a hostile takeover bid or the withdrawal of a friendly bid; and (3) poison pills did not reduce the likelihood that a company would become a takeover target. The takeover rate was similar for companies with and without pills.

These findings were confirmed by J.P. Morgan Securities in another 1997 study and, perhaps most impressive, in a 1995 study by Robert Comment and G. William Schwert, which was published in the *Journal of Financial Economics*. The results of that academic study were unequivocal:

"Poison pills ... are reliably associated with higher takeover premiums for selling shareholders, both unconditionally and conditional on a successful takeover ... . Anti-takeover measures increase the bargaining position of target firms, but they do not prevent many transactions."

Properly designed rights plans (and here we exclude "dead-hand" and other similar fringe innovations which do in fact have a profound impact on shareholders' ultimate ability to act through their voting franchise) simply are not intended to, and will not, make a company takeover-proof. Rights plans protect against takeover abuses; give companies, their shareholders, and their boards of directors breathing room to make decisions on potential takeovers; and strengthen the ability of the board of directors of a target to fulfill its fiduciary duties.

Companies interested in maximizing value for their shareholders and preventing the improper manipulation or oppression of minority stockholders, but which do not adopt a rights plan, are confusing populist rhetoric with sound thinking.

LVMH's creeping sneak attack on Gucci is only one recent example of the perils of allowing large stakes to be acquired in public companies with widely dispersed shareholdings without a mechanism in place to ensure that all shareholders are afforded the opportunity to participate in a takeover (See "Stealthy Takeover of Gucci Makes Poison Pill Look Good," *The Wall Street Journal*, January 29, 1999).

In connection with the Gucci situation, it is interesting to note that in its February 19, 1999 edition, *The Financial Times* endorsed Gucci's adoption of a kind of post facto poison pill to neutralize LVMH's creeping attempt to take control of Gucci without providing an equal opportunity to all shareholders to participate. Similarly, it is worth noting that other countries have developed a variety of legal or regulatory regimes with a similar purpose or effect, and are, in fact, generally perceived as pro-shareholder. The most prominent is the United Kingdom's requirement that persons acquiring in excess of 30 percent of a target company's stock must extend an offer to all of the remaining shareholders to purchase their shares for cash at not less than the highest price paid by the acquiror or any affiliate within the prior 12 months. The recent Olivetti offer for Telecom Italia illustrates a similar point in the Italian context. These regimes have a similar effect to rights plans—ensuring that all shareholders are treated fairly and preventing manipulative and abusive takeover tactics.

The simple facts about rights plans were clearly laid out in Georgeson's November 1997 study.

A number of specious arguments have been made against rights plans. Some have pointed out that many of the REITs that have come public over the past six or seven years are not in need of additional "shark repellent." Thinking of rights plans as "shark repellent" is erroneous because it misses their fundamental nature as tools to ensure equal treatment for all shareholders and to provide REIT boards with the leverage to create a level playing field in the event of a takeover situation. Moreover, it simply isn't the case that REITS are overloaded with "shark repellents."

There is a lively and sometimes adversarial debate in the context of REIT initial public offerings between the issuer or controlling shareholder (who may often be inclined to favor a more "takeover-proof" REIT) and the investing community (who will insist, usually successfully, on a strict limit on the anti-takeover measures baked into the REIT). The institutional shareholder community is neither stupid nor ill-advised. REITs have come public after a careful process of scrutiny and with a reasonable balance between management-and-board continuity and stability and ultimate shareholder control. Clear evidence of this is the fact that many REITs do not have significant defenses, such as staggered boards.

In addition, as we have long noted (see "REIT Takeovers—Novel Issues Raised by Excess Share Provisions and UPREIT Structures," *The M&A Lawyer*, October 1997), the conventional wisdom that REITs are bulletproof because of REIT tax rules and corresponding charter provisions is simply wrong. The "excess share" defense is largely untested and vulnerable on several fronts. Third, even if commentators were correct in believing that REITs are "takeover-proof," what difference would it make then whether or not a rights plan is put in place?

The view that the "real harm" from the adoption of a rights plan is damage to the REIT industry's credibility is, unfortunately, a circular argument, based on the fundamental misconception that rights plans are an absolute bar to hostile takeovers and a disservice to shareholder interests and value maximization. *If* that were true, which it is not, and *if* rights plans were useless surplusage in the REIT industry, which they are not, then it would be true that their adoption would be a stick in the eye of the investor community.

Rights plans are now a familiar part of the landscape in corporate America, having been adopted by over 2,300 public companies, including at least 45 percent of the Fortune 500 companies. While institutional shareholder acceptance of rights plans is certainly not universal, the issue is whether opposition is well-founded and if it promotes shareholder interests or whether it is premised on mistaken facts and a general distrust of boards' and managements' willingness to act in the best interests of all shareholders.

Hostile takeovers have occasionally been met by excessive or inappropriate responses, arguably motivated by self-interest (or in any event contrary to the wishes of shareholders). Rights plans (again, excluding dead-hand and similar fringe innovations) simply are not in that category. To demonize rights plans, which benefit and protect shareholders, and make their denunciation a sort of litmus for politically correct (i.e., shareholder friendly) thinking is simply a disservice to REITs and their shareholders.

If shareholder activists and commentators would take the time to dispassionately analyze the actual operation of rights plans and to evaluate the available evidence of their benefit to shareholders, well-intentioned REIT directors and CEOs would be spared unwarranted attacks for properly adopting rights plans for the benefit of all of their shareholders.

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The M & A Lawyer

REIT Takeovers – Novel Issues Raised by Excess Share Provisions and UPREIT Structures

by **Adam O. Emmerich and Robin Panovka***

Recent M&A activity in the REIT area illustrates, contrary to what had been the popular wisdom, that REITs are not immune from hostile takeovers. The consolidation and "corporatization" waves which are sweeping through commercial real estate have brought to the public REIT industry the possibility and the reality of unsolicited transactions. The best known examples of hostile activity so far have been a number of attempts to derail and top previously announced deals, most notably Patriot American's successful bid to derail a transaction between the Bay Meadows-Cal Jockey paired share REIT and Hudson Bay, which resulted in the Patriot-Bay Meadows merger; Sam Zell's Manufactured Home Communities' unsuccessful bid to derail the Chateau-ROC merger, which was defeated as a result of a restructuring of the Chateau-ROC transaction; Apollo's derailment of a transaction between the Santa Anita paired share REIT and Colony Capital, which resulted in a fourth-party interloper, MediTrust, ultimately outbidding Apollo (which ironically had in the meantime partnered with Colony) and entering into a transaction with Santa Anita; and Gotham's current attempt (supported by Apollo) to oust the First Union board.

REIT takeover transactions raise a number of unusual obstacles and issues which emanate from REITs' unique tax status. Most notably, hostile acquirors must contend with a unique tax-based takeover defense available to REITs, the so-called "excess share provision,"

*Messrs. Emmerich and Panovka are partners of Wachtell, Lipton, Rosen & Katz. The authors gratefully acknowledge the valuable assistance of Raymond Nomizu, also of Wachtell, Lipton, Rosen & Katz, in the preparation

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which, in essence, is a 9.8% (or lower) ownership restriction imposed by REIT charters. In addition, the "UPREIT" (and DownREIT) structures utilized by many REITs to defer taxes for their sponsors (and others) creates complex conflict of interest concerns which are heightened in change of control transactions. These and other unusual aspects of REIT takeovers are discussed below.

I. Excess Share Provisions.

The most common advance takeover defense utilized by REITs is the excess share provision. The provision is typically adopted as part of a REIT's articles of incorporation and usually restricts the number of shares that any shareholder can own to 9.8% or some lesser percentage. The purpose of the provision is to ensure compliance with the so called "5/50 rule" of the Internal Revenue Code, which prohibits five or fewer individuals from owning in excess of 50% of the shares of a REIT during the last half of the REIT's taxable year.[1] In the case of REITs in which a founding or other shareholder of the REIT owned more than 10% of the stock at the time the excess share provision was adopted, the ownership limit for other shareholders is typically set at a percentage lower than 9.8% designed to ensure compliance with the 5/50 rule even after taking into account the founding shareholder's interest. Under a typical provision, any shares acquired by a shareholder in excess of the 9.8% (or lower) restriction are stripped of voting rights or any right to receive dividends until they are transferred to a shareholder who can own them without violating the ownership restriction. The typical provision, however, grants the REIT's board of directors the discretion to waive the limitation with respect to particular acquirors if the board is satisfied (for example, through an opinion of counsel or a ruling from the Internal Revenue Service) that the acquiror is not an individual for purposes of Section 542(a)(2) of the Code — i.e., that the acquiror is a corporation, partnership, estate, trust or any other non-"individual" as to whom the 5/50 rule's look-through provision (explained below) would apply — and the board obtains representations and undertakings from the acquiror sufficient to ascertain

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1 The "5/50 rule" is one of the REIT qualification requirements of Section 856(a) of the Internal Revenue Code (the "Code").

that no individual's beneficial ownership of stock through the acquiror will violate the ownership limit.

The key to the effectiveness of the excess share provisions as anti-takeover devices is that they typically do not incorporate the “look through” mechanism of the 5/50 rule pursuant to which only actual individuals — and not corporations, partnerships or other entities — are restricted in their ownership.[2] Instead, the provisions are usually worded broadly so as to restrict any entity from acquiring in excess of the stated maximum percentage of shares regardless of whether the entity's ownership of the REIT would violate the 5/50 rule. Thus, for example, the typical excess share provision would thwart a hostile acquisition of one REIT by another REIT since, as an entity, the acquiror REIT would be prevented from acquiring more than the maximum stated number of shares, even though, under the tax laws, such an acquisition would not threaten the target's REIT status because of the Code's look-through provisions and the acquiror's own diversity of ownership required for the acquiror's own compliance with the 5/50 rule.

As part of its attack, a hostile acquiror would therefore typically seek to have the target's excess share provision set aside or nullified as a condition to its offer. As with rights plans, the key question facing a target's board is whether or at what point the board has a duty to waive the excess share provision in the face of a hostile takeover offer. The law is not well settled on this issue. Although there is Maryland case law to support the use of an excess share provision as a means of deterring a coercive bid,[3] there is little guidance as to the permissibility of using an excess share provision to block an all-cash, non-coercive tender offer, and there is a yet unanswered question as to the defensibility of using an excess share provision to block a transaction which does not threaten the target's REIT status. Recent legislation in Maryland, where most REITs are incorporated, appears to have been intended to help REITs in this regard in that it specifically permits the inclusion of transferability restrictions in charters “for any purpose,

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2 The “look-through” mechanism is incorporated into the 5/50 rule through the application of Section 544(a)(1) of the Code, which provides that “Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.”

3 See Realty Acquisition Corp., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) & 95, 245 (D.Md. Oct. 27, 1989). The court applied the business judgment rule to uphold the target's use of an excess share provision, largely because the offer being deterred was a coercive tender offer, precisely the sort of offer the excess share provision was designed to deter. Id. at 96, 083.

including restrictions designed to permit a corporation to qualify as a real estate investment trust under the Internal Revenue Code."[4] In the end, much will likely depend on the disclosure made with respect to the excess share provision at the time of adoption. If the excess share provision was sold to the target's shareholders as a device to protect REIT status and not as an anti-takeover device, then its use when no threat is posed to REIT status is likely to trigger vigorous objections. Conversely, the greater the disclosure of the anti-takeover purpose of the provision, the more likely the provision to withstand attack.

Needless to say, the untested nature of excess share provisions and the many yet-to-be-answered questions they raise is a source of concern when analyzing the reliability of the provisions as takeover shields. It is no surprise, therefore, that many REITs have adopted rights plans, or "poison pills," in addition to their excess share provisions. Poison pills may be far more effective than excess share provisions as a takeover deterrent for at least two reasons. First, unlike excess share provisions, which typically act simply as a temporary bar to voting and dividend rights until the excess shares are transferred to purchasers who do not violate the ownership limit, poison pills hold out the threat of permanent, punitive dilution to the acquiror. Second, because rights plans typically survive judicial challenge when properly drafted to comply with the company's charter and state law requirements,[5] they are likely to be less vulnerable to judicial challenge than excess share provisions, which, as discussed above, have not been explicitly upheld as a means of deterring non-coercive bids.

II. UPREIT Complications.

Takeovers of umbrella partnership REITs, or "UPREITs", present a number of unusual issues largely attributable to the complex interrelationships inherent in the UPREIT structure. The classic UPREIT combines corporate and partnership forms into a structure in which the publicly traded REIT owns properties and conducts business through an operating limited partnership in which the REIT is the general partner and the REIT's sponsors are limited partners. The UPREIT structure is used as a tax deferral mechanism by REIT sponsors (and others) who own low-basis real estate which they wish to contribute to the REIT. While contribution of the

4 Laws of Maryland for 1997, Chapter 717 (H.B. 1107).

5 See, e.g., Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985).

properties directly to the REIT in exchange for stock is a taxable transaction, contribution of the properties to the operating partnership in exchange for limited partner units (so-called "OP Units") is tax free and defers recognition of the built-in gain. Of course, as discussed below, the deferred gain will be recognized when the sponsors sell or convert their OP Units and in various other circumstances. OP Units are generally convertible by the Unitholder into stock of the REIT or cash, at the election of the REIT.

