REIT ALERT

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Barbarians at the (REIT) Gates: REITs Should Be Prepared for a New World Order of Shareholder Activists, Hostile Overtures and Proxy Fights

SPEED READ

Publicly traded REITs today face an increased risk of potential shareholder activism, proxy fights and otherwise hostile overtures. In response to this growing trend, public REITs should examine their corporate governance profiles and evaluate their takeover preparedness. While substantive changes may not be in order, regular reviews of these important internal governance features can better prepare board members and management when a threat materializes and/or when the REIT otherwise receives shareholder proposals relating to governance matters.

For over 20 years from the dawn of the modern REIT era in the early 1990s, hostile takeovers, proxy fights and shareholder activists – the stuff of everyday business in many other sectors – were few and far between in the world of publicly traded REITs. While the REIT sector was an able and willing participant in M&A activity during this period, the overwhelming majority of deals were negotiated, friendly transactions. That is to say, with some notable exceptions,[1] suitors and concerned investors generally pressed their case through and with the participation of the target's board of directors, rather than by going over or around them directly to shareholders.

In thinking about why this has historically been the case for REITs, industry experts have offered a number of reasons:

- Public REITs tend to trade within a generally predictable band above and below their NAV (net asset value). As such, given the relative transparency of the asset class and of the REIT model, an acquiror or activist is less likely to be able to unlock sufficient value to justify the cost and effort of a hostile takeover or proxy fight.
- Many REITs are and were incorporated in Maryland, a jurisdiction where the actions of directors in the face of unwanted overtures may be given more deference by the courts and where the so-called Revlon duties requiring maximization of shareholder value may be less stringently applied.
- Virtually all public REITs have ownership limitation provisions in place that restrict, to greater and lesser degrees, the ability of any one person (or group of persons) to acquire a meaningful amount of the REIT's equity capital without prior board approval (for most REITs, the threshold is 9.8%).

The validity of these rationales has been a matter of academic debate from time to time[2] but activity in the marketplace in recent years demonstrates that the constraints to hostile overtures and activist campaigns in the public REIT sector, whatever they may have been, are no longer sufficient deterrents. To the contrary, REITs large and small have seen a flurry of hostile and activist activity over the past two years, which has served, and should continue to serve, as a wake-up call for the industry as a whole. A non-exhaustive list of hostile and activist activity that has appeared in the press or in public filings during this period includes:

- the disclosure by Lakewood Capital Management of a 5.8% state in Select Income REIT and its subsequent announcement of its intent to file a preliminary proxy statement to solicit votes for the election of a competing trustee (January 2015);
- the disclosure by Corvex Capital Management of a 7.1% stake in American Realty Capital (December 2014);
- issuance of public letters by Land and Buildings to the management of Pennsylvania REIT calling for the disposal of certain assets and other changes (October 2014);
- unsolicited offer letters from Land and Buildings to Associated Estates Realty Corp. (June 2014) and to BRE Properties (June 2013);
- the disclosure by each of Blue Mountain Capital and HG Vora Capital Management of respective 4.9% stakes in Chatham Lodging Trust and subsequent unsolicited offer letter from Blue Mountain to acquire the company (November 2013);
- the disclosure by Corvex Capital Management and Related Fund Management of a collective 9.8% stake in Commonwealth REIT and their subsequent successful campaign to remove and replace the entire board of trustees (February 2013); and
- letters received by dozens of public REITs in recent years from large institutional investors requesting corporate governance changes, such as destaggering of boards and adoption of a majority voting standard in uncontested elections.

In some of these instances, the REIT has been successful in rebuffing unsolicited overtures or activism, while in others the REIT ultimately underwent a change of control or adopted changes to its corporate structure and governance. The common denominator is that a sitting public REIT and its incumbent board came under direct public pressure from investors, competitors and/or other would-be suitors for matters ranging from changes in corporate governance (such as adoption of majority voting) all the way through to complete changes of control.

