The Real Estate M&A and Private Equity Review

Sixth Edition

Editors
Adam Emmerich and Robin Panovka

The LawReviews

THE REAL ESTATE M&A AND PRIVATE EQUITY REVIEW

SIXTH EDITION

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This article was first published in September 2021
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Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK

www.TheLawReviews.co.uk

ISBN 978-1-83862-822-2

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ALLEN & GLEDHILL LLP

BINDER GRÖSSWANG RECHTSANWÄLTE GMBH

BIRD & BIRD (INTERNATIONAL) LLP

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PREFACE

For real estate investment trusts (REITs), the covid-19 pandemic has been a tale of two cities, of boom and bust, with the seismic changes in the world leading to strength in some sectors of commercial real estate and huge market dislocations and disruptions in others. In general, companies with assets that service the digital economy – cell towers, logistics and industrial properties, and data centres – benefited from the pandemic's acceleration of the digital economy. However, several traditional sectors continued to confront difficult issues involving liquidity, rent collection, dividend payouts, disclosure and guidance, as well as navigating the uncertain and sometimes shifting guidance from regulatory authorities regarding the timeline of reopening. While the distribution of the vaccine to many individuals in the US and certain other countries has blunted the pandemic in some areas, inequitable distribution has yielded an uneven economic recovery internationally. Additionally, and for many traditional REITs most importantly, there are still many unknowns with respect to how soon and to what extent people will return to their offices and resume traditional offline shopping and travel, and which of the many other changes in real estate usage will become permanent or semi-permanent. The eventual 'new normal' that emerges from the pandemic will likely have rippling effects throughout the REIT industry for years to come. As always, strategic planning and risk management will be critical to adjust to changing times. Last year, we wrote of our hope of a clearer picture of our new normal in time for the publishing of this edition. While the vaccines and new year have brought hope for a path forward out of the pandemic, and certain jurisdictions have fully 'reopened' stores, offices and restaurants, we still have longer to wait to find out how many of the pandemic shifts (work from home, massive growth in online retail, shift away from 24/7 cities) are permanent, and which will fade with time.

Stepping back from the recent market dislocations, prior to covid-19, publicly traded real estate companies and REITs, with help from real estate private equity, have steadily transformed the global real estate markets over the past 25 years. Their principal innovation, and 'secret sauce', has been liquid real estate. Unlike traditional property ownership, equity in publicly traded real estate vehicles is highly liquid, and can be bought and sold in large volumes, literally in minutes, on numerous global exchanges. Indeed, during the pandemic, REITs have issued more than US$10 billion in public equity, taking advantage of the massive amounts of liquidity washing over financial markets beginning in spring 2020.

Publicly traded real estate vehicles have an aggregate market capitalisation of approximately US$1.5 trillion globally, including over US$1 trillion in the United States and approximately US$150 to US$250 billion in each of Europe and Asia. As public REITs and other vehicles have aggregated these properties and grown in scale and sophistication, so too have real estate-focused private equity funds, playing an important role catalysing hundreds of billions of dollars of REIT and real estate M&A transactions and IPOs.

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

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

This publication is a multinational guide for understanding and navigating the increasingly complex and dynamic world of liquid real estate and the transactions that mostly produce it. The sea change in the markets, sometimes called the 'REIT revolution', has meant that major real estate transactions have migrated from 'Main Street' to 'Wall Street'. They now often take the form of mergers, acquisitions, takeovers, spin-offs and other corporate transactions conducted in the public markets for both equity and debt. They have grown exponentially in complexity and sophistication, and increasingly represent cross-border multinational transactions fuelled by the now global real estate capital markets and M&A deal professionals. And they are often intermediated by international investment banks rather than local brokers, and financed with unsecured bonds or commercial mortgage-backed securities. In a fair number of cases, they are catalysed by private equity firms or similar actors, sometimes building portfolios to be taken public or sold to public real estate companies, and sometimes through buyouts of public real estate companies for repositioning or sale.