COMPLETED REIT MERGERS (1996-1997)

ACQUIRER	TARGET	DATE	PRICE
Patriot American Hospitality	California Jockey Club/Bay Meadows	1 Jul 97	$2 Billion
Equity Residential Properties Trust	Wellsford Residential Properties Trust	1 Jun 97	$1 Billion
Camden Property Trust	Paragon Group Inc.	15 Apr 97	$620 Million
Chateau Communities	ROC Communities	11 Feb 97	$381 Million
United Dominion Realty Trust	South West Property	2 Jan 97	$579 Million
Highwoods Properties Inc.	Croker Realty Trust Inc.	20 Sep 96	$539 Million
Simon DeBartolo Group Inc.	DeBartolo Realty Corporation	9 Aug 96	$3 Billion
EastGroup Properties	Copely Properties	19 Jun 96	$100 Million

SOURCE: National Association of Real Estate Investment Trusts

In UPREIT takeover transactions, special consideration must be given to the rights and treatment of the OP Unitholders and to the ultimate treatment to be afforded to the operating partnership itself. These issues will often be of paramount importance in structuring the transaction because of the significant tax burden that could result to the OP Unitholders from certain transactions. For example, the dissolution of the operating partnerships, the repayment of operating partnerships debt or the sale of the operating partnership's assets could each trigger the very taxes on the REIT sponsor's gain that the UPREIT structure was designed to defer. Because of the sensitivity of these issues, the partnership agreement for the operating partnerships may provide the OP Unitholders veto rights over such transactions as well as over change of control transactions. And, of course, the fact that the OP Unitholders are typically also significant shareholders, directors and officers of the REIT will tend to add special emphasis to the OP Unitholders concerns and to raise conflict of interest issues.

There are a number of structural alternatives that can be employed in mergers or acquisitions of UPREITs. For example, two UPREITs could merge through the separate mergers of the two corporate general partners (the REITs) and of the two operating partnerships; a REIT or UPREIT could acquire or merge with an UPREIT without acquiring or merging with the target UPREIT's operating partnership; or the assets of an UPREIT could be contributed to the acquiror UPREIT's operating partnership in exchange for OP Units in a Section 721 transaction. Whatever the structure chosen, careful attention should be paid in any UPREIT transaction to the resolution of any conflicts of interest between the REIT shareholders (other than those who are also OP Unitholders) and the OP Unitholders.

REIT stockholders and the OP Unitholders may have adverse interests in connection with takeover bids because of their different tax positions. For example, an offer to purchase the shares of the REIT and the OP Units in exchange for the same amount of cash or the same ratio of stock in the acquiror may be attractive to the stockholders because of the price offered, but may not be attractive to the OP Unitholders because of the sizeable tax liability they would incur if they accepted. The dilemma was brought to light in the recent attempt by Manufactured Home Communities, Inc. to break up the friendly stock merger between ROC Communities and Chateau Properties, an UPREIT.

The UPREIT structure raises the issue, which was central to the litigation surrounding the Chateau takeover battle, of the extent to which directors of a REIT (some of whom also are OP Unitholders) may, or must, take into account the interests of the OP Unitholders in addition to the interests of the REIT stockholders. Put differently, the issue is how a REIT board, some of whose members are also OP Unitholders, should act when a takeover transaction gives rise to a conflict between the interests of the Unitholders and the interests of the stockholders. The board of the REIT obviously owes a fiduciary duty to the REIT's stockholders, but, at the same time, the REIT, as general partner of the operating partnership, owes a fiduciary duty to the Unitholders. The pivotal question is which duty the REIT's board should consider paramount and how to reconcile the duties. Although the law provides little guidance on this point, there is good reason to believe that the courts will hold that the duty to stockholders is paramount and that, in the case of a conflict, the board may consider the claims of the OP Unitholders only in determining what will ultimately be best for the stockholders, including taking account of potential liability of the REIT to the Unitholders for breach of fiduciary duty.

An important issue for a conflicted UPREIT board is how to address the conflict from a procedural standpoint. Although the answer will ultimately depend on the specific circumstances involved, careful consideration should be given in such instances to utilization of a special committee (particularly where a majority of the directors are also OP Unitholders) and to recusal of the "interested" directors.

The UPREIT structure may also provide a target with an anti-takeover defense. As noted above, OP Unitholders typically have the right to put their limited partner units in the operating partnership to the REIT general partner. Generally, the consideration for the limited partner units can be paid in the form of either cash or REIT stock at the REIT's election. Either way, given the often significant limited partner interests of the sponsors, the put rights offer sponsors a possible weapon against uninvited takeover attempts — albeit one that sponsors may be reluctant to exercise because the exercise would trigger recognition of the often substantial built-in taxable gain which led to the adoption of the UPREIT structure in the first place. UPREIT operating partnership agreements sometimes give sponsors additional rights which could be used to thwart or deter a takeover of the REIT, such as the right, as OP Unitholders, to veto certain transactions (e.g., a sale of all or substantially all of the REIT's assets in a taxable transaction or a merger of the REIT with another entity unless the operating partnership is included in such transaction). Such rights are generally limited, however, because of strong market pressures in the context of REIT IPOs to eliminate conflicts of interest between the OP Unitholders and the public shareholders of the REIT (or at least to limit the OP Unitholders' sway over the REIT). In any event, hostile acquirors may challenge the exercise or potential exercise of these limited partner rights, arguing that the OP Unitholder-sponsor has a duty not to veto a transaction which is in the best interests of the shareholders.

III. <u>Other Issues</u>.

For tax reasons, management companies employed by REITs may be set up as "de-controlled subsidiaries," substantially all of the economic interests in which are owned by the REIT but, because of the requirements of Section 856(c) of the Code, at least 90 percent of the voting securities of which are held by the REIT's sponsors or management. Occasionally, the management company is owned mostly by the REIT's sponsor and/or an ESOP and is not a subsidiary of the REIT. In either case, a REIT acquiror will typically want to ensure that it gains control over the management company and should therefore consider making its offer contingent on the transfer of the voting stock in the target's management subsidiary to the acquiror. Management or sponsor control of the stock of the company managing the target's properties, of course, makes a hostile acquisition more difficult.

Care must be taken in structuring any REIT takeover transaction not to violate the REIT qualification requirements of Section 856(a) of the Code. Particular attention should be paid to the 100-shareholder requirement, as well as to the REIT income and asset tests of Section 856(c) of the Code and, of course, the 5/50 rule. The 100-shareholder requirement of Section 856(a)(6) provides simply that the beneficial ownership of a REIT must be held by 100 or more persons during 335 days of each full taxable year. The 100-shareholder requirement is not subject to the "look-through" applicable to the 5/50 rule. Depending on the contemplated structure and the assets and income of each of the acquiror and the target, the restrictions of Section 856(c) on the kinds of securities and other assets that REITs can own and the type of income REITs may earn also can complicate REIT mergers and acquisitions. For example, the general prohibition on ownership by a REIT of more than 10 percent of the voting securities of another entity, other than a qualifying REIT, may complicate transactions taking the form of the acquisition of shares of the REIT (such as "reverse" triangular merger transactions). Finally, rules restricting dispositions of REIT assets may interfere with otherwise desirable post-acquisition pruning of acquired assets.

IV. Conclusion.

The increasing "corporatization" and securitization of commercial real estate in the United States is changing the way in which real estate is bought and sold, and corporate-style M&A transactions involving REITs and other real estate operating companies, including hostile takeovers, are becoming increasingly prevalent. While REIT M&A transactions are similar to non-REIT transactions in many respects, they do raise a number of unusual obstacles and issues, largely because of REIT's unique tax situation. Careful planning and experienced advisors will generally be critical to the successful transaction.

THE "UP" FACTOR IN UPREIT Change of Control Transactions

By Adam O. Emmerich
and Robin Panovka

UPREITs' tax advantages in acquisitions have made them into powerful consolidation machines that are claiming an increasing share of the commercial real estate and REIT markets. UPREITs already own approximately 50 percent of the roughly $160 billion of commercial real estate held by REITs and account for 95 of the 211 publicly traded REITs.[1]

Despite its advantages, the UPREIT structure has been criticized for the potential conflicts of interest it creates between its two main classes of equity holders, the common stockholders of the REIT and the limited partners of the operating partnership of which the REIT is the general partner. The potential conflicts of interest are often exacerbated if the UPREIT engages in certain transactions including, most notably, transactions involving a change of control.

This article attempts to provide insight with regard to the conflicts of interest faced by an UPREIT in the context of a change-of-control transaction. We begin with an overview of the UPREIT structure and the duties of the various actors in UPREITs, and then conclude with some observations.

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conduct under the traditional business judgment rule but will subject board action to judicial review under an "enhanced scrutiny"[10] standard that looks both to the board's process and its action. The decisional process, including the information relied on, must satisfy the court's enhanced standard. For example, when the board adopts a defensive measure in the face of a potential change-of-control transaction, in order to satisfy the so-called test it must show that it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and that the defensive measure chosen was reasonable in relation to the threat posed.

Entire Fairness. Actual conflicts of interest, particularly when a majority of the directors approving a transaction have such a conflict, are subject to the most exacting standard of scrutiny—the "entire fairness" review—which requires a judicial determination of whether the transaction is entirely fair to stockholders.[11] Not every conflict of interest of a director in a transaction will trigger "entire fairness" review; rather, the director's self-interest must involve evidence of disloyalty.[12] Examples of circumstances that would trigger "entire fairness" review include situations in which the directors appear on both sides of a transaction, as in a management buyout; or derive a personal financial benefit that does not devolve generally upon the corporation and its stockholders;[13] or *potentially* when directors are also OP unit holders. A difficult and necessarily fact-specific question for the courts to determine is when a single director's conflict of interest, which is not shared by the other directors, will nevertheless so infect the other directors' decisions that the board loses the presumption of the business judgment rule and the court applies "entire fairness" review.[14] In general, the "entire fairness" review would probably be applied when "the interested director *controls* or *dominates* the board as a whole or when the interested director *fails to disclose* his interest in the transaction to the board *and* a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction."[15]

Despite its advantages, the UPREIT structure has been criticized for the potential conflicts of interest that it creates between its two main classes of interest holders.

Partnership Duties

The general partner of a limited partnership—in the UPREIT context, the REIT itself—owes a fiduciary duty to the limited partners. This fiduciary duty is often understood to be equivalent in scope to the fiduciary duty a director owes to stockholders.[16] Unlike that of a corporate director, however, the fiduciary duty of a general partner is subject to contractual modification by the parties.[17] Thus, if the general partner approves or carries out a transaction that was expressly contemplated by the limited partnership agreement, the general partner will not be held to have violated its fiduciary duty to the limited partners.[18] Instead, the general partner may rely on the provisions in the agreement, so long as it does so in good faith.[19]

Corporate General Partners and Directors

The oft-quoted *In re USACafes, L.P.* case held that the directors of a corporate general partner owe the limited partners a direct fiduciary duty.[20] The extent of this duty, however, is unclear. In *USACafes*, the court applied this duty to prevent directors of a corporate general partner from engaging in obvious self-dealing, stating that directors' duty to limited partners is not necessarily coterminous with that owed by the directors to stockholders. Subsequent case law has not provided much guidance on this issue. It is possible (perhaps likely), therefore, that courts will view the duty directors owe limited partners as limited to avoid overreaching or unfair dealing with the limited partners. Almost certainly, the courts will view directors' duty to limited partners as subordinate to the paramount duty they owe stockholders.[21]

Observations

Directors of the corporate UPREIT—whether facing a change-of-control transaction or otherwise—owe a fiduciary duty to the REIT stockholders. Whether and under what circumstances directors may (or must) consider the interests of OP unit holders in addition to the interests of the stockholders in making a decision about a change-of-control transaction are questions that have not been addressed by the courts. Similarly, whether a director's "interest" as an OP unit holder in and of itself constitutes "evidence of disloyalty," which would trigger "entire fairness review," has also not been addressed.

Despite the absence of definitive legal guidelines, some general observations can be made to assist UPREIT directors and other actors in reaching decisions in a change-of-control context. For one, UPREIT directors should understand that both the limited partnership and the corporation are long-established legal forms that are governed by familiar and well-developed bodies of case law. By structuring their enterprise as an UPREIT, the sponsors in effect made certain decisions about the legal principles and rights and obligations that would control. Given this choice, a court may well adopt a formalistic approach and hold that directors owe a fiduciary duty only to the stockholders, and that the sole recourse of OP unit holders (absent self-dealing on the directors' part) is against the REIT as general partner.

