GOODWIN PROCTER REIT ALERT

JUNE 8, 2016

Waivers of Ownership Limitation Provisions in REIT Charters

Speed Read

Ownership limitation provisions in REIT charters are designed primarily to protect the company's status as a REIT under the federal income tax rules. By placing limits on the amount of stock investors can own, the REIT builds in safeguards to ensure that it will satisfy REIT ownership tests, including the so-called "5/50 test," and also protects the REIT from incurring related party tenant income, which can affect the REIT's ability to satisfy the gross income tests necessary for REIT qualification. Not all ownership limits are created equal, however, and there are a number of variations and nuances that can affect both to whom the ownership limitations apply, and whether and when the REIT's board of directors may provide waivers of the ownership limits. The ownership limitations in many REIT charters applies to holders that together form a "group" for securities law purposes but the determination of "group" status is a highly fact-dependent analysis that has historically been difficult to apply, particularly in the age of increased shareholder activism. REITs considering a waiver request must carefully review the relevant provisions in its charter and equally carefully apply to them the specific facts and circumstances at hand.

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I. Why Do REITs Have Ownership Limits in the First Place?

Ownership limitation provisions are designed primarily to protect one of a REIT's most valuable assets – its status as a REIT under the federal income tax rules. By placing limits on the amount of stock investors can own, the REIT builds in safeguards to ensure that it will satisfy the ownership tests that are a critical part of its qualification as a REIT, including the so-called "5/50 test," and also protects the REIT from incurring related party tenant income, which can affect the REIT's ability to satisfy the gross income tests necessary for REIT qualification.[1] We discuss these ownership limitations, including when or how they may be waived, in further detail below.

The REIT's charter[2] will typically include a mechanism pursuant to which a stockholder whose actual and/or constructive share ownership surpasses the stated ownership limits included in the charter will have its shares automatically and effectively confiscated and held in trust for the benefit of a designated charity until the shares are sold in the marketplace.[3] A stockholder whose shares are transferred to this trust will not receive the economic benefit of any appreciation in, or distributions paid on, these shares after the date the shares are deemed to be transferred to the trust.

II. The 5/50 Ownership Limitation

The "5/50 test" essentially provides that five or fewer individuals may not own, actually and/or constructively, more than 50% of the value of the REIT's stock during the second half of a taxable year.[4] A typical ownership limitation provision will thus generally prohibit anyone from owning, actually and/or constructively, in excess of 9.8% of the value of the REIT's outstanding stock — making it impossible for any five holders together to own more than 50%.[5] This is often described as a "5/50 ownership limit." If there is already a single individual (e.g., a founder) owning, actually and/or constructively, more than 9.8% of the outstanding stock, then the 5/50 ownership limit may be set even lower than 9.8% to ensure that any additional four "individuals," together with the founder, will not exceed 50% in the aggregate.[6]

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1 The related party tenant income ownership limitations are discussed in further detail below under "Related Party Tenant Ownership Limitations." In addition, the ownership limits in a typical REIT charter will restrict a person from holding REIT stock if such ownership would cause the REIT to have fewer than 100 stockholders or otherwise cause the REIT to fail to qualify as a REIT. Some REIT charters also include ownership limits that prevent a person from holding REIT stock if such ownership would cause the REIT to be a "pension-held REIT" under Code Section 856(h)(3)(D) or not be a "domestically controlled qualified investment entity" under Code Section 897(h)(4)(B).

2 While the majority of ownership limitations provisions are included in the articles of incorporation, certificate of formation, declaration of trust or other incorporating document of the REIT, a small minority of REITs include these provisions in their bylaws. In jurisdictions where the bylaws may be amended by the board of directors without stockholder approval, inclusion of the ownership limitations provisions in the bylaws rather than in the charter may permit a limited measure of flexibility to the board to update outdated terms as appropriate in response to changing circumstances, if otherwise permitted by the bylaws. See, e.g., footnote 6 below.

3 Market commentators have contrasted the relatively benign economic effect to the investor of having shares transferred to a trust under the ownership limitation provision to the catastrophic economic effect to an investor whose ownership triggers a shareholder rights plan. See footnote 24 below.

4 Section 856(a)(6) and Section 856(h) of the Internal Revenue Code. See also footnote 8.

5 It is important to note that the 5/50 test is a "value" test — so it is possible that shares of different classes, and sometimes even shares within the same class, have ownership value that is different from their purely mathematical percentage ownership. For example, special rights associated with certain classes or blocks of stock should be taken into account when determining the stock's value for purposes of applying the ownership limitations. Likewise, when determining the value of stock held by a founder or sponsor (and, therefore, the correct 5/50 ownership limit to include in a REIT's charter) a REIT should also consider any special rights granted with respect to the founder's or sponsor's block of shares, as well as any applicable control premium represented by the founder's or sponsor's shares. This might result in percentage ownership for purposes of the 5/50 test that is greater than the founder's or sponsor's straight economic ownership based on number of shares.

The typical 5/50 ownership limitation will apply to both the <u>number</u> of common shares outstanding as well as the aggregate <u>value</u> of all outstanding shares of capital stock of the REIT. Accordingly, as above, REITs with different classes of shares must also account for the relative values of the various classes when implementing the 5/50 ownership limitation. For purposes of these calculations, the "outstanding" shares of capital stock are those shares that are considered outstanding for tax purposes, and will exclude certain restricted stock and certain other equity interests in the REIT.

