



## EXCESS SHARE PROVISIONS AS TAKEOVER DEFENSES

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Hostile M&A – unsolicited bids and shareholder activism – has never been as prevalent in the REIT world as it has been in the larger public company universe. REITs have long been viewed as hardened targets for hostile activity, but that perception is changing. Certainly, the successful replacement of Commonwealth REIT’s board in 2013 was a sobering reminder to REITs that they too, may be vulnerable. More recently, in 2015, a number of activist overtures have been made, including one at American Realty Capital Properties (ARCP) by Corvex Capital Management, the lead activist in the Commonwealth REIT drama.

In light of a renewed interest in (or concern over) activism in the REIT world, we took a look at the excess share provisions (ESPs) of 27 publicly traded REITs to get a sense of the landscape. Here are our observations from that informal survey, with some explanation and commentary.

### Different Types of Excess Share Provisions:

#### **What are the tax concerns motivating ESPs?**

- Limits are designed at a minimum to prevent the REIT from being closely held, which means, under Section 856(a)(6) and Section 856(h) of the Internal Revenue Code, that 5 or fewer **individuals** may not own more than 50% of the stock of the REIT (the “Closely Held Ownership Limit”). All the charters we reviewed with ESPs had a Closely Held Ownership Limit.
- The ESPs in many REIT charters also protect the REIT from “related party rent,” which arises if, for example, the same person (either an individual or an entity) owns 10% or more of both the tenant and the REIT (the “Related Party Rent Limit”). Related party rent is treated as “bad” REIT income under Section 856(d)(2)(B). Twenty-four (89%) of the charters also had ESPs that were broadly designed to include a Related Party Rent Limit, while 15 (63%) contained an express limitation on ownership that would either cause any related party rent or cause sufficient related party rent to disqualify the REIT.

- All the charters we reviewed defined ownership as direct ownership or ownership through attribution of shares owned by one individual or entity to another individual or entity. Attribution rules are relevant for calculating both the Related Party Rent Limit and the Closely Held Ownership Limit, although the precise attribution rules differ for calculating the two separate limits.

### **What are the ownership limits?**

Generally, the Closely Held Ownership Limits and Related Party Rent Limits provided for in the charters we reviewed ranged from 2% to 9.9%. A lower Closely Held Ownership Limit will be required where the charter permits a founder or other investor to exceed the limit. For example, if a charter permits a founder's family group to own up to 18%, that would leave 32% (50% less the 18%) to be shared among 4 persons, so the Closely Held Ownership Limit in that charter would need to be reduced to under  $32/4 = 8$ . In such as case, there is no necessity to reduce the Related Party Rent Limits, but some charters only have one overall limit.

- Seventeen (63%) of the REITs we looked at initially implemented an ownership limit of between 9.0% and 9.9%, although some charters with lower thresholds gave to the board the ability to increase the threshold to between 9.0% and 9.9% as time passed.

### **To whom do the ownership limits apply?**

- All ESPs we reviewed applied the Closely Held Ownership Limit and, where applicable, Related Party Rent Limit to individuals and entities alike.
- Eighteen (67%) of the ESPs applied the Closely Held Ownership Limit to Schedule 13D filing groups as well. Of the 24 ESPs with Related Party Rent Limits, 16 (67%) also applied the ownership limit to 13D groups. A 13D group will generally be broader than the group of entities or individuals to which either of these limits would otherwise apply. Application of ESP ownership limits to 13D groups is not required to avoid the primary adverse tax consequences underlying ESPs and may therefore be viewed simply as a takeover defense measure.

### **Under what circumstances can the ownership limits be waived?**

- All ESPs we reviewed allowed some flexibility for the Board to waive the ownership limitations. In a significant number of the charters we reviewed, the ability to waive the Related Party Rent Limit is limited where the waiver would cause either ANY related party rent or a REIT failure.
- Some charters required the Board to receive an opinion or ruling with respect to the tax consequences of the waiver. Other charters would permit waivers in the Board's discretion and leave it to the Board's discretion as to whether to get an opinion or ruling or require representations from the excepted holder.
- In the event of an ownership limit violation, 21 (78%) of the charters we reviewed provided that the excess shares are automatically transferred to a trust for the benefit of a charity, while others did not specify the beneficiary of the trust in the charter. The nominal owner of the excess shares does not receive dividends or vote the shares, and will generally only receive the lesser of the amount received by the trust upon sale of the shares, and the amount paid by the nominal owner. That is, the nominal owner cannot profit from ownership of the shares.

