CHAPTER 1

Introduction

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§ 1.01 Introduction—Real Estate Meets M&A

The U.S. commercial real estate industry is in the midst of an ongoing transformation that is reshaping the transactional landscape. Until the early 1990s, private sources of equity capital dominated the industry, and public companies and the associated Wall Street players had an almost insignificant role. Real estate purchase and sale transactions were private and there was no need to address public company merger and acquisition (M&A) issues. Then, with the unleashing of the so-called REIT Revolution,\(^1\) the rules of the game began to change. The traditionally private real estate world has been forced to adapt to the reality that many significant real estate owners are now publicly traded REITs and that major transactions involving public REITs blend traditional real estate deal components with corporate M&A structures.

While M&A transactions involving public REITs have much in common with M&A transactions involving other public companies, REIT transactions have their own “deal technology” that is based on the unique structure of REITs, traditional real estate deal structures, peculiarities of the underlying real estate assets, and the special tax rules applicable to REITs. REITs combine the private “Main Street” real estate culture and the public Wall Street capital culture, creating a whole new set of issues to address when structuring and carrying out deals.\(^2\)

This treatise is intended to provide a roadmap for the emerging world of REIT and real estate M&A transactions. The remainder of this Chapter provides background and a statistical overview on the REIT Revolution and REITs, and then explains culture clashes that are influencing the new landscape. Chapter 2 addresses structural considerations in consensual REIT M&A transactions (including tax based impediments to the acquisition of REIT shares). Chapter 3 focuses on REIT directors’ duties, which often drive the way transactions get done. Chapters 4 and 5 provide a detailed look at the process and documentation for consensual REIT deals, and Chapter 6 focuses on the attendant tax issues. In Chapter 7, the authors address unsolicited transactions and the need to protect transactions from unsolicited competing bidders. Chapter 8 explains the process for taking

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\(^1\) See § 1.02 infra.
\(^2\) Id.
REITs private. The remaining chapters focus on various specific types of transactions and issues that arise in the REIT M&A context.
§ 1.02 The REIT Revolution—Background

The so-called REIT Revolution, which began in the early 1990s, unleashed a series of tidal waves that continue to alter the commercial real estate industry in the United States and globally. Prior to the early 1990s, the commercial real estate industry relied almost exclusively on private sources of capital. The REIT Revolution finally forced open the floodgates that had been holding back Wall Street and caused the long-predicted marriage of the capital-intensive commercial real estate industry with the largest and most efficient capital markets in the world, the publicly traded equity and debt markets. Almost overnight, two very different business cultures—the private Main Street real estate culture and the public Wall Street capital culture—were thrown together, often with the Main Street players being forced into the marriage. Real estate firms that accepted Wall Street capital often did so because the alternative was bankruptcy. And, once they accepted the capital, the newly public firms were forced to play by Wall Street’s structural and transactional rules, while the Wall Street firms that provided the capital were forced to take a crash course in real estate and to accept real estate business models and novel structures, like the Umbrella Partnership REIT (UPREIT).

The principal catalysts for the virtual avalanche of REIT initial public offerings in the early 1990s were, first, a major drought in debt financing which forced real estate firms to seek new sources of capital and, second, the development of the UPREIT structure. The debt crisis in the early 1990s left many real estate owners unable to find lenders or fresh private equity to refinance their maturing loans, resulting in an increased risk of foreclosure. Frequently, the only source of the required capital was Wall Street, which promised to provide the funds needed to repay the maturing debt by taking the owner-borrowers public. However, going public was often impractical because of the unmanageable tax bill that frequently resulted from the contribution of negative basis properties in exchange for stock or cash in a newly formed or existing REIT. The solution to this tax-based impediment was the UPREIT structure, which allowed real estate owners to defer the realization of income that would have otherwise resulted from their contribution of negative basis assets to a trust or corporation in preparation for an IPO.

An UPREIT is a REIT that holds all of its assets in, and conducts its business through, a subsidiary partnership in which the REIT is the sole general partner. The strength and attractiveness of the UPREIT structure lies in the ability of real estate owners to transfer real estate to an UPREIT, on a tax-deferred basis, in exchange for partnership units that can be converted into publicly traded stock of the general partner REIT, or cash, usually at the option of the general partner REIT.

After the first UPREIT’s initial public offering in 1992, others quickly followed. The aggregate equity market capitalization of REITs grew from $8.7 billion in 1990 to roughly $438 billion in 2006, a more than fifty-fold increase, with REIT debt rising from $10 billion in 1992 to approximately $69 billion in 2004.