6 We note that a number of REITs that adopted a 5/50 ownership limit lower than 9.8% at the time of formation or otherwise to accommodate one or more founders or other large stockholders may no longer need this lower limit. Specifically, if follow-on offerings

A casual glance, however, at the beneficial ownership tables included in the annual proxy statements REITs send to their stockholders reveals that many of today's publicly traded REITs have one or more 10% or greater stockholders. Vanguard, Fidelity, Cohen & Steers, BlackRock, to name just a few, are among the large asset managers routinely listed as beneficially owning 12, 15 even 18 percent of the outstanding stock of a REIT whose charter contains an ownership limit providing that no person can own more than 9.8% (or less) of the outstanding stock. There are really only two ways this can occur:

- the investor has applied to the REIT's board of directors for, and has received, a waiver from the relevant ownership limitations set forth in the REIT's charter or other organizational document; or
- the parties have concluded that the investor's ownership does not run afoul of the ownership limitation provisions in the REIT's charter and that a waiver is accordingly not necessary.

The key to understanding either of these approaches is to understand that the 5/50 test speaks of five *"individuals,"* which generally does not include entities such as mutual funds, corporations or most other legal "persons."[7] Strictly as a matter of the 5/50 test, then, it is possible for, say, a single mutual fund to own a significant percentage of the REIT's outstanding stock, say, 20%, without triggering a 5/50 test problem under the Internal Revenue Code because a mutual fund is not itself treated as an "individual" for this purpose. Rather, the constructive ownership rules under the Internal Revenue Code look to see whether stock owned directly by one person or entity should be treated as being owned by another person or entity.[8] For example, stock owned by an individual person will be considered as owned by certain of his or her family members; stock owned by a corporation or partnership will be considered as being owned proportionately by its shareholders or partners. Because a mutual fund is typically owed by hundreds or thousands of *individuals*, in calculating percentage ownership for purposes of the 5/50 test the REIT would "look through" the mutual fund's aggregate ownership to the actual individual holders of interests in the fund. So long as no individual holder is deemed to actually and/or constructively own REIT shares in excess of the 5/50 ownership limit, there would be no REIT qualification issue under the 5/50 test.

The mutual fund's ownership could still very well be a REIT qualification issue, however, if it would give rise to related party tenant income. If a single mutual fund owns 10% or more of the REIT's outstanding stock and also owns 10% or more of a tenant of the REIT then all of the rent received from that tenant would fail to qualify as "rents from real property" for purposes of the REIT's gross income tests, which, in turn, could cause the REIT to fail to qualify as a REIT for U.S. federal income tax purposes. As discussed in further detail below,[9] the relevant tax rules and definitions relating to related party rent determinations generally treat legal entities as single persons, irrespective of their "look through" status for purposes of the 5/50 test.

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and other stock issuances in the interim have materially increased the total outstanding shares, or if the original large stockholder has otherwise decreased its percentage ownership, adjusting the 5/50 ownership limit to 9.8% or an otherwise higher limit would forestall the need for waivers based on the original lower limit (though an amendment to the ownership limit will generally require stockholder approval). See footnote 2.

7 See Sections 856(h) and 542(a)(2) of the Internal Revenue Code. For this purpose, an "Individual" also includes private foundations, certain trusts forming part of a plan for the payment of supplemental unemployment compensation benefits and the portion of a trust permanently set aside or to be used exclusively for charitable purposes described in Section 642(c) of the Internal Revenue Code.

8 See Sections 856(h) and 544 of the Internal Revenue Code. In a typical REIT charter, the constructive ownership rules that apply to the 5/50 test are generally incorporated into the charter's ownership limitation provisions through the use of the defined term "Beneficial Ownership."

9 See below under "Related Party Tenant Ownership Limitations."

III. Parsing the Charter: Variations in Ownership Limitation Provisions

So when would an investor or fund manager seek a waiver of the ownership limit from the REIT, when would the REIT's board of directors consider granting such a waiver, and under what terms/conditions?

The question of a waiver – or whether a waiver is even necessary – begins with the particular REIT charter provisions providing for the ownership limitations and related terms and definitions. These provisions come in a variety of forms, often with subtle yet significant differences that impact how the particular charter defines holders subject to the ownership limitations.

As we have previously noted in our REIT Alert "Recent Case Raises Questions Affecting Ownership Limits in Publicly Traded REITs," because ownership limitation provisions are designed to protect the REIT's essential status as a REIT, it is not surprising that they are drafted broadly rather than surgically tailored to mimic the strict REIT qualification provisions of the tax law. We explained that "the flexibility that might accompany a more surgical application of the tax rules does not lend itself to serving as an effective firewall in the context of a publicly traded REIT," that may have hundreds of thousands and even millions of shares changing hands anonymously each day over the electronic facilities of a stock exchange. Accordingly, to perhaps oversimplify, there are generally two different basic forms of 5/50 ownership limitation provisions in use today:

- a limit that applies to any holder who beneficially owns the shares, including holders that are entities, irrespective of whether the holder's entity-level ownership would be "looked through" for purposes of the 5/50 test;[10] and

- a limit that, in addition to applying to all holders of any kind who beneficially own shares, aggregates holdings of all "persons" (individual or entities) that together form a "group" for purposes of Section 13(d) of the Securities Exchange Act of 1934, as amended, and treats the aggregate holdings of the group as being held by a single holder.[11] Under Section 13(d), two or more parties are deemed to be a "group" (and will have their beneficial ownership attributed to one another) if they act together for the purpose of acquiring, disposing or holding the relevant securities.