The courts will likely recognize that the REIT itself, as general partner of the operating partnership, owes duties to the partnership and is subject to potential liability for its acts as general partner. Thus, if a particular transaction would constitute a breach of duty by the REIT to the OP unit holders, it is virtually certain that courts would find it appropriate for the directors to consider the impact on shareholders of the risk of ensuing litigation from the OP unit holders. Directors could reasonably conclude that a transaction otherwise in the best interest of the stockholders should

The UPREIT Structure

In the classic UPREIT (or umbrella partnership REIT) structure, a publicly traded REIT owns its properties and conducts business through an operating limited partnership in which the REIT is the general partner and the REIT sponsors (and possibly other sellers of real estate) are the limited partners. Typically, the partnership is formed in conjunction with the initial public offering of REIT common stock. Concurrently with the offering the REIT's sponsors contribute their real estate assets to the operating partnership in exchange for limited partner units in the operating partnership (OP units), which are usually convertible, after a set period of time, into either shares of common stock of the REIT, on a one-to-one basis, or cash. The REIT contributes the cash it raises from its common stock offering to the partnership in exchange for a general partner interest, and the cash raised is then often used, at least in part, to pay down debt to levels acceptable to public investors and property contributors.

The sponsors benefit from the UPREIT formation transaction because, under applicable federal tax law, they receive their OP units without having to pay taxes on the difference between the value of the OP units they receive and their tax basis in the properties contributed. In simple terms, they have disposed of their (generally illiquid) properties for what is essentially freely tradeable (after conversion) equity representing an interest in what is often a much larger pool. If the sponsors have held their properties for a long time, the deferred tax liability may be substantial. Of course, the OP unit holders will recognize the deferred gain when they convert their OP units and in various other circumstances, but the deferral is obviously valuable. The sponsors' right to convert their OP units, which concededly triggers a tax event, is important because, among other things, it permits them to control the timing of their tax liability and provides them with valuable liquidity.

The UPREIT structure can give rise to different incentives for the REIT stockholders and the OP unit holders when faced with a potential change-of-control transaction. For example, an offer to purchase the shares of the REIT and the OP units in exchange for the same amount of cash or the same ratio of stock in the acquiror may be attractive to the stockholders because of the price offered but may be unattractive to the OP unit holders because of the sizeable current tax liability they would incur if they accepted.[2] This dilemma was brought to light in the recent attempt by Manufactured Home Communities, Inc. to break up the friendly stock merger between ROC Communities, Inc. and Chateau Properties, Inc., an UPREIT.

Duties of UPREIT Actors

The Chateau takeover battle presented squarely the issue of the extent to which directors of a REIT may, or must, take into account the interests of limited partners in addition to the interests of the REIT stockholders. The courts have not yet ruled on this issue, and it is, therefore, not possible to provide a clear answer. However, to understand how the courts are likely to approach these issues, it is necessary to understand the general fiduciary duties owed by directors and other relevant actors in an UPREIT.

Corporate Duties

Duties Generally. Like directors of any other corporation, directors of a corporate REIT owe the corporation's stockholders a fiduciary duty. Under widely followed Delaware law principles, this fiduciary duty comprises the "duty of care" and the "duty of loyalty." The duty of care requires that the director discharge his or her duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he or she reasonably believes to be in the best interests of the corporation.[3] The core of the duty of care may be restated as the directors' obligation to act on an informed basis, after due consideration of the relevant materials and appropriate deliberation, including the input of legal and financial experts. The duty of loyalty requires the director to exercise his or her power in the interests of the corporation and not in the director's own interest or in the interest of another person or organization. Simply put, directors should not use their corporate position to make a personal profit or gain or for other personal advantage.[4]

Business Judgment Rule. In the ordinary course, "[u]nder the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[5] The effect of the business judgment rule is to create a presumption that the directors' decision was valid.[6] A plaintiff may overcome this presumption only by proving that the board has not met its duty of care or loyalty.[7] To show that the board has not met its duty of care, a plaintiff must prove that directorial conduct has risen to the level of "gross negligence."[8] To show that the board has not met its duty of loyalty, a plaintiff must prove that members of the board engaged in "self-dealing" transactions. If directors appeared on both sides of, or derived an improper financial benefit from, a challenged transaction, the courts will, as discussed below, ignore the business judgment rule, in which case the burden is placed on the board to defend the challenged transaction by showing that it meets the requirements of "entire fairness" to the company and its stockholders.[9]

Enhanced Scrutiny. In certain limited situations the courts will not defer to board not be entered into in light of the corporation's interest in avoiding the expenses and liability associated with such litigation. In the UPREIT context, one possible basis of a breach of fiduciary duty claim against the REIT by the OP unit holders could be that the transaction is unfavorable to the OP unit holders given their tax circumstances. Although it may be argued that a general partner is entitled to disregard the individual tax circumstances of the limited partners (and courts have determined that this is the case when dealing with corporations and their stockholders), given the absence of definitive case law, the threat of such a claim may not necessarily be ruled out as completely lacking a rational basis.

The courts are likely to view REIT directors' duty to limited partners as subordinate to the paramount duty they owe stockholders.

Given that directors will probably not be permitted to take into account the interests of OP unit holders as limited partners, a board of directors must also then address the conflict of board members who themselves are OP unit holders and who therefore have an interest in the transaction (by hypothesis different from the interest of stockholders). When will it be appropriate to establish a special committee to determine the appropriate course of action? When must or should the interested directors recuse themselves?

In cases where a majority of directors are also OP unit holders, the existence of a special committee will blunt (almost certainly fatally) the allegation that the board was improperly tainted by conflict of interest and eliminate the alleged conflict as a basis to apply a standard of review more stringent than the business judgment rule.

If one or more (but less than a majority of) directors hold OP units, the directors who hold OP units should, at a minimum, disclose their holdings to the remaining directors if they wish to engage in the decision-making process. Alternatively, they may consider refraining from the decision-making process altogether. The particular facts and circumstances of each transaction will determine whether it is more prudent to avoid any entanglement by OP-unit holding directors in decisions relating to extraordinary transactions. In many cases, such participation may be perfectly appropriate and, indeed, beneficial, particularly if the individuals in question are highly knowledgeable as to the business or plans of the UPREIT. In other circumstances, the board may determine that recusal from all or a portion of the decision-making process is simpler and decreases the likelihood that a court will subject the board to a standard higher than the business judgment rule.

In all cases, the crucial question is whether a court will evaluate directors' conduct under the business judgment rule or find that it falls within the ambit of higher scrutiny. Absent a particularized showing of actual conflict of a majority of the board, and assuming that the interest of a minority of the board as OP unit holders is known to the other directors (as it almost certainly would be), it should generally be the case that the interests of some directors as OP unit holders will not *per se* remove board action from the ambit of the business judgment rule. Courts will, however, be alert to circumstances in which action is taken or foregone to the benefit of the OP unit holders and the detriment of the stockholders and will be inclined to examine carefully how the alleged conflict actually presented the director with incentives to act other than in the interest of the stockholders. The more influential the conflicted directors, the greater the likelihood of enhanced scrutiny.

Directors and other actors in an UPREIT change-of-control transaction should be aware that the judicial approach to UPREIT conflicts of interest remains to be determined and should maintain a high degree of vigilance in any circumstance where the interests of OP unit holders and stockholders might differ in change of control or other transactions. Careful thought should be given in such circumstances to recusal of conflicted directors, to the establishment of a special committee and to the duties of the various actors. R

Adam O. Emmerich and Robin Panovka are partners of Wachtell, Lipton, Rosen & Katz. *The views expressed herein are not necessarily the views of Wachtell, Lipton, Rosen & Katz.* *The authors gratefully acknowledge the valuable assistance of Raymond Nomizu and Dmitry Selipanov in the preparation of this article.*

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[1] NAREIT.

[2] Note, however, that the circumstance of varying tax basis will exist in every corporation and that it will most often be a founder/insider who will have a low stock basis even outside the UPREIT context.

[3] ABA Section of Business Law's *Corporate Director's Guidebook (1994).*

[4] *Id.*

[5] Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987) (citations omitted). *Accord*, Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Aronson v. Lewis, 473 A.2d 805, 811-12 (Del. 1984); Panter v. Marshall Field & Co., 646 F.2d 271, 293-95 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Treadway Cos., Inc., v. Care Corp., 638 F.2d 357, 382-83 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

[6] Paramount Communications Inc v. QVC Network Inc., 637 A.2d 34, 45 n.17 (Del. 1994) ("[T]he Court gives great deference to the substance of the directors' decision and will not invalidate the decision, *will not examine its reasonableness*, and 'will not substitute [its] views for those of the board if the latter's decision can be "*attributed to any rational business purpose.*"'") (emphasis added; citations omitted).

[7] *See, eg.*, Aronson, 473 A.2d at 812. Under 8 Del. C. § 102(b)(7), a Delaware corporation may in its certificate of incorporation either eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty, but such provisions may not eliminate or limit the liability of a director for, among other things, (i) breach of the director's duty of loyalty to the corporation and its stockholders or (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. Many Delaware corporations have either eliminated or limited director liability to the extent permitted by law. The limitation on personal liability does not affect the availability of injunctive relief. Maryland law, although more restrictive than Delaware law in certain respects, permits broader exculpation.

[8] For Delaware interpretation of the gross negligence standard, *see* Smith v Van Gorkom, 488

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Will REIT Takeovers Take Off?

BY ADAM O. EMMERICH & ROBIN PANOVKA

"Bear hug" letters and preparedness discussions with special takeover counsel and bankers have become relatively commonplace in the industry.

Recent takeover activity in the REIT area illustrates–contrary to what had been the popular wisdom–that REITs are not immune from unsolicited takeovers. The real estate consolidation wave, much like consolidation waves in other industries, has brought with it pressures and incentives to mount hostile attacks. The splashiest manifestations to date have been a number of attempts to derail and top previously announced deals, most notably Patriot American's successful bid to derail a transaction between the Bay Meadows-Cal Jockey paired share REIT and Hudson Bay, which resulted in the Patriot-Bay Meadows merger; Sam Zell's Manufactured Home Communities' unsuccessful bid to derail the Chateau-ROC merger, which was defeated as a result of a restructuring of the Chateau-ROC transaction; and Apollo's derailment of a transaction between the Santa Anita paired-share REIT and Colony Capital, which resulted in a fourth party interloper, MediTrust, ultimately outbidding Apollo (which, ironically, had partnered with Colony in the meantime) and entering into a transaction with Santa Anita. "Bear hug" letters and preparedness discussions with special takeover counsel and bankers have also become relatively commonplace in the industry. And there seems to be a growing consensus that the so-called "have" REITs will more aggressively prey upon the "have-nots."

The lessons are clear. Industry players should familiarize themselves with the legal and tactical considerations that arise in takeovers and re-examine their strategic plans and takeover response preparations. In entering friendly transactions, every attempt should be made to obtain maximum protection against potential unsolicited offers. This article provides a brief overview of the legal background and current thinking on REIT takeovers and provides various suggestions for REITs to consider in light of the changing environment.

Adam Emmerich and Robin Panovka are partners at the New York firm of Wachtell, Lipton, Rosen & Katz, where they have counseled on a broad variety of transactions in the REIT area and otherwise, both hostile and friendly.
The authors gratefully acknowledge the valuable assistanceof Raymond Nomizu, also of Wachtell, Lipton, Rosen & Katz, in the preparation of this article.

Hostile Transactions and the Duties of Directors

Takeover transactions in which an acquiror pursues a target without the approval or invitation of the target's board of directors are considered hostile transactions. Typically, hostile acquirors initiate their takeover attempt with a bear hug letter to the target's board of directors. In the letter, the acquiror proposes a business combination with the target and states or implies that it will deal directly with the shareholders if a friendly deal cannot be worked out. If the board rebuffs the offer, the acquiror generally proceeds to launch a tender offer, usually combining the offer with a proxy or consent solicitation to remove any obstacles to its transaction, such as shareholder rights plans–so-called "poison pills"–and, in the case of REITs, excess share provisions.

The legal parameters which govern a target board's response to a hostile offer are based on the threshold principle that the board owes a fiduciary duty to the shareholders. The fiduciary duty includes the "duty of loyalty" and the "duty of care." The duty of loyalty requires that directors act in the best interests of the corporation and not use their position to advance their own or another's interest. The duty of care requires that directors discharge their duties in good faith and with the same care an ordinarily prudent person would exercise in like circumstances. Under ordinary circumstances, directors are entitled to the benefits of the "business judgment rule," which creates a presumption that the directors have acted in conformity with their fiduciary duties. In certain prescribed circumstances, courts will not apply the business judgment rule and apply instead some form of enhanced scrutiny of the directors' actions. A hostile takeover will often cause the directors' actions to become subject to such enhanced scrutiny, particularly when the directors take actions in response to a hostile threat under circumstances which suggest that they may be doing so in order to entrench themselves. The judicial doctrines governing the application of these rules are complex, and allow for and engender complex and subtle maneuvering in takeover situations.

