REIT ALERT

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Why Green Street Should Rethink Its One-Size-Fits-All Position on Corporate Governance

SPEED READ

Research firm Green Street Advisors recently announced a revamping of its corporate governance scoring that penalizes all Maryland REITs that do not permanently opt out of the Maryland Unsolicited Takeover Act (“MUTA”). We are not certain that this “blunt instrument” approach to MUTA is appropriate. There may be scenarios where the protections available under MUTA — either alone or when used in conjunction with other available governance arrangements — can prove critical in enabling a board to act in good faith to maximize long-term shareholder value.

In our February 4, 2015 REIT Alert, “Barbarians at the (REIT) Gates: REITs Should Be Prepared for a New World Order of Shareholder Activists, Hostile Overtures and Proxy Fights,” we addressed the increased risk faced by publicly-traded REITs today from potential shareholder activism, proxy fights and otherwise hostile overtures. We concluded that the boards of public REITs would be well served to regularly evaluate their companies’ corporate governance profiles in an effort to help the board determine whether the company’s overall governance and preparedness profile is one that provides the board of directors with the tools and flexibility to fulfill their overarching duty to maximize stockholder value for the long term. While our Alert discussed a variety of possible approaches to governance, we took care to point out that governance is not a “one-size-fits-all” proposition and that we do not recommend any particular set or subset of defenses as a blunderbuss approach for all public REITs. In particular, we did not recommend that every Maryland REIT rush to permanently opt out of the Maryland Unsolicited Takeover Act, or “MUTA”,[1] since there may be scenarios in which the protections available under MUTA — either alone or when used in conjunction with other available governance arrangements — can prove critical in permitting a board acting in good faith to maximize long-term shareholder value.

In its recent “Heard on the Beach” column of May 28, 2015, entitled “Bush League Governance”, Green Street Advisors announced a revamping of its corporate governance scoring that penalizes all Maryland REITs across the board if they do not permanently opt out of MUTA. Whereas under current scoring a REIT that had opted out of MUTA would earn 6 more points than a peer that had not done so, the revised scoring would increase this difference to 25 points.[2] All other things being equal, a Maryland REIT that has not permanently opted out of MUTA will receive a significantly lower corporate governance score relative to non-Maryland REITs and/or Maryland REITs that have permanently opted out of MUTA.

We are not certain that this “blunt instrument” approach to MUTA is appropriate for every Maryland REIT, without regard to the REIT’s specific facts and circumstances. MUTA exists, indeed all corporate governance measures with possible anti-takeover effects exist, because legislatures and/or other actors in the investment community believe that the good faith exercise of protective measures in the face of a hostile bid may in many cases be the correct response by a target board seeking to fulfill its fiduciary duties to stockholders, as opposed to, say, promptly embracing a short-term premium that may undervalue the company’s long-term business prospects. In particular, as stated in Goodwin Procter’s February REIT Alert, the availability of one or more of the protections under MUTA can serve to:

- give the 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;
- discourage the accumulation of stakes (whether actual or through use of lower-cost derivatives) in the company or other activist initiatives designed to generate volatility in the stock price and trading profits for the activist(s);
- deter potential acquirors from engaging in and benefiting from coercive tactics to the detriment of other stockholders; and
- 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.

Of course this is not to say that every REIT should arm itself with every takeover defense not prohibited by law or its governing documents. In the vast majority of cases, we believe the very best takeover defense is a management team that regularly and meaningfully engages with stockholders.

At a recent lunch panel hosted by Michael Bilerman, Head of Citi Research’s Real Estate and Lodging team, at which corporate governance in the REIT Industry was discussed, one panelist noted that in hostile situations you need good actors, you need good rules and that it is important to keep in mind what are you solving for.[3] We think most parties would agree with this formulation. First and foremost, you need “good actors,” a board of directors that is genuinely and in good faith seeking to maximize stockholder value in furtherance of its fiduciary duties to the company and is not seeking to entrench itself or management. Second, you need “good rules,” a corporate governance structure that is both conducive to the board’s exercising that duty in a deliberate and informed manner and that does not make necessary change unattainable by stockholders. Third, the board and stockholders need to keep in mind the ultimate goal, which is neither immediate capitulation nor indefinite entrenchment — it is identifying and implementing the solution that is ultimately the right one for stockholders, even if it takes a little longer until the right solution becomes clear.

So while the stated goal of activists and bidders generally is getting to a place where target boards are compelled to engage in a process instead of “just saying no,” the thoughtful activist or bidder would also agree that it is not prudent for the board to be compelled to immediately throw all caution to the wind and immediately accept any bid that crosses the transom. Instead, during the Citi Research event, all of the panelists expressed support for a structure under which a target board would have the ability to impose a temporary “stay” on an activist or other hostile campaign, creating the critical space and time in which the board could work in good faith on formulating and executing on whatever plan is ultimately determined to be in the best interests of stockholders. If stockholders disagree with the board’s

approach, they will have their full say as soon as the “stay” expires but at least the board would have been given a realistic opportunity to demonstrate why its chosen plan was in the best interests of stockholders. The appropriate duration of a “stay” can and should be the topic of debate among interested parties in a given situation, but the essential notion that a board should be given time to fulfill its fiduciary duties appears to be accepted by all but those with the most short-term interests. Conversely, the one-size-fits-all approach now recommended by Green Street appears to be based on the assumption that not only can duly elected boards not be trusted to make the right decision in the face of a hostile bid, they shouldn’t even be given the chance without being immediately forced to take the matter to the ballot box. This approach undervalues the benefits that boards can and do provide as fiduciaries for public company stockholders, irrespective of whether the board’s actions are governed by Maryland, Delaware or another state’s law.