Inasmuch as both these types of ownership limitation apply to holders that are entities (or even groups of entities) rather than just "individuals," they are drafted more broadly than is strictly necessary to satisfy the 5/50 test. Indeed, there are several REITs that have 5/50 ownership limitation provisions that are narrowly tailored to apply to only "individuals" — but these too are coupled with a second ownership limitation provision that applies to entities. This is because an ownership limit that is narrowly tailored to cover only "individuals" for purposes of the 5/50 test[12] (without any additional ownership limitation on entities) would

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10 For an ownership limit of this type, the charter might provide in relevant part that "no Person (other than an Excepted Holder as determined by the Board of Directors) shall Beneficially Own or Constructively Own shares of common stock in excess of 9.8% in value or in number of shares, whichever is more restrictive, of the aggregate outstanding shares of common stock." The term "Person" would be defined to include an individual, corporation, partnership, limited liability company, estate, trust or other entity. The term "Constructively Own" relates to the related party tenant income ownership limit and is discussed below in footnotes 29-32 and the accompanying text. See also footnote 17 with respect to the definition of "beneficial ownership".

11 For an ownership limit of this type, the relevant charter provision would further expand the definition of the term "Person" to include a "group" as used for purposes of Section 13(d)(3) or Rule 13d-5(b) of the Exchange Act.

12 E.g., "No Individual shall Beneficially Own shares of common stock in excess of 9.8% in value or in number of shares, whichever is more restrictive, of the aggregate outstanding shares of common stock," where the term "Individual" is defined by reference to Section 542(a)(2) of the Internal Revenue Code, which generally does not include entities such as mutual funds, corporations or most other legal "persons." Note, however, that if an entity were to hold stock that causes an "individual" to violate the ownership limitation by

pose at least three distinct challenges: (i) the REIT would still be exposed to REIT qualification risk in the form of receiving related party tenant income; (ii) it would be near impossible for the REIT to continuously monitor and investigate the ultimate beneficial ownership of its shares under the tax rules; and (iii) investors themselves would not know when their ownership had triggered a REIT qualification problem and resulted in a portion of their shares being transferred to a trust under the charter.

But because the ownership limitations are still drafted more broadly than is strictly necessary under the Internal Revenue Code, typical REIT charters also authorize the board of directors, as a "safety valve" of sorts, to waive an ownership limitation (prospectively or retroactively) to the extent the board determines, after consulting with counsel and evaluating all relevant facts and circumstances, including representations and undertakings made by the stockholder, that the proposed investment would not, among other things, jeopardize the REIT's tax status. A minority of public REIT charters not only authorize the board to grant waivers from the ownership limitations, they require the board to grant a waiver, again so long as the board in its discretion is able to definitively conclude, after consulting with counsel and evaluating all relevant facts and circumstances, including representations made by the stockholder, that the proposed investment would not, among other things, jeopardize the REIT's tax status.

It is important to note, however, what *cannot* be waived under any circumstances. A 5/50 ownership limitation applicable only to "individuals," for example, would never be waivable at all, since to do so would jeopardize the company's REIT qualification. Likewise, even in practice where the ownership limitation provision is drafted more broadly, any provision or restriction that, if violated, would result in a true REIT qualification concern (such as the company becoming closely held or receiving related party tenant rent) is simply not waivable. A properly drafted charter will in fact by its terms – irrespective of any language or provision in a purported waiver – never permit the waiver of any provision or restriction that, if violated, would result in a true REIT qualification concern.[13] The only restrictions that the board can consider waiving are those that are more broadly worded than the bare REIT qualification minimum, and only to the extent of such additional reach.

IV. Beneficial Ownership and "Group" Status Under the Securities Laws

Let's take the common case of a large investment management company seeking to acquire REIT shares in excess of the charter's 9.8% ownership limit on behalf of one or more of its clients. In a typical scenario, the "clients" will be passive or actively managed funds or mutual funds of various size, strategy and sector focus:

- If the ownership limitation provisions in the relevant REIT charter is of the first type listed above (i.e., treats entities such as corporations and partnerships as "persons" but does not treat a "group" as a "person") then neither the investment management company nor any individual fund can acquire REIT shares in excess of the 9.8% ownership limit absent a waiver of the ownership limit. However, because the management company and each individual fund is a separate person for this purpose, each of them can own up to 9.8% of the REIT's shares for its own account. Moreover, a fund's

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virtue of the individual's beneficial ownership of the stock through such entity, it is possible that some or all of the shares of stock held by the entity would be transferred to a charitable trust pursuant to the charter provisions described above.

