REITs Come of Age

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REITs have transformed the commercial real estate industry over the last twenty-five years and are now a mature asset class. Their explosive growth is likely to continue, especially as they expand into properties that are critical to the digital economy, but the environment has changed and presents new opportunities and headwinds. This Article explores those opportunities and headwinds, and offers some thoughts on navigational tools to cut through the business and legal complexities.

Contents

I. Background 107
II. Structural Innovations 109
III. Transactional Models 110
IV. UPREIT Complications 116
V. REIT Spin-Offs and OpCo/PropCo Splits 120
VI. Unsolicited Transactions 121
VII. Activism 123
VIII. Outlook 124

I. Background

After twenty-five years of growth, publicly traded Real Estate Investment Trusts (REITs) have become a mature asset class. Their special sauce—liquid real estate—has transformed huge swaths of the commercial real estate industry. But just as REITs have come of age, their businesses are changing rapidly as they adapt to COVID's acceleration of the digital economy and macro-economic shifts. Demand for traditional properties, like enclosed malls and office buildings, is being challenged by digital alternatives, while at the same time demand grows for properties that fuel the online economy, like data centers, logistics

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warehouses, and cell towers. Rising interest rates, market volatility, inflationary pressures, and economic uncertainty have similarly rippled through REITs' business models, requiring reassessment of growth strategies and capital structures. Navigating these challenges and opportunities requires a nuanced understanding of both the business and the legal contours of the REIT industry, including the complicated web of relevant tax and securities laws, capital markets requirements, and governance and mergers-and-acquisitions (M&A) regimes. This Article explores these contours and offers some thoughts on possible navigational techniques.

REITs now own approximately US$4.5 trillion of real estate and dominate many sectors of the commercial real estate industry.[1] The explosive growth so far, likely just a start, was fueled largely by the financial and legal alchemy that transformed illiquid real property into liquid stock. Publicly traded shares in REITs have many of the economic and tax advantages of direct investment in their underlying real estate, but fewer of the disadvantages and costs that come with the traditionally private, illiquid real estate investments. The REIT vehicle provides operators access to Wall Street's relatively cheap and efficient capital markets, and is also attractive to investors because of the diversification and predictable dividends it offers.

Until the "REIT Revolution" of the 1990s, private sources of capital dominated the U.S. commercial real estate industry, and publicly traded real estate vehicles, such as REITs, played a relatively small role. The tables have now turned. The REIT industry's equity market capitalization today exceeds US$1 trillion in the United States.,[2] US$300 billion in Asia, and US$150 billion in Europe.[3] There are now more than 110 REITs in the United States with a market capitalization over US$1 billion, and thirty-seven of those are over US$10 billion.[4] Compare this to 1995, when the entire market capitalization of the U.S. REIT industry was approximately US$57 billion, and when there were only six REITs with a market capitalization over US$1 billion.[5]

In addition to growing in size, U.S. REITs have broadened their reach in terms of asset classes, and have begun to expand geographically outside the United States. While REITs traditionally owned office, multifamily, retail, industrial, and lodging assets, today REITs extend to properties underlying an array of non-traditional sectors, including telecommunications, healthcare, timber, data storage, outdoor advertising, and gaming. REITs that support the tech environment already represent four of the ten biggest REITs, and their growth trajectory will likely continue.[6]

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1. *See* Nat'l Ass'n of Real Est. Inv. Trs., REITWatch: A Monthly Statistical Report on the Real Estate Investment Trust Industry 1 (Jan. 2023), https://www.reit.com/sites/default/files/reitwatch/RW2301.pdf (compiling data as of Dec. 31, 2022).

2. *See id.* (addressing NYSE-listed REITs).

3. *See id.*

4. S&P Capital IQ (data as of Feb. 14, 2023).

5. *See* REIT Watch, *supra* note 1, at 20.

6. *See Leading Real Estate Investment Trust*, Statista, https://www.statista.com/statistics/1064641/largest-global-reit-market-cap/ (last visited Sept. 19, 2023) (compiling, as of Mar. 2023, the largest

II. Structural Innovations

The path to the current REIT model required the development of hybrid structures that combined features of both publicly traded corporations and private partnerships in order to comply with the REIT rules of the Internal Revenue Code and to address various operational, financial, and cultural issues. Many of the REITs that exist today were created through transactions that married constructs of corporate M&A with traditional real estate acquisitions, often leaving footprints of both. As a result, REITs have unique features that affect both their transactional and capital market activities and their day-to-day operations.

