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REIT M&A, Governance and Activism – Themes for 2017

REIT expansion and consolidation continued their steady march in 2016, and, based on the current pipeline, appear to be on track for a similar, steady pace in 2017. The wild cards, of course, are interest rates and political uncertainty. At the same time as they have scaled up, REITs have also grown in sophistication and in many cases have become models of good corporate governance and responsible stewardship. Of course, the landscape keeps evolving, and REITs, like other public companies, need to assess, adjust and address an ever-changing array of issues and challenges, some truly substantive and others mostly cosmetic.

We offer below some observations and practical suggestions on a number of key M&A and governance themes that we expect to continue to warrant attention in 2017:

1. Corporate Real Estate. Despite the IRS's 2016 guidance limiting certain tax-free spinoffs of REITs by non-REITs, the trend of moving under-utilized corporate real estate into REITs or other real estate vehicles is continuing, utilizing a variety of structures. Similarly, the use of REIT vehicles for non-traditional real estate assets continues to gather steam, with many non-conventional REITs growing at the fastest rates.

2. Activists. The REIT arena continues to attract interest from activists, sometimes offering interesting ideas, but often simply seeking short-term profits by offering relatively obvious ideas that can be harmful in the long run, like selling the company or assets to capture unrecognized value, adjusting leverage, dropping takeover defenses to make the company more susceptible to a forced takeover or pressure tactics, or replacing management. The best way to deal with activists is to get ahead of them, and "be your own activist" with respect to areas involving true opportunities for strengthening the company. A well-functioning board will have thought through the criticisms and suggestions of the activists well before the activist deck shows up on the internet – not just because it's good preparation, but more importantly because the board knows the company best and will have thought through the alternatives before landing on the company's strategy. In the face of an actual activist attack, a strong and unified board of directors is essential to producing a satisfactory outcome.

3. Sustainable Long Term Strategy and Board Involvement. Regardless of the governance flavor of the day or prods from short-term activists, the board's responsibility is to keep its eye on long-term strategy and value creation. Check-the-box governance prescriptions may be important for various short-term scores, but the board's core responsibility is to formulate and implement a long-term, sustainable strategy, vision, and corporate culture, work constructively with management in doing so, and have the backbone to resist value-destructive, short-sighted or otherwise inadvisable ideas.

4. Succession Planning. Few issues are more central to the board's long-term responsibilities than succession planning and implementation. Selection of a CEO is a core obligation of the board, not only because the choice and smooth transition of chief executives has tremendous consequences for the direction and performance of the REIT, but also because it creates important incentives (or disincentives) for managers who are

reaching for the brass ring. Succession planning should occur well before it is needed, when the board has the luxury of designing a well-considered process. Depending on the circumstances and the talent on the bench, a board will want to consider whether the successor should be an insider or an outsider, whether the bench should be built out with an eye to succession, whether a "tournament approach" among two or more internal candidates is advantageous or whether it is best to pick a single candidate who can be groomed. The board should also be comfortable that management is focused on attracting, developing and retaining strong talent beyond the C-suite.

5. Board Quality. Board quality, including composition, is an increasingly important issue, with particular focus on relevant expertise, average tenure, diversity and, of course, independence, in addition to the baseline requirements of character and integrity. While some have advocated implementation of term limits and quotas of various sorts, many believe that a more nuanced approach, often based on an annual board self-evaluation process, is a better tool to achieve a board composition that best serves the needs of the company without arbitrarily denying the board, the company and shareholders the benefit of strong, experienced directors. An appropriate evaluation process is more likely to organically address complex issues, and to yield a strong and truly independent board, willing to take responsibility for stewardship and the creation of long-term value. It is important in designing any evaluation process to focus on the ongoing needs of the company, the experience, expertise and contributions of existing board members, and any deficiencies in the current composition. But encouraging the right board behavior and fostering strong board practices fundamentally drives board quality too, and this should not be forgotten. Experience shows that internal transparency on these issues tends to promote helpful and orderly – rather than reactive and rushed – change.

6. Executive Compensation. Board compensation committees must continue to walk the fine line between, on the one hand, establishing an executive compensation program which adequately rewards performance (including richly rewarding outstanding performance) and, on the other hand, avoiding, to the extent practicable, criticisms from both interested and disinterested parties of purported excessive executive compensation. This is best accomplished by thoughtfully linking pay to performance. Consideration should be given to establishing performance goals that properly reflect not only shareholder returns, but also factors over which management has some greater level of control. For REITs this could mean, for example, establishing goals based on FFO and other metrics in addition to the more commonly used TSR. From a more practical standpoint, the Dodd-Frank pay ratio rules, which require expressing the compensation of the CEO as a multiple of that of the "median employee," become effective with 2018 proxy statements but relate to 2017 pay. Due to the complex data collection needed to establish the ratio and the alternative methodologies that may be employed, it is not too early to gather a team of internal personnel and external advisors and begin the process. Most of the large compensation consulting firms have developed specialty practices to assist in this area. We summarize the pay ratio rule here.

