COMMENTS

REITS AND UPREITS: PUSHING THE CORPORATE LAW ENVELOPE

CHADWICK M. CORNELL[†]

INTRODUCTION

The boom-and-bust real estate market has been a gold mine at times and a minefield at others. The specter of the 1980s, when cavalier lending fueled wild speculation on dubious real estate ventures, still lingers in many investors' minds. As we move through the 1990s, however, many experts feel that real estate is once again on the rise.¹ And, as seems to be true of investing generally, real estate assets are increasingly being held by large conglomerates.² One vehicle being used with greater frequency by real estate investors is the Real Estate Investment Trust, or "REIT."³ REITs are a creation of

[†] B.A. 1995, Marquette University; J.D. Candidate 1998, University of Pennsylvania. I dedicate this Comment to my parents, Thomas and Sarah Cornell, for the encouragement they have given, and the many sacrifices they have made, in support of my education. I would also like to thank Brooke Gallagher for her enlightening criticism, unwavering support, and constant friendship. Finally, I would like to thank the *University of Pennsylvania Law Review* editors, especially Robyn Babcock, for making this Comment much better than it ever could have been without their assistance.

¹ See, e.g., Jerry Edgerton, *Earn Up to 28% in REITs*, MONEY, Nov. 1996, at 104 ("If you're leery of investing in bricks and mortar because you were burned in the real estate crash of the mid- to late-1980s, rest assured that times have changed."); Vanessa O'Connell, *REITs Grow Popular as Way to Diversify, but It Can Be Hard to Pick the Right Ones*, WALL ST. J., Oct. 11, 1996, at C1 ("Real estate is rebounding, as rents and occupancy rates continue to inch higher.").

² See, e.g., Ben W. Johnson, *The Great REIT Compete*, NAT'L REAL EST. INV., July 1, 1996, available in 1996 WL 9371937 ("The bottom line is that REITs in recent years have been instrumental in the increasing institutionalization of the commercial real estate markets . . ."); Joelle Tessler, *REITs Use Offerings for Buying Spree*, WALL ST. J., Nov. 29, 1996, at A3 ("What we're seeing is a wholesale consolidation of private real estate assets into the public sector . . .") (quoting Paine Webber Inc. analyst Jonathan Litt)).

³ See, e.g., Frank Byrt, *Study Projects REITs' Growth Through 2000*, WALL ST. J., June 6, 1997, at A9 (noting that in 1996, REIT stocks recorded a 36.4% return compared with

the Internal Revenue Code that allow investors to pool real estate holdings, resulting in beneficial tax consequences.⁴

REITs, however, are not only growing from the contribution of real estate by property owners. Increasingly, they are looking toward the capital equity markets to finance acquisitions.⁵ This influx of capital has helped REITs prosper as they look for further acquisition and merger opportunities. The funds from these equity offerings also bring a new type of investor into the REIT equation: the common stockholder. The addition of common stockholders to a REIT's organizational structure can cause conflicts between the property owners, who contributed their real estate to the REIT to enjoy the effects of diversification and beneficial tax consequences, and the common shareholders in the REIT, who are concerned with dividends and the appreciation of the stock.

Because both REITs and UPREITs,⁶ the latest and most popular incarnation of the REIT, are relatively modern inventions, the legal issues they present, particularly in scenarios where UPREITs are merging with or acquiring other UPREITs, are new and untested. In the few instances in which courts have addressed issues involving REITs, they have analyzed the REIT as they would any other corporate entity—usually deferring to the business judgment of the

a 23% return by the S&P 500); Kathleen Morris & Richard A. Melcher, *REITs Are Going Like a House Afire*, BUS. WK., June 2, 1997, at 122 (noting that REITs outperformed the S&P 500 by a 29% to 25% margin during the year prior to June 1997); see also George Covucci & Andrew Pace, *Umbrella Partnership Real Estate Investment Trusts Can Facilitate Property Acquisition*, NAT'L L.J., Oct. 21, 1996, at B10 ("[T]he growth and expansion of REITs . . . likely will have a major impact in the real estate market in the late 1990s and beyond.").

⁴ The portions of the Internal Revenue Code pertaining to REITs are contained in I.R.C. §§ 856-860 (1994).

⁵ See, e.g., Stephanie Fitch, *Big-City Office Landlords to Boost Stock Offers Through REITs Sharply*, WALL ST. J., Mar. 3, 1997, at B7 (noting that planned 1997 IPOs of big-city office property REITs are expected to total more than \$5 billion, compared to \$1.2 billion in IPOs for real estate companies of all kinds in 1996); Patrick McGeehan, *REIT Issuance Surges on Wall Street*, WALL ST. J., Oct. 1, 1997, at C17 (noting that proceeds from REIT offerings as of October 1997 were \$12 billion, more than twice the level as of October 1996).

⁶ "UPREITs" (Umbrella Partnership Real Estate Investment Trusts) are a derivation of the basic REIT structure. They are essentially a combination of a REIT and a partnership. The joining of these two entities allows investors and property contributors not only to enjoy the advantages the basic REIT structure offers, but also to realize additional tax advantages not found in the basic REIT structure. Because of these added benefits, most REITs are now grouped with related partnerships and are organized as UPREITs. For further discussion, see *infra* Part II.

REIT's officers and directors.⁷ Though such deference may be appropriate in some situations concerning UPREITs, the UPREIT structure presents many inherent conflicts between shareholders and fiduciaries that a regular corporation does not. Because an UPREIT is more likely to generate conflicts of interest for fiduciaries,⁸ a reviewing court's decision to automatically defer to the business judgment of the fiduciaries becomes more suspect.⁹

This Comment explains why courts should not treat UPREITs as they would treat any other corporate entity. This conclusion is based on the inherent conflicts between individuals who became shareholders by contributing property to the UPREIT and those who became shareholders through the stock market. Before granting an UPREIT the type of deference that is usually given to the business judgment of a corporation's board and officers, courts must understand the reasons why the UPREIT structure makes conflicts of interest so much more likely than in a normal corporation. In litigation concerning UPREITs, courts should be wary of these

⁷ Cf. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1993) ("Under normal circumstances, neither the courts nor the stockholders would interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled."); Michael W. Schwartz et al., *Mergers and Acquisitions: Recent Developments in Takeover Tactics and Defense*, in 1 NEW DIMENSIONS IN SECURITIES LITIGATION: PLANNING AND STRATEGIES 443, 451 (1992) ("The recent decisions in Delaware . . . emphasizing the application of the business judgment rule to acquisition activity . . . have all contributed to the changes evidenced in the current takeover environment.").

Courts apply business judgment deference as readily to REITs as to other corporate entities. See, e.g., *Realty Acquisition Corp. v. Property Trust of Am.*, No. CIV. JH-89-2503, 1989 WL 214477, at *3 (D. Md. Oct. 27, 1989) (applying business judgment deference to the decision of a REIT board not to waive a percentage equity ownership limitation). For further discussion, see *infra* note 169 and accompanying text.

⁸ REITs are normally corporations that fulfill certain requirements of the Tax Code, allowing them to acquire REIT status. See *infra* Part I.A. Since UPREITs are a combination of a REIT and a partnership, they contain two categories of interested parties—the common stockholders in the REIT and the partners in the related partnership. Because of certain tax advantages that are available to the partners and not to the common stockholders, these two types of parties may have different goals with regard to the business decisions of the UPREIT. These conflicts are exacerbated by the fact that the partners, who also generally either sit on the REIT board or own substantial equity in the REIT, owe a fiduciary duty to the common stockholders. See discussion *infra* Part II.C-E.

⁹ The fact that these conflicts of interest are inherent in the UPREIT structure supports the proposition that reviewing courts should closely examine the business decisions of a REIT board or fiduciary, especially when the litigation involves a dispute between REIT common stockholders and the fiduciaries that are supposed to represent the best interests of those stockholders. See discussion *infra* Part IV.

inherent conflicts and their effect on the decisions of UPREIT fiduciaries. This increased scrutiny is more likely to result in a heightened standard of review than that which is usually given to the decisions of corporations under the business judgment rule. Understanding the complexity of the UPREIT structure is an ambitious task, but it is one that should be undertaken to ensure that courts are protecting the interests of the REIT's common shareholders.

The purpose of this Comment is twofold: first, to show why the decisions of UPREIT fiduciaries merit greater judicial scrutiny than that which is usually given to corporate fiduciaries; and second, to show how this more rigorous scrutiny is consistent with the current majority doctrinal approach to breach of fiduciary duty claims. Part I of this Comment will briefly describe the structure and mechanics of a basic REIT, as well as the advantages a REIT entity has over a partnership or corporate organization. Part II will analyze why investors are almost exclusively switching to UPREITs, which are a derivation of the basic REIT, and will focus both on the advantages the UPREIT structure offers and on the types of conflicts the structure engenders among investors in the UPREIT. Part III will discuss the different standards of review a court may apply when dealing with corporate litigation, including business judgment, entire fairness, and *Schnell/Blasius* review. Parts IV and V will describe why the application of the business judgment rule to UPREITs is difficult, especially in the context of a merger or acquisition scenario, and how courts should analyze an UPREIT involved in breach of fiduciary duty litigation. This Comment will not postulate a new doctrinal approach or standard of review for a court faced with litigation involving UPREITs; rather, it will show how the greater judicial scrutiny merited by the UPREIT structure can be fit within the current doctrinal framework.

I. REITS GENERALLY

Real Estate Investment Trusts are investment vehicles that allow investors to pool real estate assets with beneficial tax consequences.¹⁰

¹⁰ See Robert J. Haft & Peter M. Fass, *Real Estate Investment Trusts: An Alternative to the Real Estate Limited Partnership*, in 4C TAX-ADVANTAGED SECURITIES: ILPS, PASS-THROUGHS, AND OTHER VEHICLES § 16.01, at 16-4 to -5 (1996) ("Real estate investment trusts (REITs) are financial vehicles that allow investors to pool funds for participation in real estate ownership or financing. . . . REITs that operate in compliance with special tax laws . . . pay no federal tax on income or gains passed on to their shareholders."); Gary J. Purpura & Kevin E. Adler, *Allocating UPREIT Income to Prevent REIT Disqualification*, 13 J. PARTNERSHIP TAX'N 82, 82 ("A REIT is a passive investment

In 1960, Congress created REITs as a means of encouraging small investors to participate in the type of real estate investments that were traditionally available only to institutions or wealthy individuals.¹¹ Organizations that operate as REITs do not have to pay federal tax on income or gains and can opt to pass their income through to shareholders.¹² REIT investors also enjoy the advantages of limited liability and transferability of shares (i.e., liquidity) that a corporate structure offers, without incurring the costs of double taxation.¹³ Thus, a REIT is essentially a combination of a corporation and a partnership in that it combines the benefits of a corporation with the pass-through nature of a partnership.