In 1960, the Real Estate Investment Trust Act became law, creating the REIT structure in the United States.[7] 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 U.S. federal income tax), but must comply with an extensive array of restrictions to qualify for this tax-advantaged status.[8] For example, in general, a REIT must pay dividends to its shareholders of at least 90 percent of its taxable income, at least 75 percent of a REIT's total assets must consist of real estate assets, cash, and cash equivalents, and a REIT must derive at least 75 percent 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).[9]

In addition, the Code requires that a REIT have no more than 50 percent of its shares held by five or fewer individuals, commonly known as the "5/50 rule."[10] To ensure that the 5/50 rule is not violated, REITs customarily include provisions in their organizational documents restricting any shareholder—an individual or otherwise—from holding more than 10 percent of their shares, with thresholds often set at a slightly lower percentage, such as 9.8 percent.[11] If properly structured, these ownership limits (called excess share provisions) can also act as a takeover defense.[12] 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

REITs worldwide, where the Top Ten includes American Tower Corp., Equinix, Inc., Crown Castle, Inc., and Digital Realty Trust).

7. Real Estate Investment Trust Act, Pub. L. No. 86-779, § l0(a), 74 Stat. 998, 1003 (1960) (codified as I.R.C. §§ 856–858). Unless otherwise noted, any reference to the "Code" is a reference to the Internal Revenue Code of 1986, as amended, and any reference to "section" is a reference to a section of the Code.

8. *See* I.R.C. §§ 856–857.

9. *See id.* §§ 856(c)(3)–(4), 857(a)(1).

10. *See id.* § 856(a)(6), (h)(1)(A) (excluding from the definition of "REIT" entities which are closely held pursuant to the stock ownership provisions of I.R.C. § 542(a)(2)).

11. *See* James M. Lowy, *Real Estate Investment Trusts*, *in* REITs 1999: Strategies for Financing & Growth in a Challenging Market 87, 102–03 (1999).

12. For further discussion of the anti-takeover implications of excess share provisions, see *infra* Part VI.

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, because many REITs, called "UPREITs,"[13] 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 Part IV.

REITs' unusual distribution requirements, coupled with the capital-intensive nature of the real estate business, have meant that REITs need frequent access to the capital markets. This need can be especially challenging when, as now, the capital markets are constrained and interest rates are rising.

Another interesting wrinkle comes from the market's focus on REITs' net asset value (NAV)—the private market value of their assets. When their stock trades below their NAV, REITs can be attractive targets for private equity acquirors, who could theoretically sell off their assets at a profit after taking them private. In practice, however, the mismatch between public and private values may result more from the delay in the illiquid private market's response to changing conditions than from fundamentals. The highly liquid REIT markets can respond quickly to changing dynamics, like rising interest rates, and are often leading indicators of where private values are heading.

III. Transactional Models

The growth of the public REIT markets has been accomplished through REIT acquisitions of private assets and of other REITs, so-called REIT M&A transactions, as well as through the steady stream of initial public offerings of newly created REITs. REIT M&A transactions borrow features of traditional corporate mergers, as well as traditional real estate acquisitions, reflecting the unique tax rules that apply to REITs, the nature of the underlying assets, and the mindsets of the decision-makers.

One of the key areas where the private and public deal structures sometimes conflict is conditionality. In traditional private real estate acquisitions, the purchase agreement typically allows the buyer to walk away from the deal for a short, say thirty- to sixty-day, feasibility period. This conditionality allows the buyer to perform its due diligence investigation of the assets after it has locked in the price and deal terms. Buyers are often reluctant to incur the considerable