7. Say-on-Pay. The say-on-pay vote has become routine for most REITs, but still warrants close attention. Most companies easily pass the vote. But a lack of focus, combined with one or more down years for the stock, can result in a close call or even a

loss which then requires an inordinate amount of management and board attention, which could better be spent focusing on the business. In the past it has been adequate to keep up to date with the latest policy positions of ISS and Glass-Lewis. But more recently, several large institutional shareholders, including Blackrock, Fidelity, State Street and Vanguard, have moved away from passively following the recommendations of the shareholder advisory services and developed their own say-on-pay voting guidelines. Familiarity with the voting guidelines of major shareholders, including identifying those that follow the shareholder advisory services and those which have their own guidelines, will go far toward tailoring a pay program which will pass muster. That said, there is no substitute for the board's independent judgment of the best way in which to compensate executives, and sometimes the best answer for a particular REIT will not align with ISS' or others' one-size-fits-all guidelines. And, as always, strong disclosure and ongoing shareholder outreach, ideally outside of the proxy season, remains the single best way to obtain the optimum voting result.

8. UPREIT Conflicts. Far too much is made of the potential conflicts between unitholders and shareholders. In practice, this is rarely an issue, and is best resolved through tried and true methods for dealing with actual conflicts, when they do arise, such as recusal and special committees where needed. Extreme measures like disenfranchising unitholders are unnecessary; letting unitholders vote their economic interests *pro rata* best serves the enterprise in the long term.

9. MUTA. In August 2016, ISS issued its annual survey of issuers, investors and other market participants regarding governance-related topics in advance of announcing ISS' 2017 proxy voting policies. Of special relevance to many REITs, the survey asked "Should ISS consider recommending against directors at Maryland companies who have not opted out of one or more of (1) the ability to amend corporate bylaws without shareholder approval? (2) the ability to increase authorized shares without shareholder approval? (3) MUTA or similar 'problematic' provisions?" We think the answer is clearly no, and that not reflexively opting out of these important Maryland provisions should be the norm, and supported by thoughtful, well-informed shareholders. The tools provided by Maryland law to a board of directors in the context of an unsolicited takeover bid or activist situation should not be voluntarily blunted without very careful consideration. Once given up, they cannot be restored. Of course, it is incumbent upon boards to behave responsibly, and takeover protections should be deployed only with careful thought and deliberation, and with careful attention to the situation in which a company finds itself. We continue to urge investors to judge boards fairly, by their actions, and not believe the myth that boards do not possess the judgment and skill to act responsibly on behalf of investors, taking into account the long-term value of the corporation. In our experience, boards work very hard to do the right thing in takeover (and activist) situations, carefully assessing industry and general economic conditions, their company's probability-weighted prospects and the associated risks and uncertainties, and the timing of – and possibility of opportunism in – the unsolicited bid or activist approach. Calls to deprive boards of the tools to effectively discharge their fiduciary duties for the benefit of all shareholders in the context of takeover and activist situations by disempowering boards and instituting what amounts to one-size-fits-all governance by plebiscite deny the fundamental nature of the corporation and the value of the board. And as we have previously stated, ISS's questionable survey

methodology and "leading the witness" survey design as to Maryland law undermines the value and objectivity of the ISS survey results on this topic.

10. Risk Management. Corporate risk taking and the monitoring of risks remain front and center for boards, legislators and the media, fueled by the powerful mix of continuing financial instability, ever-increasing regulation, and anger and resentment at the alleged power of business and financial executives and boards. Thoughtful board engagement with relevant risk issues and encouraging risk-aware and risk-adjusted decision-making accordingly remains central board functions.

11. Tone at the Top. All the pressures of the market notwithstanding, boards must remember their role as stewards of the corporation and actively cultivate a corporate culture and "tone at the top" that prioritizes ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements, ethically sound strategic goals and long-term sustainable value creation.

12. Holding Investors to a Higher Standard. REITs increasingly find themselves effectively controlled by a handful of major institutional investors. Accordingly, REIT boards and management teams have the right to expect their shareholders to share candid feedback directly and privately with the company instead of through activist hedge funds or proxy advisory firms, to make shareholder decision-makers available to the company, to provide steady support for companies who pursue sensible strategies for long-term growth and value creation and to work hand-in-hand and constructively with the board and management to understand a company's strategy and business and manage any disagreements.

At the end of the day, good governance requires careful thought and judgment by the board. Overly formulaic, one-size-fits-all approaches are a disservice to shareholders, and distract from the board's ultimate responsibility, which is to focus on long-term sustainable shareholder value and wealth creation.

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