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

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

Adam Emmerich and Robin Panovka
Wachtell, Lipton, Rosen & Katz
New York
July 2021

Chapter 16

UNITED STATES

Adam Emmerich, Robin Panovka, Sara Spanbock and Kyle Diamond[1]

I OVERVIEW OF THE MARKET

The covid-19 pandemic that began in 2020 has continued to have a profound impact on the commercial real estate industry, including REITs and real estate private equity. In general, companies with assets that service the digital economy – cell towers, logistics and industrial properties, and data centres – benefited from the pandemic's acceleration of the digital economy. Conversely, several traditional sectors continue to confront difficult issues involving liquidity, rent collection, dividend payouts, disclosure and guidance, as well as navigating the uncertain and sometimes shifting guidance from regulatory authorities regarding the timeline of reopening. However, with the introduction and distribution of vaccines in the United States, a robust, if uneven, recovery has begun to take hold within the commercial real estate industry. As always, strategic planning and risk management have been, and still will be, critical in order to adjust to changing times, to adapt to the resulting acceleration of technological change in the real estate industry and beyond. Only time will tell with respect to how soon and to what extent people will return to their offices and resume traditional offline shopping and travel, and which of the many other changes in real estate usage will become permanent or semi-permanent.

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

US REITs today own approximately US$2 trillion of commercial real estate, and the industry's equity market capitalisation is approximately US$1.3 trillion.[2] There are now approximately 152 REITs in the United States with a market capitalisation of over US$1 billion, and 36 of those are over US$10 billion.[3] Compare this to 1995, when the entire market capitalisation of the US REIT industry was just US$57.5 billion, and there were only six REITs with a market capitalisation over US$1 billion.[4]

In addition to growing in size, US REITs have broadened their reach in terms of asset classes and have begun to expand geographically outside of the United States. While REITs

1 Adam Emmerich and Robin Panovka are partners and Sara Spanbock and Kyle Diamond are associates at Wachtell, Lipton, Rosen & Katz.
2 NAREIT REITWatch (data as of 31 March 2021).
3 S&P CapitalIQ.
4 See footnote 2.

traditionally owned office, multifamily, retail, industrial and lodging assets, today REITs extend across an array of non-traditional sectors, including telecommunications, healthcare, timber, data storage, outdoor advertising and gaming.

Along with REITs, private equity (PE) funds have also become dominant institutional players in US commercial real estate over the past 20 years. In 2008, real estate PE funds raised over US$130 billion per annum,[5] and PE funds have continued to raise large amounts of capital (reaching over US$118 billion in 2020),[6] and have been the architects of some of the largest recent M&A deals in the real estate sector. While international institutional investors have had exposure to the US real estate sector for many years, sovereign wealth funds and other sources of international capital have demonstrated increased interest in the US real estate sector, including through joint ventures with US-based REITs and PE funds.

As noted earlier, the market dislocation caused by the spread of covid-19, and the ongoing uncertainty as to the shape the recovery will take and the pace of vaccination and reopening, has had a significant impact on REITs. This dislocation, particularly in those subsectors that have been hit the hardest, continues to present openings for opportunistic investors and strategic buyers to acquire high quality assets at significant discounts. Activists and opportunists may continue to try to capitalise on the situation, particularly if, as the recovery takes shape, their targets lag behind others.

Even prior to the pandemic, technological change continued to drive significant activity for REITs and real estate PE funds, and it remains to be seen whether the events of 2020–2021, and the evolving manner in which people use and interact with various forms of real estate, will further and more permanently accelerate this trend. REITs that harness the technological momentum or provide the infrastructure for the new economy, including data centres, cell towers and logistics facilities, are likely to continue to grow rapidly. However, traditional retail REITs and REITs in other disrupted sectors will need to work hard to adjust to the new environment through restructurings, redevelopment and other changes. Already, four of the 10 biggest REITs are tech REITs, and the trend shows no sign of slowing.

II RECENT MARKET ACTIVITY

i M&A transactions

Recent M&A activity has been focused primarily on PE funds' acquisitions of public REITs (public-to-private transactions) and combinations of REITs (public-to-public deals), with REIT spin-offs and restructurings to unlock the value of corporate real estate also playing a role. The take-private transactions have been driven largely by PE firms' belief that their target REITs are trading at a discount to the value of their assets, thus providing an opportunity to profit from the arbitrage. The public merger transactions, however, have been a function of the continuing consolidation in the various REIT sectors in order to create scale, benefit from synergies and carry out strategic growth plans, among other reasons.