The key to preserving the ability to carefully and deliberately go about getting to the right solution for stockholders is to ensure the right mix of available corporate governance provisions, paying particular attention to the interconnectedness of some provisions and the way the efficacy of some may depend on the availability or structure of others. For example, an effective takeover measure employed by many public companies in the face of an actual or threatened hostile bid is the adoption of a limited duration stockholder rights plan (a “poison pill”).[4] In general, only the board of directors is given the power to redeem the rights or amend the plan so a rights plan, by its adoption, deters coercive takeover tactics by making them unreasonably expensive to the bidder and thus encourages prospective acquirors to negotiate rather than to attempt a hostile takeover.

More modern varieties of these plans typically have a hardwired sunset provision that causes the plan to automatically terminate in a year or less, unless otherwise approved by stockholders. In theory, this provides the temporary “stay” period in which the incumbent board can focus on the best course for maximizing stockholder value without a proverbial gun to its head. In practice, however, if a majority of the board can be replaced by stockholders at the next upcoming annual meeting or removed by stockholders without cause at a duly called special meeting to be held even earlier — then the incoming board can simply redeem the rights and/or amend or terminate the plan entirely and guarantee that the original’s board’s alternative business plan is never given an opportunity to succeed. This would bring us back to square one, a situation in which the board simply may not have the ability to properly evaluate a hostile bid versus its alternatives or the leverage to negotiate with a hostile bidder, which would be to the detriment of all stockholders.[5]

Indeed, this is when having the ability to stagger the board under MUTA for a limited duration would close the gap, working in tandem with the stockholder rights plan to impose the temporary “stay” that would benefit all stockholders. For example, if the board voted to adopt a limited duration stockholder rights plan, say for one year, and also to stagger its board under MUTA for that same one-year period,[6] then the two of these together effectively implement a one-year “stay” on the ability of an activist, raider or coercive bidder (or more likely a coalition of them), to either accumulate a significant amount of stock or to amend or eliminate the rights plan to permit an accumulation of stock. If, as urged by Green Street, the REIT had previously permanently opted out of the MUTA, then it would also knowingly have opted out of the ability to ensure its board had breathing room when evaluating strategic alternatives and the leverage to negotiate a better price for all stockholders. Some Maryland REITs in light of the total mix of facts and circumstances unique to that REIT may conclude that they do not want the benefits that MUTA provides, but we believe MUTA can be an important tool for boards to use to protect and enhance stockholder value in the face of a hostile bid when it is used responsibly.

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1 MUTA permits a Maryland corporation with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors to elect to be subject, by provision in its charter or bylaws or a resolution of its board of directors and notwithstanding any contrary provision in the charter or bylaws, to any or all of five provisions:

(i) a classified board;

(ii) a two-thirds stockholder vote requirement for removing a director;

(iii) a requirement that the number of directors be fixed only by vote of the directors;

(iv) a requirement that a vacancy on the board be filled only by the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred; and

(v) a majority requirement for the calling of a special meeting of stockholders.

2 Green Street will implement the new scoring by awarding only 5 out of 30 potential points to a Maryland REIT that does not have a staggered board but that has not opted out of MUTA. REITs organized in states other than Maryland will receive the full 30 points if they do not have a staggered board, presumably where applicable state law also does not permit staggering of the board without stockholder approval.

3 Citi Research, Weekly REIT and Lodging Strategy report, April 24, 2015.

4 A stockholder rights plan establishes a level of stock ownership (typically 10% or 15%) which a stockholder cannot exceed without incurring significant dilution to its holdings. A typical rights plan provides for a distribution to existing stockholders of rights that (a) in the event of an acquisition of more than a certain percentage (generally 10% to 25%) of the common stock, entitle the stockholder to purchase additional common stock at a significant discount (the “flip-in” feature) and (b) in the event of a squeeze-out transaction, entitle the stockholder to purchase the acquiring person’s equity at a significant discount (the “flip-over” feature).

5 As noted during the Citi Research event, corporate governance rules in Canada are a useful reference point. Until only recently, Canadian public companies were generally significantly more vulnerable to hostile buyers and activist investors than their American peers, due primarily to blunderbuss statutory provisions that curbed use of corporate governance measures that could have an anti-takeover effect. Canadian law does not provide for staggered boards, any 5% shareholder may call a special meeting and investors can amass up to a 10% stake under the radar before public disclosure is required. Likewise, poison pills adopted by a target board were generally quickly done away with, often within two months. As a result, boards of target Canadian companies often had very little time to properly develop, let alone execute on, strategic alternatives to a hostile bid. Regulators and market participants alike did not view this state of affairs as necessarily positive for Canadian business as a whole. In an effort towards somewhat rebalancing the playing field, the Canadian Securities Administrators have proposed various new rules in recent years to give target company boards greater time to respond to hostile bids and flexibility. See, e.g., “Amendments Proposed to Significantly Change Take-Over Bid Rules” by Goodmans LLP, April 1, 2015.

6 While MUTA does not on its face provide for temporary staggering of the board, any opt in by the board can be accompanied by a formal commitment to de-stagger at the end of the year (or at the next annual meeting of stockholders).

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