[13] This is typically effected in the charter through the inclusion of additional ownership limitations that are not subject to being waived under the terms of the charter. For example, the charter might provide in relevant part simply that "No Person shall Beneficially Own or Constructively Own shares of Capital Stock to the extent that such Beneficial Ownership or Constructive Ownership of Capital Stock would result in the Corporation (i) being "closely held" within the meaning of Section 856(h) of the Code, or (ii) otherwise failing to qualify as a REIT".

ownership in excess of the 9.8% ownership limit typically should not adversely affect the REIT's compliance with the 5/50 test and the board would have the ability to consider waiving the broad ownership limit after weighing all relevant facts and circumstances (including whether any single fund will own in excess of 9.8% and, if so, whether that fund's ownership could result in a related party tenant issue as described below).

- If the ownership limitation provisions in the relevant REIT charter is of the second type listed above (i.e., treats entities such as corporations and partnerships as "persons," as well as Section 13(d) "groups") then, as above, neither the investment management company nor any individual fund can acquire REIT shares in excess of the 9.8% ownership limit absent a waiver, and, if the investment management company and/or its affiliated funds act together as a "group" in the acquisition, disposition, voting or holding the REIT shares, then the aggregate holdings of the investment management company and all affiliated funds cannot exceed the 9.8% ownership limit absent a waiver. However, because the funds' aggregate ownership in excess of the 9.8% limit typically should not adversely affect the REIT's compliance with the 5/50 test, the board would have the ability to consider waiving the broad ownership limit after weighing all relevant facts and circumstances (including whether any single fund will own in excess of 9.8% and, if so, whether that fund's ownership could result in a related party tenant issue as described below).

To be sure, the determination of "group" status is a highly fact-dependent analysis that has historically been difficult to apply, particularly in the age of increased shareholder activism.[14] For example, if two or more otherwise unaffiliated investors jointly approach the REIT to discuss strategic alternatives or to propose corporate governance changes, then these investors are clearly acting as a "group" and their collective ownership would be aggregated for purposes of Section 13(d) and thus under the ownership limitation provision, as applicable. But what if two or more otherwise unaffiliated investors speak to each other on a regular basis generally about the REIT and its prospects – at what point, if any, do they become a "group"? Likewise, even historically passive asset management organizations such as pension plans and mutual funds have recently taken actions that may be viewed as attempts to influence companies' internal policies and procedures. When would an investment manager and its client funds constitute a "group" under these circumstances?

Rule 13d–5(b) under the Exchange Act simply provides that a group is formed when "two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer." The courts have confirmed that a writing or other formal agreement is not necessary to form a "group," and that no actual acquiring, voting or disposing of securities has to occur. It is enough for two or more stockholders to act together in furtherance of a common objective.[15] While, as above, the

[14] With the aim of curbing the potential for abuse when activist hedge funds form loose associations of "wolf packs," in May 2016, Senators Tammy Baldwin of Wisconsin and Jeffrey A. Merkley of Oregon introduced the "Brokaw Act," a bill that would, among other things, expand the definition of "person" for purposes of Section 13(d) to specifically include persons acting together as a group to "control or influence the board, management or policies" of a public company, as well as shorten the number of days that activists have to disclose newly acquired stock, whether held directly or in the form of derivatives. See https://www.baldwin.senate.gov/press-releases/brokaw-act.

[15] See, e.g., *Wellman v. Dickinson,* 682 F.2d 355, 362-64 (2nd Cir. 1982) ("Touchstone of 'group' [. . .] is that the members combined in furtherance of a common objective, but concerted action of the members of the group need not be expressly memorialized in writing"); *Morales v. Quintel Entertainment, Inc.,* 249 F.3d 115, 124–25 (2d Cir.2001) ("Whether the requisite agreement exists is a question of fact. The agreement may be formal or informal and may be proved by direct or circumstantial evidence. Moreover, the alleged group members need not be committed to "acquiring, holding, voting, or disposing of equity securities" on certain specified

determination of "group" status in any given instance can be subjective and fact-specific, in the context of an investment management company and its client funds the analysis can begin with a very objective first question: does the investment management company or any other affiliated entity file a Schedule 13G showing the organization's aggregate holdings (whether in the REIT or any other public company)?[16] In other words, has the investment management company or any other entity already publicly conceded that it is the Section 13(d) beneficial owner[17] of all the securities held throughout the organization, including those held by the client funds?[18]

If the answer is no, then merely being the parent company of entities that own similar securities would not, in and of itself, render the entire enterprise a "group" for purposes of Rule 13d-5(b). The SEC has provided guidance in the context of Section 13 to the effect that beneficial ownership need not be attributed to parent entities when there are substantive policies and procedures in place to ensure that voting and investment powers are independently exercised by subsidiaries and/or client funds.[19] Accordingly, for an investment management organization that disaggregates beneficial ownership in reliance on the inter-company barriers outlined by the SEC, the board of directors of the REIT might reasonably conclude that the investment management company and its client funds do not constitute a "group" for purposes of the ownership limitation provisions – absent any other facts and circumstances that suggest to the board that the various affiliated investor entities are in fact acting as a "group."[20]

If, however, the answer is yes, the investment management company or an affiliate is a Schedule 13G filer with respect to securities held by its client funds, then it gets harder, though not impossible, for the board of directors to reasonably conclude that all of the affiliated entities do not constitute a "group." In most cases, a Schedule 13G filing by the investment management company is an acknowledgment that the parent entity ultimately has or shares voting or investment power (or both) for all securities held by its client funds. There

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terms, but rather they need only have combined to further a common objective regarding one of the just-recited activities.") (internal citations omitted).