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

6 Preqin Quarterly Real Estate Update, Q1 2021.

ii PE transactions

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

a Brookfield Asset Management acquired Forest City Realty, which owned apartment buildings, shopping centres and other assets, in an all-cash transaction valued at approximately US$11.4 billion in December 2018. The price represented a 26.6 per cent premium for the target's stock, and the agreement had a break fee of US$261 million and a reverse break fee of US$488 million. The acquisition followed years of pressure from activist investors at Forest City, ultimately leading to the elimination of the company's dual class voting structure, which reduced the founding family's control over the company and paved the way for an acquisition.

b Blackstone purchased Gramercy Property Trust, an owner and manager of industrial commercial real estate, in October 2018 in an all-cash transaction valued at US$7.6 billion. The price represented a 15 per cent premium for the target's stock, and the agreement had a break fee of US$138 million (or US$46 million under certain circumstances) and a reverse break fee of US$414 million. Additionally, while not a take-private of a public REIT, in September 2019 Blackstone completed its purchase of assets comprising approximately 179 million square feet of warehouse space from GLP, a Singapore-based developer of logistics properties, for US$18.7 billion in one of the largest-ever private real estate transactions globally. The transaction nearly doubled the size of Blackstone's US industrial footprint and is emblematic of its long-term bet on logistics-related spaces, which it expects to benefit from growing e-commerce demand.

c Greystar Real Estate Partners acquired Education Realty Trust (EdR), one of the largest developers, owners and managers of collegiate housing communities in the US, for US$4.6 billion in cash in September 2018. The price represented a 13.6 per cent premium for the target's stock, and had a break fee of approximately US$118 million and a reverse break fee of US$200 million. In connection with the acquisition, funds associated with Blackstone acquired EdR's student housing portfolio for US$1.2 billion in cash.

d Brookfield Asset Management purchased GGP Inc, the then-second largest owner of mall space in the US, in which Brookfield was a dominant investor, in August 2018 for approximately US$15 billion in cash and stock, a premium of approximately 20 per cent to the price of GGP's stock prior to widespread rumours of Brookfield's interest. The agreement had a break fee of US$400 million and a reverse break fee of US$1.2 billion.

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

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

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

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

iii Public REIT mergers

REIT mergers may be motivated by the advantages of scale, including a potentially lower cost of capital, to benefit from synergies or to garner other benefits of consolidation. Given the challenges posed by the pandemic, additional scale can provide a leg-up to certain market participants. Major recent REIT mergers have included:

a Realty Income Corporation's acquisition of VEREIT, Inc. in a stock-for-stock transaction to form a combined company with an enterprise value of US$50 billion (announced April 2021);

b Kimco Realty Corp. acquisition of Weingarten Realty Investors in a stock-for-stock transaction to form a combined company with an enterprise value of US$12 billion (announced April 2021);

c Simon Property Group Inc's acquisition of Taubman Centers, Inc and an 80 per cent ownership interest in The Taubman Realty Group Limited Partnership in an all-cash transaction valued at US$9.8 billion (December 2020);

d Prologis, Inc's acquisition of Liberty Property Trust in a stock-for-stock transaction valued at US$13 billion (February 2020);

e Park Hotels & Resorts, Inc's acquisition of Chesapeake Lodging Trust for US$2.6 billion in cash and stock (September 2019);

f Cousins Properties' acquisition of TIER REIT, Inc, a US$7.8 billion cash and stock transaction (June 2019);

g Government Properties' US$1.2 billion all-stock merger with Select Income REIT, with the combined company renamed Office Properties Income Trust (December 2018);

h Pebblebrook Hotel Trust's acquisition of LaSalle Hotel Properties for a mix of cash and stock that valued LaSalle at US$5.4 billion. The acquisition represented the conclusion of Pebblebrook's nine-month pursuit of LaSalle, which terminated its original agreement with Blackstone in order to accept Pebblebrook's topping bid (November 2018);