13. UPREIT is short for "umbrella partnership real estate investment trust."

costs and time required to properly investigate the assets unless they know that the seller is locked into the transaction. So, effectively, buyers are provided an option to purchase the asset, and can walk away without penalty if they are dissatisfied. Other typical conditions for private buyers to proceed include review of the legal title to the assets, and sometimes the ability to obtain financing. Private sellers, on the other hand, are fully locked in to the deal when the purchase agreement is signed, and do not have conditionality. So, it comes as a bit of a surprise to private buyers to learn that, in public M&A, the conditionality construct is reversed. Merger agreements typically provide the buyer very few exits from the deal, and instead provide the seller optionality based on shareholder vote contingencies and "fiduciary duty outs."[14] Sellers are reluctant to give buyers optionality after signing a merger agreement, which must be publicly disclosed, because of the adverse consequences of the public learning that the deal failed, especially the de-stabilizing impact on leasing and financing activity and employee morale. Instead, a seller typically insists that the buyer complete due diligence prior to execution of the definitive agreement and agree to consummate the transaction unless the seller breaches its representations and warranties in the agreement to an extent that amounts to a material adverse effect on the company, a high threshold that is difficult to prove.[15] Typical title or environmental discrepancies seldom provide a buyer an exit from the deal.

As a result of the seller's contingencies in REIT deals, which put the buyer at risk of losing a deal after considerable investment, REIT M&A transactions typically provide the buyer various deal protections. These range from covenants preventing the selling REIT from soliciting or facilitating competing bids from other parties (no-shop provisions) to break-up fees paid to the buyer.[16] 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 limited period after signing the acquisition agreement, paired with a lower break-up fee.[17] 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

14. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 936–39 (Del. 2003) (en banc) (concluding that contract would compel directors to violate their fiduciary duties and that, to be enforceable, the contract required inclusion of a "fiduciary out" clause).

15. *See* IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14, 68 (Del. Ch. 2001) ("[A] buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close.").

16. *See Omnicare, Inc.*, 818 A.2d at 937–38 (noting that no-shop provisions are presumptively valid in the abstract); Brazen v. Bell Atl. Corp., 695 A.2d 43, 45 (Del. 1997) (upholding validity of termination fee).

17. *See In re* Topps Co. S'holder Litig., 926 A.2d 58, 66, 86–87 (Del. Ch. 2007) (upholding two-tier termination fee).

coupling a no-shop provision with a two-tiered break fee that is low for an initial fixed period and ratchets up thereafter.

Another area where private and public deals differ, and have been evolving, is earnest money deposits. In traditional real estate deals, the buyer puts up a deposit, say 5 or 10 percent of the purchase price, which it agrees to forfeit if it fails to close in breach of the agreement. The deposit serves as liquidated damages, effectively capping the buyer's exposure. No such concept exists in merger agreements between two public REITs. In such deals, the damages for failing to close are uncapped, and each REIT's full faith and credit is on the line. Take-private transactions, in which a private equity firm or other private buyer is purchasing a REIT and taking it private, often meld the two constructs and have "reverse break fee" structures, in which the buyer owes the seller a fee of, say, 5 to 10 percent (and no other damages), if it is unable to close because of failure to obtain financing or other negotiated conditions.[18]

Private and public deals also differ markedly in the area of post-closing liability for the seller. In private deals, much time is spent negotiating the survival period for the seller's indemnification for breach of its representations and warranties, as well as caps and baskets for any resulting liability.[19] In acquisitions of public REITs, there is generally no indemnification from the seller, and, in fact, the seller typically is merged into the buyer, which effectively assumes all of its liabilities. Notably, among the seller's liabilities inherited by the buyer are costs relating to shareholder litigation against the seller's board relating to the transaction itself.

The disclosure obligations that come into play in selling public REITs have implications for many of the constructs used in sale transactions, and also affect the pre-agreement mechanics. In private deals, signed letters of intent and exclusivity agreements are fairly common. Not so on the public side, where they might have to be publicly disclosed in advance of any deal, with the usual repercussions. Public deals tend to be announced only when the definitive agreement is executed and the buyer is fully locked into the transaction.

In a private deal, the parties typically structure the transaction as an asset sale, where deeds to properties are executed and recorded in local real estate records. REIT deals are instead often structured as triangular mergers, where no deeds are used and there are no direct property transfers. 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 acquiror, which generally provides a shield from the target's liabilities. If the merger sub survives the merger with the target REIT, the structure is known as a "forward triangular merger." If, instead, the target REIT survives the merger, the structure is known as a "reverse triangular merger." While reverse triangular mergers have a lower likelihood of triggering third-party consent rights under the contracts of the target REIT,

18. *See generally id*. at 72 (noting that a relatively small reverse termination fee capped the buyer's obligations if it chose not to consummate the deal).