Finally, while REIT takeovers are similar to takeovers in other industries in many respects, they do have a number of unique elements. Most notably, REIT charters typically contain unusual ownership limitations–commonly referred to as "excess share provisions"–which are ostensibly designed to protect REITs' unique tax status, but which are often written very broadly in order to provide takeover protection. In addition, REITs often utilize the so-called UPREIT structure, which combines corporate and partnership forms into an unusual tax-motivated hybrid entity where complex interrelationships raise potential conflicts of interest in the takeover context.

Takeover Preparedness

It is vitally important for REITs to make advance anti-takeover preparations. Without the benefit of adequately structured defensive arrangements, REIT directors will be under significant pressure when they receive an unsolicited offer and will, therefore, be more likely to make rash decisions. In addition, defensive measures taken in response to a hostile bid are subject to a higher level of judicial scrutiny than preplanned strategies, and are therefore more likely to be invalidated by the courts. Advance planning also makes good business sense; studies have shown that takeover premiums and targets' bargaining power in takeover battles have been enhanced historically by the advance adoption of rights plans.

Excess Share Provisions

The most common advance takeover defense utilized by REITs is the excess share provision. The provision is typically adopted as part of a REIT's articles of incorporation and usually restricts the number of shares that any shareholder can own to 9.8 percent or some lesser percentage. The purpose of the provision is to ensure compliance with the so called "5/50 rule" of the Internal Revenue Code, which prohibits five or fewer individuals from owning in excess of 50 percent of the shares of a REIT during the last half of the REIT's taxable year.[1] In the case of REITs in which a founding or other shareholder of the REIT owned more than 10 percent of the stock at the time the excess share provision was adopted, the ownership limit for other shareholders is typically set at a lower percentage, designed to ensure compliance with the 5/50 rule even after taking into account the founding shareholder's interest. Under a typical provision, any shares acquired by a shareholder in excess of the 9.8 per cent or lower restriction are stripped of voting rights or any right to receive dividends until they are transferred to a shareholder who can own them without violating the ownership restriction. The typical provision, however, grants the REITs' board of directors the discretion to waive the limitation with respect to particular acquirors if the board is satisfied, such as through an opinion of counsel or a ruling from the Internal Revenue Service, that the acquiror is not an individual for purposes of Section 542(a)(2) of the Code – i.e., that the acquiror is a corporation, partnership, estate, trust or any other non-"individual" as to whom the 5/50 rule's look-through would apply – and the board obtains such representations and undertakings from the acquiror as it deems to be reasonably necessary to ascertain that no individual's beneficial ownership of stock through the acquiror will violate the ownership limit.

The key to the effectiveness of the excess share provisions is that they typically do not incorporate the "look through" mechanism of the 5/50 rule pursuant to which only actual individuals–and not corporations, partnerships or other entities–are restricted in their ownership.[2] Instead, the provisions are usually worded so as to restrict any entity from acquiring in excess of the stated maximum percentage of shares. Thus, the typical excess share provision would thwart a hostile acquisition by a REIT since, as an entity, the acquiror REIT would be prevented from acquiring more than the maximum stated number of shares, even though, under the tax laws, such an acquisition would not threaten the target's REIT status because of the Code's look-through provisions.

As part of its attack, a hostile acquiror would, therefore, typically seek to have the excess share provision set aside or nullified as a condition to its offer. As with rights plans, the key question facing a target's board is whether or at what point the board has a duty to waive the excess share provision in the face of a hostile takeover offer. The law is not well settled on this issue. Although there is Maryland case law to support the use of an excess share provision as a means of deterring a coercive bid,[3] there is little guidance as to the permissibility of using an excess share provision to block an all-cash, non-coercive tender offer, and there is a yet unanswered question as to the defensibility of using an excess share provision to block a transaction which does not threaten the target's REIT status. Much will likely depend on the disclosure made with respect to the excess share provision at the time of adoption. If the excess share provision was sold to the target's shareholders as a device to protect REIT status and not as an anti-takeover device, then its use when no threat is posed to REIT status is likely to trigger vigorous objections. Conversely, the greater the disclosure of the anti-takeover purpose of the provision, the more likely the provision to withstand attack. Needless to say, the untested nature of excess share provisions and the many yet to be answered questions they raise is a source of concern when analyzing the reliability of the provisions as takeover shields.

Poison Pills

Perhaps the most effective device a REIT can adopt to protect itself against abusive takeover tactics and inadequate bids is the same device hundreds of the nation's largest corporations have adopted–the share purchase rights plan, popularly known as the poison pill. Poison pills may be far more effective than excess share provisions as a takeover deterrent for at least two reasons. First, unlike excess share provisions, which typically act simply as a temporary bar to voting and dividend rights until the excess shares are transferred to purchasers who do not violate the ownership limit, poison pills hold out the threat of permanent, punitive dilution to the acquiror. Second, because rights plans typically survive judicial challenge when properly drafted to comply with the company's charter and state law requirements,[4] they are likely to be less vulnerable to judicial challenge than excess share provisions, which have not been explicitly upheld as a means of deterring non-coercive bids.

The defining features of a rights plan is its "flip-in" provision. When a shareholder, or a group of shareholders acting in concert, acquires stock in excess of a stated threshold, usually 15 percent or 20 percent, all other shareholders of the corporation have the right to purchase the target's stock (flip-in) at a substantial discount, effectively diluting the acquiror's stock ownership. The risk of dilution, combined with the authority of a target's board of directors to redeem the rights prior to a triggering event, gives a potential acquiror a powerful incentive to negotiate with the target's board of directors rather than proceeding unilaterally.

A properly drafted rights plan provides an obstacle to an unsolicited takeover that is virtually insurmountable absent agreement by the target or judicial action.

Charter and By-Law Provisions

Other defensive charter and by-law provisions generally do not, and are not intended to, prevent a hostile acquisition. Rather, they provide some measure of protection against certain takeover tactics and allow the board of directors some additional negotiating leverage. Provisions of this kind include: "fair price" provisions; classified board provisions; provisions which eliminate or regulate shareholder action by written consent; and by-law provisions governing shareholder nominations for directors and the submission of shareholder proposals at meetings. Fair price provisions require that shareholders receive equivalent consideration at both ends of a two-step bid, thus deterring coercive two-tier, front-end loaded offers. Classified board provisions divide the board into several (usually three) equal size classes of directors, each of which usually serves a three-year term. These terms are staggered so that only a portion of the directors (usually one-third) come up for election each year, thus preventing a bidder from obtaining control of the board quickly and assuring a company sufficient time to cope with an attempted takeover. However, classified boards and fair-price charter provisions require shareholder approval to be implemented and, due to general institutional investor opposition to such provisions, few companies have established such preclusions in recent years, other than in the context of initial public offerings or spinoffs.

By-law provisions governing the calling of, the business to be conducted at, and the manner of presenting proposals for, annual and special meetings (and related matters as to action by written consent) can be adopted without shareholder approval. These provisions can be especially helpful in protecting against an unexpected proxy contest for control of the board of directors. However, they should be reviewed periodically to ensure that they are consistent with recent case law and SEC developments.

Change of Control Agreements

Finally, REITs should give serious consideration to adopting change of control employment and benefit arrangements. These are designed to ensure that senior executives and other employees will be properly protected in the event of a merger or other business combination. This will reduce the uncertainty of the executives' own future when faced with a change of control transaction, thereby easing pressure and helping assure their full participation in the merger negotiation process. Appropriately structured change of control employment agreements are both legal and proper, but careful attention must be paid to tax, regulatory and other legal concerns. Although there is little case law relating to the adoption of such agreements, they have typically been found to be enforceable and consistent with directors' fiduciary duties, absent a conflict of interest.[5]

Protecting the Deal

In the case of a publicly traded REIT, any merger or acquisition agreement approved by the board must generally be submitted to a vote of the shareholders. This creates a risk that a third-party bidder could come along and derail the deal–even after the boards of the respective companies have approved the deal–by offering a higher bid during the period between the signing and announcement of the agreement and the closing. To address the risk, and in order to prevent an agreed deal being used as a stalking horse, acquirors in business combination transactions frequently request or insist on certain protections from, or compensation for, third-party interference. In the case of the target, these protections are often viewed as an inducement to a potential acquiror to enter into an acquisition or merger agreement, and can also serve to prompt the acquiror to increase its bid in consideration for the protection. Although recent court cases such as Paramount Communications Inc. v. QVC[6] show that such protective mechanisms will be closely scrutinized by the courts, target boards continue to have substantial means available to protect a transaction.

Stock Options and Bust-Up Fees

Stock options and bust-up fees are designed to compensate a jilted acquiror for losing the deal and to increase the likelihood of successful consummation of an agreed-upon transaction. Typically, a stock option in favor of the acquiror is exercisable upon various contingencies–including failure of consummation following a third-party bid–and usually carries an exercise price equal to the deal price, or at the level at which the target company's stock was trading prior to announcement of the original acquisition agreement. Thus, in the event the deal is not consummated because of a higher offer having been made, the initial acquiror will be compensated in an amount equal to the difference between its price and the higher price that was ultimately accepted as if it had held an ownership interest in the target. [7] Stock options granted in connection with acquisitions may also include a so-called "cash put" provision providing that, in the event of a higher bid, the acquiror has the right to "put" the option back to the target at a per-share price equal to the difference between the option exercise price and the higher bid. This produces the same economic effect, without the need for any actual purchase or sale of stock. A bust-up fee is simply a pre-agreed flat fee that the target is required to pay the jilted acquiror upon loss of the deal.

A target will want to limit exercise of any stock option or payment of any bust-up fee to actual change of control events–i.e., the consummation and not just the proposal of a competing offer–so as not to expose the target to a third-party bid that allows the initial acquiror to exercise the option or receive the bust-up fee but is then never consummated, leaving the target with depleted capital and a long face. As a result, so-called "double triggers" that provide for certain "vesting" events–such as a publicly announced competing bid–as conditions to the exercise of the options or payment of the bust-up fee are often negotiated.

Stock options have long been accepted as part of merger transactions and may be necessary to induce an acquiror to enter into an acquisition agreement. Reasonable bust-up fees are also a common means of inducing a party to enter into a transaction by compensating the bidder for its opportunity costs, fees and expenses in connection with making a proposal. Precedent provides basis for the view that a bust-up fee of up to 2 percent to 3 percent of the aggregate transaction value is sustainable, even in a large transaction. In smaller transactions, somewhat higher bust-ups may be reasonable. However, where they are granted primarily as a defensive tactic to deter potential third-party bidders, stock options and bust-up fees, like any other defensive device, will be subject to enhanced judicial scrutiny.[8]

No-Shop and Window-Shop Clauses

A "no-shop" provision in a merger agreement provides that, subject to limited exceptions–typically fashioned to allow the target's directors to comply with their fiduciary duties–the target company will not negotiate with third-party bidders. A "window-shop" clause generally allows the seller to respond to unsolicited offers by supplying confidential information and to consider certain competing bids but prohibits actual solicitation of bids. A window-shop clause will often be included in lieu of a more complete no-shop in cases where a target board had not had a full opportunity to explore alternatives and wishes to retain flexibility to entertain competing offers within an agreed framework. Depending upon the circumstances and procedures relating to the target company's decision to enter into a merger agreement, a reasonable no-shop or window-shop provision in a negotiated merger will be sustainable. The exact nature of the provision will depends on the context of the acquisition and must be carefully crafted to comply with a complicated set of legal rules.

Management/Shareholder Voting Agreements

In addition to stock options, no-shop clauses and bust-up fees, an acquiror may also seek commitments from significant shareholders of the seller, whether members of management or otherwise, to support the transaction. Such arrangements may be in the form of voting agreements or separate options for the acquiror on such individuals' stock. The visible, up-front support of major shareholders for a transaction can be a significant deterrent–both actual and psychological–to third-party bids, and may be critical in consummating the transaction. Obtaining such voting agreements from REIT sponsors and/or REIT management, who often are significant shareholders, is obviously desirable in a REIT acquisition transaction. Consideration need also be given, however, to the way in which these voting arrangements will be scrutinized to determine whether the board has fulfilled its duties.

UPREIT Complications

Takeovers of umbrella partnership REITs, or UPREITs, present a number of unusual issues that are largely attributable to the complex interrelationships inherent in the UPREIT structure. The classic UPREIT combines corporate and partnership forms into a structure in which the publicly traded REIT owns properties and conducts business through an operating limited partnership, or OP, in which the REIT is the general partner and the REIT's sponsors are limited partners. The UPREIT structure provides tax deferral to sponsors who wish to contribute low-basis properties to a REIT. While contribution of the properties directly to the REIT in exchange for stock would be a taxable transaction, contribution of the properties to the OP in exchange for limited partner units, or OP Units, is tax free and defers recognition of the built-in gain.