i Taylor Morrison Home Corporation's acquisition of AV Homes, a cash and stock transaction valued at approximately US$963 million in enterprise value (October 2018);

j Annaly Capital Management's acquisition of MTGE Investment Corp, a transaction valued at approximately US$900 million in equity value (September 2018);

k ProLogis' acquisition of DCT Industrial Trust, a US$8.4 billion stock-for-stock transaction, including the assumption of debt (August 2018);

l Welltower's acquisition of Quality Care Properties and Quality Care Properties' acquisition of HCR ManorCare at the completion of HCR ManorCare's Chapter 11 bankruptcy process, a transaction valued at approximately US$3.9 billion (July 2018);

m Penn National Gaming's acquisition of Pinnacle Entertainment, a transaction valued at approximately US$2.8 billion in enterprise value (October 2018);

n Kennedy-Wilson Holdings' acquisition of Kennedy Wilson Europe Real Estate Plc, creating a leading global real estate investment and asset management platform with a US$8 billion enterprise value (October 2017);

o Digital Realty Trust's acquisition of DuPont Fabros Technology, a transaction valued at approximately US$7.8 billion in enterprise value (September 2017). DuPont Fabros shareholders received shares of Digital Realty in the merger;

p Sabra Health Care's acquisition of Care Capital Properties, creating a combined healthcare REIT with a pro forma total market capitalisation of approximately US$7.4 billion and an equity market capitalisation of approximately US$4.3 billion (August 2017). Care Capital Properties shareholders received shares of Sabra Health Care in the merger;

q Regency Centers' acquisition of Equity One, creating a combined shopping centre company with a total market capitalisation of approximately US$16 billion (March 2017). Equity One was merged into Regency, and its stockholders received shares of Regency in the merger;

r Annaly Capital Management's acquisition of Hatteras Financial Corp, a transaction valued at approximately US$1.5 billion in equity value (July 2016). At their election, Hatteras stockholders received shares of Annaly common stock or cash, or both, in the merger;

s Starwood Waypoint Residential Trust's acquisition of Colony American Homes and internalisation of its manager, creating a combined company, renamed Colony Starwood Homes, with a combined asset value of approximately US$7.7 billion (January 2016). Starwood Waypoint Residential Trust and Colony American Homes shareholders received shares of Colony Starwood Homes in the merger;

t Chambers Street Properties' acquisition of Gramercy Property Trust, creating an industrial and office net lease company with an enterprise value of approximately US$5.7 billion (December 2015). Gramercy stockholders received shares of Chambers Street in the merger; and

u Washington Prime Group's acquisition of Glimcher Realty Trust, a transaction valued at approximately US$4.3 billion (January 2015). Glimcher shareholders received shares of Washington Prime and cash in the merger.

iv Separation of real estate assets

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

Penn National Gaming separated its casino assets into a REIT, Gaming and Leisure Properties, which then leased most of these assets back to Penn National. Shares of the REIT were distributed to Penn National shareholders through a tax-free spin-off in November 2013.[7]

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

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

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

v Spin-offs

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

a Simon Property Group's spin-off of its shopping centre business and smaller malls into Washington Prime Group (May 2014);
b Vornado's spin-off of its shopping centre business into Urban Edge (January 2015);
c Ventas' spin-off of its skilled nursing portfolio into Care Capital Properties (August 2015);
d Vornado's spin-off of its Washington, DC assets into JBG Smith Properties (July 2017); DDR's spin-off of its lower-quality US strip centres and its Puerto Rico portfolio (December 2017); and
e Realty Income Corporation and VEREIT, Inc.'s spin-off of substantially all the office properties of both companies in connection with the pending merger between the companies (announced April 2021).