16 Assuming that the organization's aggregate ownership is 5.0% or more so that reporting under Section 13 of the Exchange Act would otherwise be required.

17 The definition of "beneficial ownership" for securities law purposes is entirely different from – and should not be confused with – the definition of the same term under the Internal Revenue Code and as typically used in the ownership limitation provisions. Rule 13d-3 under the Exchange Act defines "beneficial ownership" as including "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares (i) voting power which includes the power to vote, or to direct the voting of, such security; and/or (ii) investment power which includes the power to dispose, or to direct the disposition of, such security".

18 See also our REIT Alert "Recent Case Raises Questions Affecting Ownership Limits in Publicly Traded REITs," where we discussed the implication under REIT ownership limitation provisions of the Southern District of New York discussion and decision in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP,* 562 F. Supp. 2d 511 (S.D.N.Y. 2008). That case turned a spotlight on derivatives trading and raised significant issues as to what it means to "beneficially own" shares of a public corporation in a world in which financial institutions and investors routinely structure synthetic positions that shift the benefits and risks of being a holder of traditional equity securities for a wide variety of reasons. As noted above, in May 2016, Senators Tammy Baldwin of Wisconsin and Jeffrey A. Merkley of Oregon introduced the "Brokaw Act", a bill that would, among other things, amend the relevant beneficial ownership rules to specifically include derivatives and short positions. See https://www.baldwin.senate.gov/press-releases/brokaw-act.

19 SEC Release No. 34-39538 (January 12, 1998). In the SEC's words, these policies must not be "arbitrary or artificial" but should be based on "written policies and procedures reasonably designed to prevent the flow of information to and from the other business units, divisions and entities that relate to the voting and investment powers over the securities." The SEC's guidance further provides that organization's relying on this type of disaggregation of beneficial ownership should also obtain an annual, independent assessment of the operation of the policies and procedures established to prevent the flow of information among the related entities.

20 We note that determinations regarding securities-law or tax-law beneficial ownership or any other legal conclusions reached by an investor about its ownership of a REIT's securities, while informative, is not binding on the REIT's board of directors, who are charged with independently evaluating all relevant facts and circumstances in interpreting and enforcing the REIT's own charter.

are likely a limited number of circumstances where this does not automatically equate to finding that the organization as a whole constitutes a "group" for purposes of its aggregate holdings of a given REIT's securities, for example, where the organization has nonetheless implemented the procedural and informational barriers discussed above to ensure independent exercise of voting and investment powers.[21] In these cases, and in all other instances where the investment management company is a Schedule 13G filer on a consolidated basis, the REIT may need to obtain additional information and/or representations from the investment management company to enable the REIT to conclude to its satisfaction that the management entity and client funds do not in fact constitute a "group" for purposes of the charter provisions, as applicable.

We note that there are a number of increasingly common fact patterns that would suggest the existence of a "group" among an investment management company and its client funds, irrespective of whether a consolidated Schedule 13G is filed or not. These include:

- all shares held by the consolidated group are consistently voted each year on the same day, at the same time and in the same way (for, against, abstain, etc.);
- when the REIT seeks to engage in shareholder outreach, either generally or in connection with a specific proposal, there is a single address, phone number and/or contact person or department to which inquiries for all consolidated shares are directed;
- the investment management company emphasizes or notes the aggregate holdings of its client funds when communicating with the REIT or when otherwise addressing its consolidated investment in the REIT (e.g., mailing a letter to the REIT advocating for change in the REIT's internal governance policies).

While none of these alone may be dispositive in determining whether a "group" exists, these and similar facts and circumstances may be seen as persuasive by the REIT's board of directors in discharging its duty to interpret and enforce the REIT's charter provisions.

V. Waiver Considerations

If, following a careful review of the relevant charter provisions, the REIT's ownership limit is of a type that can be waived because it is drafted more broadly than strictly necessary to protect the REIT's tax status, what are the primary concerns and considerations the board must evaluate before granting a waiver to the investment company manager and/or any or all of the affiliated client funds?

First and foremost, as above, a properly drafted charter will not permit the board to waive any provision of the charter necessary to protect the REIT's essential status as a REIT under the Internal Revenue Code. To be clear, if the acquisition of REIT shares by an investor who has the benefit of a waiver would cause the REIT to fail the 5/50 test, have fewer than 100 shareholders or fail the REIT gross income tests due to related party rent – then in all cases the charter provisions providing for automatic transfer of shares to a charitable trust must always kick in and preserve the REIT's tax status, regardless of how the waiver may or may not be crafted.

Second, the board must determine whether the requesting investor (for example, the investment management company here) is the type of investor whose ownership of a significant percentage of the

[21] See Douglas Hammer et al., Shartis Friese LLP, U.S. Regulation of Hedge Funds (2005) at 274-275.

REIT's outstanding shares is likely to be beneficial to the REIT's stockholders as a whole. In many cases, large investment company managers and their client funds are exactly the types of investors the REIT is seeking to attract – professional money managers with robust allocations to REITs and with a history of long-term investing in the sector. Indeed, these are the institutional investors who, through their client funds, collectively own a very sizeable amount of aggregate publicly traded REIT market today. A REIT's board of directors would thus be well justified in concluding that increased ownership by this type of institutional investor would bode well for the REIT and its stockholders as a whole, and that an appropriately tailored waiver of the ownership limit is warranted, so long as it does not create a REIT qualification concern.