A. Basic REIT Structure

A REIT is defined as any corporation, trust, or association that meets the requirements of § 856 of the Internal Revenue Code.¹⁴ REIT ownership is shared by two different types of parties. The distinction between these parties is a function of the type of capital each party contributes to the REIT. Those who contribute real estate in exchange for equity are generally called "sponsors" of the REIT. Those who purchase shares in the REIT with cash are called "investors."¹⁵

vehicle organized to pool the capital of a large number of investors to invest in real estate. . . . Unlike an ordinary corporation, however, a REIT is entitled to deduct dividends paid to its shareholders [which] . . . effectively eliminates the corporate level tax on income earned by the REIT.").

¹¹ See S. REP. NO. 85-1983 (1958), available in 1958 WL 3687 (Leg. Hist.), at *161 ("[T]he methods of investment [in REITs] constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources."); see also Haft & Fass, *supra* note 10, § 16.01 (providing a brief history of why REITs were created by Congress).

¹² See I.R.C. § 857(a)(1) (1994); see also Haft & Fass, *supra* note 10, at § 16.01 ("REITs that operate in compliance with special tax laws (called 'qualified' REITs) pay no federal tax on income or gains passed on to their shareholders. This so-called conduit or pass-through feature is the foremost benefit that shareholders enjoy as a result of investing in REITs.").

¹³ See Purpura & Adler, *supra* note 10, at 83 ("Generally organized as corporations, REITs provide investors with the usual advantages of corporate ownership, including limited liability and freely transferable shares. Unlike an ordinary corporation, however, a REIT is entitled to deduct dividends paid to its shareholders.").

¹⁴ I.R.C. § 856.

¹⁵ The distinction between sponsors and investors is not crucial in terms of a basic REIT structure because each group receives the same types of benefits. In a basic REIT, both parties receive dividends from the REIT, and both parties receive the diversification and bargaining power advantages that a REIT offers over private real

Section 856 of the Tax Code includes four types of requirements that a business must meet to qualify as a REIT: organizational requirements, distributional requirements, income tests, and asset tests.¹⁶ The overall purpose of these tests is to ensure that the REIT operates primarily as a passive real estate investment vehicle.¹⁷

1. Organizational Requirements

Section 856 of the Internal Revenue Code includes six different organizational requirements that a REIT must satisfy. First, the REIT must be managed by one or more trustees or directors for the entire taxable year.¹⁸ Second, beneficial ownership of the REIT must be evidenced by transferable shares.¹⁹ Third, the entity must be one that, but for the REIT election, would be taxable as a domestic corporation or trust.²⁰ Fourth, the entity can be neither a financial institution, as

estate holdings. See discussion *infra* Part I.B. In an UPREIT structure, sponsors receive benefits different from those received by the investors. Thus, the distinction between "sponsors" and "investors" is vital when discussing the UPREIT structure. See discussion *infra* Part II.A.

¹⁶ I.R.C. § 856.

¹⁷ See Haft & Fass, *supra* note 10, § 16.05, at 16-56.34 ("The overall goal of the REIT provisions of the Code is to set up a passive real estate investment vehicle. To this end, the Code prescribes . . . tests [that] ensure [the] strict passivity of a REIT—i.e., that it does not actively engage in a trade or business.").

The justification for requiring the nature of REIT income to be passive lies in the nature of the REIT and its legislative origins. REITs are hybrid entities. They are conduits in that their income is passed through the entity to shareholders. See I.R.C. § 857(a)(1) (1994) (allowing REITs to deduct dividends paid to shareholders). Yet they are allowed to operate as corporations, see *id.* § 856(a)(3), thus availing themselves of the advantages of the corporate form. Congress recognized this and enacted income requirements for REITs that seek to ensure the entity is not being actively managed by shareholders that organize as a REIT simply to escape double taxation. See, e.g., *id.* § 856(c)(2)-(5) (describing various income requirements for REITs). These concerns are reflected in requiring REIT income to be essentially "passive"—the inference being that the property contributors are not actively managing a trade or business, but are simply pooling their real estate assets with the assets of other owners. See H.R. CONF. REP. NO. 99-841 (1986), available in 1986 WL 31988 (Leg. Hist.), at *520 ("Certain requirements are imposed on . . . REITs . . . that are intended to prevent [them] from engaging in the active conduct of a trade or business."); S. REP. NO. 94-938(I) (1976), available in 1976 WL 13862 (Leg. Hist.), at *1045-46 ("These tests are intended to allow the special tax treatment for a REIT only if there really is a pooling of investment arrangement which is evidenced by its organizational structure . . . and if its income is clearly passive . . . as contrasted with income from the operation of a business involving real estate.").

¹⁸ See I.R.C. § 856(a)(1).

¹⁹ See *id.* § 856(a)(2).

²⁰ See *id.* § 856(a)(3).

defined in § 582(c)(5) of the Code, nor an insurance company pursuant to Subchapter L of the Code.²¹ Fifth, beneficial ownership of a REIT must be held by 100 or more persons.²² Sixth, during the last half of each taxable year, not more than fifty percent of a REIT's outstanding stock can be held by five or fewer persons, pursuant to the personal-holding company provisions in § 542.²³

These organizational requirements reflect the general policy initiative behind the creation of the REIT structure—giving small investors the opportunity to invest in real estate. The most prominent of these requirements (and the most troubling for REIT organizers) are the five person/fifty percent requirement and the 100 person beneficial ownership requirement.²⁴ By setting up rigid quantitative ownership requirements, these rules address the concern that REIT ownership will be concentrated in the hands of wealthy individual real estate investors.

2. Income Tests

After meeting the six basic organizational requirements, a REIT must satisfy three different income tests. These tests are “complicated, mechanical tests which are intended to limit the investments of a REIT to real estate and certain other types of passive investments.”²⁵ Thus, by limiting the types of investments with which a REIT can involve itself, these tests limit a REIT's earnings to income

²¹ See *id.* § 856(a)(4). Financial institutions, which cannot qualify as REITs, include banks, chartered savings institutions, and small business investment companies. See *id.* § 852(c)(2)-(5).

²² See *id.* § 856(a)(5).

²³ See *id.* § 856(a)(6) (incorporating §§ 856(h) and 542).

²⁴ See William B. King, *Factors That Influence the Organization and Governance of Today's REIT*, in REITS 1994: WHAT YOU NEED TO KNOW NOW 77, 82 (1994) (“The not-closely-held requirement . . . (sometimes also referred to as the ‘5 or fewer’ or ‘5-50’ rule) requires close attention. Virtually all REIT charters have ‘Excess Share’ provisions designed to provide mathematical certainty that 5 shareholders may not own more than 50% of the value of the outstanding shares of the REIT.” (citation omitted)).

²⁵ Richard M. Lipton, *REITs and UPREITs: The New Game in Real Estate*, in 2 CREATIVE TAX PLANNING FOR REAL ESTATE TRANSACTIONS 829, 837 (ALI-ABA Comm. on Continuing Prof'l Educ. ed., 1994) (describing how REITs operate under the Internal Revenue Code).

that is both passive and derived from transactions that are closely connected with real estate activities.²⁶

3. Assets Tests

A REIT must also meet several requirements based on the nature of the assets it holds. These requirements ensure that a REIT's asset holdings are primarily comprised of real property or assets related to real property ownership. At least seventy-five percent of the value of a REIT's assets must be represented by real estate assets, cash and cash items (for example, receivables), and government securities.²⁷ In addition, not more than twenty-five percent of a REIT's total assets may be comprised of securities, not more than five percent may be the securities of a single issuer, and the REIT cannot own more than ten percent of the outstanding voting securities of a single non-REIT issuer.²⁸

4. Distribution Requirements

Section 857 of the Code sets out a number of requirements which dictate the manner in which a REIT is to distribute income to its shareholders.²⁹ The basic purpose of these requirements is to ensure that a REIT operates as a pass-through entity. The major distribution requirement is that at least ninety-five percent of the REIT's annual income must be distributed to shareholders as dividends.³⁰ If the REIT meets these requirements, it is allowed to deduct the amount of dividends paid.³¹ This dividend deduction allows a REIT to avoid double taxation and is the primary difference between a REIT and a normal corporate entity.³² The requirements also ensure REIT share-

²⁶ See Haft & Fass, *supra* note 10, § 16.05, at 16-56.34 (noting that the income tests in the Tax Code are structured so as to ensure the passivity of a REIT and its focus on real estate).

²⁷ See I.R.C. § 856(c)(5)(A).

²⁸ See *id.* § 856(c)(5)(B).

²⁹ See *id.* § 857.

³⁰ See *id.* § 857(a)(1).

³¹ See *id.*

³² See Julius Westheimer, *REITs Feature Growth, Stability, and High Income*, BALT. SUN, Nov. 27, 1996, at 8C ("To avoid being taxed at the corporate level, 95 percent of REITs' earnings must be paid out to stockholders.").

holders of a steady stream of dividends, assuming the REIT has a positive cash flow.³³

B. Advantages of REITs over Other Investment Vehicles

The fact that REITs hold pools of real estate assets offers sponsors and investors several significant advantages over other real estate investment vehicles. First, there are the diversification advantages that a large pooling of different assets offers. Sponsors and investors, because they invest different types of capital in the REIT, realize this benefit in different ways. By investing in a REIT, a sponsor mitigates the level of risk associated with the property she contributed. Through the REIT, she becomes a shareholder in an entity that owns different types of real estate assets.³⁴ Sponsors also avail themselves of the opportunity to eliminate the personal liabilities that encumber their contributed property by having the REIT assume these liabilities.³⁵ Investors do not realize any benefit vis-à-vis their personal assets (as sponsors do), but they are given the opportunity to invest in assets that have historically been the domain of only wealthy, property-owning individuals.³⁶

A second advantage of REITs is that, by pooling different real estate holdings, a REIT has more bargaining power than an individual real estate owner would have when negotiating items such as loans and service costs.³⁷ The capital accumulation that REITs provide can be utilized to get better interest rates on mortgages and other

³³ See Edgerton, *supra* note 1, at 105 ("[I]nvestors can expect dividends to keep increasing if a REIT's cash flow is growing."); Westheimer, *supra* note 32, at 8C ("[B]ecause REITs must distribute [their] profits, they pay high yields of 6 percent to 10 percent or more.").

³⁴ See Tessler, *supra* note 2, at A3 (stating that REITs are expanding and diversifying their property bases in order to avoid risks resulting from a limited geographic concentration).

³⁵ See Robert J. Crnkovich, *UPREITs: The Use of Partnerships in Structuring and Operating Real Estate Investment Trusts*, in REITs 1993: WHAT YOU NEED TO KNOW NOW 63, 65 (1993) (discussing sponsors' ability to avoid personal liability for outstanding real estate debts).

³⁶ See Vanessa O'Connell, *A Hot Property: Popular REITs Put Investors in Real Estate Game*, CHI. TRIB., Nov. 14, 1996, at C1 ("For small investors, REITs offer a broader exposure to real estate markets than most investors otherwise could attain."); Westheimer, *supra* note 32, at 8C ("REITs allow you to invest alongside real estate's big names." (quoting Martin Cohen, president of a large New York REIT)).