19. *See* Therese H. Maynard, Mergers and Acquisitions 398–408 (5th ed. 2021).

because the target remains in existence following the merger, forward triangular mergers have predominated primarily because of tax considerations. The decision to choose a forward or reverse triangular merger structure often depends on tax and third-party consents considerations.

While asset purchases can be an alternative mechanism for acquiring a REIT, and are sometimes considered, the direct transfer of legal ownership of real estate is complex, time-consuming, and potentially results in considerable transaction costs, including transfer taxes. Asset purchases can also increase the need to obtain lender or other third-party consents. Such transactions can also implicate tax law restrictions on REITs selling assets,[20] and may require de-REIT-ing. As a result, asset purchases and liquidations of assets tend to be rare.

For REITs structured as UPREITs, the 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 partnerships 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.

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, the 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 if regulatory and judicial requirements are satisfied. 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, the parties must also consider the tax consequences on operating partnership unitholders (especially because the interests of unitholders and shareholders may differ). 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 realized on the contribution of this appreciated real estate.[21] As a result, operating partnership unitholders often have tax protection agreements in place that are 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. Such tax concerns may influence the transaction structure at the level of the operating

20. *See* I.R.C. § 857(b)(6)(A) (imposing a tax equal to 100 percent of the net income derived from prohibited transactions).

21. *See id.* § 721.

partnership, and can frustrate plans to sell some or all of the assets of an acquired portfolio.

Finally, rules restricting dispositions of REIT assets may interfere with otherwise desirable post-acquisition pruning of acquired assets. The prohibited transactions rules provide a strong deterrent to such pruning by imposing a stiff 100 percent tax on the net income from certain prohibited transactions.[22] These rules, however, apply only to the sale or disposition of section 1221(a)(1) property, namely, property held primarily for sale to customers in the ordinary course of a trade or business, which is not foreclosure property.[23] In addition, certain transactions will be exempt from this tax if they qualify for either of two statutory safe harbors.[24] The more generally applicable safe harbor imposes three principal requirements.[25] First, the REIT must have held the property (in the case of land or improvements, not acquired through foreclosure or lease termination, for the production of rental income) for at least two years.[26] Second, the aggregate expenditures includible in the property's basis during the two years prior to its sale must not exceed 30 percent of the net sales price.[27] Third, with certain exceptions, either the REIT must not have made more than seven such sales during a taxable year or the aggregate bases or fair market values of all the properties sold must not exceed 10 percent of the REIT's aggregate bases or fair market values, respectively, in all of its assets.[28] Thus, although there exists the possibility for post-acquisition pruning of the acquired assets, some flexibility in that regard may be lost due to the prohibited transactions rules.

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 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.

22. *See id.* § 857(b)(6)(A).

23. *See id.* §§ 857(b)(6)(B)(iii), 1221(a)(1).

24. *See id.* § 857(b)(6)(C), (D).

25. *See id.* § 857(b)(6)(C). The other safe harbor provision applies specifically to property held in connection with the trade or business of producing timber and is not discussed further in this Article. *See id.* § 857(b)(6)(D).

26. *See id.* § 857(b)(6)(C)(i), (iv).

27. *See id.* § 857(b)(6)(C)(ii).

28. *See id.* § 857(b)(6)(C)(iii). The Internal Revenue Service (Service) privately ruled that a section 1031 like-kind exchange will not be treated as a sale for purposes of this safe harbor and that the receipt of boot "does not affect the treatment of the property in the exchange," but, to the extent that any boot is received in the exchange, "that portion of the transaction may be treated as a sale for purposes" of the safe harbor. I.R.S. Priv. Ltr. Rul. 201614009 (Apr. 1, 2016); *see* I.R.S. Priv. Ltr. Rul. 200701008 (Jan. 5, 2007).

In structuring a transaction (and considering the optimal financing strategy), a REIT acquiror must consider the implications of a transaction on its own debt as well as the target's debt. A transaction may violate change-of-control provisions or covenants in the target's 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.