Conversely, the board of directors could likewise determine that increased ownership by shorter term investors, such as hedge funds, arbitrage funds and other funds with alternative investment strategies may not be beneficial in the long term for the REIT's stockholders as a whole, inasmuch as the short-term goals and activities of these investors can occasion increased volatility and speculation in the stock. The board could thus conclude that granting a waiver that would permit this type of investor to increase its ownership above the ownership limit applicable to all other investors would not be in the REIT's best interest. We note in this regard that the corporate statutes of many states, including Maryland[22] and Delaware,[23] specifically permit a company's organizational documents to provide for restrictions on transferability and ownership for any lawful purpose.[24] Similarly, we note that each waiver request must be independently evaluated and considered by the board of directors in light of all available facts and circumstances, as above. The fact that the board determined to grant or not grant a waiver in a previous instance, even on similar facts, is not dispositive or even informative on whether the board should grant or withhold a waiver in any other instance.[25]

If the board determines to grant a waiver to an investor, there are a series of decisions to be made (and/or negotiated) with respect to the scope and terms of the waiver, including:

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22 See Section 8-203 of the Maryland General Corporation Law (authorizing the organizational documents of a Maryland 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" (italics added).

23 See Section 202[(e)] of the Delaware General Corporation Law (authorizing any "lawful restriction on transfer or registration of transfer of securities, or on the amount of securities that may be owned by any person or group of persons").

24 While beyond the scope of this article, in our REIT Alert "Barbarians at the (REIT) Gates" we noted the possible anti-takeover effect of broadly worded ownership limitation provisions and their overlap with more traditional anti-takeover devices. For example, we noted that "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, the typical shareholder rights plan might serve as a more effective deterrent to a determined activist or other hostile acquiror of shares since the effect of triggering a rights plan (immediate and catastrophic dilution of the triggering stockholder's economic interest) is far more draconian, at least from an economic perspective, than application of the typical REIT charter's mandatory transfer provisions (pursuant to which the economic value, measured at the time the limit is exceeded, of the shares owned in excess of the ownership limit is largely retained, even though appreciation in value, or distributions received, after the deemed transfer to the trust are disgorged).

25 Section 2-405.1 of the Maryland General Corporation Law provides that a director's standard duty of care (i.e, to act in good faith, in the best interests of the corporation and with the care of an ordinarily prudent person in similar circumstances) applies to all acts and decisions the director makes in his/her capacity as a director and that acts or decisions by a director with respect to extraordinary transactions "may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director." Moreover, the General Assembly of Maryland recently adopted amendments to Section 2-405.1 to further clarify that Maryland does not impose a heightened duty of care in any "transaction or potential transaction involving the corporation." See Venable LLP Client Memo, "Maryland Legislature Amends the Maryland General Corporation Law and the Maryland REIT Law to Clarify Director and Trustee Duties," April 27, 2016 (available at https://www.venable.com/nep/publications/NewslettersList.aspx).

Scope. Who is covered by the waiver and how long does it last? Is it strictly the investment management company or does it extend to any or all of its client funds? Are affiliates included and how are affiliates defined? The typical formulation is for the waiver to extend to the investment management company and all its client funds as a group, but not to any one of them individually. Waivers are typically strictly nontransferable and provide that the waiver will automatically terminate with respect to any shares transferred by the waiver recipient.[26]

Excepted Holder Limit. Up to what percentage threshold should the investor or investor group be permitted to own (generally referred to as the "Excepted Holder Limit")? It is not uncommon in today's world of supersized mutual funds to receive requests for waivers up to 15%, 18% and even 20% of the total outstanding stock of a REIT. As indicated above, the board of directors must carefully weigh all relevant facts and circumstances in determining how high an Excepted Holder Limit might be appropriate in any given situation.

"Use It or Lose It." Should the waiver be given on a "use it or lose it" basis, so that if the recipient subsequently sells any shares owned in excess of the standard ownership limit in reliance on the waiver then the waiver is permanently reduced by that same number of shares? Alternatively, the waiver can provide the recipient with the flexibility to freely sell and reacquire shares in excess of the standard ownership limit and below the Excepted Holder Limit, but if total holdings ever fall below the standard ownership limit, the recipient may not again acquire shares beyond the standard ownership limit without applying for and receiving another waiver. Or, even if the waiver remains intact, is there a lower percentage threshold, say 5.0%, below which the waiver automatically terminates or should the waiver continue indefinitely irrespective of then-current ownership? As an alternative to automatic termination, perhaps the waiver should provide the board with the flexibility to notify the recipient of a "use it or lose it" ratcheting down of the Excepted Holder Limit?