³⁷ See Tessler, *supra* note 2, at A3 ("REITs . . . have more bargaining power when negotiating prices for such things as janitorial services.").

financing activities. Similarly, REITs provide significant economies of scale in the management and administration of various properties.³⁸

A third advantage of REITs is their attractive investment returns for both investors and sponsors. REITs offer relatively constant rates of return and, thus, protection against the volatility of the stock market.³⁹ REITs generally have a low correlation with the stock market and they have historically performed better than stocks during market downturns.⁴⁰ They generally offer higher yields than other "conservative" investments such as CDs and money market funds,⁴¹ and, because of the distribution requirements of the Internal Revenue Code, REIT shareholders are assured dividends, even if the share price of the REIT drops.

C. Increasing Merger Activity for REITs

REITs first gained widespread popularity from tax law changes made in the 1986 Tax Reform Act.⁴² In the Act, Congress eliminated accelerated depreciation for most real property and adopted passive loss provisions.⁴³ These changes eliminated many of the tax advan-

³⁸ See *id.* ("[R]eal estate companies are able to achieve significant economies of scale in their management and administration operations by becoming larger.").

³⁹ See O'Connell, *supra* note 36, at C1 ("Real-estate investment trusts . . . can be a smart choice for stock and bond investors aiming for smoother overall returns.").

⁴⁰ See Edgerton, *supra* note 1, at 104 ("REITs are attractive bets right now because they've historically lost less than other stocks—or even managed to gain value—during market downturns."); O'Connell, *supra* note 36, at C1 ("REITs have a low correlation with the stock market, especially over periods of longer than 10 trading days.").

⁴¹ See Crnkovich, *supra* note 35, at 65 (asserting that investors are attracted to REITs because of their steady income flow). Although REITs are generally thought to be a safe investment, they do not necessarily underperform the stock market. In 1996, REIT stocks outperformed the S&P 500 by over a 13% margin, 36.4% to 23%. See Byrt, *supra* note 3, at A9 (comparing the performance of REITs to equity markets); see also Ed McCarthy, *REITs: Is It Time for Another Look?*, PENSION MGMT., Feb. 1, 1996, at 14 ("For the five-year period ending Oct. 31, 1995, equity REITs averaged an annual total return of 17.29%, matching the S&P 500's 17.23% for the same period.").

⁴² Tax Reform Act of 1986, Pub. L. No. 99-514, § 201, 100 Stat. 2121, 2121 (1986).

⁴³ The passive loss provisions enacted in the 1986 Tax Act restrict the ability of investors to deduct losses from certain types of activities. See I.R.C. § 469 (1994); MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 418 (3d ed. 1995) ("This section was intended primarily to preclude taxpayers from using losses derived from tax shelter investments to reduce taxes on earned income and on investment income such as interest and dividends.").

Prior to the enactment of the passive loss provisions, real estate investors could utilize the limited partnership structure to invest in real estate ventures and deduct losses that were passed through. This made limited partnerships more popular than REITs because REITs cannot pass through losses to shareholders. See McCarthy, *supra*

tages held by limited liability partnerships and private real estate holdings, the proliferation of which had fueled the wild speculation in real estate markets during the early 1980s.⁴⁴

Since 1986, REITs have grown steadily, performing well against the stock market,⁴⁵ and, as a result, raising impressive amounts of capital in the initial and secondary public offering markets.⁴⁶ As REITs continue to prosper, industry experts expect merger activity to greatly increase among REITs.⁴⁷ This forecast is based largely on the success of REITs in the public offering markets and the interest of large institutional investors. These factors have provided a large influx of capital that can be used to fund merger activity.⁴⁸ Also, the REIT industry is becoming increasingly standardized and mature.⁴⁹

note 41, at 15 ("You could pass losses through to investors with a limited partnership. You can't do that with a REIT. So everyone invested in real estate through limited partnerships."). Section 469 of the Tax Code greatly restricts this type of activity and, as a result, REITs have gained popularity with investors. See *infra* text accompanying note 44.

⁴⁴ See Lipton, *supra* note 25, at 832 ("The changes in the tax law in 1986, particularly the passive loss rules, have resulted in most individuals leaving the real estate market."); McCarthy, *supra* note 41, at 15 ("[T]he 1986 Tax Reform Act canceled many of the benefits of limited partnerships and individually owned real estate. That made REITs a relatively better place to hold real estate.").

⁴⁵ See *supra* note 41 and accompanying text.

⁴⁶ See, e.g., Philip S. Scherrer, *Why REITs Face a Merger-Driven Consolidation Wave*, MERGERS & ACQUISITIONS, July 17, 1995, at 41, 41 ("During the last few years, the property-owning real estate investment trust (REIT) has staged a dramatic comeback in investor popularity."); Tessler, *supra* note 2, at A3 ("The REIT industry's total market capitalization has ballooned from about \$9 billion five years ago to about \$73 billion today" (quoting analyst Kevin Comer of BT Securities Inc.)).

⁴⁷ See, e.g., Johnson, *supra* note 2 ("One of the . . . most important major trends in the REIT industry is the recent flurry of mergers and acquisitions activity."); Scherrer, *supra* note 46, at 41-42 ("[I]t is the [REIT's] need for capital to fund future growth and the pricing of that capital that should trigger a cycle of mergers and acquisitions."); Barry Vinocur, *Speculation on Potential Mergers Helps Fuel the Recent Rally in REIT Shares*, BARRON'S, Sept. 16, 1996, at 40, 40 ("[T]here is no question that there's increased speculation about a wave of consolidations.").

⁴⁸ See Scherrer, *supra* note 46, at 41 ("During the last few years, the property-owning real estate investment trust (REIT) has staged a dramatic comeback in investor popularity. . . . When the IPO frenzy subsided, there were clear indications that it may have led to excesses and industry fragmentation which are likely to be corrected by consolidation through mergers and acquisitions."); Vinocur, *supra* note 47, at 40 ("Another factor [that is driving REIT share prices higher] is an influx of money into REITs. . . . A number of firms specializing in REIT investing on behalf of institutions report a significant inflow of fresh capital.").

⁴⁹ See Byrt, *supra* note 3, at A9 (quoting Douglas Poutasse, managing director of research for AEW Capital Management LP, as saying the REIT industry has "grown up"); Vinocur, *supra* note 47, at 40 ("[T]he recent run-up in [REIT] prices has been

REITs now have long-term growth strategies, making it easier for managers to identify economically beneficial merger opportunities.⁵⁰

II. UPREITS

Up to this point, I have discussed REITs in their most basic form. Most REITs, however, do not exist in this form. Real estate investors have recently developed a derivation of the REIT called an Umbrella Partnership Real Estate Investment Trust ("UPREIT"). The UPREIT offers all the advantages of a basic REIT,⁵¹ but it also offers additional tax advantages⁵² to sponsors.⁵³ Currently, over seventy-five percent of entities originally organized as REITs have adopted the UPREIT structure.⁵⁴

selective, which seems to underscore the contention that after exhibiting some growing pains, the REIT industry is beginning to mature.").

⁵⁰ See Scherrer, *supra* note 46, at 42 ("The ability of a REIT to generate operating income is based on its economies of scale and scope through internalization of management and operations.").

⁵¹ As discussed in Part I.B. *supra*, the basic REIT structure offers three types of advantages: diversification effects and the ability of the REIT to assume the liabilities encumbering contributed property; increased bargaining power; and investment returns that are less volatile than the stock market, but higher than other more conservative investments. See discussion *supra* Part I.B.

⁵² Although the terminology differs in real estate literature, the distinction between those who contribute real property to the UP and those who purchase REIT stock in the equity markets is very important. Note, however, that this distinction is not important when dealing with a basic REIT structure. See *supra* note 15. Generally, those who contribute property are called "sponsors." Those who purchase REIT stock in the stock market are called simply "investors." Both parties are investors in the sense that they are contributing assets to an entity with the expectation that they will receive some form of economic return. The difference between the two parties is a function of the type of asset they contribute. Because "sponsors" contribute real property, a primary motivation for their investment is the tax advantages an UP offers. "Investors," in contrast, contribute cash by purchasing public shares of the REIT. The primary motivations for these individuals, like all equity holders, are the dividends paid out and the share appreciation, not the tax advantages.

⁵³ See discussion *infra* Part II.A-B.

⁵⁴ See McCarthy, *supra* note 41, at 16 ("Today, over 75% of new REITs take the umbrella partnership form."); see also Covucci & Pace, *supra* note 3, at B10 ("Most of the REITs formed in the recent boom are structured as umbrella partnership REITs, or UPREITs.").

The majority of UPREITs are incorporated in Maryland, which was one of the first states to enact legislation to attract REITs. Maryland also has minimal organization and franchise taxes. See King, *supra* note 24, at 103-06 (outlining the flexibility of Maryland's general corporation statute, its favorable case law precedent, and its minimal organization and annual fee requirements as reasons for Maryland's popularity in the area of UPREITs).

The additional tax advantages UPREITs offer sponsors can be significant, but they also lead to a number of potential conflicts between the sponsors and investors.⁵⁵ The effects of these conflicts can be greatly exacerbated when an UPREIT is presented with a merger or acquisition opportunity. Moreover, if industry experts are correct, merger activity among UPREITs will only increase in future years,⁵⁶ thus increasing the probability that disagreements between sponsors and investors will come to the courts. Before analyzing the approach courts should take in reviewing litigation concerning UPREIT sponsors and investors, however, it is necessary to delve into the arena of the Tax Code and analyze why such conflicts exist.

A. *Organizational Structure of an UPREIT*

An UPREIT is a combination of a partnership and a REIT.⁵⁷ A typical UPREIT starts with a group of real estate owners ("sponsors") who form a limited partnership and contribute their property in return for limited partnership interests. Simultaneously, a corporation contributes cash that it raised in a public offering in return for a general partnership interest. The resulting partnership is called an "umbrella partnership" ("UP").⁵⁸

In such an entity, the general managing partner is usually a corporation that satisfies the REIT requirements of § 856.⁵⁹ Thus, such a partner is subject to the organizational, income, asset, and

⁵⁵ See discussion *infra* Part II.C-E.

⁵⁶ See discussion *supra* Part I.C. Although this section discusses merger activity among REITs, the vast majority of REITs to which the articles discussed therein refer are UPREITs. Journalists writing on the subject use "REIT" as a generic term, inclusive of both the basic REIT structure, see discussion *supra* Part I.A., and the UPREIT derivation, see discussion *supra* Part II.A. Only those articles that are specifically concerned with UPREITs make the terminological distinction.

⁵⁷ For a basic discussion of the UPREIT structure, see Lipton, *supra* note 25, at 850 (describing how an UPREIT is formed through a combination of a limited partnership and a REIT).