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2. See §§ 1.03 and 6.04[1] infra for a detailed discussion of the UPREIT structure.
3. The term negative basis property refers to property the tax basis of which is less than the amount of the liability to which the property is subject. Debt-financed depreciable property becomes negative-basis property because the property is being depreciated for tax purposes at a rate that exceeds the rate at which principal payments are being made on the debt to which the property is subject. See § 6.04[1] infra for a comprehensive discussion of the tax implications of contributing property for stock.
Chart 1

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7 Chart is from NAREIT, “Real Estate Investment Trusts: Investing for Dividends and Diversification (June 30, 2007) (slide show), available at http://www.nareit.com (subscription only) (last visited Aug. 27, 2007). It is reproduced with the permission of NAREIT, the publisher and copyright holder.
But despite the impressive growth of the REIT industry thus far, REITs still represent a small fraction of the real estate market, arguably less than 7%, which highlights the potential for future growth. 

Chart 2

*Represents approx. 10% of “Institutional Assets”*
Predictions as to how much bigger the REIT industry will grow, and how fast, are all over the map, but the potential is clear. If the REIT industry were to absorb only one quarter of the commercial real estate in the U.S., it could account for as much as 10% of all publicly traded U.S. stocks.\(^\text{10}\)

Chart 3\(^\text{11}\)

The rate of absorption of various classes of real estate has differed markedly. By 2007, the REIT market had absorbed 18% of all residential property, 14% of all regional shopping malls, 11% of non-mall shopping centers and 14% of all office buildings in the U.S.\(^\text{12}\)

\(^{10}\) *Id.*

\(^{11}\) *Id.* This chart was reproduced with the permission of NAREIT, the publisher and copyright holder.

§ 1.03 Trends

As the industry has begun to mature, a number of trends have emerged. The trend toward significant consolidation and growth in company size continues to pick up steam. Just since January 1, 2000, the number of REITs with market capitalizations in excess of $4 billion has increased sevenfold from three to twenty-one, the number of REITs with market capitalizations between $2 billion and $4 billion has increased from seventeen to twenty-one, and, significantly, the number of REITs with market capitalizations under $500 million has shrunk from 116 to fifty-nine.\(^1\) As of July 31, 2007, there were nine REITs with market capitalizations in excess of $10 billion.\(^2\)

Clearly, some of these shifts are attributable to the significant run-up in REIT stock prices during this period, but the numbers also bespeak a strong consolidation and growth trend. All in all, the maturation of the REIT markets has meant, and will likely increasingly lead to, significant merger and acquisition activity involving publicly traded REITs.\(^3\)

The growth and consolidation trends have been matched by a healthy increase in trading volume of REIT stocks, which itself has stimulated growth by providing the greater liquidity that is critical to large institutional investors. From 2000 to 2007, the average trading volume of REIT stocks skyrocketed, from about $400 million per day to over $4 billion per day.\(^4\) In all respects, REITs have become an increasingly mainstream investment, with fourteen REITs being members of the S&P 500 by June 2007, fourteen being members of the S&P 400 Mid Cap, and a further sixteen being members of the S&P 600 Small Cap.\(^5\)

Another noteworthy trend has been the movement towards more traditional and institutionalized governance. As REITs have matured and become more mainstream vehicles, REIT governance has become increasingly conventional and has improved markedly. The trend has clearly been to adopt traditional corporate governance models and, over time, to replace the old entrepreneurial leadership with professional managers.\(^6\)

Consistent with the trend in the broader markets, the REIT industry saw a significant number of going-private transactions in 2006 and through the first half of 2007. The bulk of REIT M&A transactions in the first half of 2007 and many of the 2006 transactions were deals in which private equity buyers took REITs private. In essence, the private equity buyers were simply taking advantage of the disparity between REIT stock prices and the higher private market value of the REITs’ assets. The strategy employed in many of these transactions was to buy the REITs and then quickly sell much of their assets at a profit.\(^8\) One of the principal drivers of the privatization trend was the availability of huge amounts of cheap debt. It is too soon to tell whether the instability in the credit markets witnessed in the summer of 2007 will put an end to the privatization trend, but it is sure to slow things down.

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\(^2\) Id.

\(^3\) A roster of selected REIT M&A transactions that have taken place since January 2000 is included in Appendix A infra.


\(^6\) REITs have been highly successful in implementing traditional corporate governance measures. In 2006 and 2005, the REIT industry ranked second (behind utilities) in average corporate governance rankings, as measured by Institutional Shareholder Services’ Corporate Governance Quotient (CGQ) database. REITs had an average CGQ of 61.0 in 2006, as compared to an overall average of 50.5. See Wanner, “Real Estate Again Shines in Governance Rankings,” NAREIT, Real Estate Portfolio (July/Aug. 2006).

\(^8\) See Chapter 8 infra for a more detailed discussion.
§ 1.04 REIT and UPREIT Basics

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

In order to qualify as a REIT, an entity must satisfy detailed organizational, operational and record-keeping rules. As a consequence of the special rules applicable to REITs, acquisitions of REIT shares (whether or not consensual), and placements of significant blocks of REIT stock with a domestic or foreign investor, can raise significant tax and nontax issues. In part to address these issues, REIT charters typically contain various ownership limitations. Unfortunately, instead of simplifying matters, these limitations raise their own set of complex issues.