Financing for REIT acquisitions can occur at the entity level, in the form of preferred stock or senior or subordinated notes, or at the property level, in the form of mortgage loans secured by the REIT's assets, which may include issuance of commercial mortgage-backed securities. Depending on the type of financing and whether it is secured, lenders' commitments to the deal may require substantial due diligence and be heavily conditioned. One challenge in these circumstances is to manage the gap between financing commitments and closing conditions in the merger agreement.

Finally, foreign acquirors of U.S. REITs face one additional complication. The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) can create challenges for international investors considering an investment in U.S. real estate.[29] In general, FIRPTA can subject foreign owners of U.S. real property (or interests in certain entities holding U.S. real property) to taxation on gains recognized on the disposition of such property or interests.[30] 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 percent of the value of its shares held directly or indirectly by non-U.S. holders), FIRPTA does not apply to the disposition of shares of such REIT by non-U.S. holders.[31] A similar exception applies to dispositions of stock of a publicly traded REIT by a non-U.S. holder as long as such holder has not owned more than a specified percentage of the stock during a certain time period.[32]

Acquisitions of high-profile real estate assets may also be politically controversial, particularly in situations where the acquiror is sponsored by a foreign government entity, such as a sovereign wealth fund. Appropriate communications strategies and partnerships with local players should be considered 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 advantage 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-

29. Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599, 2682 (principally codified as I.R.C. § 897); *see* I.R.C. § 1445 ("Withholding of tax on disposition of United States real property interests").

30. *See* I.R.C. § 897(a)(1).

31. *See id.* § 897(h)(2).

32. *See id.* § 897(c)(3), (k)(1)(A).

U.S. acquirors (including real estate acquisitions), but it is unlikely that any CFIUS review would affect the typical real estate transaction. However, the Foreign Investment Risk Review Modernization Act of 2018 represents a large expansion of CFIUS's jurisdictional reach and may portend greater regulatory scrutiny of foreign investment in general.[33] In addition, a transaction involving a foreign acquiror may implicate U.S. 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.

IV. UPREIT Complications

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.[34] In particular, special consideration must be given to the rights and treatment of the unitholders of the operating partnership (OP Unitholders) and to the ultimate treatment to be afforded to the operating partnership itself in any change-of-control transaction. These issues will often be of paramount importance in structuring the transaction because of the significant tax burden that could result for the OP Unitholders[35] 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 UPREIT 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 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 generally necessitate special attention to the OP Unitholders' concerns and the potential conflicts of interest.

An UPREIT's board of directors confronts a dilemma when the interests of REIT shareholders and limited partners are adverse, which was first brought to light in the attempt by Manufactured Home Communities, Inc. to break up

33. Foreign Investment Risk Review Modernization Act of 2018, Pub. L. No. 115-232, §§ 1701–1793, 132 Stat. 1636, 2174 (codified at 50 U.S.C. §§ 4501–4565).

34. *See supra* notes 13–29 and accompanying text. For an excellent discussion of federal income tax issues and alternatives in reorganizations involving REITs and UPREITs, see Marshall E. Eisenberg, *Mergers and Acquisitions in an UPREIT/DownREIT World*, 74 Taxes 993 (1996). "REITs that hold assets both at the REIT level and through one or more operating partnerships are commonly referred to as 'DownREITs.'" David M. Einhorn, Adam O. Emmerich & Robin Panovka, *REIT M&A Transactions—Peculiarities and Complications*, 55 Bus. Law. 693, 696 (2000). For brevity, this Article henceforth refers only to UPREITs, but the issues addressed apply equally to DownREITs.

35. There are a number of structural alternatives that can be employed in M&A involving 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 section 721 transaction. *See* I.R.C. § 721.

the friendly stock merger between ROC and Chateau, an UPREIT.[36] Litigation surrounding that takeover battle centered on the extent to which directors of a REIT (some of whom were also OP Unitholders) may, or must, take into account the interests of the OP Unitholders in addition to the interests of the REIT stockholders.[37] 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 OP 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 OP Unitholders.[38] 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 a court would hold that the duty to shareholders is paramount and that, in the case of conflict between the interests of shareholders and OP Unitholders, the board, when determining the course of action that best serves the shareholders, may consider only the potential liability of the REIT to the OP Unitholders for any breach of duty, rather than their interests generally.