⁵⁸ The umbrella partnership can be thought of as an umbrella, with numerous spines all connecting at its tip. These spines represent the limited partners in the umbrella partnership. The umbrella staff and handle represent the managing partner of the UPREIT.

⁵⁹ See Lipton, *supra* note 25, at 833 (arguing that the shift from the use of trusts to the use of corporations to form REITs "appears to be based upon the greater flexibility in corporate laws, the possible reduction in franchise tax and the increased ability of corporations to indemnify officers and directors in the same manner as trusts").

distributive tests applicable to a REIT.⁶⁰ Because this REIT is also usually a corporation, it has common stockholders. These shareholders purchase common stock in the REIT and have no role in the contribution of real property to the UP.⁶¹ They invest in the REIT for the same reasons that most individuals invest in stocks—dividends and the potential appreciation of the share price.

The limited partners ("sponsors") who contribute property to the UP generally receive limited partnership interests that are convertible into common stock of the UPREIT.⁶² This conversion feature has the potential to become problematic for both limited partners and common stockholders.⁶³

B. *Why UPREITs Are Preferred over Basic REITs*

The popularity of the UPREIT form stems from certain tax advantages that the UPREIT offers over the REIT. A discussion of these advantages follows.

1. Nonrecognition of Gain on Contribution of Property

Generally, under § 351(e) of the Tax Code, transfers of appreciated property to a REIT are taxable events.⁶⁴ Thus, under the basic REIT form, a sponsor who contributes appreciated property to the REIT must recognize gain in an amount equal to the excess of the value of the stock received over the basis of the property contrib-

⁶⁰ See discussion *supra* Part I.A. (discussing the requirements of I.R.C. §§ 856-857 (1994)).

⁶¹ See, e.g., Lipton, *supra* note 25, at 850-51 (discussing the formation of an UPREIT and the fact that common stockholders become involved with the UPREIT through a public offering, whereas the limited partners obtain their interests by contributing real property to the umbrella partnership).

⁶² The limited partners receive convertible interests to enhance the liquidity of their investment. See *id.* at 850-51 ("In order to provide the [limited partners] with liquidity, the [limited partners'] interests in the Umbrella Partnership are usually convertible into stock of the UPREIT . . ."); see also discussion *infra* Part II.C, E.2.

⁶³ See discussion *infra* Part II.C, E.2.

⁶⁴ I.R.C. § 351(e) (1994) (excluding transfers of property to investment companies from the tax exemption provisions of I.R.C. § 351). This is an exception to the general rule of § 351 that contributions to a controlled corporation in exchange for stock are not taxable to the shareholder. A "controlled corporation" is one where the transferors own at least 80% of all voting stock and 80% of all outstanding stock immediately after incorporation. See *id.* § 351. The Treasury Regulations include REITs within the definition of "investment companies." See Treas. Reg. § 1.351-1(c)(1) (1994).

uted.⁶⁵ Section 351(e), however, applies only to corporations, not to partnerships. Pursuant to § 721, the transfer of appreciated property to a partnership does not result in the recognition of gain or loss to the transferor.⁶⁶ The shareholder's basis is said to "carryover," giving the partnership the same basis in the transferred property that the sponsor had.⁶⁷

The effect of § 721 is to make the contribution of appreciated property a nontaxable event when the property is contributed to a partnership, but not when it is contributed to an investment company like a REIT. By utilizing the UPREIT form, sponsors are able to contribute their property to the UP, rather than to the REIT, with the result of tax-free treatment.

2. Nonrecognition of Gain upon Partnership's Assumption of Liabilities

Section 357(c) of the Tax Code requires that a taxpayer who contributes property to a corporation must recognize gain to the extent that the sum of any liabilities encumbering the property that the corporation assumes exceeds the taxpayer's basis in the property.⁶⁸

Section 357(c)'s requirement can be a problem for real estate investors utilizing the basic REIT form. Because real estate frequently has a low basis due to accumulated depreciation⁶⁹ and may have been

⁶⁵ This is generally called "precontribution gain." See discussion *infra* Part II.D.2.

⁶⁶ I.R.C. § 721 (stating that transfer of property in exchange for a partnership interest results in no recognition of loss or gain for either the partner or the partnership).

⁶⁷ Although under § 721 no precontribution gain is recognized by the transferors on transfers to a partnership, the unrecognized gain is merely deferred, not eliminated. Under § 704(c), any precontribution gain is allocated to the contributing partner over the depreciable life of the asset or, if the property is sold by the partnership before the end of its depreciable life, the precontribution gain is allocated to the contributing partner upon disposition of the property. *Id.* § 704(c) (explaining the allocation of precontribution gains); Treas. Reg. § 1.704-3 (1994) (clarifying the allocation of precontribution gains under I.R.C. § 704). The methods by which this allocation is achieved are complex and beyond the scope of this Comment. The general purpose of these provisions "is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss." *Id.* § 1.704-3(a)(1).

⁶⁸ See I.R.C. § 357(c). Gain is only recognized to the extent that the sum of the liabilities assumed exceeds the contributor's basis in the property. Upon contribution, the contributor reduces her basis in the asset, to the extent of liabilities assumed, until her basis equals zero. The remaining value of the liabilities assumed is then recognized as income. See *id.*

⁶⁹ See Lipton, *supra* note 25, at 850. The relevant Tax Code provisions on depreciation are contained in I.R.C. §§ 167-168.

refinanced, it is common for the property to be encumbered by liabilities which exceed the property's adjusted basis.⁷⁰ If such property were contributed to a REIT, gain would have to be recognized under § 357(c). If such property is contributed to a partnership rather than to a corporation, however, § 731 stipulates that no gain or loss is recognized by the transferor.⁷¹ Instead, the transferor reduces her basis in the partnership to the extent of the excess of the liabilities assumed by the partnership over her adjusted basis in the contributed asset.⁷² Thus, the transfer of liabilities in excess of basis is nontaxable when the property is contributed to the UP.

3. Avoiding 5/50 Rule Problems

To ensure that REIT ownership is not concentrated in the hands of a few wealthy investors, the Tax Code requires that a REIT not be "closely held."⁷³ Section 856(h), which incorporates the requirements of § 542(a)(2), requires that no more than fifty percent of the stock of a REIT be held directly or indirectly by five or fewer persons.⁷⁴ This is commonly referred to as the "5/50 Rule."⁷⁵ However, the UPREIT structure allows sponsors and investors to circumvent this requirement, because the 5/50 Rule applies only to the REIT, not to the UP.⁷⁶ Thus, an UP can be formed by fewer than five people owning greater than fifty percent of the UP, as long as the sponsors contribute their property to the UP rather than to the REIT.

C. Conflicts Regarding Business Decisions of the UPREIT

The ownership of the UP is shared by the limited partners who contributed property to the partnership and the general partner,

⁷⁰ See Lipton, *supra* note 25, at 851 ("In many situations, the contributed property is subject to liabilities equal to 80% or more of the fair market value of the contributed property . . .").

⁷¹ See I.R.C. § 731 (stating that distributions by a partnership to a partner shall not be recognized as a loss or a gain).

⁷² See *id.* (describing how losses and gains in excess of the adjusted basis of a partner's interest in a partnership should be calculated).

⁷³ *Id.* § 856(a)(6), (h). For further explanation of the "closely held" determination, see discussion *supra* Part I.A.1.

⁷⁴ See *id.* § 856.

⁷⁵ See *supra* note 24 and accompanying text.

⁷⁶ See Crnkovich, *supra* note 35, at 68 ("The 5/50 rule could in many instances be violated if the sponsors were to acquire their interests in the REIT due to a concentration of REIT ownership in the sponsors and a few large institutional investors By giving the sponsors interests in the UP, that aggregation is avoided.").

which is generally a publicly traded REIT. Because the REIT is the managing partner of the UP, it is responsible for the strategic direction of the UP, and the management and administration of the properties held by the UP.⁷⁷ This would seem to be an acceptable relationship, assuming the limited partners and the REIT share the goals of successfully furthering the business of the UP. The REIT, the managing partner of the UP, however, commonly is also a publicly traded corporation owned by common stockholders.⁷⁸ Through their ownership of the REIT, these common stockholders also have a voice in the management of the UP.

In theory, management of an UPREIT should not be contentious. The limited partners, simply because they are "limited" partners, should not expect to have a voice in the management of either the REIT or the UP.⁷⁹ After all, these individuals voluntarily accepted limited partnership interests in exchange for the assurance that they could not be held personally responsible for any liability the UP incurs. The problem is that most UPREITs are not structured in this way.

In most UPREITs, the limited partners receive limited partnership interests that are convertible into common stock of the managing partner REIT.⁸⁰ The primary purpose of this feature is to give limited partners a degree of liquidity in their investment.⁸¹ Rather than being restricted to holding an illiquid limited

⁷⁷ The general partner is responsible for the management of the partnership and is responsible for any liability the partnership incurs. The "limited partners" have no voice in the management of the partnership and are liable only to the extent of the amount of capital they have invested in the partnership. See generally Robert W. Hamilton, *FUNDAMENTALS OF MODERN BUSINESS* § 13.5 (1989) (discussing the evolution and characteristics of limited partnerships).

⁷⁸ See discussion *supra* Part II.A.

⁷⁹ See *supra* note 77 and accompanying text.

⁸⁰ See Crnkovich, *supra* note 35, at 67 n.2 ("[T]he sponsors are given options to convert their interests in the UP for interests in the REIT."); Lipton, *supra* note 25, at 850-51 ("[T]he Transferors' interest in the Umbrella Partnership are usually convertible into stock of the UPREIT at a future time at the option of the Transferors.").

⁸¹ See Covucci & Pace, *supra* note 3, at B10 (noting that limited partnership unit holders "have certain rights to convert the units to REIT shares and sell these shares in the public marketplace if they desire the liquidity"); Gary A. Cutson, *Formation and Operation of a REIT/UPREIT: Income Tax Considerations*, in REITS 1994: WHAT YOU NEED TO KNOW NOW, *supra* note 24, at 119, 121 ("The property owners can 'put' their UPREIT partnership units to the UPREIT or REIT in exchange for cash or REIT stock, at the UPREIT/REIT's election. The exchange is generally on a one-for-one basis or the current trading value of a REIT share. Thus, the property owner obtains liquidity.").

partnership interest, the partners can convert their interests to common stock and then sell the stock.⁸² More importantly, however, the convertibility feature gives the limited partners the opportunity to gain substantial ownership interest in the REIT, thus giving them a voice in the REIT's role as managing partner of the UP.