Thus, real estate entrepreneurs are able to use the UPREIT structure to take their historic holdings public, without paying a large tax as if they had sold even the assets they retain. Of course, the deferred gain will be recognized when the sponsors sell or convert their OP Units and in various other circumstances. In general, though, this recognition will coincide with the receipt of cash by the sponsor.

In UPREIT transactions, special consideration must be given to the rights and treatment of the OP Unitholders and to the ultimate treatment to be afforded to the OP itself. These issues will often be of paramount importance in structuring the transaction because of the significant tax burden that could result to the OP Unitholders from certain transactions. For example, the dissolution of the OP, the repayment of OP debt or the sale of the OP's assets could each trigger the very taxes on the REIT sponsor's gain that the UPREIT structure was designed to defer. Because of the sensitivity of these issues, the partnership agreement for the OP may provide the OP Unitholders veto rights over such transactions, as well as over change of control transactions. And, of course, the fact that the OP Unitholders are typically also significant shareholders, directors and officers of the REIT will tend to add special emphasis to the limited partners' concerns and to raise conflict-of-interest issues.

The REIT stockholders and the OP Unitholders may have adverse interests in connection with takeover bids because of their different tax positions. For example, an offer to purchase the shares of the REIT and the OP Units in exchange for the same amount of cash or the same ratio of stock in the acquiror may be attractive to the stockholders because of the price offered, but may not be attractive to the OP Unitholders because of the sizeable tax liability they would incur if they accepted. This dilemma was brought to light in the recent attempt by Manufactured Home Communities, Inc. to break up the friendly stock merger between ROC Communities and Chateau Properties, an UPREIT.

The UPREIT structure raises the issue–which was central to the litigation surrounding the Chateau takeover battle–of the extent to which directors of a REIT, some of whom also are OP Unitholders, may or must take into account the interests of the OP Unitholders in addition to the interests of the REIT stockholders. Put differently, the issue is how a REIT board, some of whose members are also OP Unitholders, should act when a takeover transaction gives rise to a conflict between the interests of the Unitholders and the interests of the stockholders. The board of the REIT obviously owes a fiduciary duty to the REIT's stockholders but, at the same time, the REIT, as general partner of the OP, owes a fiduciary duty to the Unitholders. The pivotal question is which duty the REIT's board should consider paramount. Although the law provides little guidance on this point, there is good reason to believe that the courts will hold that the duty to stockholders is paramount and that, in the case of a conflict, the board may consider the claims of the OP Unitholders only in determining what will ultimately be best for the stockholders, including taking account of potential liability of the REIT to the Unitholders for breach of fiduciary duty.

An important issue for a conflicted UPREIT board is how to address the conflict from a procedural standpoint. Although the answer will ultimately depend on the specific circumstances at issue, careful consideration should be given in such instances to utilization of a special committee–particularly where a majority of the directors are also OP Unitholders–and to recusal of the “interested” directors.

Conclusion

The increasing corporatization and securitization of commercial real estate in the U.S. will continue to change the way in which real estate is bought and sold. Corporate-style M&A transactions involving REITs and other real estate operating companies, including hostile takeovers, are likely to become increasingly prevalent. While many of the principles of corporate M&A will apply equally in the REIT context and should be taken into account by the real estate industry, REIT transactions raise several unique and complex issues which do not arise in typical corporate deals. This article has sought to provide a brief introduction to the REIT-specific and non-REIT specific concepts and issues which are likely to be relevant in REIT takeover transactions.

1 The "5/50 rule" is one of the REIT qualification requirements of Section 856(a) of the Internal Revenue Code (the "Code").

2 The "look through" mechanism is incorporated into the 5/50 rule through the application of Section 544(a)(1) of the Code, which provides that "Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners or beneficiaries."

3 See Realty Acquisition Corp., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) & 95,245 (D. Md. Oct. 27, 1989). The court applied the business judgment rule to uphold the target's use of an excess share provision, largely because the offer being deterred was a coercive tender offer, precisely the sort of offer the excess share provision was designed to deter. Id. at 96,083.

4 See, e.g., Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985).

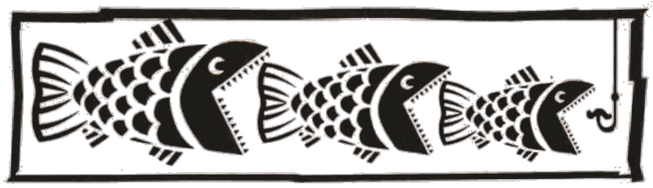
5 See, e.g., Buckhom, Inc. v. Ropak Corp., 656 F. Supp. 209 (S.D. Ohio), aff’d, 815 F.2d 76 (6th Cir. 1987).

6 Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34

REIT Mergers and Acquisitions and Takeover Preparedness

Part 1: Poison Pills and Excess Shares

by Adam O. Emmerich and Robin Panovka



Consolidation: An Emerging Trend

The REIT industry appears to be on the verge of a period of major acquisition and consolidation activity. Difficulties in finding property acquisition opportunities, coupled with a need to increase dividend yield, are driving healthy REITs to acquire other REITs or private real estate companies. Declines in share prices and limited access to much-needed capital are forcing underperforming REITs to seek partners among the stronger REITs. Lessened investor appetite for REIT offerings is stimulating private real estate companies' interest in merging with public REITs, and certain sponsors of underperforming REITs who are frustrated with the demands of running public companies are searching for an exit strategy. In addition, fragmentation in the REIT industry—there are approximately 200 public REITs in an industry with an aggregate capitalization of $50 to $60 billion—and economies of scale resulting from business combinations portend a strong consolidation trend.

The trend requires that members of the industry familiarize themselves with the legal and strategic considerations that apply in takeover transactions, and develop appropriate strategies—implementing defenses (recognizing that any REIT can become an acquisition target at any time) and, in the case of stronger REITs, considering acquisition alternatives. This article, the first in a two-part series, provides an overview of the duties of directors in merger and acquisition transactions, as well as in the context of the adoption of defensive measures, and a discussion of certain defensive measures to be adopted in advance of any threatened takeover.

Duties and Responsibilities of a REIT Director

The standards of conduct to which directors are held are an important factor in takeovers. Corporate directors owe a fiduciary duty to their stockholders. Maryland law (under which most REITs are incorporated) requires directors to perform their duties in a manner which they reasonably believe to be in the corporation's best interest and with the care that an ordinary prudent person in a like position would exercise under similar circumstances.[1]

The duties of corporate directors are generally classified as the "duty of loyalty" and the "duty of care". The duty of loyalty is the directors' obligation to act in good faith for the benefit of the REIT and its shareholders, and not with some other goal in mind. For example, the duty of loyalty prohibits a director from causing a REIT to enter into a one-sided contract for the benefit of another entity the director controls. The duty of care is the directors' obligation to act on an informed basis, after due consideration of the relevant facts; in so acting, directors are entitled to rely, where appropriate, on the input of legal and financial experts.

Business Judgment Rule. Under normal circumstances, judicial review of director conduct is based upon the business judgment rule. Under the rule, directors are entitled to a rebuttable presumption that they have acted in accordance with their duties, in good faith, in the best interests of the REIT and with prudent care.[2] Courts are hesitant to substitute their judgment for that of the board of directors. The presumption can be rebutted by a showing of fraud, bad faith or breach of the fiduciary duties of care and loyalty, including uninformed decision-making based on insufficient knowledge.[3] In the takeover context, Maryland courts have indicated that the presumption of the business judgment rule is defeated when the board of directors acts with the principal purpose of perpetuating its control (presumably a violation of the duty of loyalty). Conversely, where the board is primarily motivated by a legitimate corporate purpose, even board action that may have the collateral effect of consolidating or perpetuating management control has traditionally been protected by the business judgment rule.[4]

Enhanced Scrutiny. Under the often persuasive and extensively developed Delaware corporate law, there are limited situations in which courts will not defer to board decisions by applying the traditional business judgment rule. These include the adoption of defensive measures in response to an alleged threat to corporate control or policy, and approval of a transaction involving a sale of control and/or a break-up of the company.[5] In these circumstances, board action is subject to judicial review under an "enhanced scrutiny" standard which looks both to the board's process as well as to its action. Although there is no explicit authority in Maryland for applying the enhanced scrutiny standard to the adoption of defensive mechanisms or the sale of control of a corporation, it is reasonable to assume that Maryland courts follow most jurisdictions that apply a higher than normal level of scrutiny to board actions because of the high stakes involved and because inside directors (management) may face potential conflicts between the best interests of stockholders and their self-interest.

Directors who adopt defensive mechanisms in response to an alleged threat to corporate control or policy (including an unsolicited takeover proposal) carry the burden of proving that their

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process and conduct satisfy a two-pronged test before the business judgment rule attaches. Under the so-called Unocal test, they must first show they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed (which may be shown by the directors' good faith and reasonable investigation), and second, that the defensive measure chosen was reasonable in relation to the threat posed, which may be demonstrated by the objective reasonableness of the course chosen.[6] While Unocal has enhanced the scrutiny courts pay to director conduct, courts continue to grant boards of directors considerable latitude.[7]

Transactions involving a sale of control also are subject to enhanced judicial review. Under Delaware law, a director has the duty in the sale of control context to achieve the highest value reasonably available for stockholders. In Revlon, the Court found that, once the directors had decided to sell control of the company, "the directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[8] The Revlon test, although defining a different responsibility than that of Unocal, has also been construed as imposing enhanced duties on directors.

Entire Fairness. When an actual conflict of interest that affects a majority of the directors approving a transaction is found, Delaware courts apply the more exacting "entire fairness" standard, which requires a judicial determination of whether the transaction is entirely fair to stockholders both in terms of process and price. Such conflicts may arise in situations in which the directors appear on both sides of a transaction, as in a management buyout, or derive a personal financial benefit that does not devolve generally upon the REIT and its stockholders.[9] Application of the entire fairness standard of review can often be avoided through the adoption of procedures that insulate interested directors from the decisionmaking process. One example of such a procedure is the creation of a special board committee to evaluate a proposed transaction.

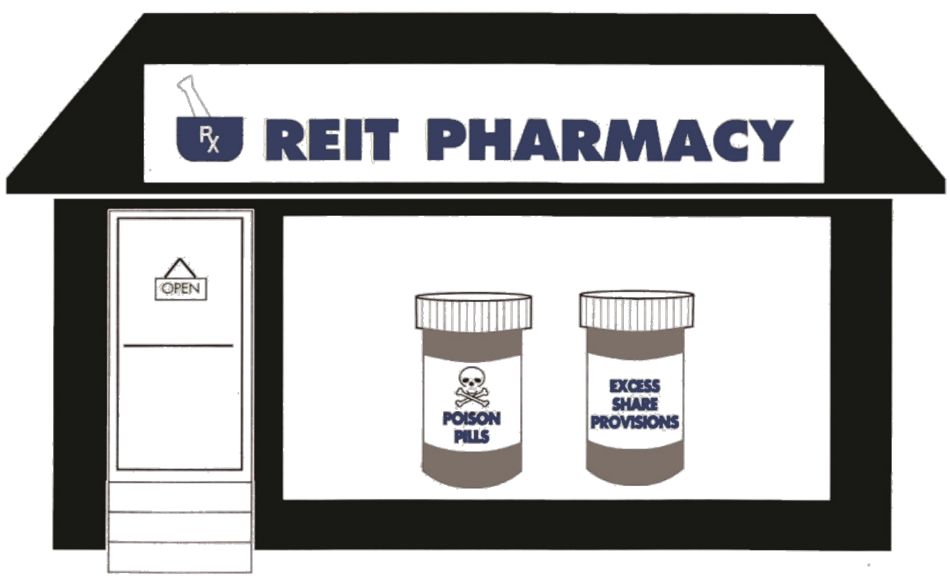
Takeover Preparedness

Advance takeover preparedness is vitally important from a legal as well as a business perspective. Defensive measures taken in response to a hostile bid are subject to a higher level of judicial scrutiny and are more likely to be invalidated by the courts than are preplanned strategies. Advance planning also makes good business sense. An unprepared REIT faced with an unsolicited offer is likely to have fewer choices. In addition, certain defensive measures, such as a rights plan (popularly known as "poison pills"), may lead to higher takeover premiums.

Excess Share Provisions-Effective Shields? The most common advance takeover defense utilized by REITs is the excess share provision. Typically found in a REIT's articles of incorporation, the provision restricts the number of shares that any shareholder can own—ostensibly in order to protect the REIT from violating the so-called "5/50 rule".[10] Under the 5/50 rule, five or fewer individuals are not permitted to own in excess of 50 percent of the shares of a REIT during the last half of the REIT's taxable year. As a result, a typical excess share provision restricts the maximum number of shares that any shareholder can acquire to 9.8 percent; in the case of REITs in which a sponsor or other shareholder owned more than ten percent of the stock at the time the excess share provision was adopted, the ownership limit for other shareholders is typically set at a lower number to ensure compliance with the 5/50 rule. Excess share provisions typically do not incorporate the "look-through" mechanism of the 5/50 rule pursuant to which only actual people—and not corporations, partnerships, estates, trusts or other entities—are restricted in their ownership,[11] and therefore restrict any entity from acquiring in excess of the stated maximum percentage of shares.