The merits of shareholder activism and unsolicited hostile overtures continue to be topics of extensive debate among market participants and commentators. The one thing that is clear, however, is that no public REIT should assume that it is immune from the forces at work in the current marketplace. Rather, REITs would be well served to undertake thorough reviews of their current corporate governance profiles to ensure that both the company and the board are optimally prepared to successfully navigate possible hostile activity for the benefit of all stockholders. Just as critically, if not more so, a public REIT must "know its stockholders" – that is, spend time understanding who the company's stockholders are and how they view the REIT's current business plan and prospects for growth.

REIT Anti-Takeover Protections

Takeover protections in the strictest sense have historically been identified with preventing, delaying or discouraging a party from acquiring a controlling interest in a company, unless the company's board of directors approves the acquisition. The array of takeover protections in use or available today also have the effect of preventing or delaying an array of corporate actions short of a change of control, such as charter and bylaw amendments, nominations and appointments to the board of directors.

The table below provides summary statistical data on a number of corporate governance provisions currently available and in use in the public REIT market, which may be useful under certain circumstances in the event of a hostile overture or threatened proxy fight. *Data is as of December 31, 2014 and based on a sample of over 50 NYSE-listed equity REITs of multiple enterprise values selected across multiple sectors, including both older and newer entrants to the market.*

PROVISION/STATUTE	PUBLICLY TRADED REITS*
Ownership limitation provision in charter [3]	100%
Blank check preferred	96%
No opt out of Maryland unsolicited takeover act (Subtitle 8)	85%**
Supermajority vote to remove directors	73%
Shareholders may not take action by (less than unanimous) written consent	73%
Majority of shareholders necessary to call special meeting	73%
Supermajority vote to amend certain provisions in the charter	72%
Only board permitted to fill vacant director positions	69%
Only board can amend bylaws [4]	69%
Directors may be removed only for cause	52%
Supermajority vote required to approve extraordinary transactions	24%
No opt out of business combination statute	24%
Classified board with staggered terms	12%
Exclusive forum selection bylaw	12%
No opt out of control share acquisition statute	12%
Active poison pill/shareholder rights plan	2%

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** Percentages are rounded.*

*** Percentage shown is a percentage of only those REITs incorporated in Maryland.*

Opponents of takeover protections believe that their principal purpose is to enable a company's board and management to entrench themselves, or enable management to extract significant personal concessions, such as employment agreements or severance payments, as a condition to agreeing to a proposed change of control. Proponents believe that, when properly used by boards discharging their fiduciary duties to all stockholders, these types of takeover protections give a board the ability to maximize stockholder value. Proponents believe that these devices help in the following ways:

- they give a board time and flexibility to consider whether a proposed action or transaction is in the best interests of the company, which otherwise could be difficult to assess in a crisis situation created by a hostile proxy fight or unsolicited offer;
- they discourage the accumulation of stakes in the company or other activist initiatives designed to generate volatility in the stock price and trading profits for the activist(s);
- they deter potential acquirors from engaging in and benefiting from coercive tactics to the detriment of other stockholders; and
- they help protect stockholders from the costs associated with the distraction to management and employees, and the loss of valuable employees, caused by the hostile overture and/or other proposals.

As indicated by the data above, a majority of public REITs, both those organized in Maryland and otherwise, will typically have most of the takeover defenses listed in the table above available, either as embedded in charters and/or bylaws, or as adopted by the board of directors. Boards of directors, particularly in Maryland, may also have available more general defenses against unsolicited overtures, including (i) the "just say no" defense permitting the board of a company that is not "in play" to reject any acquisition offer involving a change of control regardless of the nature of the consideration offered, and (ii) a presumption that an act of a director of a corporation satisfies the director's standard of conduct under Maryland law. It is particularly worth noting that Maryland does not have a parallel to Delaware's *Unocal* standard under which defensive actions taken by the board of directors in response to a hostile threat can be subject to a stricter level of scrutiny than ordinary business actions.