The UPREIT limited partners, who are responsible for contributing the real estate to the UP, generally receive limited partnership interests that, if converted simultaneously into common stock of the managing partner REIT, would give the limited partners controlling ownership in the REIT.⁸³ Limited partners are presumably given such large convertible interests because the value of the property contributed by the partners greatly exceeds the relative investments of the individual investors who own stock in the REIT. Furthermore, the limited partners are generally real estate professionals experienced in the acquisition and management of real estate properties whose expertise made formation of the UPREIT possible.⁸⁴

⁸² The conversion of these shares is a taxable event for the limited partners. Conversion of a limited partner's interest in the partnership to common stock ownership in the corporate REIT is construed as a redemption of the partnership interest and triggers taxable gain if the value of the common shares in the REIT received by the partner exceeds the partner's basis in the partnership. I.R.C. § 737 (1994) ("In the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to . . . the excess . . . of the fair market value of property . . . received in the distribution over the adjusted basis of such partner's interest in the partnership."). There are also other scenarios where the convertibility of the limited partnership interests could provide tax liability problems for the limited partners. Pursuant to several Code provisions, the IRS could view the UP as the alter ego of the UPREIT due to the convertibility feature and tax the property contributions of the limited partners retroactively. See *id.* §§ 737, 707(a)(2)(B), 721; Treas. Reg. § 1.707-3(c)(1) (1996). The specific tax issues are beyond the scope of this Comment. For further discussion of the concerns surrounding UPREITs, see Lipton, *supra* note 25, at 854-56; Crnkovich, *supra* note 35, at 73.

⁸³ See Barry Vinocur, *Sam Zell's Offer for Chateau Properties Exposes a Flaw in a Common REIT Structure*, BARRON'S, Aug. 26, 1996, at 34, 34 (noting that umbrella partnership limited partners often own substantial equity shares in the corresponding UPREIT, and listing the UPREITs in which limited partners own the greatest amount of equity).

In this article, Vinocur discusses the susceptibility of UPREITs to breach of fiduciary duty claims because of the fact that limited partners have such large equity interests in the REIT. Vinocur terms this the UPREIT's "Achilles' heel" and feels that this makes UPREITs likely takeover targets: "A lot of people are busy putting together lists detailing the ownership structure of UPREITs. Clearly, there are going to be investment bankers . . . trying to figure out which companies that have a large percentage of the company in operating partnership units are the best targets." *Id.* (quoting an unnamed Wall Street "veteran" analyst).

⁸⁴ See Lipton, *supra* note 25, at 858-59 ("[M]any of the sponsors of UPREITs have been involved in property management . . ."); Alfred D. Youngwood & Deborah B.

Thus, they expect to have a voice in the management of the UPREIT.⁸⁵

With all of these factors in mind, the common shareholders of the REIT must elect a board of directors to represent their interests. Generally, limited partners in the UP are also either members of the REIT board of directors, or are influential enough to have their interests strongly represented on the board.⁸⁶ At first glance, the limited partners of the UP seem to be the logical choice as representatives. They are real estate professionals who were responsible for contributing the properties that the UPREIT is now managing, and thus are likely to be well versed in the real estate trade and in the management of the properties they once owned individually. In addition, they are potential shareholders in the REIT because they have the option to convert their shares. This last factor would seem to imply that the limited partners' goals would be the same as those of the common shareholders, thus limiting the possibility that conflict will arise. The actual shareholders of the REIT must not forget, however, that the limited partners may also have conflicting interests. Though they are potentially large shareholders, their original intent in forming the UPREIT was to realize all of the tax and financial advantages that the UPREIT structure offered them.⁸⁷

Contributing to the UP may have allowed a limited partner to relieve herself of personal liability on the contributed property or to defer the recognition of gain on the property if it had appreciated—advantages unrelated to, and even at odds with, the interests of the

Weiss, *Partners and Partnerships—Aggregate vs. Entity Outside of Subchapter K*, 48 TAX LAW. 39, 53 (1994) ("An UPREIT is a REIT that invests indirectly in real estate by transferring cash to an operating partnership to which the other partners (primarily real estate developers and other owners of real estate) contribute property . . .").

⁸⁵ Note that in many cases, if all of the UP limited partners were simultaneously to convert their interests into REIT common stock, the resulting equity structure of the REIT would violate the "5/50 rule." See discussion *supra* Part I.A.1. This may or may not be a problem, depending on the factual circumstances of the relevant transaction. For example, the fact that conversion would cause the UPREIT to lose its favored tax status under I.R.C. §§ 856-857 would not be troublesome if the limited partners intended to merge with another REIT entity or to sell all of the UPREIT's assets—such a business plan would not require that the existing UPREIT structure survive. Thus, the fact that it would lose its favored tax status would be irrelevant.

⁸⁶ See Vinocur, *supra* note 83, at 34 (discussing UPREITs which have the majority of their equity contained in convertible limited partnership interests and the fact that the owners of these interests have a fiduciary obligation to other shareholders).

⁸⁷ For an explanation of the tax advantages that UPREITs offer individual property contributors, see discussion *supra* Part II.B.

common shareholders.⁸⁸ For these reasons and those discussed below, the limited partners may have different goals than the common shareholders. Shareholders and courts must recognize that it would be overly simplistic to assume that the economic self-interests of limited partners (acting in a fiduciary capacity vis-à-vis the common shareholders) are always perfectly correlated with the interests of the common stockholders.

D. *Conflicts Regarding Ordinary Business Transactions*

As discussed above, the limited partners in the UP are usually its directors, or they at least have substantial equity interests in the REIT and, thus, are a strong influence on the decisions of the REIT board of directors.⁸⁹ This can lead to different types of conflicts between the limited partners and the common stockholders. As directors, the limited partners are required to act as fiduciaries for the common stockholders, but they may also have independent interests in their capacity as limited partners that conflict with their fiduciary duties to these shareholders. Below are examples of potential conflicts that may arise in the course of an UPREIT's ordinary business dealings.

1. Paydown of Property Debt

An UPREIT is formed by two independent transactions. In one transaction, limited partners contribute real property to the UP. Simultaneous with this transfer, a corporate REIT issues stock. The proceeds received from this offering are then contributed to the UP. The most common use for this cash influx is to pay down debt associated with the properties.⁹⁰ Any reduction of liabilities assumed by the

⁸⁸ Common stockholders are interested in the rate of return they earn on their investment in the REIT (i.e., dividends and share price appreciation). They do not have the concerns regarding individual tax liability that the limited partners have. For example, the common stockholders would likely support a decision of the REIT board to sell certain properties if the board expected such a decision to increase investment returns for the stockholders. The limited partners, however, might oppose such a decision if it meant that a number of limited partners would have to recognize taxable gain on the disposition of the property. See discussion *infra* Part II.D-E.

⁸⁹ See *supra* note 83 and accompanying text.

⁹⁰ See, e.g., Crnkovich, *supra* note 35, at 69 ("On the contribution of cash by the REIT to the operating partnerships through the UP, debt will be reduced."); Lipton, *supra* note 25, at 851 ("The cash which is contributed to the UPREIT by the public shareholders can be used in one of several ways. Most frequently, the cash is used to pay down a portion of the liabilities which encumber the contributed property.").

UP, however, is also treated as an income distribution to the partners under § 752(b).⁹¹ The partners must recognize income to the extent that their share of the debt reduction exceeds their basis in the partnership.⁹² Thus, it may not be in the partners' economic self-interest to have REIT funds allocated toward debt reduction. The common shareholders in the REIT, however, do not share these concerns. They did not contribute property and thus are not concerned with the tax effects of §§ 752(b) and 731. For them, it may be economically advantageous for the REIT to use its cash to reduce the debt on the UP's properties⁹³ (for example, using cash to reduce debt on UP properties would be beneficial if interest rates were expected to rise on the mortgages encumbering those properties). Limited partners who sit on the board of the REIT will have a conflict of interest in this respect—do they allocate cash towards reducing debt on various properties when it means greater individual tax liability for themselves?

2. Built-In Gains and Losses

A second conflict that arises in the context of ordinary business operations relates to the fair market value of the properties that an UPREIT holds. The property contributed by limited partners to an UP is usually "built-in" gain property.⁹⁴ This means the fair market value of the asset exceeds the contributor's adjusted tax basis of the asset at the time of contribution.⁹⁵ Section 704(c) requires the contributing partner to recognize the amount of built-in gain on the property if the partnership later disposes of it.⁹⁶ This causes another

⁹¹ I.R.C. § 752(b) (1994) ("Any decrease in a partner's share of the liabilities of a partnership . . . shall be considered as a distribution of money to the partner by the partnership.").

⁹² See *id.* § 731 ("In the case of a distribution by a partnership to a partner, gain shall . . . be recognized to such partner . . . to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership.").

⁹³ Assuming the market values of certain properties were expected to drop for whatever reason, it would be beneficial to dispose of those properties.

⁹⁴ See Covucci & Pace, *supra* note 3, at B10 ("The property being contributed will, quite frequently, be property that has a lower tax basis than fair market value, because of market appreciation and tax depreciation, and, therefore, be subject to a 'built-in gain.'").

⁹⁵ Precontribution gain property is common with real assets because depreciation deductions lower the adjusted basis of the property annually. This reduction in basis is not correlated with the fair market value of the property, which is determined by market forces.

⁹⁶ See I.R.C. § 704(c).

potential conflict between the limited partners and the shareholders. The limited partners will not want the UP to sell contributed property if it means that the partners will have to recognize substantial gains on the transactions. The shareholders obviously will not share this concern, because they will not be exposed to any of the tax liability that would befall the partners in such a transaction. Thus, common stockholders would favor a sale of contributed property if, for example, its market value were expected to decline.⁹⁷ Limited partners, however, may oppose such a disposition if it means that certain partners will have to recognize large taxable gains on the property that they originally contributed to the UP.

In addition to the effect on sales of contributed property, § 704 also applies to the allocation of depreciation deductions taken by the UP on built-in gain property.⁹⁸ A partner who contributes built-in gain property generally receives lesser depreciation deductions than the other limited partners when the deductions are passed through from the UP to the limited partner.⁹⁹ This is because the contributing partner must account for the built-in gain of the property in her annual depreciation deductions for that property. The amount of depreciation allowed for the contributing partner is adjusted so that the partner recognizes a portion of the gain each year. This amount is taken against the annual depreciation deduction the partner would normally receive. The UP does have its choice of three different allocation methods for accomplishing this, but each of these methods amounts to the contributing partner having to recognize the amount of built-in gain on his contributed property incrementally over the useful life of the property.¹⁰⁰

⁹⁷ Note that this conflict is greatly exacerbated when limited partners in the UP also sit on the board of directors of the REIT, and thus ultimately bear the responsibility for the business decision of whether to use cash to reduce the debt on UP properties. See discussion *supra* Part II.C.

⁹⁸ See I.R.C. § 704(c).

⁹⁹ See Crnkovich, *supra* note 35, at 72 (discussing 704(c) allocations).

¹⁰⁰ See generally Treas. Reg. § 1.704-3(a)(1) (1996) ("Under section 704(c) a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner . . . so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution."). The details of this provision are beyond the scope of this Comment.