In re USACafes, L.P. Litigation held that the directors of a corporate general partner owe the limited partners a direct fiduciary duty.[39] 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.[40] Subsequent case law has not provided much guidance on this issue. It is possible, perhaps even likely, that courts will limit the duty that the directors (of a corporate general partner) owe limited partners to bar overreaching and unfair dealing.

Despite the absence of definitive legal guidelines, some general observations can be made. First, both the limited partnership and the corporation are long-

36. *See* Einhorn, Emmerich & Panovka, *supra* note 34, at 702–05.

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

38. States have adopted different approaches to the question of which constituencies a board may consider in deciding how to deal with potential acquisitions of a company. *See* James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 Stetson L. Rev. 97 (1991). 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 id.* at 103–06 (providing an overview and evaluation of such statutes). Maryland enacted legislation that 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) (West, Westlaw through 2023 Reg. Sess. of the Gen. Assemb.). Throughout this Article, we pay special attention to Maryland law, because many REITs are incorporated in Maryland. *See* Jay L. Bernstein, *REIT Merger Issue Outline*, *in* REITs: Using Financial and Legal Techniques to Capitalize on the Exploding Market 281, 286 (1997).

39. 600 A.2d 43, 49 (Del. Ch. 1991).

40. *See id.*

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 pursued to avoid 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. Although it may be argued that a general partner is entitled to disregard the tax circumstances of each of the limited partners, as courts have held when dealing with corporations and the tax circumstances of individual shareholders, any such claim would not lack a rational basis, given the absence of definitive case law.

As directors will probably not be permitted to directly consider the interests of OP Unitholders *as* limited partners, the board must address the potential conflict of any directors that 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.[41]

If one or more (but less than a majority of) directors hold OP Units, those directors should disclose their holdings to the remaining directors if they wish to engage in the decision-making process.[42] Those directors should also 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

41. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 709 & n.7 (Del. 1983) (en banc).
42. *See, e.g.*, Del. Code Ann. tit. 8, § 144(a)(1) (2023).

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 more closely scrutinize the board's actions, rather than apply the business judgment rule.[43]

Absent a particularized showing of *actual* conflict of a majority of the directors, and assuming that the interest of a minority of the directors as OP Unitholders is known to the other directors (as it almost certainly would be), any such conflicts involving a minority of the directors—standing alone—should not remove board action from the ambit of the business judgment rule.[44] Courts, however, will be alert to circumstances in which action is taken or forgone to the benefit of the OP Unitholders and the detriment of the shareholders, and courts will be inclined to examine carefully *how* the alleged conflict actually presented any 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. 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.

The UPREIT structure may also provide 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.[45] 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 sponsors' reluctance and may therefore remain deterred by the threat of the exercise of their 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 OP

43. In Maryland, however, legislation provides that directors, when responding 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(h) (West, Westlaw through 2023 Reg. Sess. of the Gen. Assemb.).

44. *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 on other grounds*, 636 A.2d 956 (Del. 1994).

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

Unitholders' right 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).[46] Strong market forces, however, generally limit such rights when REIT shares are initially offered to the public, and also generally eliminate conflicts of interest between the OP Unitholders and the public shareholders. In any event, hostile acquirors may challenge the exercise or potential exercise of these limited partner rights, arguing that the OP Unitholders/sponsors have a duty not to veto a transaction that 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.

V. REIT Spin-Offs and OpCo/PropCo Splits

In situations where the real estate of a publicly traded non-REIT company would have a higher market value if transferred outside of the company or where a company's real estate is underutilized or represents trapped value, the company can potentially unlock the value of its real estate by spinning off a REIT. The basic idea is to separate the business into an asset-light operating company (OpCo) and a property-owning REIT or other vehicle (PropCo) which leases the property back to the OpCo and may have flexibility to redevelop or sell excess real estate that is no longer needed by the OpCo. These transactions can create value when the multiple at which the PropCo trades is higher than the multiple at which the original company traded, which may be justified by the security and predictability of the lease cash flows as well as the tax advantages of moving the real estate into a REIT solution.