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

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

The tax advantages of UPREITs come with costs. The principal cost is a layer of complexity resulting from the dual corporate-partnership form of the UPREIT entity and the rather unfamiliar “OP unit” class of equity. In addition, it is often argued that the UPREIT structure can create con-

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3 See IRC § 857(b)(1)(B); 26 U.S.C. § 857(b)(1)(B). Unless otherwise noted, all references herein to “the Code” are references to the Internal Revenue Code of 1986, as amended, and references to “section” or citations to “IRC §” are references to sections of the Code. References to “Regulation §” or “Reg. §” and citations to “Treas. Reg. §” are to the Treasury Regulations promulgated under the Code.
4 See IRC § 856; 26 U.S.C. § 856.
5 See: §§ 7.01-7.03 infra for a detailed discussion of the ownership limitation and excess share provisions found in REIT charters.
6 The term “UPREIT” is an acronym for “umbrella partnership REIT.”
8 See IRC § 351(a), (c); 26 U.S.C. § 351(a), (e). Acquisitions taking the form of reorganizations within the meaning of Section 368(a) are beyond the scope of this chapter. See Chapter 6 infra for a detailed discussion of tax considerations in REIT mergers and acquisitions.
Conflicting fiduciary duties for the directors of the REIT because while REIT directors owe a fiduciary duty to the REIT’s shareholders, the REIT general partner arguably also owes a fiduciary duty to its limited partners, the OP unitholders. The conflict between these two sets of fiduciary duties is often thought to be heightened in the context of change of control transactions. This is due primarily to the differing tax positions of REIT shareholders and the OP unitholders. Although the precise contours of REIT directors’ duties in these conflict situations have yet to be tested, the potential conflicts may be mitigated through various procedural safeguards.

In order to compete effectively with UPREITs in property acquisitions, traditional REITs often mimic the UPREIT structure by creating operating partnerships that acquire and hold assets separate and apart from the REITs’ other assets. Creation of the operating partnerships gives traditional REITs an acquisition currency in the form of limited partner interests in the operating partnerships, similar to UPREIT OP units. REITs that hold assets both at the REIT level and through one or more operating partnerships are commonly referred to as “downREITs.” As is the case with UPREITs, the downREIT structure is sometimes thought to give rise to conflicts of interest in the context of change of control transactions and may also give rise to potential differences between unitholders with their entire interest in the limited partnership and shareholders with an interest in a broader pool of assets.

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9 See § 3.03 infra for a discussion of directors’ duties in REIT merger and acquisition transactions.
10 See, e.g., § 3.04 infra.
12 See id. at 10.
§ 1.05 Clashes of Culture, Custom and Deal Structures at the Crest of the Revolution

As important as the tax and other features of REITs and UPREITs are, the ongoing REIT Revolution owes many of its contours to the melding and clashing of the real estate and Wall Street cultures and historical deal structures.

[1]—Cultural Differences

The REIT Revolution has brought together two business cultures that had developed separately for decades—the traditional “privately held” real estate culture and the “public company” culture that comes with acceptance of publicly traded equity. The traditional real estate business model continues to apply in much of the commercial real estate industry, but the growth of the public company REIT sector and the increasing market power of REITs have meant that the influence and importance of the public company models have grown dramatically. The public company model has obviously been accepted by publicly traded REITs (often with some chafing and growth pains, but accepted nonetheless), and its influence has also been felt strongly well beyond the REIT sector throughout the institutional private sector. The result is an ongoing melding of cultures, sometimes forced, rushed and uncomfortable.

The real estate industry’s historical reliance on private capital resulted in business models and deal technology that had no need to address public company disclosure requirements, corporate governance models or the constraints imposed by corporate or securities laws. A typical business model in the traditional real estate world uses a limited partnership or limited liability company structure, with the promoter serving as the general partner or managing member and the capital providers serving as limited partners or nonmanaging members. The founder has broad operating control and generally is only constrained with respect to certain “major decisions,” if at all. There is no board of directors holding management accountable and management generally cannot be replaced. Disclosure is limited to whatever the partnership or limited liability company agreement provides for, and, in general, the relationship between the investors and management is prescribed by the operating agreement (which often can be rather thin), with few state or federal statutory constraints.

The model for publicly traded REITs is very different. Ignoring for the moment the UPREIT structure, REITs are structured and operated like other public companies—shareholders periodically elect directors, management is accountable to the board of directors and can be replaced, disclosure to shareholders is carefully prescribed and mandated by SEC rules, the well-developed bodies of corporate and securities laws apply, and investment banks, accountants, rating agencies and other intermediaries and monitors play a powerful role.