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs – structure and role in the market

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

These tax rules influence the structure and governance of REITs. In addition to the rules described above, the Internal Revenue Code requires that a REIT have no more than 50 per cent of its shares held by five or fewer individuals, commonly known as the '5/50 rule'. To ensure that the 5/50 rule is not violated, REITs customarily include provisions in their organisational documents restricting any shareholder – an individual or otherwise – from holding more than 10 per cent of their shares, with thresholds often set at a slightly lower percentage such as 9.8 per cent. If properly structured, these ownership limits (called excess share provisions) can also act as a takeover defence.[8] The consequences of violating an excess share provision can be severe, so it is essential for acquirors of REIT shares to understand and address the ownership limitations in a target REIT's charter, particularly in unsolicited transactions. Excess share provisions typically allow a REIT's board of directors to waive the limitation with respect to specific shareholders if the board is satisfied that such a waiver will not result in the violation of the 5/50 rule (or other relevant REIT qualification rules), allowing negotiated M&A transactions to proceed.

In addition to these tax complexities, the structure of REITs can often differ from that of a typical public company, since many REITs, called 'UPREITs',[9] include partnership entities in their corporate structure. UPREITs are REITs that hold their assets and conduct business through an operating partnership in which the REIT is the general partner. Holders of units in a REIT's operating partnership generally have the right to exchange their units for REIT shares or cash (at the election of the REIT). REITs generally choose the UPREIT structure because of the tax advantages that such a structure provides, as discussed further in Section IV.v.

ii Real estate PE firms – footprint and structure

Real estate PE funds aggregate investor capital to generate returns through the acquisition, ownership and sale of real property assets or interests in such assets, and are also active in the origination and trading of real estate debt. PE fund managers may choose a particular area of geographical focus, property type or investment strategy. Core funds tend to invest in stable assets, such as office properties with high-credit quality tenants located in major urban areas. Opportunistic funds use more leverage and take on higher-risk opportunities (such as developing new buildings or repositioning distressed or poorly capitalised assets). Blackstone, a firm with a leading real estate PE business, describes the strategy of its opportunistic funds simply as 'buy it, fix it, sell it'[10] – indicating how such funds acquire distressed properties or underperforming REITs and then use their asset management personnel to stabilise these assets or companies prior to sale. Value-added funds tend to adopt strategies and have risk profiles that fall between core and opportunistic funds, and may focus on geographies outside of the largest urban areas.[11] PE transactions are often driven by arbitrage opportunities between the public and private markets. When REIT valuations are high relative to the private real estate market, PE funds may focus on aggregating portfolios that are then sold to REITs (or taken public as REITs). When the reverse is true, and REITs are undervalued relative to the private real estate market, PE funds may work to take REITs private.

Real estate PE funds are often structured as Delaware limited liability companies or limited partnerships. Investors commit to provide a specified amount of capital to these funds as (and when) needed to make acquisitions. Typically, fund managers are compensated with management fees (generally a fixed percentage of the fund's assets under management) and performance fees. These performance fees are generally structured in a waterfall format, under which investors must achieve a specified minimum return (a hurdle rate) before the

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

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

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

11 This investment-style overview is based on the categories used by the National Council of Real Estate Fiduciaries.

fund managers earn performance fees. Once the hurdle rate is met, the manager generally earns carried interest (a percentage of overall gains) above the threshold. PE fee structures are complex, and can involve tiered hurdle rates, discounts for initial investors, scaled-back management fees or clawbacks of excess carried interest in the later stages of a fund's lifecycle.[12]

IV TRANSACTIONS

i Legal frameworks and deal structures

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

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

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

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

Courts in Delaware, where many US firms are incorporated, will review directors' compliance with their duties based on standards that vary based on the situation in which directorial decision-making occurs. The business judgement rule is the default standard of judicial review applying to the actions of directors, under which the business decision-making of a director generally does not give rise to personal liability. However, higher judicial

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

standards apply in situations when a company is being sold. In particular, *Revlon* duties apply under Delaware law in the context of a corporate change of control. When a company is engaged in a transaction that may result in a sale, '[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company'. While there is no single blueprint a board must follow in a *Revlon* context, in general, *Revlon* duties require that the board work to maximise the sale price of the business. However, in Maryland, where many REITs are incorporated, a director is not subject to greater scrutiny in a change-of-control context, a significant divergence from Delaware law.[13]