## **Issues affecting whether the ESPs constitute a valid takeover defense:**

### **General observations:**

- Ownership and transfer restrictions on shares generally are permitted by state corporate statutes in order to preserve certain benefits (such as desired tax treatment) for the corporation. Public disclosure (and thus approval) upon implementation (such as at an initial public offering) and subsequently of the effects of an ESP bolsters the argument for validity of a company's ESP. Other aspects of ESPs may come into question, as well as determinations by a board when a waiver of the provisions is sought.
- The validity of using an ESP as a takeover defense may depend on the particular threat posed (**e.g.**, bid for company versus activists).
  - A challenger may argue that if the ESP is not related to tax benefits (clearly the primary purpose of ESPs), then the ESP would be an impermissible takeover defense.
  - We note that the Maryland statute specifically permits ESPs for purposes other than the REIT's tax status and therefore can be argued as a basis for a valid takeover defense.
    - Maryland Code, Corporations and Associations, §8-203, permits a declaration of trust for a REIT to allow “[f]or any other preferences, rights, restrictions, including restrictions on transferability or ownership designed to permit the real estate investment trust to qualify under the Internal Revenue Code or regulations adopted under the Code or for any other purpose, and qualifications not inconsistent with law.”
    - Section 2-105 also permits the charter for any corporation to provide “any other preferences, rights, restrictions, including restrictions on transferability, and qualifications not inconsistent with law.”

### **Some observations from the review of the charters:**

- Because prohibiting ownership by 13D groups may go beyond what is necessary to protect against the adverse tax effects from being closely held or generating related party rent (though possibly an important roadblock for activists), inclusion of the 13D concept in an ESP may open a line of challenge where tax concerns are not present.
- Similar to poison pill provisions, the ability of the Board to waive an ESP at its discretion may also open the door for a line of challenge.
- In addition to litigation challenges, the use of an ESP as a takeover defense may affect voting recommendations, such as those from ISS, in connection with any takeover battle. Although ISS does not have a formal policy that relates to ESPs as a takeover defense (unlike its policies on poison pills), ISS voting recommendations may be influenced by how a board uses an ESP, particularly where tax concerns are not at play.

- Where there is a separate Related Party Rent Limit, it may be ineffective as a takeover defense if, as is often the case, the limit applies only if the investor's ownership creates at least some related party rent, that is, the investor both exceeds the limit (e.g., 9.8%) and owns 10% or more of one or more tenants. The majority of REIT charters reviewed do have such a dual requirement, i.e., the limit is applicable only if the excess ownership creates at least some related party rent.
- Given that the Closely Held Ownership Limit looks only at ownership by individuals, the application of an ownership limit intended to prevent shares in excess of the Closely Held Ownership Limit to entities/13D groups may raise scrutiny. On the other hand, since an entity's ownership of REIT stock and a tenant could give rise to related party rent, constructive ownership limitations which apply to entities may be easier to justify; we note, however, that attribution rules would generally not attribute ownership to as broad a set of entities as would comprise a 13D group. Furthermore, as noted in the preceding paragraph, such limitation may not be effective if the activist investor does not own stock of a tenant of the REIT (directly or via applicable attribution rules).

### **How Do ESPs Compare to a Poison Pill?**

#### **Implementation:**

- ESPs are charter provisions and are put in place when a REIT is established. Amendments to ESPs require both board and shareholder approval.
- Poison pills may be kept "on the shelf" and available for use only if and when needed. This avoids unnecessary corporate governance concerns and allows for the pill to be tailored to the specific situation. Poison pills can be put in place, and amended, without shareholder approval.

#### **Validity:**

- The implementation and use of defensive tactics – including both Poison Pills and ESPs – against substantial accumulations of stock are limited by the fiduciary duties of boards.
- Where such defensive tactics are not prohibited, Poison Pills are a proven defensive tactic. They are an extremely strong deterrent because they are crafted specifically to prevent all unwanted accumulations of stock exceeding their triggering threshold and their effects, if triggered, are draconian. However, to the extent they are solely a takeover defense, the use of Poison Pills is closely scrutinized by the courts.
- ESPs may also provide protection against unwanted accumulations of stock. However, since they are crafted with a view toward preventing adverse tax consequences, there may be "holes" in any given ESP so that not all situations are covered. In particular, ESPs without 13D language may provide little protection against hostile accumulations of shares because it may be relatively easy to structure ownership around the ESP's ownership limits.
- ESPs with 13D language may provide protection similar in breadth to a Poison Pill. Given the dual purpose of the ESP, it is possible that an ESP might withstand judicial scrutiny in circumstances where a poison pill might not.
- With respect to the recent wave of activism generally, and potentially in the REIT space:

- The 13D group language will be a concern for activists.
- Given the ownership limitation thresholds in our informal survey, however, activists in many cases may not be significantly affected.
  - Especially with larger REITs, activists regularly take on companies with smaller stakes.
  - In smaller REITs, the ownership limitation limits the amount of an activists investment in the REIT, which may make activism less interesting or less lucrative. However, it is likely that smaller activist funds will still be interested in most REITs of a size to be publicly traded.
  - ESPs do not prevent activists from running a proxy contest and replacing the board or a number of directors.
  - It should be noted that, to the extent the ownership limitations of ESPs with 13D language will not deter an activist, neither will a Poison Pill deter an activist. Apart from Poison Pills designed to protect tax net operating losses (NOLs), the triggering thresholds of Poison Pills tend to be at or above the ownership limitations found in ESPs.

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