Such transactions are complex and potentially expensive and time-consuming. They often have operational implications (particularly where the company no longer has direct control of its real estate), and simpler transactions, like borrowing against the real estate, might better achieve the corporate purpose. Such spin-offs can also trigger real estate transfer taxes and have other significant tax implications, especially in light of tax law changes that eliminate the ability of non-REIT companies to accomplish REIT spin-offs on a tax-free basis.[47]

Another form of REIT spin-off is the separation of an existing REIT into separate, more focused REITs. Unlike spin-offs from non-REIT corporations, spin-offs from existing REITs can be done on a tax-free basis.[48] The rationale for a

46. *See, e.g.*, Irvine Apartment Communities, L.P., Annual Report (Form 10-K), exh. 3.5, § 7.3(E) (Mar. 31, 1998), http://www.sec.gov/edgar/Archives/edgar/data/912084/0000892569-98-000903.txt (Second Amended and Restated Agreement of Limited Partnership of Irvine Apartment Communities, L.P.).

47. *See* I.R.C. § 355(h).

48. *See id.* § 355(h)(2)(A).

typical REIT spin-off is to separate operationally distinct businesses and provide the market with a more targeted investment opportunity by separating elements of the parent company's property portfolio into a new, independent REIT. These transactions, like all spin-offs, are complex but may create value or enhance operations of the disparate businesses.

VI. Unsolicited Transactions

Although REITs have a number of defenses 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 defense, 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 defenses, 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 defenses, such as a rights plan, and may often be less so.[49] 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.

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 percent or some lesser percentage.[50] The ostensible purpose of the provisions is to ensure compliance with the 5/50 rule of the Code, discussed earlier, which prohibits five or fewer individuals from owning in the aggregate in excess of 50 percent of the value of the shares of a REIT during the last half of the REIT's taxable year.[51] In the case of REITs in which a founding individual owned more than 10 percent of the stock at the time the excess share provision was adopted, the ownership limit for other shareholders is typically set at a lower percentage, designed to ensure compliance with the 5/50 rule even after taking into account the founder's interest.[52] Under a typical provision, any shares acquired by a shareholder in excess of the 9.8 percent (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.[53] Importantly, the 5/50 rule operates

49. *See* Einhorn, Emmerich & Panovka, *supra* note 34, at 699–701.

50. *See* Lowy, *supra* note 11, at 102–03.

51. *See supra* note 10 and accompanying text.

52. *See* Lowy, *supra* note 11, 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%.").

53. 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

on a "look-through" basis, so that only individuals[54]—not corporations, partnerships, or other entities—are restricted in their ownership.[55] 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 may not threaten the target's REIT status because of the Code's "look-through" provisions.[56]

Given their broad applicability, excess share 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 (e.g., by an opinion of counsel or a ruling from the Service) that the acquiror is not an individual for purposes of section 542(a)(2) of the Code (i.e., that the acquiror is a corporation, partnership, estate, trust, or any other non-"individual" as to whom the 5/50 rule's "look-through" would apply) and the board obtains such representations and undertakings from the acquiror as it deems to be reasonably necessary to ascertain that no individual's beneficial ownership of stock through the acquiror will violate the ownership limit.

Due to 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 is whether, or at what point, the board has a duty to waive the excess share provision in the face of a hostile takeover offer. The law is not well settled on this issue. Although there is Maryland case law to support the use of an excess share provision as a means of deterring a coercive bid,[57] there is little guidance as to the permissibility of using

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purported acquiror receives no economic or voting benefit from its purchase. *See generally* I.R.S. Priv. Ltr. Rul. 9627017 (July 5, 1996) (discussing the workings and tax implications of excess-shares trusts); I.R.S. Priv. Ltr. Rul. 9534022 (May 31, 1995) (same); PETER M. FASS ET AL., REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 4.02[6][b], at 4-15 to -20 (1998) (discussing excess share provisions, excess-share trusts and related matters).

54. For purposes of this rule, the meaning of "individuals" includes certain organizations and trusts. *See* I.R.C. § 542(a)(2).

55. The "look-through" mechanism is incorporated into the 5/50 rule through the application of section 544(a)(1) of the Code, which provides that "[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." *Id.* § 544(a)(1).

56. Indeed, some REITs' ownership restrictions go farther still by applying their ownership limits to "groups" as contemplated by section 13(d)(3) of the Securities Exchange Act of 1934. *See* 15 U.S.C. § 75m(d)(3)(2018). Section 13(d)(3) defines "person" to include "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.*

57. *See* Realty Acquisition Corp. v. Prop. Tr. of Am., No. 89-2503, 1989 WL 214477 (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 hostile tender offer was coercive, precisely the sort of offer the excess share provision was designed to deter. *See id.* at *3.

