REIT CORPORATE GOVERNANCE IN THE NEW ENVIRONMENT: NEW REGULATORY FRAMEWORK COULD SPUR CHANGES AND REIGNITE FOCUS ON OLD GOVERNANCE ISSUES

As the public markets continue to recalibrate, the changing regulatory landscape and embedded governance issues affecting Real Estate Investment Trusts may renew investor focus and present new opportunities for investors to promote or effect corporate governance changes. Many publicly traded REITs should be cognizant that the somewhat more "shareholder-friendly" structural changes that they have implemented in recent years, coupled with lower stock prices as a result of the economic crisis, may make them vulnerable as a result of new developments and trends.

- New regulatory rules, such as those proposed by the Securities and Exchange Commission (SEC), will make it easier for shareholder activists to generate interest, and potentially bring about changes, in the governance methods of publicly traded REITs.

- REIT Boards of Directors may be targeted by shareholder activists due to the history of REIT governance concerns, including director conflict issues at UPREITs that have been highlighted in previous takeover contexts. Particularly where there exists an UPREIT structure, directors who have a relationship with the REIT's founders or operating partnership unitholders must recognize and consider appropriate means of addressing potential conflicts of interest, or otherwise face scrutiny from shareholders.

Recent Developments in REIT Corporate Governance; Lingering Structural Deficiencies

Recent studies suggest that many REITs have improved their corporate governance structures. One indicator is the Corporate Governance Quotient (CGQ), developed by RiskMetrics. In addition to general corporate governance practices, such as board independence, the CGQ takes into account takeover defenses, including shareholder rights plans, "supervoting" classes of shares, the ability of shareholders to call special meetings and the annual election of board members.[1] This year's study of CGQs across all industries concluded that real-estate companies, including a sample of 133 publicly traded REITs, are less likely to possess shareholder rights plans and "supervoting" classes of shares and more likely to allow their investors to call special meetings and to elect board members annually.[2] Specifically, the RiskMetrics study found that 15% of REITs surveyed possessed shareholder rights plans (compared to 40% of S&P 500

[1] *See* Paul Wanner, *Real Estate Industry Remains High in Governance Rankings*, REAL ESTATE PORTFOLIO, July-August 2009, at 34.

[2] *Id.*

companies) and that 42% employed a classified board structure (similar to the percentage of S&P 500 companies).[3] The study also found that only 10% of REITs both elected their boards on a staggered basis and had implemented a shareholder rights plan.[4]

Despite the evidence suggesting that many REITs have moved towards more shareholder-favorable corporate governance features, certain structural features unique to REITs provide significant protection even in the absence of a staggered board or shareholder rights plan. For tax purposes, REITs are required to comply with a "5/50 test," which requires that five or fewer individuals may not own more than 50% of a REIT's stock during the second half of any year. As a result, many REITs choose to include "excess share" or "maximum ownership" limitations in their charters which preclude a shareholder from acquiring more than anywhere from 5% to 10% of a REIT's outstanding shares. These excess share provisions operate much like a poison pill, although the ability to use these provisions as a *de facto* shareholder rights plan is unclear and REIT boards considering relying on them as such should note that doing so may go beyond the nature of their original intent. In addition, many publicly traded REITs are incorporated in Maryland which has over time developed into a more "management-friendly" jurisdiction than Delaware.

An area that has caused (and continues to cause) corporate governance scrutiny of REITs derives from the fact that many REITs are organized as so-called "UPREITs," or Umbrella Partnership REITs. In an UPREIT structure, all acquired properties of the REIT are owned by an operating partnership, with the publicly traded REIT itself owning an interest as a limited partner of the operating partnership and an interest as the sole general partner of the operating partnership. Currently, nearly half of the publicly traded REITs registered on U.S. exchanges have an UPREIT structure. When a REIT is organized through an UPREIT framework, certain matters, such as REIT takeover bids, can give rise to conflicts of interest between the REIT's public shareholders and holders of operating partnership units. Members of the REIT board of directors may have relationships with or ties to the holders of the operating partnership units (who are often the founders of the entity that controlled the real estate holdings prior to the organization of the UPREIT), and REIT directors also may themselves be holders of operating partnership units.

The dilemma for REIT board members in this situation is addressing the conflicting interests of public shareholders, who, in a takeover context, may wish to accept a premium takeover bid, and the interests of holders of the operating partnership units, who may have little or no economic interest in the public company and may have tax or legacy reasons for opposing the takeover. Although the REIT board of directors, in its capacity as general partner of the operating partnership, may have legitimate concerns about a fiduciary duty owed to the operating

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[3] *See* Anthony Siatta, *REIT Poison Pills: Better Safe Than Sorry?*, REAL ESTATE FINANCE & INVESTMENT, March 23, 2009.

[4] *Id.* In comparison, a review of REITs conducted by Green Street Advisors in August 2003 highlighted several grievances with REIT corporate governance structures at the time, including the prevalence of staggered boards, shareholder rights plans, and what Green Street Advisors viewed as a dearth of independent directors on the boards of many of the REITs surveyed. *See* Mike Kirby et al., *Corporate Governance in the REIT Sector*, August 13, 2003.

partnership unitholders by the REIT, the board also must ensure that the personal interests of the REIT board members do not prevent the board from acting in the interest of the public shareholders. That obligation generally can be fulfilled only if the directors making the decision are truly independent of the founders, operating partnership unitholders and other influential constituencies, and are assisted by outside counsel and investment bankers independent of any conflicted constituency. Therefore, the best practice is for a REIT board of directors to address conflicts of interest faced by individual board members by appointing an active and truly independent special committee to consider matters relating to the transaction creating the conflict of interest. If economic or regulatory factors increase unsolicited bids for control of REITs, these conflict issues will be highlighted.