Excess share provisions strip any shares acquired by a shareholder in excess of the 9.8 percent (or lower) restriction of any voting rights or rights to receive dividends until the "excess" shares are transferred to a holder who can own them without violating the ownership restriction. However, they also typically provide the REIT's board of directors with the discretion to waive the limitation with respect to particular persons if the board is made comfortable (through an opinion of counsel or a ruling from the Internal Revenue Service) that the acquiror is not an individual for purposes of Section 542(a)(2) of the Code (i.e., the acquiror is a corporation, partnership or any other non-"individual" as to whom the 5/50 rule's look-through would apply) and the board obtains such representations and undertakings from the acquiror as it deems to be reasonably necessary to ascertain that no *individual's* beneficial ownership of stock will violate the ownership limit.

Excess share provisions are a potent deterrent to unfairly priced or coercive hostile takeover attempts. Unlike rights plans,



which, if triggered, would inflict permanent and severe economic dilution to the transgressing acquiror, however, excess share provisions are not invulnerable—the “excess shares” are not permanently tainted; rather, they can be restored to their normal status by transfer to a non-offending person.[12] As a result, the potential acquiror can legitimately threaten disruption; while its own ability to acquire the REIT may be foreclosed, its threat of transfer to a number of unaffiliated institutions may in and of itself prove an effective bargaining lever.

Extra Strength Prescription

Experimental Defense

In addition to the manner in which an excess share provision may be defused after the fact, a hostile acquiror would typically seek to have the provision set aside or nullified as part of its hostile attack. As with rights plans, the key question facing a target’s board is whether, or at what point, the board has a duty to waive the excess share provision in the face of a hostile takeover offer. The law is still not well-established on the issue.

In Realty Acquisition Corp. v. *Property Trust of America,*[13] a federal district court applying Maryland law upheld Property Trust of America’s (PTA) refusal to waive its excess share provision in the face of a hostile partial tender offer by Realty Acquisition Corp. (RAC). RAC had expressly conditioned its partial tender offer on the court’s invalidation of PTA’s excess share provision, poison pill and other defenses. RAC argued that the failure of PTA’s trustees to exempt RAC from PTA’s 9.8 percent ownership limit was contrary to PTA’s declaration of trust (the equivalent of a corporate charter) and, in addition, constituted a breach of the trustees’ fiduciary duty. The court rejected RAC’s first assertion by pointing out that the declaration of trust permitted, but did not require, the trustees to exempt from the ownership limit acquirors who provide evidence and assurances acceptable to the trustees that the REIT status of PTA would not be jeopardized by their stock ownership. However, the court appeared to ground its decision on the fact that the offer was a partial offer. It was the type of offer that, according to the proxy statement proposing the excess share provision, the provision was aimed at deterring.[14] In rejecting RAC’s breach of fiduciary duty argument, the court applied the business judgment rule without any heightened scrutiny to the case, and stated:

> In the present case, there is no evidence that [PTA’s] trustees acted with “gross or culpable negligence”. . . in refusing to exempt [RAC] from the ownership limit or that the trustees’ conduct was in any way fraudulent.[15]

Excess share provisions were held to be invalid in two earlier cases.[16] However, in each case, the provision was adopted by the board of directors in response to a takeover threat, and the directors were found to have exceeded their authority.[17]

The excess share provisions adopted by many of the REITs formed in recent years differ in a number of important respects from the provisions which were invalidated because directors exceeded their authority and from the PTA excess share provision. Unlike the invalidated provisions, modern excess share provisions are usually adopted by the shareholders in the articles of incorporation, thus obviating any argument that the adoption of the provision is beyond the scope of the directors’ authority. And, unlike the PTA provision, modern provisions frequently are not limited to coercive tender offers and would apply to cash tender offers for all outstanding shares. Moreover, many prospectuses of modern REITs describe the excess share provision as a device that is intended to protect the REIT’s status under Section 856 of the Code and which may have the incidental or collateral effect of deterring takeovers, rather than describing it, as did the PTA proxy statement, as having been designed to protect against takeovers. The more recently adopted excess share provisions are likely to be tested in the coming consolidation wave, particularly in instances where the excess share provisions are used to thwart non-coercive cash offers for 100 percent of the stock of the REIT or transactions which do not threaten the REIT status of the target.

Poison Pills—Harder to Swallow than Excess Shares. The most effective device yet developed in response to abusive takeover tactics and inadequate bids is the share purchase rights plan, popularly known as the “poison pill.” Unlike excess share provisions, poison pills hold out the threat of punitive economic dilution to the acquiror. In all, over 1,550 companies have adopted rights plans, including 51 percent of the Business Week 1000 companies, 56 percent of the Fortune 500 companies and 68 percent of the Fortune 200 companies. Perhaps because of the increasing pace of hostile merger activity and strategic consolidation in 1994, the number of companies implementing rights plans rose significantly in 1994.

Rights plans, properly drafted to comply with state law and the company’s charter, typically survive judicial challenge.[18] Economic studies have concluded that takeover premiums are higher where rights plans or modern anti-takeover statutes are in effect than in the absence of such provisions, and that a rights plan or similar protection increases the target’s bargaining power. In addition, numerous studies have concluded that the negative impact, if any, of adoption of a rights plan on the company’s stock price is very small (less than one percent).

Rights plans do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. The evidence is clear, however, that they do have the desired effects of both forcing acquirors to deal with the target’s board of directors and ultimately extracting from acquirors higher acquisition premiums than would otherwise have been the case.

Careful consideration must be given to the adoption of a rights plan, even if an excess share provision is in place. A rights plan may be particularly important in cases where the threatened takeover does not jeopardize the REIT's tax status under the 5/50 rule because, as discussed above, the excess share provision may be vulnerable as a takeover defense in such circumstances.

The key features of a rights plan are the "flip-in" and "flip-over" provisions of the rights, the effect of which, in specified circumstances, is to impose unacceptable levels of dilution on the acquiror. The rights are triggered when the stock ownership of a shareholder, or a group of shareholders acting in concert, exceeds a stated threshold (generally an acquisition of 10-20 percent of the target's stock), and they give all other shareholders the right to purchase either the target's stock (flip-in) or the acquiror's stock (flip-over) at a substantial discount, effectively diluting the acquiror's stock ownership. The risk of dilution, combined with the authority of a target's board of directors to redeem the rights prior to a triggering event, gives a potential acquiror a powerful incentive to negotiate with the target's board of directors rather than proceeding unilaterally.

Properly drafted rights plans also provide that, once the triggering threshold is crossed, the target company's board may exchange, in whole or in part, the rights of all holders other than the acquiror for one share of the company's common stock. This provision avoids the expense of requiring rights holders to exercise their flip-in rights, eliminates any uncertainty as to whether individual holders will in fact exercise the rights, producing the intended dilution, and provides the board additional flexibility in responding to a triggering event. In cases where the acquiring person holds less than 50 percent of the company's stock, the dilution caused by implementation of the exchange feature is substantial and can be roughly comparable to the dilution caused by the flip-in provision, assuming all eligible rights holders exercise their rights. The exchange also allows the board to control the amount of dilution, since these provisions typically provide that the rights may be exchanged in whole or in part.

In the REIT context, consideration should be given, among other things, to the impact of rights (particularly after triggering) under the option attribution rules applicable to the 5/50 test and excess share provisions discussed above.

Other Defenses-Charter and By-Law Provisions. The "excess share" provision is not the only defensive charter and by-law provision available to REITs. Other provisions that give a measure of protection against certain takeover tactics and allow the board of directors some additional negotiating leverage include: "fair price" provisions; classified board provisions; provisions which eliminate shareholder action by written consent; and bylaw provisions governing shareholder nominations for directors and the submission of shareholder proposals at meetings. Fair price provisions require that shareholders receive equivalent consideration at both ends of a two-step bid, thus deterring coercive two-tier, front-end loaded offers. Classified board provisions divide the hoard into several (usually three) equal size classes of directors, each of which serves a multi-year (usually three year) term. The terms are staggered so that only a portion of the board (usually one-third) comes up for election each year, thus preventing a bidder from obtaining control of the board quickly and assuring a company sufficient time to cope with an attempted takeover. Classified boards and fair-price charter provisions require shareholder approval to be implemented. However, due to general institutional investor opposition to such provisions, few companies have put forth proposals for such provisions in recent years.

Bylaw provisions governing the calling of, the business to be conducted at, and the manner of presenting proposals for, annual and special meetings can be adopted without shareholder approval. These provisions, as well as the elimination of shareholder action by written consent, can be especially helpful in protecting against an unexpected proxy contest for control of the board of directors. Such provisions should be reviewed periodically to ensure that they are consistent with recent case law and SEC developments.

The REIT Executive-Change of Control Employment Agreements. Change of control employment and benefit arrangements should be reviewed to ensure that senior executives and other employees will be properly protected in the event of a merger or other business combination. In the event of a takeover involving a change of control or a strategic merger, senior executives typically face a great deal of pressure, including the uncertainty of their own future, and such arrangements can help assure their full participation in the merger negotiation process and in the transition period after a combination. Appropriately structured change of control employment agreements are both legal and proper. Careful attention must be paid to tax, regulatory and other legal concerns in structuring such agreements. Although there is little case law relating to the adoption of such agreements, they typically, absent a conflict of interest, have been found to be enforceable and consistent with directors' fiduciary duties.[19]

As part of the Tax Reform Act of 1986, as amended by the Tax Reform Act of 1986, Congress adopted Sections 280G and 4999 of the Code imposing so-called "golden parachute" tax penalties on certain change-of-control payments in an effort to curb perceived abuses. In general, the golden parachute tax rules subject "excess parachute payments" to a dual penalty: the imposition of a 20 percent excise tax upon the recipient employee and non-deductibility of such payments by the paying corporation.[20] Excess parachute payments result if the aggregate payments received by an employee that are "contingent on a change of control" equal or exceed three times the employee's "base amount" (the average annual taxable compensation of the employee for the five years preceding the year in which the change of control occurs). In such a case, the excess parachute payments are equal to the excess of such aggregate change of control payments over one times the employee's base amount. Payments which constitute "reasonable compensation" for services actually rendered may be excluded from excess parachute payments in some cases. Tax counsel can assist in developing approaches to address the consequences of golden parachute tax penalties.

Companies may also wish to consider so-called "tin parachutes" for less senior executives in order to formalize company policies regarding severance as well as the appropriate treatment of stock-based compensation plans, bonus plans, and supplemental executive retirement plans and other forms of deferred compensation in the event of a change of control.

Conclusion

Advance takeover preparedness is vitally important. The emerging consolidation trend requires that REITs review their defenses, consider fortifications and familiarize themselves with the M&A landscape. In this article we have sought to provide an introduction to the duties and responsibilities of REIT directors in the takeover context and to certain defensive measures which may be adopted in preparation for possible takeover threats. The second article in this series will address responses to unsolicited offers and techniques for protecting takeover transactions from the time they are publicly announced until they are consummated.

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Endnotes

1. *See* Md. Code. Ann., Corps. & Assns § 2 405.1 (1993).

2. *See Zimmerman* v. *Bell*, 800 F.2d 386, 392 (4th Cir. 1986); *Devereaux* v. *Berger*, 284 A.2d 605 (Md. 1972); *Yost* v. *Early*, 589 A.2d 1291, 1298 (Md. Ct. Spec. App. 1991).

3. *See NCR Corp.* v. *AT&T*, 761 F. Supp. 475, 490-92 (S.D. Ohio 1991); *Black* v. *Fox Hills North Community Assoc.*, 599 A.2d 1228, 1231 (Md. Ct. Spec. App. 1992); *Mountain Manor Realty* v. *Buccheri*, 461 A.2d 45, 50-51 (Md. Ct. Spec. App. 1983).

4. *See Zimmermann*, 800 F.2d at 392; NCR Corp., 761 F. Supp. at 495-96; *Cummings* v. *United Artists Theatre Circuit, Inc.*, 204 A.2d 795 (Md. 1964); *Mountain Manor Realty*, 461 A.2d at 52-53.

5. *See,* e.g., *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (defensive mechanism adopted in response to alleged threat to corporate control and policy); *Paramount Communications Inc.* v. *QVC Network, Inc.*, 637 A.2d 34 (Del. 1994) (transaction involving a sale of control); *Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (transaction involving a break-up of the company).

6. *Unocal*, 493 A.2d at 955.