E. Conflicts Regarding Merger and Acquisition Activity

A merger or acquisition scenario precipitates further and more significant conflicts, beyond the potential conflicts involving the daily operations of UPREITs. The underlying foundation for such conflicts is, again, a function of the differences between the limited partners and the common shareholders. As previously discussed, these differences are exacerbated when the limited partners sit on the board of directors of the REIT.¹⁰¹ The limited partners who sit on the board are forced to recognize a fiduciary duty toward the common shareholders, despite their goals as limited partners.¹⁰² Although there has been very little litigation involving UPREITs in a takeover or merger scenario, as UPREITs begin to merge more frequently, the amount of litigation in this area will increase.¹⁰³ The following discus-

¹⁰¹ See discussion *supra* Part II.C.

¹⁰² See, e.g., DEL. CODE ANN. tit. 8, § 141(c) (1991) (noting that a board of directors may not delegate its responsibility to inform stockholders of sale, lease, or exchange of the corporation's assets, or other major changes in the corporation or its bylaws). The fact that board members have fiduciary duties to stockholders is not mentioned explicitly in the statute. It is, however, a concept of corporate governance that fundamentally underlies corporate law. See, e.g., *Arnold v. Society for Sav. Bancorp., Inc.*, 678 A.2d 533, 540 (Del. 1996) ("[C]orporate directors . . . are acting as fiduciaries of the stockholders in managing the business and affairs of the corporation."); *Harden v. Eastern States Pub. Serv. Co.*, 122 A. 705, 712 (Del. Ch. 1923) ("While the corporation is the owner of the assets . . . their control and management rest in the officers and directors, whose relation to the assets is one of a fiduciary character.").

¹⁰³ See, e.g., Erica Copulsky, *Hostile Bid May Alter REIT Industry*, MERGERS & ACQUISITIONS REP., Aug. 26, 1996, available in 1996 WL 11277553 ("We've been expecting hostile bids in the REIT business.' . . . REIT mergers and acquisitions to date have been friendly because of REIT regulations, among other issues, but these unsolicited bids may be the impetus for accelerated consolidation among public REITs." (quoting Paine Webber REIT analyst John Litt)).

There has been only one case that involved an UPREIT in the context of a hostile acquisition: the litigation surrounding Manufactured Home Communities Inc., an UPREIT operating out of Chicago, and its hostile tender offer for Chateau Properties Inc., an UPREIT operating in Michigan. The lawsuit was ultimately dropped by MHC. Briefs submitted by the parties on MHC's motion for a preliminary injunction (seeking to enjoin various takeover defenses instituted by Chateau) discussed the potential conflicts that may arise with UPREITs in hostile acquisitions. See discussion *infra* Part II.E.1-2. For a discussion of the takeover battle that occurred between the two parties, see Copulsky, *supra*; Mitchell Pacelle, *Chateau Sweetens Terms of Merger Plan with ROC, Sues to Halt Sam Zell's Offer*, WALL ST. J., Sept. 19, 1996, at A4; Mitchell Pacelle, *Manufactured Home's Zell to Launch a Hostile Offer for Chateau Properties*, WALL ST. J., Sept. 4, 1996, at A4.

sion analyzes a number of ways in which the limited partners of an UP may find themselves in conflict with the shareholders of a REIT.¹⁰⁴

1. Structure of the Merger/Acquisition Transaction

If a corporate bidder makes an acquisition or merger offer for an UPREIT, the bidder can easily structure the offer to place the interests of the limited partners and the shareholders at odds. An example occurred in September 1996, when an UPREIT, Manufactured Home Communities, Inc. ("MHC"), made a tender offer for another UPREIT, Chateau Properties, Inc. ("Chateau").¹⁰⁵ MHC offered to purchase Chateau shares in exchange for either twenty-six dollars in cash, or for MHC stock, which was valued (at the time of the initial tender offer) at \$21.28 per share.¹⁰⁶ Chateau's shareholders logically favored the twenty-six dollar cash option, as it was worth almost five dollars more per share than the MHC stock. The bifurcated offer, however, placed Chateau's limited partners (who also controlled the Chateau board) in a precarious position.¹⁰⁷ Accepting the cash offer would have meant that the limited partners would have had to recognize capital gain under § 741 in an amount

¹⁰⁴ An important assumption underlying this discussion is that the limited partners in the UP will either be directors of the REIT or will have such a large potential interest in the REIT (through the convertibility of their limited partnership interests) that they will wield considerable influence over the business decisions of the REIT. As discussed *supra*, this is a safe assumption. See discussion *supra* Part II.C.

¹⁰⁵ Both MHC and Chateau are UPREITs and, thus, both are managing partners in umbrella partnerships managed by each respective UPREIT (MHC Operating Limited Partnership and Chateau Properties Limited Partnership, respectively).

¹⁰⁶ See Steven Lipin, *Bidding War Breaks Out for Chateau as Sun Communities Makes Rival Offer*, WALL ST. J., Aug. 22, 1996, at A4 (explaining the offer made by MHC and its valuation).

¹⁰⁷ Prior to MHC's tender offer, Chateau had approximately 6 million shares of outstanding common stock. It also had approximately 8.8 million shares of convertible partnership interests outstanding. Thus, approximately 60% of Chateau's equity was in the form of nonvoting convertible partnership interests, while the remaining 40% was held by common shareholders who did have voting rights. See *id.* ("About 60% of the equity is in the form of [operating partnership units], which carry a potentially bigger tax bill, while 40% is in the form of shares. But only shareholders have voting rights."). Of the 8.8 million partnership interests, Chateau board members owned approximately 4.2 million. See Defendant's Answer and Verified Counterclaims and Third Party Complaint at 17, Chateau Properties, Inc. v. Manufactured Home Communities, Inc., No. WMN-96-2930 (D. Md. Sept. 26, 1996); CHATEAU PROPERTIES, INC., 1994 PROXY STATEMENT, at 3. Thus, if the Chateau board members would have converted their partnership interests into common stock, they would have held approximately 28% of the outstanding Chateau common stock.

equal to the amount of gain they originally deferred under § 721.¹⁰⁸ Industry analysts estimated that if the limited partners were to accept the cash offer they would end up keeping approximately \$19 of the \$26 value, with the remaining portion going to taxes.¹⁰⁹ On the other hand, if the limited partners accepted MHC stock in exchange for their shares, the merger would be tax-free, and the partners could continue to defer their § 351 gains.¹¹⁰ Thus, their personal interests were in direct conflict with the interests of the stockholders. Though it was in the shareholders' interests to accept the cash tender offer, it was in the limited partners' interests to accept the stock swap offer because it would allow the partners to continue to defer their respective shares of § 351 gains.

2. Conversion of Limited Partnership Interests

Another conflict between managers and shareholders which arises in the UPREIT merger/acquisition context, and one which was present in the MHC/Chateau battle, involves the convertibility of the limited partners' interests. The partnership interests held by the limited partners are "limited" and thus non-voting. However, they are also convertible to common shares in the REIT. Conversion of these interests, however, is a taxable transaction.¹¹¹ It would require the partners to recognize gain to the extent that gain was deferred when the partners originally contributed their property to the UP.¹¹² Section 721 allows the limited partners to defer built-in gains at the

¹⁰⁸ I.R.C. § 741 (1994) (noting that gain or loss shall be recognized to the transferor partner in the case of a sale or exchange of an interest in a partnership and will be considered a gain or loss resulting from the sale or exchange of a capital asset); see also Treas. Reg. § 1.741-1 (1996) (explaining the type and character of gain or loss recognized on the sale or exchange of a partnership interest). For further discussion, see *infra* Part II.E.2.

¹⁰⁹ See Vinocur, *supra* note 83, at 34 (explaining the tax ramifications for Chateau board members if they accepted MHC's cash offer for their partnership interests).

¹¹⁰ So-called "stock-swap" mergers are generally tax-free under I.R.C. § 354 (a)(1). The rationale for tax-free treatment in such a reorganization is based on the "continuity of interest" doctrine. See, e.g., Note, *Three-Party Mergers: The Fourth Form of Corporate Acquisition*, 57 VA. L. REV. 1242, 1243 (1971) (explaining the concepts and mechanics of mergers generally and triangular mergers specifically). This doctrine recognizes that when shareholders are exchanging their stock for stock in another corporation, the nature of their investment is not fundamentally changing, as it would be if the shareholders sold their shares for cash. The details of the taxation of shareholders on a merger are beyond the scope of this Comment.

¹¹¹ See *supra* note 82 and accompanying text.

¹¹² See I.R.C. § 741 ("In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner.").

time of contribution by requiring the partners to subtract the amount of deferred gain from their basis in the partnership.¹¹³ If the partners subsequently convert their partnership interests into common stock, they are required to recognize the deferred gain.¹¹⁴

Chateau's response to MHC's tender offer presented an interesting twist to this conversion issue, and an illustration of the power limited partners have over a REIT and its common shareholders. The limited partner-dominated Chateau board¹¹⁵ declined the MHC tender offer in favor of a merger with another UPREIT that allowed the Chateau partners to defer their personal tax liabilities and to transfer those liabilities to the shareholders of the merged entity.¹¹⁶ The effects of such a transaction would clearly not be in the shareholders' interests. First, the transaction would allow continued deferral of § 351 gain,¹¹⁷ even though recognition of these gains would benefit shareholders by stepping-up the company's tax basis in its underlying properties, thus allowing greater depreciation deductions for the UPREIT.¹¹⁸ Second, the continued deferral would cause a higher proportion of the dividends received by Chateau shareholders to be taxable as income or capital gains, rather than

¹¹³ See *id.* § 721.

¹¹⁴ See *id.* § 741 ("Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset . . .").

¹¹⁵ See *supra* note 107 and accompanying text.

¹¹⁶ The net effect of such a transaction is that the limited partners would be able to escape the recognition of built-in gain on property they contributed. The gains would continue to be deferred, but would be transferred to the balance sheet of the merged entity—in effect, becoming the liabilities of the common shareholders. MHC challenged this action in federal court on the grounds that it is a breach of the Chateau director's fiduciary duty. See Defendant's Answer and Verified Counterclaims and Third Party Complaint at 7, Chateau Properties Inc. v. Manufactured Home Communities, Inc., No. WMN-96-2930 (N.D. Md. Sept. 26, 1996). The lawsuit was eventually dropped by MHC after a Maryland district court judge hinted in a temporary restraining order hearing that the court would not be sympathetic to MHC's claims. See discussion *infra* note 172 and accompanying text. The tax details of the transaction are beyond the scope of this Comment, but its validity (with respect to the Tax Code) was not challenged by MHC in the litigation. MHC instead brought the action under a breach of fiduciary duty claim. This transfer of the partners' personal tax liability to the common shareholders would have been an unprecedented transaction in the history of UPREITs and an issue of first-impression (based on representations made in the defendants' counterclaim). See Memorandum of Defendants in Support of Their Motion for a Temporary Restraining Order at 8, Chateau (No. WMN-96-2930).

¹¹⁷ I.R.C. § 351; see also discussion *supra* Part II.B.1.