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.[58] Much will likely depend on the disclosure made with respect to the excess share provision at the time of adoption. If the excess share provision was 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.

VII. Activism

Activist investors have become a familiar presence in the REIT markets, with multiple campaigns being waged each year. In many respects, activism in REIT stocks has followed the same pattern as other industries, but there are some key differences.

Some of the key REIT activists focus narrowly on the real estate space, and tend to have fairly limited amounts of capital to deploy. Their strategy is sometimes to initiate a campaign in hopes of drawing in larger multi-sector activists or private equity firms. In some cases, they have made bids for REITs to stimulate activity by others.

In addition to the typical thesis, the activist typically argues for a sale based on the REIT's stock price relative to its NAV. If the stock price is well below the NAV, the activist argues for a quick sale of assets at a profit, often ignoring the frictional costs of asset sales and liquidations, as well as the REIT-prohibited transactions rules, discussed earlier, which limit asset sales.[59] Another typical approach is to argue for retailers or other property-rich companies to unlock the value of their real estate, through a REIT spin-off or some other OpCo/PropCo separation, as discussed in Part V.

In most cases, the REIT's board has already considered (and rejected) the activist's ideas, but sometimes that outside perspective merits consideration. Of course, as with non-REITs, REIT boards should "be their own activists" and think broadly and strategically about their company and should also prepare for activist attacks. Well-prepared boards have many tools available to properly address activist attacks, and should work to avoid distraction from the company's business.

More broadly, U.S. REITs incorporated in Maryland have continued to face pressure from investors and proxy advisory firms to opt out of the Maryland Un-

58. *Cf.* Md. Code Ann., Corps. & Ass'ns § 2-405.1(h) (West, Westlaw through 2023 Reg. Sess. of the Gen. Assemb.) (providing that directors, when responding 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").

59. *See supra* notes 22–28 and accompanying text.

solicited Takeovers Act,[60] which empowers the directors to classify themselves without shareholder approval.[61] While, in some cases, it may be prudent to do so, each case is different, and care should be taken not to reflexively follow the herd and cede defenses that might be appropriate.

VIII. Outlook

REITs have now been battle-tested through financial crises, a pandemic, and periods of inflation and rising interest rates. Perhaps their biggest test, still underway, is how they will adjust to an increasingly digital economy that utilizes real estate differently. Thus far, the signs are positive, with the REIT industry showing flexibility and resilience.

REITs that focus on traditional property types are modernizing their business models and adjusting their focus to better serve the changing markets. At the same time, REITs that are part of the digital economy continue to grow rapidly.

Even prior to the COVID-19 pandemic, REITs were confronting a rapidly changing technological 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 ten years, creating risks and opportunities for REITs that will either adapt or in some cases risk obsolescence. That said, artificial intelligence and the metaverse are not on the verge of replacing the built environment in the immediate future. For the foreseeable future, humans will need places to sleep, eat, work, learn, hang and play, and brick-and-mortar-based commerce has even enjoyed a resurgence in some sectors. Regardless of any resurgence, the built environment must adapt to our increasingly digital lives. Many functionally obsolete, well-located assets that are well-served by transportation and other infrastructure will likely be converted to other uses. And buildings will need to decarbonize and address climate risk. Fortunately, REITs, with their professional management and access to capital, are well positioned to capture the massive opportunities involved.

Regardless of the property type and focus, the REIT model continues to benefit from the liquidity of its equity and the advantages of operating as a public company. While REITs have grown dramatically over the last twenty years, they still have substantial room for growth, both in the United States and in other industrial economies.

Liquid real estate's advantages have resulted in a vibrant US$1 trillion market for REITs in the United States and a well-functioning market for corporate control of real estate. We expect to see more growth and consolidation, punctuated by take-privates, spin-offs, and debt-driven restructurings as the market continues to evolve.

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60. S. 169, 1999 Leg., Reg. Sess. (Md. 1999) (codified in scattered sections of Md. Code Ann., Corps. & Ass'ns).

61. *See* Md. Code Ann., Corps. & Ass'ns §§ 3-801 to -805 (West, Westlaw through 2023 Reg. Sess. of the Gen. Assemb.).