7. *See,* e.g., *Unitrin, Inc.* v. *American General Corp.*, 651 A.2d 1361 (Del. 1995).

8. *Revlon*, 506 A.2d at 182.

9. *See,* e.g., *Weinberger* v. *UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Ivanhoe Partners* v. *Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987).

10. The "5/50 rule" is one of the REIT qualification requirements of Section 856(a) of the Internal Revenue Code (the "Code"). Under the 5/50 rule, five or fewer "individuals" are not permitted to own in excess of 50 percent (by value) of a REIT's outstanding stock at any time during that last half of the REIT's taxable year. I.R.C. §§ 542(a)(2), 856(h)(1)(A).

11. The "look-through" mechanism is incorporated into the 5/50 rule through the application of Section 544(a)(1) of the Code, which provides that "Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall he considered as being owned proportionately by its shareholders, partners, or beneficiaries."

12. Some excess share provisions do have potentially punitive components, such as an option allowing the REIT to purchase the excess shares from the acquiror at a price that is potentially unfavorable for the acquiror and sometimes with payment of the purchase price deferred almost indefinitely.

13. [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) Par. 95,245 (D. Md. Oct. 27, 1989).

14. *Realty Acquisition Corp.*,[1990 Transfer Binder] Fed. Sec. L. Rep. (CCII) at 96,083.

15. *Realty Acquisition Corp.*,[1990 Transfer Binder] Fed. Sec. L. Rep. (CCII) at 96,083.

16. *Pacific Realty Trust* v. *APC Investments, Inc.*, 651 P2d 163 (Or. Ct. App. 1982); *San Francisco Real Estate Investors* v. *Real Estate Investment Trust of America*, 701 F.2d 1000 (1st Cir. 1983).

17. In *Pacific Realty Trust, supra,* the trustees of Pacific Realty Trust adopted an excess share bylaw provision, without shareholder approval, in an effort to block a partial tender offer by APC Investments, Inc. The Court of Appeals of Oregon held that the excess share bylaw provision was invalid because its adoption by the trustees without shareholder approval exceeded the authority granted to the trustees by Pacific Realty Trust's declaration of trust.

Similarly, in San Francisco Real Estate Investors, supra, the court believed that the adoption by the trustees of Real Estate Investment Trust of America (REITA) of an excess share bylaw provision which was more restrictive than the general provision of the target's declaration of trust effectively repealed the declaration's provision without the requisite shareholder approval. The court therefore grained a preliminary injunction against the enforcement of the excess share provision to block the acquirer's takeover attempt. Interestingly, the court noted that although it had no occasion to address whether the adopted excess share provision was a "manipulative device," it did have a concern "over the possibility that business enterprises . . . may, by internal bylaws or charter amendments, insulate themselves from takeover actions." *San Francisco Real Estate Investors*, 701 F.2d at 1007 n.10.

18. *See*, e.g., *Moran* v. *Household International, Inc.*, 500 A.2d 1346 (Del. 1985).

19. *See*, e.g., *Buckhorn, Inc.* v. *Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio), affd, 815 F.2d 76 (6th Cir. 1987).

20. Deductibility may also be affected by Section 162(m) of the Code denying deductions for compensation to an affected employee exceeding $1 million in any taxable year. This $1 million limit is reduced by the amount of any excess parachute payments.

REIT Mergers and Acquisitions

Part II: Structuring Transactions, Protecting Deals and Responding to Unsolicited Offers

by Adam O. Emmerich and Robin Panovka

The much talked-about increase in corporate transactions involving REITs appears to be gathering momentum. Although the pace of merger and acquisition activity involving REITs has disappointed some, many continue to believe in the inevitability of consolidation and foresee the commercial real estate industry with an increasing number of assets held by a decreasing number of publicly owned players. In addition to REIT mergers and acquisitions (M&A), the past year has seen a marked increase in the number of "white-squire," strategic alliance and quasi-change-of-control transactions involving REITs. Slowly but surely, the REIT industry is gaining familiarity with transactions that are commonplace in the non-REIT corporate world, including M&A.

Given the pace of developments, REITs and their directors, officers and advisors would be wise to familiarize themselves with the M&A landscape. The first article in this two-part series (published in *The REIT Report*, Autumn 1995) discussed the duties and responsibilities of REIT directors in M&A transactions and examined certain defensive measures that could be adopted in preparation for possible hostile takeover threats. This article provides an overview of the typical structures of M&A transactions, techniques for protecting transactions from the time they are publicly announced until they are consummated, and responses to unsolicited takeover offers.

Transaction Structures

REIT acquisitions, like other acquisitions, can be structured in a number of ways.[1] An acquiror of a REIT can purchase all of the target's stock, either through a tender offer followed by a merger or in a unitary merger transaction. In a transaction structured as a tender offer followed by a merger, the follow-up merger is used to eliminate any minority shareholders remaining after the tender offer. In a unitary merger transaction, the target's shareholders generally receive cash, stock of the acquiror, or a combination of stock and cash. Whether used as a follow-up to a tender offer or alone, a merger makes one of the corporations disappear (with its shareholders either being cashed out or becoming shareholders of the surviving corporation). In "forward" and "reverse" triangular mergers, a newly-formed shell subsidiary of the acquiror is used as the merger vehicle in order to keep the target as a separate subsidiary, and either the newly-formed shell or the target disappears. Mergers generally require shareholder approval; however, if the merger is a second step in a tender-offer/merger transaction, the tender offer will usually be conditioned on the buyer acquiring sufficient stock in the tender offer to assure the vote with respect to the merger.

An acquiror of a privately-held real estate company (including a wholly-owned subsidiary of a public company) also can effect a stock acquisition by negotiating for the purchase of stock directly from the stockholders. If there are numerous stockholders, the acquiror must take care to comply with the provisions of the Williams Act, which require that "tender offers" comply with certain timing, disclosure and equal treatment rules.

In a third type of transaction, an asset acquisition, the acquiror acquires the target's assets rather than its stock. The advantage of asset acquisitions over stock acquisitions, from the acquiror's perspective, is that the liabilities of the target are not necessarily all assumed by the acquiror. In general, however, asset transactions are possible where the seller is a privately held real estate company (if the seller can be convinced to use such a form and to retain all unassumed liabilities) but are impractical in the context of an acquisition of a publicly traded REIT.

In any transaction, tax considerations must be borne in mind; in particular, care must be taken not to violate the complex Internal Revenue Code rules applicable to REITs that are discussed below.

Typical Hostile Transactions. Takeover transactions in which the acquiror pursues the target without the approval or invitation of the target's board of directors are "hostile" transactions. Hostile transactions typically begin with a "bear-hug" letter to the target's board of directors in which the acquiror proposes a business combination with the target and states or intimates that it will deal directly with the target's shareholders if a friendly deal cannot be worked out quickly. If the target's board rejects the advance, the persistent acquiror generally proceeds to launch a tender offer and/or a proxy solicitation—appealing directly to the target's shareholders. In most instances, the tender offer will be conditioned on removal by the target's board of any obstructions to the acquiror gaining control of the target (*e.g.*, waiving any applicable excess share provision or redeeming a poison pill, if one has been adopted). If the obstructions are removed and if, having held open its offer for the minimum 20 business-day period required by the Williams Act, the acquiror has received tenders of a sufficient number of shares for it to gain control of the target, the acquiror will purchase the tendered shares. With the shares in hand, the acquiror would take control of the target—either through a written consent procedure that allows it to replace the target's board or through a merger approved at a meeting called by the acquiror-shareholder. If the obstructions are not removed, the persistent acquiror may commence a proxy or consent solicitation, in order to circumvent the limits imposed by shareholder rights plans (so-called poison pills) or, in the REIT context, by excess share provisions, on the accumulation of shares. Particularly since the development and widespread acceptance of rights plans, hostile tender offers have often been accompanied by such proxy or consent solicitations from the outset.

Tax Considerations. Tax considerations often drive the choice of a particular transaction structure (including the form of the transaction, the consideration offered and the timing of steps) in acquisitions and combinations. Sections 351 and 368 of the Internal Revenue Code provide a number of methods for effecting acquisition and combination transactions as tax-free incorporations and reorganizations. Both Sections generally require the issuance of acquiror stock as the sole or principal consideration. Failure to qualify as an acquisition under an applicable non-recognition provision of the Code can result in taxable gain to stockholders of the acquired REIT and, in some cases, to the REIT entity itself. In the REIT context, in addition to the usual concerns of qualifying for tax-free treatment (if sought), it typically will also be important to structure the transaction in a manner that takes account of the REIT qualification provisions of Section 856 of the Code and does not jeopardize REIT status. Finally, state and city real estate transfer and mortgage recording taxes must also be considered in structuring REIT acquisition and combination transactions, particularly in states and cities like New York where substantial transfer and gains taxes may apply to transfers of stock of entities that own real estate (as well as to direct transfers of real property) and where special rules may apply to transfers to REITs.

In any transaction, tax considerations must be borne in mind; in particular, care must be taken not to violate the complex Internal Revenue Code rules applicable to REITs.

Securities Law Considerations and Disclosure Requirements. The periodic and other disclosure duties that apply to all aspects of public REIT operations are heightened in the context of change-of-control transactions. In addition to particular disclosure rules and regulations uniquely applicable to changes of control and potential changes of control (*e.g.*, the requirement to disclose any accumulation of 5 percent or more of the stock of a publicly traded REIT as well as specific disclosure requirements and forms applicable to making and responding to tender offers and proxy contests), the potential for misuse of confidential and non-public information during an actual or potential change of control is particularly acute. Leaks, even inadvertent leaks, by corporate insiders of non-public information during pending change of control transactions can derail potential transactions and lead to significant personal liability for those involved.

UPREITs. The Umbrella Partnership REIT (UPREIT) structure, which has been utilized by many recently formed REITs, gives rise to a number of unusual issues in M&A transactions. In the classic UPREIT structure, the publicly traded REIT conducts its business and owns its properties through an operating partnership in which the REIT is the general partner and the REIT's sponsors are the limited partners. The UPREIT structure is employed to provide tax-deferral to sponsors with appreciated real estate. While the transfer of the real estate to the REIT in exchange for REIT stock would be a taxable transaction, transfer to the operating partnership in exchange for limited partnership units is a tax-free transaction.

In UPREIT transactions, special consideration must be given to the rights and treatment of the limited partners in the operating partnership and to the ultimate treatment to be afforded to the operating partnership itself. These issues will often be of paramount importance in structuring the transaction because of the significant tax burden that could result to the limited partners from certain transactions. For example, the dissolution of the operating partnership, the repayment of operating partnership debt or the sale of the operating partnership's assets could each trigger the very taxes on the REIT sponsor's gain that the UPREIT structure was designed to defer. And, of course, the fact that the limited partners are typically also significant shareholders of the REIT will tend to add special emphasis to the limited partners' concerns.

There are a number of structural alternatives that can be employed in mergers or acquisitions of UPREITs. For example, two UPREITs could merge through the separate mergers of the two corporate general partners (the REITs) and of the two operating partnerships; a REIT or UPREIT could acquire or merge with an UPREIT without acquiring or merging with the target UPREIT's operating partnership; or the assets of an UPREIT could be contributed to the acquirer UPREIT's operating partnership in exchange for limited partner units in the operating partnership in a Section 721 transaction. Whatever the structure chosen, careful attention should be paid in any UPREIT transaction to the resolution of any conflicts of interest between the REIT shareholders (other than those who are also limited partners) and the limited partners of the operating partnership. The conflict of interest concern, which is inherent in the UPREIT structure, will be exacerbated in the context of M&A transactions because of the limited partners' particular tax objectives and, frequently, their desire to retain control of the REIT.

The tax deferral achieved by contributions of property to operating partnerships in exchange for partnership units is a powerful tool for UPREITs in acquisitions of properties and private non-REIT real estate companies, as well as, possibly, in acquisitions of other REITs.

Control Over Management Company. Management companies employed by REITs are often "subsidiaries" of the

REITs, substantially all of the economic interests in which are owned by the REITs but, because of the requirements of Section 856(c) of the Code, at lease 90 percent of the voting securities of which are held by the REITs' sponsors or management. Occasionally, the management company is owned mostly by the REIT's sponsor and/or an ESOP and is not a subsidiary of the REIT. In either case, a REIT acquiror will typically want to ensure that it gains control over the management company and should therefore consider making the acquisition contingent on the transfer of the voting stock in the target's management subsidiary to the acquiror. Management or sponsor control of the stock of the company managing the target's properties, of course, makes a hostile acquisition more difficult.