¹¹⁸ See I.R.C. § 1016(a) (explaining that recognized gains are added to the tax basis of an asset).

non-taxable as returns of capital.¹¹⁹ Third, it would simply be inequitable to allow the limited partners to transfer their personal tax liabilities to common shareholders. If such a transaction were permitted, the limited partners would effectively circumvent the tax laws to the detriment of the common shareholders, even when the partners bear a fiduciary duty to those same shareholders.¹²⁰ The net effect of permitting limited partners to convert their non-voting interests to voting interests is to allow them both the benefits of deferring gains on the contribution of property to a partnership (§ 721), as well as the benefits of attaining voting power in the corporation (through the UPREIT), which normally would not be available unless gain had been recognized on the contributed property. Furthermore, the limited partners would be saddling shareholders with their personal tax liabilities. Thus, allowing such a transaction would be tantamount to allowing the limited partners to realize all of the benefits of the UPREIT, while circumventing the tax rules governing it. Finally, conversion of the partners' interests to common shares would give the partners control in most UPREITs (in Chateau's case, conversion would have given the limited partners sixty percent ownership).¹²¹ This conversion, in turn, ensures the partners' victory in any sort of shareholder vote.¹²²

¹¹⁹ This relates to the REIT not stepping up its basis in the assets and the fact that any REIT distributions to shareholders, in excess of that shareholder's basis in the REIT, are taxable as capital gains (instead of being nontaxable returns of capital). See I.R.C. § 301(c)(3) (stating that the portion of the distribution that exceeds the adjusted basis of the stock is treated as gain from the sale or exchange of property); Treas. Reg. § 1.857-6(a) (1996) ("A shareholder receiving dividends from a real estate investment trust shall include such dividends in gross income for the taxable year in which they are received."); Lipton, *supra* note 25, at 848-49 ("If the distributions in excess of current and accumulated earnings and profits also exceed the shareholder's basis, the excess would be capital gains to the shareholder."). The details, however, are beyond the scope of this Comment.

¹²⁰ Note that the amount of tax liability transferred may or may not be significant. In the case of Chateau, the limited partners sought to transfer approximately \$100 million of deferred gains. See Memorandum of Defendants in Support of Their Motion for a Temporary Restraining Order at 2, *Chateau* (No. WMN-96-2930). As a point of reference, MHC's cash tender offer was valued at approximately \$400 million. See Lipin, *supra* note 106, at A4.

¹²¹ See *supra* note 107 and accompanying text.

¹²² A conversion of this magnitude would cause a REIT to violate the 5/50 rule, thus causing the REIT to lose its favored tax status. However, this would be of no concern to the limited partners if their goal was to terminate the existence of the UPREIT and merge its assets or equity into another entity. See *supra* note 85 and accompanying text.

III. JUDICIAL REVIEW OF UPREITS

The conflicts engendered by the UPREIT structure are a function of the Tax Code. Yet, although these conflicts have their foundation in the tax law, they also affect the fiduciary relationship of the controlling parties and the common stockholders in an UPREIT. A court sitting in review of an UPREIT fiduciary breach case must consider how these conflicts may distort the thinking of an UPREIT board member or majority shareholder. The fact that there are so many possible conflicts in an UPREIT structure demands that a court review the decisions of an UPREIT fiduciary with greater scrutiny than is usually given the actions of a fiduciary in a normal corporate entity. It is therefore useful to summarize the current judicial review doctrines applicable to business organizations generally, before analyzing their applicability to UPREITs specifically.¹²³

A. *Business Judgment*

Courts reviewing corporate litigation are generally very deferential to the business decisions made by a board of directors: "[A] court will not substitute its judgment for that of the board if the [board's] decision can be 'attributed to any rational business purpose.'"¹²⁴ Courts refer to this deference as the "business judgment rule."¹²⁵ The rule provides the "presumption that in making a business decision the directors of a corporation acted on an informed

¹²³ In discussing standards of judicial review, I rely on Delaware precedent, although most UPREITs are incorporated in Maryland. See King, *supra* note 24, at 103 (stating that Maryland is the "current corporate domicile of choice for many REITs"); *MHC Countersuit Names Chateau Properties, ROC*, WALL ST. J., Sept. 26, 1996, at B9 (stating that "virtually all" REITs are incorporated in Maryland). Maryland, however, models its corporate law after that of Delaware. See, e.g., *Grill v. Hoblitzel*, 771 F. Supp. 709, 712 n.3 (D. Md. 1991) (relying on Delaware precedent); *Independent Distributors, Inc. v. Katz*, 637 A.2d 886, 893-94 (Md. Ct. Spec. App. 1994) (same). Because many states are rapidly enacting more favorable REIT legislation, it is likely that newer REITs will file in the state in which they are located. See King, *supra* note 24, at 105 (recognizing that some new REITs are choosing not to incorporate in Maryland, but rather in the state where their principal operations are located). However, because Delaware law continues to be the most persuasive precedent in the state corporate law area, I utilize it in my analysis.

¹²⁴ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

¹²⁵ *Id.*

basis, in good faith and in the honest belief that the action taken was in the best interests of the company."¹²⁶

Although a court is generally deferential to the ordinary business decisions of a board, the factfinder will apply a heightened level of scrutiny when the board takes action in response to a takeover bid: "Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."¹²⁷

When the board takes action in the face of a takeover bid, Delaware courts apply the two-pronged *Unocal* test, which must be satisfied if the board is to be granted business judgment deference.¹²⁸ First, the board must show "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."¹²⁹ This burden is satisfied if the board shows "'good faith and reasonable investigation'" in arriving at its decision.¹³⁰ Proof that the board reasonably perceived a threat is "materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors."¹³¹ Second, the board must satisfy a "proportionality test,"¹³² which requires it to show that its response to a takeover bid was "reasonable in relation to the threat posed" (i.e., a

¹²⁶ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citations omitted). In addition to being a substantive rule of law that grants deference to directors' decisions, the business judgment rule is also a procedural burden-shifting device. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) ("As a *procedural* guide the business judgment presumption is a *rule of evidence* that places the initial burden of proof on the plaintiff."). Plaintiffs challenging a board's decision bear the initial burden of proving that courts should not apply business judgment deference. If the plaintiff successfully rebuts the business judgment rule, the burden then shifts to the directors to establish the "entire fairness" of the transaction. See *id.*

¹²⁷ *Unocal*, 493 A.2d at 954; see also *Bennett v. Propp*, 187 A.2d 405, 409 (Del. 1962) (concluding that in light of the conflict of interest for directors which is inherent in a takeover bid, heightened scrutiny is warranted).

¹²⁸ *Unocal*, 493 A.2d at 955. For a recent and more thorough explanation of the *Unocal* standard, see *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1372 n.9 (Del. 1995).

¹²⁹ *Unocal*, 493 A.2d at 955.

¹³⁰ *Id.* (quoting *Cheff v. Mathes*, 199 A.2d 548, 554-55 (Del. 1964)).

¹³¹ *Id.* An "outside director" is defined by Delaware courts as "a non-employee and non-management director." *Unitrin*, 651 A.2d at 1375. "Independent" is defined by Delaware courts as meaning "that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Aronson*, 473 A.2d at 816.

¹³² *Unitrin*, 651 A.2d at 1373 (emphasis omitted).

proportional response):¹³³ "This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise."¹³⁴ The Delaware Supreme Court recently elaborated on this test in *Unitrin, Inc. v. American General Corp.*, explaining that a board will satisfy the proportionality test if its defensive actions are: (1) not "draconian," (i.e., coercive or preclusive) and (2) are within a range of reasonableness.¹³⁵

The test laid out in *Unocal* should be flexibly applied: "The enhanced judicial scrutiny mandated by *Unocal* is not intended to lead to a structured, mechanistic, mathematical exercise."¹³⁶ In fact, since the Delaware Supreme Court's opinion in *Paramount Communications, Inc. v. Time, Inc.*,¹³⁷ a watershed case in merger and acquisition law, legal practitioners have viewed boards as having broad discretion both in their determinations of whether takeover bids represent threats to corporations and in their responses to these perceived threats.¹³⁸

In *Time*, the Time board rejected a tender offer by Paramount and instead pursued a friendly merger with Warner Brothers. Paramount sued Time, claiming that the actions of Time's board precluded its shareholders from entertaining Paramount's tender offer.¹³⁹ Time's board defended its actions on the grounds that it had carefully considered the opportunity to merge with Warner Brothers and that the Warner Brothers merger represented the best strategic fit for the

¹³³ *Unocal*, 493 A.2d at 955.

¹³⁴ *Id.*

¹³⁵ 651 A.2d at 1383-84, 1386-87. *Unitrin* defines any defensive tactic as "draconian" if it is either "coercive" or "preclusive." *Id.* at 1387. An example of a coercive tactic is when a board "'cram[s] down' on its shareholders a management-sponsored alternative." *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1155 (Del. 1990). A preclusive tactic is when a board takes action that entirely prevents some form of shareholder action (for example, a shareholder vote, a proxy fight, a bidder's ability to make a tender offer, or a shareholder's group to tender their shares). *See id.*

¹³⁶ *Unitrin*, 651 A.2d at 1373.

¹³⁷ 571 A.2d 1140 (Del. 1990).

¹³⁸ *See, e.g.*, Melissa M. Kurp, *Corporate Takeover Defenses After QVC: Can Target Boards Prevent Hostile Tender Offers Without Breaching Their Fiduciary Duties?*, 26 LOY. U. CHI. L.J. 29, 40 (1994) ("In *Paramount Communications, Inc. v. Time, Inc.*, the Delaware Supreme Court reintroduced the discretion given to target boards as exemplified in *Unocal*." (citations omitted)); Schwartz et al., *supra* note 7, at 455-56 ("The Delaware Supreme Court's opinion, which upheld Time's revised merger agreement with Warner and therefore precluded Time shareholders from accepting Paramount's tender offer . . . constitutes an unequivocal endorsement of director prerogatives.").

¹³⁹ *Time*, 571 A.2d at 1142.

Time corporation.¹⁴⁰ Because this type of rationale for rejecting a tender offer is rather generic (in the sense that any board could defend an action by saying the board acted for "strategic reasons"), it is often referred to as a "Just Say No" defense.¹⁴¹

The Delaware Supreme Court's opinion in *Time* reinforced the primacy of the business judgment rule in corporate law. Only in limited circumstances will a court inquire into the business decisions of a corporate board.¹⁴² Thus, any litigation concerning the business decisions of corporate fiduciaries is very likely to be reviewed under the business judgment rule.

B. *Entire Fairness*

In situations where certain conflicts of interest exist between a board or controlling shareholder and the common shareholders, a court will apply the entire fairness standard, a much stricter standard of review than the business judgment rule.¹⁴³ Entire fairness only applies when there is an actual conflict. There must be some evidence that the fiduciaries took some type of action which was not in the best interests of the shareholders. The court will presume that as a result of those conflicts, the decisions made by the fiduciary were

¹⁴⁰ See *id.* at 1144-45. "The primary concern of Time's outside directors was the preservation of the 'Time Culture.' [The directors] believed that Time had become recognized in this country as an institution built upon a foundation of journalistic integrity . . . [and] feared that a merger with an entertainment company would . . . threaten the Time Culture." *Id.* at 1143 n.4.