Scope of Representations. Most waivers are given by the board of directors on the basis of representations made to it by the investor group/recipient (often referred to as an "Excepted Holder") and the waiver is typically conditioned on the continued accuracy of these representations. If a representation lapses or otherwise becomes inaccurate, the waiver automatically terminates. Representations a board might want to require include, as applicable:

- that the collective ownership of the Excepted Holder group is not and will not be in excess of the Excepted Holder Limit;
- that no single member of the Excepted Holder group owns or will own shares in excess of the standard ownership limit;
- that ownership of shares by any member of the Excepted Holder group does not and will not cause any "individual" (as defined under Section 542(a) of the Internal Revenue Code) to be the beneficial owner of shares in excess of the standard ownership limit or a specified lower percentage;
- if the Excepted Holder group includes an investment management company, that such company itself does not and will not own shares for its own account in excess of, say, 1.0% of the outstanding REIT shares;

[26] In the real estate private equity sector, where a real estate investment fund might invest a significant amount of equity capital in a public REIT in connection with an initial public offering or otherwise, the waiver may contain limited transferability rights.

- if applicable, that all members of the Excepted Holder group are eligible to report their beneficial ownership of REIT shares (whether or not required) as a Schedule 13G filer and not as a Schedule 13D filer. Schedule 13G is generally reserved for qualified institutional investors who acquire securities in the ordinary course of business and not with the purpose of changing or influencing control of the issuer;
- that no member of the Excepted Holder group is currently part of a Section 13(d) "group" relating to the REIT's shares nor will any member of the Excepted Holder group join such a "group" in the future;
- if the waiver is being granted in reliance on the Excepted Holder group qualifying for "disaggregation" treatment under Section 13(d) of the Exchange Act, that it so qualifies and will continue to so qualify; and
- that ownership of shares by any member of the Excepted Holder group does not and will not cause the REIT to constructively own 10% or more of the ownership interests of any of its tenants.[27]

Many REITs also require Excepted Holders to covenant that they will promptly notify the REIT in the event any representations fails to be true and to generally cooperate with requests for information by the REIT regarding the number of shares owned at any given time during the life of the waiver. Representations and covenants are typically made by the Excepted Holder either in a separate representation letter addressed to the REIT (sometimes referred to as an "Excepted Holder Certificate") or in a separate section in the waiver document itself. In circumstances where there is a heightened risk of related party tenant income, the Excepted Holder Certificate may also include a series of covenants and other safeguards designed to monitor related party tenant issues.[28]

Termination. Can the REIT unilaterally terminate the waiver at any time for any reason or for no reason? Every waiver must give the board the ability to immediately (and even retroactively) terminate the waiver if the board has determined that the REIT's tax status may be in jeopardy. But there may be other circumstances in which the board of directors might determine that it no longer is in the REIT's and its stockholders' best interest to maintain a waiver for a particular investor or investor group, whether due to a related party tenant problem or otherwise. Waivers may give the board the ability to unilaterally terminate the waiver, provided that there will typically be a notice period (e.g., 30-90 days) during which time the Excepted Holder will have the ability to sell down or otherwise transfer its position to get below the standard ownership limit (though investors may still resist being required to sell stock at what may prove to be an inopportune time). Of course the granting of any sell-down period must be subject to the board's determination that no actual REIT qualification concerns exist on account of the investor's continued ownership.

Adjustments. The number of outstanding shares of the REIT is unlikely to stay static during the term of a waiver, which means the percentage ownership of the Excepted Holder will also go up and down, more typically down as the REIT issues additional shares in financing, acquisitions or other transactions. When the total outstanding shares of the REIT decrease, however, such as when the REIT repurchases its own shares under a stock repurchase program, the Excepted Holder may

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27 See discussion below under "Related Party Tenant Ownership Limit".

28 See discussion below in footnote 32 and accompanying text.

suddenly find that its percentage ownership has in fact increased and that it now holds shares in excess of the Excepted Holder Limit. To address this and other circumstances where the Excepted Holder Limit may inadvertently be breached, the parties can consider providing for a limited "sell down" window, say 30 days, during which the Excepted Holder will have the chance to sell shares to get back down below the Excepted Holder Limit before the charter's automatic transfer provisions will be triggered.

Disclosure. Does the fact that the board has granted a waiver need to be publicly disclosed? The view of most practitioners is that waivers granted to dedicated institutional investors that invest in REITs in the ordinary course of their business is not generally a disclosable event, so neither a press release nor Form 8-K would typically be filed. While not required, some REITs sometimes add disclosure to their annual proxy statements stating that waivers have been granted by the board of directors to a given institutional investor in the ordinary course. Nevertheless, even in these cases, the waiver itself and/or a description of its specific terms are not generally disclosed. As noted above, however, whether or not a REIT publicly discloses a waiver, a casual glance at the beneficial ownership table included in its proxy statement will usually reveal whether an institutional investor or affiliated group has a position in the stock in excess of the ownership limit. If yes, then, as discussed above, the implication is either that a waiver has been granted or that one is unnecessary under the particular REIT's charter.

Conversely, waivers granted by the board not in the ordinary course of business and/or to investors that are (or would be required to be) Schedule 13D filers would generally be disclosable events to be reported in the appropriate periodic report under the Exchange Act and/or in an amendment the relevant Schedule 13D.

