

REIT M&A Transactions—Peculiarities and Complications

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INTRODUCTION

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 1990¹ 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 billion 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

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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.

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

BACKGROUND

REITs

In 1960, the first REIT legislation⁷ 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

7. See Real Estate Investment Trust Act of 1960, Pub. L. No. 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.

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.

UPREITs

The UPREIT¹¹ 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.

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 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

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

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

12. See I.R.C. § 721. See generally John P. Napoli & John F. 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.

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

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

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 instability 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

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.

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).

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 individuals²²—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 stated 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

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. § 542(a)(2) (1994)).

20. See Lowy, *supra* note 18, at 103 ("In some REITs 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).

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.*

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 acquirors 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 Code²⁵ (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 Maryland²⁶ 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 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.

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.

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

SHAREHOLDERS RIGHTS PLANS AND EXCESS SHARE PROVISIONS COMPARED

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

The Advantages of Poison Pills Over Excess Share Provisions

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

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, *REIT 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.

provisions is scant, conflicting, and based upon provisions that differ in a number of significant 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 ownership³⁴ 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

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).

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, unlike 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 acquirors. 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 potential.⁴²

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 Owner-

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).

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.

ship," 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.

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

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 interpretive 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 Coun-

MHC's tender offer was subject to several conditions, including the condition that it be 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.

terclaims, 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 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 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 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 acquirors 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

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.

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 *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 acquirors 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

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.

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

[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 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, be-

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).

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).

cause 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 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

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

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

64. *See id.* at 1005.

65. *See id.* at 1007.

66. *Id.* at 1007.

67. *Id.* at 1007 n.10.

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

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,

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 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.

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

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.

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.

The Rights separate from the stock, are physically distributed (Distribution), and become exercisable on the 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

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).

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 90-11 expressly stated that it did not address

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 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 tax consequences of any redemption of the Rights, or of any transaction involving Rights subsequent to the Rights separating from the stock.⁸²

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 would be viewed as options if the issuer were a regular corporation,

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.

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 limi-

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).

tation, 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 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% share-

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.

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.

holder 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.

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

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.

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).

creating a more than 9.8% individual shareholder or when exercise would not cause the previously described ownership problems.⁹⁵

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 suggested 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

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 with any REIT taxable year beginning after December 31, 2000, reduces a REIT's 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).

not be inadvertently diluted upon the exercise of a pill, through issuance of rights to the OP Unitholders or otherwise.

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 transaction¹⁰² 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 UPREIT¹⁰³ 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.

RESOLVING CONFLICTS OF INTERESTS BETWEEN REIT SHAREHOLDERS AND LIMITED PARTNERS: WHERE DOES AN UPREIT BOARD'S PARAMOUNT 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

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.

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

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.

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.

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 passed "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).

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

108. See *id.* at 49.

109. See *id.*

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.

DEALING WITH POTENTIAL INTERNAL BOARD CONFLICTS ARISING FROM BOARD COMPOSITION IN UPREITS AND DownREITS

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 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 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.

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 the business judgment rule, there must be evidence of disloyalty, and that a showing of self-interest alone is insufficient), *modified*, 636 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.

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 acquirors 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.

113. The exchange of OP Units for stock of the REIT will generally be taxable. *See* I.R.C. § 1001 (1994).

114. *See, e.g.,* Irvine Apartment Communities, Inc., 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>>.

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.

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

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

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.

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 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,

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

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).

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.

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

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).

122. See *id.* § 857(b)(6)(A).

123. See *id.* § 1221(1).

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

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.

ADDITIONAL TAX AND TAX-BASED IMPEDIMENTS TO ACQUISITIONS OF REIT SHARES¹²⁸

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.

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

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).

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 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 in which the entity was not a REIT. See *id.* § 857(a)(2) (Supp. III 1997).

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 person¹³¹ 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

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.

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

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. § 1.856-1(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 (Sept. 29, 1995); Priv. Ltr. Rul. 95-34-022 (May 31, 1995). The issue of whether the use of very expansive ownership limitations can cause a REIT's shares to be considered nontransferable in violation of § 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.

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, transferees 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 estate¹⁴⁴ 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 acqui-

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).

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% of such class of stock at some time during the preceding 5-year period. See *id.* § 897(c)(3). In addition, because a USRPI does not include an interest solely as a creditor, a so-called mortgage REIT may not be a USRPHC. See 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).

sition 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

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)?

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).

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).

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 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

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

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

151. Professors Bittker and Eustice, in commenting on the terminology of "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 BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS & 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.*

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 to find otherwise than it has to do 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

§ 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.

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.* § 1.856-4(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

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

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

"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% 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) (1994) *with id.* § 544.

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

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 amount 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 onerous reporting requirements appear to support it. Regulation section 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 of the trust’s interest of 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.

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 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 § 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 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).

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

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

[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.

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 exchange, the Service has ruled that the restrictions on employee stock do not render a REIT's shares nontransferable.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.

171. Regulation § 1.856-1(d)(2) provides:

Provisions in the trust instrument or corporate charter or bylaws 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 (May 31, 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 non-transferable. *See id.*

173. *See, e.g.*, Priv. Ltr. Rul. 97-47-034 (Aug. 25, 1997).

174. *See id.*

175. *See id.*

176. *See* Priv. Ltr. Rul. 89-21-067 (Feb. 28, 1989).

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.

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 raise a number of unusual obstacles and issues, largely because of REITs' unique tax situation. Careful planning and analysis, as well as attention to the interplay between federal and state law in the REIT area, will generally be critical to any successful transaction.

177. E.g., "group" level ownership limits. See *supra* notes 43-73 and accompanying text.