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

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

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

13 Md Code Ann Corps & Ass'ns, Section 2-405.1(f).

ii Acquisition agreement terms

Consideration

In a REIT merger, target stockholders receive cash, securities or a mixture of both. When stockholders are receiving stock, the value of the consideration may fluctuate based on the market value of the acquirer's stock in the time period between signing and closing, depending on the specifics of the exchange mechanism. Parties can use a number of techniques to address this risk, including pricing structures based on the average price of the acquirer's stock over a period of time or termination rights triggered by a decline in the acquirer's stock price. Generally, REIT mergers have fixed basket consideration, whether cash, stock or a combination of the two, with the amount and form of such consideration determined at signing, while only a minority of transactions provide for post-signing variation in the amount and form of the basket.

Representations and warranties

The representations and warranties in REIT merger agreements generally resemble those of other public company merger agreements (and do not include the very detailed property-level representations that are common in real estate asset purchases). Instead, an acquirer will often rely on broad representations and a REIT's financial statements and public filings (and will typically get representations relating to their accuracy). The representations and warranties in a REIT merger agreement will serve as a guide for due diligence, as a risk-allocation mechanism and as a set of preconditions for closing. Representations relating to the tax status of the REIT are particularly important to ensure that the REIT complies with applicable tax regulations (both before and after the transaction).

Covenants

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

A target will generally agree to conduct its business in the ordinary course consistent with its past practices. However, since this standard can be vague, a merger agreement typically contains a number of specific restrictions, which can include prohibitions on acquisitions, dispositions, material capital investments or major changes in compensation policies (among other restrictions) unless the acquiring party consents. The target will also typically agree to avoid actions that will compromise its REIT tax status. The severe disruptions caused by covid-19 highlight the importance of contractual language that establishes the freedom of a target to operate during the period between signing and closing, including with respect to whether actions taken in response to extraordinary circumstances may be taken without a buyer's prior consent.

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

Deal protection, termination and break fees

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

A merger agreement will contain provisions indicating when either party can walk away from the deal. These provisions may be triggered by an incurable breach of the merger agreement, failure to obtain shareholder approval or failure to close the deal by a specified date. Should an agreement be terminated under certain circumstances (such as pursuant to a fiduciary out in order to accept a superior proposal), the target may have to pay a break-up fee or an expense reimbursement fee to the acquirer. The size of the break-up fee is typically heavily negotiated and will often depend in part on the extent of the pre-signing market check conducted by the target's board. Where a target has conducted a robust pre-signing market check, such as an auction process, the target will typically be subject to no-shop obligations coupled with a higher break-up fee. However, a target that has not engaged in an extensive pre-signing market check may try to negotiate a go-shop provision, allowing it to solicit a better deal for its shareholders for a fixed period following signing, paired with a lower break-up fee. One compromise approach to balancing deal protections while preserving a board's ability to fulfil its fiduciary duties is to allow for a post-signing market check by coupling a no-shop provision with a two-tiered break fee that is low for an initial fixed period (e.g., 1–1.5 per cent of the equity value of the transaction for a 30 or 45-day period after signing) and ratchets up thereafter (e.g., 2.5–3.25 per cent). While the bifurcated break-up fee structure still remains a minority approach in REIT M&A deals, a number of recent transactions, including Blackstone's 2018 acquisition of Gramercy Property Trust, have included such a construct. Reverse break-up fees (payable by the buyer in the event of certain termination events) are common in PE deals, and operate much like a traditional real estate deposit. Recent reverse break fees have been asymmetrical, generally exceeding the termination fees payable by the target.

Closing conditions

In general, closing conditions provide a list of events that must occur (or be waived) before the transaction is consummated. For example, closing conditions may include stockholder approval (or the approval of unitholders, if necessary) or receipt of necessary consents. In addition, one condition may involve a bring-down of certain representations and warranties, requiring that the representations and warranties made at signing are also true at closing. Other closing conditions may involve the absence of a material adverse change in the target. Additionally, the delivery of an opinion that the target qualifies as a REIT is uniformly required, with the buyer's tax counsel also providing such assurances in a stock-for-stock transaction.