Nevertheless, recent history has demonstrated that the availability of takeover defenses is in-and-of-itself not always going to be sufficient in the face of a determined activist or hostile actor.[5] For example, even a fully classified board can see a majority of incumbent directors voted off the board in the course of two consecutive annual elections. Moreover, in recent years a growing number of influential corporate governance advocates in the REIT sector, including several of the largest institutional stockholders sector-wide, have brought substantial pressure to bear on the boards of many REITs to irrevocably surrender important takeover defenses, such as permanently opting-out of

Maryland's statutory anti-takeover protections generally, or at least foregoing the ability to unilaterally classify the board.

Again, there is robust debate across the industry and beyond on the relative merits of these efforts and whether or not a company and its stockholders are ultimately helped or harmed by foreclosing the board's ability to deploy defensive measures in the face of a perceived threat – but it is clear that before voluntarily and permanently surrendering an otherwise available defense, a REIT's board should first fully consider the totality of defensive measures available to it and the relative efficacy of these measures in confronting a perceived threat to the company and its stockholders.[6]

Being prepared for a coercive bid or other hostile activity is not a one-size-fits-all proposition, and we do not recommend any particular set or subset of defenses as a blunderbuss approach for all public REITs. For example, a REIT that has the ability to unilaterally stagger its board at any time under the Maryland Unsolicited Takeover Act may feel less threatened by the specter of an activist campaign to take control of the board; a REIT whose ownership limitation provision is drafted so as to restrict accumulation of large blocks of stock by investors not approved by the board – even if the accumulation does not present a REIT qualification concern from a U.S. income tax perspective – may feel less of a need to have the ability to unilaterally adopt a shareholder rights plan. Conversely, REITs whose governing documents impose a mandatory sunset on duly adopted shareholder rights plan (e.g., after one year) may need to rely on other defenses once the rights plan expires.

We recommend that each public REIT take stock of its current corporate governance profile and state of its takeover preparedness (including the interconnectedness of takeover defenses and the way the efficacy of some may depend on the availability or structure of others). An evaluation of governance and takeover preparedness need not necessarily precipitate substantive changes, or any changes, and need not be undertaken with a particular threat in mind or on the horizon. Rather, periodic reviews of these important internal governance features can help the board and management be better prepared when a perceived threat does materialize and/or when the REIT otherwise receives shareholder proposals relating to governance matters. The review and evaluation process can help the board of directors determine whether the company's overall governance and preparedness profile is one that is responsive to the overarching duty of the board to be able to maximize stockholder value for the long term and in line with the corporate governance standards the board believes are appropriate for the company.

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[1] Some notable exceptions include the 1998 proxy battle waged by hedge funds led by Gotham Partners against the board of First Union Real Estate Investments; Simon/Westfield's hostile bid for Taubman in 2003; and Public Storage's hostile bid for Shurgard in 2005.
[2] For example, there have been pockets of time during which many REITs traded at relatively significant discounts to NAV. Likewise, the ability to take an initial ownership stake of nearly ten percent will often be more than sufficient for a determined hostile bidder or activist to gain the attention of a target and other shareholders.
[3] While beyond the scope of this article, note that ownership limitation provisions are not created equal and that the particular wording and definitions of each charter will generally determine the scope of the ownership limitation's perceived anti-takeover effect. For example, some charters impose the ownership limitation only on actual individuals as required to strictly comply with the relevant REIT qualification provisions under the Internal Revenue Code, while other charters impose the ownership limitation on entities and groups as well.
[4] Note that in some jurisdictions, such as Delaware, the board may not make substantive amendments to the bylaws without shareholder approval.
[5] In an extreme example, Commonwealth REIT in 2013 had in place essentially every possible takeover defense available, including a staggered board, a shareholder rights plan, draconian advance notice bylaw provisions, supermajority voting requirements and an affirmative "opt in" to Maryland's Unsolicited Takeover Act – yet determined activist investors were still able to remove the entire board of trustees without cause in 2014.
[6] See, e.g., "*Getting Nothing for Something*" by James J. Hanks, Jr., REIT Zone Publications, September 3, 2014 ("[W]hy give up, for no economic benefit to the REIT, an option that may provide some protection against an effort by investors or activists with goals other than those typically held by long-term shareholders to seize control of the company on a short-term basis in what may be temporarily unfavorable market conditions?")

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