Potential for Corporate Governance Changes: Proposed SEC "Proxy Access" Rules and Amendments to Delaware General Corporation Law

Recent regulatory developments could present new opportunities for shareholders to effect or promote corporate governance changes at REITs, particularly with respect to board composition. In fact, the shareholder-friendly governance features adopted by many REITs (such as the annual election of directors) may make REITs particularly vulnerable to such activities as compared to companies in other industries. Concurrently with the regulatory developments, the losses in market value of some publicly traded REITs have created speculation among investors over the possibility of potential takeovers of REITs, which may make REIT shareholders more likely to intervene in corporate governance matters.[5]

Proposed Rule 14a-11, which was announced in June 2009 by the SEC, would provide that eligible shareholders or groups of shareholders can require a company to include in its proxy statement and on its proxy card board nominees running in opposition to those nominated by the company's management. Various limitations in the proposed rule — including threshold share percentage requirements, limitations on the number of directors a shareholder or shareholder group may nominate and a requirement that nominating shareholders must not be seeking control — may constrain the effectiveness of the proposal as a mechanism for widespread corporate change. However, the proposal, if enacted, would appear to open the door to many investors who could use the liberalized "proxy access" standards to generate interest in the governance methods of a publicly traded REIT. It should be noted that proposed Rule 14a-11, if adopted by the SEC, could be revised significantly from the original proposal. Because it has received a significant number of comments on the proposal, the SEC is not likely to act on its "proxy access" proposal in time for the 2010 proxy season.[6]

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[5] The tightening of credit markets over the previous year created a subsequent depression in the stock prices of publicly traded REITs, as evidenced by a drop in the Dow Jones Equity All-REIT Index of 66% between October 2008 and March 2009. While REIT stock prices have recovered somewhat since then, as of October 19, 2009, the Index was still off nearly 30% from its value at the beginning of October 2008.

[6] Speaking at the Corporate Counsel Institute on October 2, 2009, SEC Commissioner Elisse B. Walter dismissed speculation that final action could be taken as early as this November, stating that the final rules are "not likely to be in place at the beginning of next year's 'proxy season.'" Full text of the speech is available at http://www.sec.gov/news/speech/2009/spch100209ebw.htm

As contemplated by the proposal, in order to obtain access to the benefits of proposed Rule 14a-11, threshold share requirements would have to be met and held for at least one year. For "large accelerated filers," which have on the aggregate a worldwide market value of voting and nonvoting stock held by nonaffiliates of $700 million or more, the threshold would be 1% of the company's voting stock. For "accelerated filers," companies with an aggregate worldwide market value of voting and nonvoting stock of more than $75 million but less than $700 million, the threshold would rise to 3% of the company's voting stock. For companies that fall into neither of these two categories, the threshold would be 5% of the company's voting stock.

The proposal would allow shareholders and shareholder groups that hold the prerequisite threshold of stock to nominate the greater of one director or the number of directors equal to 25% of the company's board (with any fraction rounded down). However, if multiple shareholders or shareholder groups seek to require the company to include their director nominees in a company's proxy materials and the number of shareholder nominees exceeds the maximum number the proposal requires to be included, nominees would be chosen on a "first come, first served" basis.

The advantages provided to shareholders by proposed Rule 14a-11 include the ability to avoid the potentially significant costs of preparing a separate proxy statement and proxy card, clearing them with the SEC's review process, and printing and mailing them. On the downside for shareholders, proposed Rule 14a-11 limits the number of board seats shareholders can seek under the rule. More significantly, proposed Rule 14a-11 would only be available to shareholders and shareholder groups that do not hold their shares for the purpose or with the effect of changing control of the company or gaining more than a limited number of seats on the board.

Proposed Rule 14a-11 comes on the heels of the April 10, 2009 signing of several amendments to the Delaware General Corporate Law (DGCL), which became effective on August 1, 2009. The most significant of these amendments is the adoption of a new §112 of the DGCL, relating to shareholder access to proxy solicitation materials. Section 112 authorizes, but does not require, a corporation to adopt a bylaw provision providing stockholders with a right of access to its proxy materials. Section 112 expressly permits the bylaw to impose conditions and limitations on proxy access, including threshold share ownership percentages and durational ownership requirements.

In addition to new §112, the recent amendments to the DGCL include a provision for the reimbursement of shareholder expenses in proxy solicitations. New §113 provides that a corporation's bylaws may, but are not required to, include a provision requiring a company to reimburse shareholders for costs incurred in soliciting proxies in connection with an election of directors.

The recent DGCL amendments apply, of course, only to Delaware-organized corporations, whereas a number of REITs are incorporated in Maryland and other jurisdictions. However, these amendments are emblematic of what appears to be a developing trend toward opening up the process of electing directors.

Conclusion

Despite its inability to bring about broad corporate governance changes within a company, the SEC's "proxy access" proposal would allow more investors in REITs to effectively voice their concerns about governance structures. Increased focus on REITs as potential investment opportunities or takeover targets, coupled with the enhanced ability of investors to voice discontent (for example, with respect to director independence at UPREITs), may generate demand for an enhanced governance framework, including changes to board composition, at some of these companies. REIT boards of directors and shareholders should be cognizant of these developments and trends and should plan ahead in anticipation of the upcoming proxy seasons and beyond.

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