Indemnification

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

iii Hostile transactions

Although REITs have a number of defences at their disposal, they are still vulnerable to unsolicited offers. The excess share provisions of most REITs can and generally do serve as a form of takeover defence, and many REITs specifically disclose that such provisions may be used for anti-takeover purposes. However, excess share provisions are relatively untested as anti-takeover defences, and may be vulnerable because of their grounding in the tax code or the specific manner in which they are drafted. Excess share provisions – even when designed for anti-takeover purposes – are unlikely to be more powerful or robust than other common takeover defences such as a rights plan, and may often be less so. Indeed, during the market dislocations caused by the covid-19 pandemic, a number of REITs shelved rights plans to have them ready for rapid deployment if and when advisable based on a nuanced assessment of the threat and the possible costs. While hostile takeovers are not common in a REIT context, they have occurred. For example, in 2006, Public Storage successfully completed a hostile takeover of Shurgard, and interlopers making unsolicited bids designed to top announced mergers are rather common.

More recently, activist investors have successfully instigated changes of control at REITs, including the campaign against the CommonWealth REIT (now Equity Commonwealth) in 2014, and the aforementioned events at Forest City Realty. Activists may also pressure REIT boards to consider a sale of a company, particularly if there is a large spread between the market value of the REIT and the net value of its assets. Alternatively, activists may agitate for sales of certain assets to capture arguably unrecognised value, adjustments to leverage, dismantling of takeover defences or the replacement of management or directors.

While activist campaigns against REITs have historically often stayed under the radar, they are becoming more mainstream, particularly as well-capitalised, higher-profile and non-REIT-dedicated activists increasingly look to the REIT sector. In 2020, 20 new activist campaigns were launched against REITs, ranging from shareholder proposals to declassify boards or otherwise dismantle representing a significant increase in activity.[14] In 2020, approximately 3 per cent of all announced activist campaigns against US companies were in the real estate sector.[15] As noted above, during the market dislocations caused by the covid-19 pandemic, buyers quietly accumulated positions in a number of REITs. Activists' approach in

14 FactSet SharkRepellent.

15 S&P CapitalIQ (includes all announced activist campaigns against US companies with market capitalisations above US$50 million).

the coming years may be to park money in well-run REITs that are expected to have a strong recovery, without an immediate activist thesis, while retaining the optionality to shift gears if the recovery does not match expectations.

More broadly, US REITs incorporated in Maryland have continued to face pressure from investors and proxy advisory firms to opt out of the Maryland Unsolicited Takeovers Act, which allows boards to take certain actions, including classifying themselves without shareholder approval, and to remove prohibitions or restrictions on shareholders' ability to amend by-laws.

iv Financing considerations

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

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

v Tax considerations

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

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

Where an UPREIT is being purchased by a private equity buyer, there is no surviving publicly held entity, so the flexibility and protections previously available through the conversion of operating partnership units into stock or its cash equivalent often must be replaced with a security that satisfies the unitholders' needs. For example, unitholders may be offered an option to elect to receive a fixed-return preferred security or a combination of consideration including a mixture of cash and preferred securities. Issues to consider when creating the security include the yield, windows for puts and calls and redemption rights, voting rights (if any) and continuing tax protection arrangements.

vi Cross-border complications and solutions

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

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

From a regulatory standpoint, the Committee on Foreign Investment in the United States (CFIUS) can review acquisitions in the United States by non-US acquirers (including real estate acquisitions), but it is unlikely that CFIUS reviews will affect typical real estate transactions. However, the Foreign Investment Risk Review Modernisation Act of 2018 represents a large expansion of CFIUS's jurisdictional reach, and may portend greater regulatory scrutiny of foreign investment in general. In addition, a transaction involving a foreign acquirer may implicate US securities laws (if, for example, a foreign company is issuing shares as consideration in a transaction), and the disclosure requirements of these laws and any ongoing compliance costs they may impose should be considered.