Section 856 REIT Qualification Requirements. Care must be taken in structuring any transaction not to violate the REIT qualification requirements of Section 856(a) of the Code. Particular attention should be paid to the "not-closely-held" (or "5/50") requirement, the REIT's related prophylactic excess share provision, and the 100-shareholder requirement, as well as to the REIT income and asset tests of Section 856(c) of the Code. Under the 5/50 rule, five or fewer "individuals" are not permitted to own, directly or constructively, after the application of certain constructive ownership rules set forth in Section 544 of the Code, in excess of 50 percent (by value) of a REIT's outstanding stock at any time during the last half of the REIT's taxable year. The 5/50 limitation generally is not problematic where one REIT is acquiring or merging with another REIT, because of the "look-through" provisions of Section 544(a) of the Code which provide that if a corporation owns stock in a REIT, the 5/50 test is applied by treating the corporation's stock as being owned by the shareholders of the corporation. The 100-shareholder requirement of Section 856(a)(6) provides simply that the beneficial ownership of a REIT must be held by 100 or more persons during 335 days of each full taxable year. The 100-shareholder requirement is not subject to the "look-through" applicable to the 5/50 rule. Depending on the contemplated structure and the assets and income of each of the acquiror and the target, the restrictions of Section 856(c) on the kinds of securities and other assets that REITs can own and the type of income REITs may earn also can complicate REIT mergers and acquisitions. For example, the general prohibition on ownership by a REIT of more than 10 percent of the voting securities of another entity, other than a qualifying REIT, may complicate transactions taking the form of the acquisition of shares of the REIT (such as "reverse" triangular merger transactions). Finally, rules restricting dispositions of REIT assets may interfere with otherwise desirable post-acquisition pruning of acquired assets.

There is almost always a risk that a third-party bidder will derail the deal with a higher bid during the period between the signing and announcement of the agreement and the closing.

Protecting The Deal

Unlike the case of the typical acquisition of a real estate property, even after board approval, the consummation of a merger or acquisition agreement with a public company target is dependent upon target shareholder acceptance (either through a vote or because of the need for a minimum level of tenders, usually 50.1 percent, in a tender offer). As a result, there is almost always a risk that a third-party bidder will derail the deal with a higher bid during the period between the signing and announcement of the agreement and the closing. To address the risk, and in an effort to avoid having their deal used as a stalking horse, acquirors in business combination transactions frequently request or insist on certain protections from, or compensation for, third-party interference. From the target's perspective, the protections are often viewed as an inducement to a potential acquiror to enter into an acquisition or merger agreement, and can also serve to prompt the acquiror to increase its bid in consideration for the protection. Although recent court cases such as *Paramount Communications Inc. v. QVC*[2] show that such protective mechanisms will be closely scrutinized by the courts, target boards continue to have substantial means available to protect a transaction.

Stock Options and Bust-Up Fees. Stock options and bust-up fees are designed to compensate a jilted acquiror for losing the deal and to increase the likelihood of successful consummation of an agreed-upon transaction. A typical stock option is exercisable upon various contingencies, including, commonly, failure of consummation following a third-party bid. Since the option is priced at the deal price, or at the level at which the target company's stock was trading prior to announcement of the original acquisition agreement, the initial acquiror receives compensation in the amount of the premium over its contract price which is being paid by the second bidder.[3] A bust-up fee is simply a pre-agreed flat fee that the target is required to pay the jilted acquiror upon loss of the deal.

A target will want to limit exercise of any stock option or payment of any bust-up fee to actual change of control events (that is, the consummation and not just the proposal of a competing offer) so as not to expose the target to a third-party bid that allows the initial acquiror to exercise the option or receive the bust-up fee but is then never consummated, leaving the target with depleted capital and a long face. As a result, so-called "double triggers" that provide for certain "vesting" events (such as a publicly announced competing bid) as conditions to the exercise of the options or payment of the bust-up fee are often negotiated.

Stock options have long been accepted as part of merger transactions and may be necessary to induce an acquiror to enter into an acquisition agreement. Reasonable bust-up fees may also be a permissible means of inducing a party to enter into a transaction by compensating the bidder for opportunity costs, fees and expenses in connection with making a proposal. Precedent provides basis for the view that a bust-up fee of up to 2 to 3 percent of the aggregate transaction value is sustainable even in a large transaction. In smaller transactions, somewhat higher bust-ups may be reasonable. Where, however, they are granted primarily as a defensive tactic, to deter ☛ ***continued on page 4***

potential third-party bidders, stock options and bust-up fees, like any other defensive device, will be subject to enhanced judicial scrutiny[4]: there must be reasonable grounds for the belief that there is a danger to corporate policy and the defensive measure must be reasonable in response to the perceived threat. The *Unocal* enhanced scrutiny standard and the other standards of conduct applicable to boards are discussed in the first article in this series.

When considering stock options and bust-up fees, it is important to appreciate that, in the final analysis, less may be more. A deal that shifts control and is structured to block third-party interest is vulnerable if another bidder emerges. Favoring one bidder in such a case may especially jeopardize the deal.

Cash Put Provisions. Stock options granted in connection with acquisitions may include a so-called "cash put" provision providing that, in the event of a higher bid, the acquiror has the right to "put" the option back to the target at a per share price equal to the difference between the option exercise price and the higher bid. The exercise of the put right can serve both to protect the initial transaction and provide the unsuccessful acquiror with a profit should the initial transaction be outbid.

Expense Reimbursements. In addition to stock options and bust-up fees, acquirors often also seek agreement by the target company to reimburse the acquiror for its actual expenses incurred in connection with the transaction, up to a negotiated cap, in the event the transaction is not consummated through no fault of the acquiror.

"No-Shop" and "Window-Shop" Clauses. A "no-shop" provision in a merger agreement provides that, subject to limited exceptions (typically fashioned to allow the target's directors to furnish information to a later emerging bidder under certain circumstances and to accept a better offer if one materializes), the target company will not negotiate with third-party bidders; a "window-shop" clause generally allows the seller to respond to unsolicited offers by supplying confidential information and to consider certain competing bids but prohibits actual solicitation of bids. Depending upon the circumstances and procedures relating to the target company's decision to enter into a merger agreement, a reasonable no-shop or window-shop provision in a negotiated merger will be sustainable.

At the same time, while a prohibition on the solicitation of other bidders may be reasonable, overly restrictive no-shops may be rejected by the courts as not in the best interest of stockholders. Courts generally will not oblige negotiations with all comers, but they also will not look favorably on boards that wish to impose on themselves ignorance as an excuse for inaction. A board in a sale of control situation must be careful not to subject itself to contractual liability for fulfilling its fiduciary duty to be informed as to the true value of the company and of all bids, including bids received subsequent to signing the initial agreement. In other words, no-shop restrictions must be reasonable, even outside of the sale of control context. Thus, a typical no-shop provision will prohibit a company from initiating discussion with third parties but will permit the company to provide and receive information in response to unsolicited third-party initiatives.

Management/Shareholder Voting Agreements. In addition to stock options, no-shop clauses and bust-up fees, an acquiror may also seek commitments from significant shareholders of the seller, whether members of management or otherwise, to support the transaction. Such arrangements may be in the form of voting agreements or separate options for the acquiror on such individuals' stock. The visible, upfront support of major shareholders for a transaction can be a significant deterrent to third-party bids and may be critical in consummating the transaction. Obtaining such voting agreements from REIT sponsors and/or REIT management, who often are significant shareholders, is obviously desirable in a REIT corporate transaction.

In court, however, these voting arrangements, if used in a change-of-control transaction, will be scrutinized together with other protective and defensive measures to determine whether the board has fulfilled its duties. Stockholder voting agreements granted at the request of the board of the seller rather than the acquiror may be suspect because such arrangements can prevent or deter third-party bidders. Stockholder voting agreements obtained prior to or in conjunction with the board's approval of the merger agreements will be significant elements of a court's review of whether the board has fulfilled its fiduciary obligations, particularly under any heightened standard, since substantial voting agreements have the ability to effectively eliminate the possibility of a third-party bid.

The Use of Protective Devices in Non-Control Transactions. Bust-up fees, stock options and stockholder voting agreements have long been recognized as permissible means of protecting a transaction not involving a sale of control from third-party bids or as part of the bargaining to induce a preferred merger partner into an agreement. Such devices are generally upheld in non-change of control transactions if they are adopted for a rational business purpose. The reasonableness inquiry is not, however, a rubber stamp for directors' actions. A seller who attempts to build an impermeable fortress against all third-party offers, by definition unknown at the time the devices are adopted, is not likely to receive much deference. In addition, a board considering such a strategy must question the propriety, in view of its fiduciary duties of loyalty, care and candor, of seeking to restrict as totally as possible its ability to learn of and consider third-party offers that may prove to have even greater strategic or financial benefits to stockholders than the current preferred merger.

Responding To An Unsolicited Offer

Public companies that receive unsolicited takeover offers can usually respond lawfully in a variety of ways. The course of action the target board decides to take, however, may be subject to judicial scrutiny, and the directors must act in accordance with the applicable legal standard which, as discussed in the first article in this series, will depend on the particular circumstances surrounding the proposed acquisition.

The “Just Say No” Defense, White Knights and White Squires. Unless a target corporation has agreed to a sale of control of the company, the target may generally just say “no” to an unsolicited acquisition proposal. A “just say no” response is most likely to be accepted by the courts if the target’s board has adopted a policy of independence and a long-range plan. The Delaware Supreme Court has stated, for example, that “[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.”[5]

A white knight transaction, namely a merger or acquisition transaction with a friendly acquiror, can be a successful response to an unfriendly approach where the white knight transaction provides greater economic value to the target company’s shareholders than the initial hostile offer would have. As with all defenses, advance preparation—the identification of potential friendly suitors in this case—is important. A white squire defense, which involves placing only a block of voting stock in friendly hands, may often be realized more quickly than a white knight defense. White squire defenses are generally upheld by the courts unless the result is to consolidate voting control in management or employee hands. While they have several advantages, sales of stock to white squires should be carefully structured to avoid an unintended subsequent takeover bid by the former friend. Voting and standstill agreements are often appropriate in this context.

State Anti-Takeover Statutes. Most states have adopted anti-takeover statutes, which are another source of potential protection for a REIT target. Maryland, for example, has enacted the Control Share Act[6] and the Business Combination Act.[7] Under the Control Share Act, if, prior to a takeover, an acquiror acquires a controlling block of shares (at least 20 percent of the target’s shares) in a Maryland corporation, the acquired “control shares” are stripped of voting rights unless two-thirds of the target’s shareholders other than the acquiror, officers or employee-directors vote otherwise at a meeting specially called for such purpose. A corporation may opt out of these control share provisions by a charter or bylaw provision. The Business Combination Act provides, generally, that a Maryland corporation may not enter into any “business combination” transaction with a stockholder who acquires 10 percent or more of the corporation stock for a period of five years following the acquisition, unless the corporation’s board approved the transaction before the 10 percent acquisition.

Put Rights and Other Rights of Limited Partners in UPREITs. UPREIT limited partners (including the REIT sponsors) typically have the right to put their limited partner units in the UPREIT’s operating partnership to the REIT general partner. Generally, the consideration for the limited partner units can be paid in the form of either cash or REIT stock at the REIT’s election. Either way, given the often significant limited partner interests of the sponsors, the put rights offer sponsors a possible weapon against uninvited takeover attempts—albeit one that sponsors may be reluctant to exercise because the exercise would trigger recognition of the often substantial built-in taxable gain which led to the adoption of the UPREIT structure in the first place. UPREIT operating partnership agreements sometimes give sponsors additional rights which could be used to thwart or deter a takeover of the REIT, such as the right, as limited partners, to veto certain transactions (*e.g.*, a sale of all or substantially all of the REIT’s assets in a taxable transaction or a merger of the REIT with another entity unless the operating partnership is included in such transaction). Such rights are generally limited, however, because of strong market pressures to eliminate conflicts of interest between the holders of limited partner interests and the public shareholders of the REIT. In any event, hostile acquirors are likely to challenge the exercise or potential exercise of these limited partner rights, arguing that the limited partner-sponsor has a duty not to veto a transaction which is in the best interests of the shareholders.

Conclusion

The increasing securitization and “corporatization” of commercial real estate is changing the way in which real estate is bought and sold. It is therefore becoming increasingly important for members of the real estate industry to gain familiarity with corporate M&A concepts, strategies and doctrines which have been extensive developed in the non-real estate corporate world. This article and the preceding article in this series have sought to provide a brief introduction to some of the M&A topics which are of particular relevance to REITs.

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Endnotes

1. Since most REITs are corporations, this article generally assumes corporate form when referring to REITs.

2. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).

3. It should be noted that stock options must be taken into account in determining whether the Code’s 5/50 requirements or most excess share charter provisions have been satisfied.

4. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

5. Paramount Communications v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990).

6. Md. Code Ann., Corps. & Ass’ns (ßß†3 701 to 3-709 (1993).

7. Md. Code Ann., Corps. & Ass’ns ßß†3 601 to 3-604 (1993).

PLEASE NOTE:

The following committees will meet on May 16 during NAREIT’s 1996 Law & Accounting Conference:

Accounting
Government Relations
Insurance
Public Relations
State Tax Subcommittee