[2]—Structural Differences

The different mind-sets in the REIT and private real estate sectors clash in cross-sector transactions. The structure used for a typical acquisition of a REIT or of a substantial portion of a REIT’s assets tends to require the purchaser to perform relatively limited due diligence (especially property-level due diligence) prior to entering into the acquisition agreement—often without the protection of an exclusivity period—and tends to severely limit the conditions under which the purchaser is excused from closing. The typical contract affords the buyer a closing condition triggered only if the representations and warranties it has obtained from the seller’s fail to be true to an extent that would have a material adverse effect on the condition of the assets or entity being sold as a whole (commonly referred to as a “MAC” or “MAE”). If the buyer does not uncover a MAC, it is required to close and pay the full agreed upon price. Failure to do so typically exposes the

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1 These representations and warranties are often more general in scope than the typical detailed representations found in a single property acquisition agreement.
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buyer to unlimited damages. Provisions liquidating damages at a 10% deposit or the like are rare in public company transactions and, in any event, given the prices for public companies, the amount of the deposit would likely be so large that the ability to walk away and forfeit the deposit would be of little practical value.

This is a far cry from the typical private real estate acquisition structure in which the buyer is not required to expend funds on due diligence until it has locked up the deal with a definitive agreement. In such acquisitions, the due diligence investigation usually is performed during a “feasibility” or “free look” period and the buyer is free to walk away from the transaction if it determines during that period that it is dissatisfied with the property for any reason. Moreover, if the purchaser ultimately breaches the contract by refusing to close, damages generally are limited under a liquidated damages provision to the “earnest money” or “good faith deposit” put up by the purchaser.

Traditional real estate players are often baffled when they are told, in the context of negotiating the acquisition of a REIT, that their due diligence will largely be limited to publicly filed disclosures, and materials located in a “data room,” with limited access to updated “property level” documents like title policies, surveys, environmental reports or leases. From their perspective, it would be foolish and unheard of to purchase a property without extensive, updated due diligence, especially at the property level. The explanation that they are buying a public company, not real estate, often provides cold comfort. But from the public company seller’s perspective, property-level due diligence seems like overkill, carries significant risks and is impractical. Extensive due diligence, including property visits and employee interviews, could jeopardize employee or customer retention and morale. Public company sellers view their companies as more than the sum of their assets. They consider the intellectual capital, experience and relationships that their personnel bring to the table to be important aspects of their enterprises. As a result, the risk of destabilizing the human side of their companies prematurely—before a deal is locked in—is generally unacceptable. Often more troubling than the employee or customer issues are the risks of premature leaks and disclosure to the stock market. In the public company context, unsettling the market prematurely can negatively impact market perception of the REIT and thus hurt its stock performance. If a deal is disclosed prematurely and then fails to materialize, the company or the assets being sold may retain a “failed deal” or “damaged goods” taint that could make future deals and business operations more difficult or raise questions about management’s ability to execute deals. In addition to legitimately wishing to guard against these risks, public company sellers can argue that purchasers require less due diligence because of the security afforded by the SEC filings and audited financials of the sellers and by the many watchdogs (rating agencies, investment bankers, accountants, analysts, etc.) who have all already performed their own due diligence. Finally, given the large number of assets typically involved, it is usually impractical for the buyer to obtain and review current property-level reports on every property within the usually short fuse time parameters of public company M&A transactions.

Purchasers from the private REIT world may be equally baffled by the notion that executed letters of intent are virtually unheard of in public company deals, just like the “feasibility period” contingencies discussed above. While such features are typical in private real estate transactions, from the public seller’s perspective, they are virtually unheard of for reasons similar to the ones discussed above—signing a letter of intent or a definitive agreement with significant buyer contingencies creates the risk of public disclosure, market disruption and loss of employees (or damage to employee morale) and customers before a deal is locked in. From the REIT’s perspective, it makes little sense to disclose a deal until there really is one, and if there is only a letter of intent or a contract with material buyer contingencies then there is no definitive deal. REITs will tend to fight against entering pre-contract exclusivity agreements for similar reasons—disclosure might be required in advance of a definitive deal, with the attendant risks.

Far from being able to negotiate for contingencies to closing in their favor, buyers dealing with public REIT sellers are often told—frequently to their amazement—that in contrast to the buyer
contingencies with which they are familiar, it is customary for the public seller to have contingen-
cies that entitle the seller to walk away from the deal if it fails to obtain shareholder approval for
the transaction or if the seller’s “fiduciary duty out” is triggered.\(^2\) Once the buyer digests the notion
that, while the buyer is locked into the deal, the seller is free to walk away in various circum-
stances, the buyer quickly focuses on break-up fees, no-shop provisions and other methods for
protecting its deal.\(^3\)