V CORPORATE REAL ESTATE

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

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

VI OUTLOOK

REITs in many sectors continue to face considerable uncertainty as the country proceeds with its robust if uneven recovery from the covid-19 pandemic. With hopefully the worst of the pandemic behind the country and the industry, REITs across the board have begun to consider how and when to go on the offence, whether by dusting off pre-pandemic deal plans, taking advantage of a relatively friendly and inexpensive debt market, or shedding non-core assets and shifting strategic focus. As REITs begin to chart the course forward, a key factor will be the extent to which the pandemic has permanently changed the way that we interact with real estate, and compressed a decade or more of digitisation into 15 months, with the new normal involving fewer or at least different in-person work or shopping.

Indeed, the currently accelerating digital shift from 'bricks' to 'clicks' predates covid-19, with REITs and other businesses already shifting or adapting business models to account for the new, digital world. It is clear that some of these business models have performed better than others during this period, and there may be valuable lessons to be learned.

Even prior to the covid-19 pandemic, REITs were confronting a rapidly changing environment, with nearly all sectors facing some degree of external disruption. Technological change will continue to transform real estate business models, a trend that is likely to accelerate further and become more pervasive over the next five to 10 years (or perhaps even sooner in light of the disruptive impact on long-term demand that seems to have resulted from the pandemic), creating risks and opportunities for REITs that will be forced to either adapt or in some cases become obsolete. Indeed, with the rollout of 5G technology, the continued growth of artificial intelligence-related products and services and the world-wide hunger for data centres to service a wide swath of industries, the growth and consolidation of technology-focused REITs will likely pick up pace, with these and other groundbreaking technologies continuing to impact REITs and their business models in unpredictable ways.

In 2020, REIT equities were pummelled by the covid-19 pandemic, but recovered to post a decline of approximately 7.57 per cent,[16] a figure that fell as low as 26 per cent early in the pandemic. However, REIT equities underperformed the S&P 500 in 2020, with the S&P 500 up approximately 16.26 per cent for the year.[17] Furthermore, the value of assets held by REITs continues to grow,[18] underscoring the strength of the sector and the

16 MSCI US REIT Index (USD) (https://www.msci.com/documents/10199/08f87379-0d69-442a-b26d-46f749bb459b).

17 S&P Dow Jones Indices: S&P 500 Factsheet (https://us.spindices.com/indices/equity/sp-500).

18 See Section I for further information.

advantages that the REIT structure brings to the investment community. However, REIT equities have roared back in the first half of 2021, with the MSCI US REIT Index up more than 25 per cent through mid-June 2021.

As a handful of mega-deals in the spring of 2021 have shown, the window for M&A has reopened, and REITs and private equity sponsors alike are eager to move forward with potentially transformational transactions. As the recovery continues to build and offices and retail spaces continue to reopen across the country, continued M&A activity is expected among public REITs both in terms of acquisitions by larger, stronger sector leaders and spin-offs by REITs of their non-core assets. However, with the net asset value (NAV) gap at many REITs narrowing or even flipping to a premium, take privates may fade in prominence, with only a small number of private equity firms continuing to dominate the space. This dynamic will continue to make 'club' bids difficult, and will require sellers to be careful and creative when designing a sale process. The resulting complex bidding processes, coupled with a dearth of big bidders, will result in more transactions that allow for a meaningful post-signing market check.

An increasingly vocal group of activists targeting REITs is likely to continue to push for M&A activity, particularly as the recovery takes shape and develops and they perceive that some REITs continue to trade at significant discounts to their NAV. While many of the REIT activists are thinly capitalised and often have a short-term outlook, they have sometimes been successful garnering the support of institutional investors, further empowering their initiatives. The trend of unlocking corporate real estate value through transactions using the REIT structure will likely continue, although such activity has, and is expected to continue to, slow because of the recent restrictions on the use of tax-free REIT spin-offs.

In the short term, the recovery from the covid-19 pandemic, potential inflation associated with large-scale government stimulus, trade uncertainty, trans-oceanic regulatory barriers or a downturn in the broader commercial real estate market may complicate the outlook for real estate M&A, with the return of Chinese capital to the real estate market unlikely given the current regulatory environment and complex relationship. However, in the long term, the liquidity and transparency of, and access to capital in, the public US real estate market makes the growth of REITs seem inevitable.

Appendix 1

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ISBN 978-1-83862-822-2