VI. Related Party Tenant Ownership Limitations

As noted above, the ownership limitation provisions in a REIT's charter are also designed to protect the REIT from running afoul of another potential REIT qualification pitfall, receiving "bad" REIT income in the form of related party rent. If a single person or entity owns (including under certain constructive ownership rules that attribute the ownership of shares owned by one person to another[29]) 10% or more of both the REIT and one of its tenants, then the rent received by the REIT from that tenant will be considered "bad" REIT income and not "rent from real property" for purposes of satisfying the minimum percentage threshold requirements under the REIT gross income tests.[30] By providing that no one can own shares, actually and/or constructively, in excess of the specified ownership limit – which to be safe should always be less than 10.0% – the REIT protects itself from ever incurring a related party tenant income problem. This is particularly important for REITs with assets in a sector (such as office, retail and industrial) where large

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[29] In a typical REIT charter, the constructive ownership rules that apply to the related-party tenant income rules are generally incorporated through the use of the defined term "Constructive Ownership" whereas the constructive ownership rules that apply to the 5/50 ownership test are commonly referred to in a REIT charter as "Beneficial Ownership," as noted above in footnote 8.

[30] Under Section 856(c)(2) and 856(c)(3) of the Internal Revenue Code, a REIT must generally derive (i) at least 75 percent of its gross income from rents from real property, interest on obligations secured by mortgages on real property, gain from the sale or disposition of real property (other than the sale of dealer property), and certain other income related to real property and (ii) 95 percent of its gross income from real property related income meeting the 75% gross income test and certain other passive sources, e.g., dividends, interest and other capital gains. Related party rent will not qualify as income meeting either of these tests, though certain exceptions apply. A REIT has only a 5% basket for "bad" REIT income that does not qualify for the 95% gross income test (which would include related party rent as well as certain other sources of income). While beyond the scope of this article, we note that in addition to the fact pattern described above in which a stockholder holds both 10% or more of the REIT and 10% or more of a tenant, there are other more circuitous and complicated paths of ownership attribution that can apply under the relevant constructive ownership rules which would also result in related party rent to the REIT.

institutional stockholders of the REIT may also own 10% or more of the REIT's tenants. These stockholders rarely present a true 5/50 test concern but often can potentially raise a related party tenant income issue.

Unlike the 5/50 test, the relevant tax rules and definitions relating to related party rent determinations generally treat legal entities as single persons.[31] So a single mutual fund that owns 10% or more of the REIT's outstanding stock and also owns 10% or more of a tenant of the REIT would cause all of the rent received from that tenant to fail to qualify as "rents from real property" for purposes of the REIT's gross income tests, which, in turn, could cause the REIT to fail to qualify as a REIT for U.S. federal income tax purposes. This is true irrespective of the fact that the mutual fund's ownership would not cause a 5/50 test concern.

This means that a REIT must proceed with caution when considering a waiver request from the related party tenant ownership limit for a single entity, even if the entity is, say, a widely held mutual fund. If the REIT grants a related party tenant ownership limit waiver to a single entity, the REIT would first be required to obtain extensive representations from the investor that it does not own (including constructively) 10% or more of any tenant of the REIT and the REIT should then also endeavor to monitor, including by way of undertakings from the investor, the investor's direct and indirect ownership percentages in the REIT's tenants. Otherwise, the REIT runs the risk of receiving related party rent, which could jeopardize its REIT status.[32]

Accordingly, many forms of ownership limit waivers and/or related Excepted Holder Certificates place the affirmative covenant on the Excepted Holder to notify the REIT of any acquisitions by the Excepted Holder of actual or constructive interests in tenants of the REIT. Similarly, large stockholders who may also be or become tenants should self-monitor their relevant ownership percentages to ensure the related-party tenant ownership limit is not breached. If a fund or mutual fund were to acquire a 10% or greater interest in both the REIT and one of the REIT's current or prospective tenants – not a remote possibility in today's world of enormous collective investment funds – then the waiver will immediately terminate and the ownership limit in the REIT's charter will kick in and automatically transfer that portion of the fund's REIT shares in excess of 9.8% to a charitable trust, as described above. For this reason, the related party tenant ownership limitations may be perceived as having anti-takeover effect, even if a strict 5/50 ownership limit would not.[33]

VII. Conclusion

Not all ownership limits are created equal. REITs considering a waiver request from the ownership limitation provisions in their charter must first carefully review the relevant provisions in the charter and then equally carefully apply to them the specific facts and circumstances at hand. Some provisions in the charter ownership limitations may be waivable by the board of directors under certain circumstances, while other

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31 Section 856(d)(2)(B) and 856(d)(5) of the Internal Revenue Code.

32 Even though the REIT's charter will typically include a provision that would result in the transfer of a stockholder's shares to a charitable trust to the extent the person's ownership caused the REIT to have related party tenant income or otherwise caused the REIT to fail to qualify as a REIT, the board will nonetheless want to review any potential related party tenant issues that could arise with respect to a waiver recipient's ownership of 10% or more of the REIT's stock rather than rely solely on the charter provisions to protect the REIT's status as a REIT. In some isolated cases, the board may even require that a recipient of an ownership limit waiver (i) review tenant lists and make representations with respect to its lack of actual or constructive ownership in tenants, and (ii) agree to review revised tenant lists and update its representations on a periodic basis, subject in each case to appropriate agreements relating to preserving the confidentiality.

33 See discussion accompanying footnote 24 above.

provisions that work to protect the company's ongoing qualification as a REIT are never waivable. Determining whether a waiver is warranted and, if so, the scope and terms of the waiver, requires careful analysis by the board, with the assistance of counsel.

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