¹⁴¹ See, e.g., Daniel A. Dreisbach & Catherine G. Wagner, *The Right of the Target's Board to 'Just Say No' in Delaware*, INSIGHTS, March 1996, at 25, 25, available in LEXIS, News Library, Insite File (discussing the Delaware District Court's opinion in *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*, 898 F. Supp. 1089 (D. Del. 1995), and stating that "the court reaffirmed the right of a target's board to reject a hostile bid, i.e. the 'just say no' defense"); Schwartz et al., *supra* note 7, at 487 (discussing the development of the "Just Say No" cases); Patricia A. Vlahakis, *"Just Say No" Made Easier: Lessons in "Just Saying Yes"*, 1990 INST. ON SEC. REG. 331, 333 ("In [*Time*], the Delaware Supreme Court has reaffirmed the primacy of the Board of Directors . . . and has rejected the 'let the stockholders decide' refrain of the 1980's.").

¹⁴² See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("[T]he business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments.").

¹⁴³ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."); see also *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1115 (Del. 1994) ("A controlling or dominating shareholder standing on both sides of a transaction . . . bears the burden of proving its entire fairness.").

more likely to be affected by bias.¹⁴⁴ Because of the greater likelihood that a breach of fiduciary duty occurred, courts will scrutinize the fiduciary's decision.¹⁴⁵ Instead of deferring to the business judgment of the board, the court places the burden on the board to prove the "entire fairness" of the transaction: "The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."¹⁴⁶

The entire fairness test includes two prongs: fair dealing and fair price.¹⁴⁷ Fair dealing relates to how a transaction was initiated, the timing of the transaction, and how approvals of the action taken by the board or shareholders were obtained.¹⁴⁸ Fair price relates to the "economic and financial considerations" of the proposed transaction.¹⁴⁹ An analysis of fair price is broad in scope, "including all relevant factors."¹⁵⁰

The independence of a board is extremely important if its decisions are to survive entire fairness review. If a court determines that a transaction was approved by a vote of independent directors or shareholders, the decision will likely survive entire fairness scrutiny.¹⁵¹

¹⁴⁴ See *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 502 (1990) (explaining the policy rationale for application of the entire fairness standard within the factual context of merger transactions).

¹⁴⁵ See *Weinberger*, 457 A.2d at 710. A common scenario involving a controlling shareholder and its fiduciary duty towards minority shareholders is the parent-subsidiary relationship. In *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971), shareholders of a subsidiary alleged, inter alia, that the parent corporation was forcing the subsidiary to pay out excessive dividends, causing corporate waste. Because the parent corporation stood on both sides of the dividend transaction (it was a fiduciary and also had a personal interest in maximizing the amount of dividends it received), the court held the issuance of dividends amounted to "self-dealing" and applied the entire fairness standard. "Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." *Id.* at 720.

¹⁴⁶ *Weinberger*, 457 A.2d at 710.

¹⁴⁷ See *id.*

¹⁴⁸ See *id.*

¹⁴⁹ See *id.*

¹⁵⁰ *Id.*

¹⁵¹ See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1117 (Del. 1994) ("[A]n approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.").

A court, however, will scrutinize whether the vote was truly "independent."¹⁵²

C. Blasius/Schnell—Implicating Shareholder Voting Concerns

When the actions of a corporate board affect the shareholders' right to vote, courts are likely to apply an intermediate level of scrutiny—somewhere between business judgment and entire fairness. The first Delaware case to address substantially shareholder voting rights was *Schnell v. Chris-Craft Industries, Inc.*¹⁵³ In that case, the Chris-Craft board attempted to advance the date of a shareholder meeting from a date set in the bylaws of the corporation to prevent a dissident shareholder group from waging a proxy contest.¹⁵⁴ The court stated: "In our view . . . management has attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office. . . . These are inequitable purposes, contrary to established principles of corporate democracy."¹⁵⁵

Subsequent to *Schnell*, a number of decisions analyzed whether a specific action taken by a board was "inequitable," and therefore invalid.¹⁵⁶ The next major doctrinal development came in *Blasius Industries v. Atlas Corp.*¹⁵⁷ *Blasius* involved a hostile takeover attempt by Blasius. After Atlas rejected a proposal by Blasius that called for a leveraged restructuring, Blasius commenced a consent solicitation to amend Atlas's bylaws and increase the size of the Atlas board, which

¹⁵² *Id.* Delaware courts have accepted a two-prong test to determine whether an "independent vote" is really "independent": "The mere existence of [independence] . . . does not itself shift the burden First, the majority shareholder must not dictate the terms of the merger. Second, the [independent party] must have real bargaining power that it can exercise with the majority shareholder on an arms length basis." *Rabkin v. Olin Corp.*, 16 DEL. J. CORP. L. 851, 861-62 (1990) (citations omitted), *aff'd*, 586 A.2d 1202 (Del. 1990).

¹⁵³ 285 A.2d 437 (Del. 1971).

¹⁵⁴ *See id.* at 439.

¹⁵⁵ *Id.*

¹⁵⁶ *See, e.g.*, *Phillips v. Insituform of N. Am., Inc.*, 13 DEL. J. CORP. L. 774, 792-94 (Del. Ch. 1987) (invalidating bylaw amendments intended to prevent the majority stockholder from taking control of corporation); *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906, 914 (Del. Ch. 1980) (holding that the board's manipulation of by-laws governing the annual shareholders' meeting was designed to prevent a dissident group from participating in a proxy contest); *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975) (enjoining management's attempt to use corporate funds to purchase stock to maintain its control of corporation).

¹⁵⁷ 564 A.2d 651 (Del. Ch. 1988).

would then be filled with Blasius nominees.¹⁵⁸ Atlas's board responded by amending the bylaws to increase the size of the board, but then filled the positions with its own representatives.¹⁵⁹ The Atlas board conceded that the effect of its actions was to preclude the Blasius group from gaining majority representation on the board.¹⁶⁰

The Delaware Chancery Court held that, although the Atlas board had "acted in good faith"¹⁶¹ and in response to a valid "threat" by the Blasius group,¹⁶² the board's actions violated the duty of loyalty it owed to the shareholders.¹⁶³ The court chose not to apply neither the business judgment rule nor *Unocal's* standard of review, but applied a form of closer scrutiny: "Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. . . . [I]t may not be left to the [board's] business judgment."¹⁶⁴

The court went on to develop what has come to be known as the *Blasius* standard of review: "In . . . cases dealing with . . . board acts done for the primary purpose of impeding the exercise of stockholder voting power . . . the board bears the heavy burden of demonstrating a compelling justification for such action."¹⁶⁵

Though academics and practitioners have generally treated *Blasius* as establishing a separate and distinct standard of review,¹⁶⁶ Delaware courts have sought to construe *Blasius* as invoking a standard of review similar to *Unocal*.¹⁶⁷ The courts have also emphasized

¹⁵⁸ See *id.* at 654.

¹⁵⁹ See *id.* at 655.

¹⁶⁰ See *id.* at 656.

¹⁶¹ *Id.* at 658.

¹⁶² *Id.*

¹⁶³ See *id.* at 663.

¹⁶⁴ *Id.* at 660.

¹⁶⁵ *Id.* at 661.

¹⁶⁶ See, e.g., Andrew C. Houston, *Blasius and the Democratic Paradigm in Corporate Law*, 17 DEL. J. CORP. L. 843, 855 (1992) (analyzing *Blasius* as promulgating a distinct standard of review "drastically" altering the traditional approach taken by Delaware courts, which have been loath to "adopt any limiting construction of directorial powers"); Irwin H. Warren & Kevin G. Abrams, *Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests*, 47 BUS. LAW. 647, 655 (Feb. 1992) (describing the "compelling justification" test invoked under *Blasius* as "the *Blasius* inquiry" and "separate from the *Unocal* proportionality standard"); Gregory S. Schaer, Comment, *Blasius Industries, Inc. v. Atlas Corp.: Closer Scrutiny of Board Decisions Under the "Compelling Justification" Standard*, 16 DEL. J. CORP. L. 639, 641 (1991) ("[E]xploring the scope and implication of this new standard of judicial review.") .

¹⁶⁷ See, e.g., *Hubbard v. Hollywood Park Realty Enter.*, 17 DEL. J. CORP. L. 238, 253 (Del. Ch. 1991) ("Conceptually speaking, *Blasius* breaks no new ground . . ."); *Stahl v.*

their desire not to promulgate per se rules regarding board action vis-à-vis shareholders and that the standard of review utilized by the court in *Unocal* or *Blasius* should not be determinative.¹⁶⁸

IV. WHY UPREITS MAY REQUIRE GREATER JUDICIAL SCRUTINY

Because the UPREIT structure is unique, the application of a standard of review is more complex than when a court is dealing with a more typical corporate entity. Furthermore, because there has been so little litigation involving UPREITs, there has been no real discussion of which standard is most appropriate.¹⁶⁹ The only Maryland litigation dealing with UPREITs in a takeover scenario was *Chateau v. MHC*.¹⁷⁰ Although the Maryland District Court never handed down

Apple Bancorp, Inc., (Stahl II), [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,412, at 97,031, 97,036 (Del. Ch. Aug. 9, 1990) (comparing *Unocal* and *Blasius* and stating that "these tests are structurally similar and may . . . be functionally similar as well"); Stahl v. Apple Bancorp, Inc., (Stahl I), 579 A.2d 1115, 1122 (Del. Ch. 1990) ("*Blasius*" reference to 'compelling justification' reflects only the high value that the prior cases had placed upon the exercise of voting rights It [does not] represent new law."); Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 286 (Del. Ch. 1989) ("[Under] *Blasius*, the 'heavy burden' imposed upon defendants was not a new standard apart from *Unocal*. Rather, it was a specific expression of the proportionality test as applied to conduct that effectively precluded the election of directors.").

¹⁶⁸ See, e.g., Stahl II, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,036 ("[C]hoice of a form of judicial review between [*Unocal* and *Blasius*] is probably not decisive of anything."); Stahl I, 579 A.2d at 1125 ("[I]nquiries concerning fiduciary duties are inherently particularized and contextual. It is probably not possible to work out rules that will be perfectly predictive of future cases involving claimed impediments to the shareholder vote."); see also Hubbard, 17 DEL. J. CORP. L. at 257 ("[T]he case-by-case development of the law governing fiduciary obligations [is] a process that is integral to our common law tradition.").

¹⁶⁹ The most recent case decided in Maryland involving REITs was analyzed under the business judgment rule. See Realty Acquisition Corp. v. Property Trust of Am., No. CIV.JH-89-2503, 1989 WL 214477, at *3 (D. Md. Oct. 27, 1989). Realty Acquisition involved two REITs, not UPREITs, in a hostile takeover situation. The litigation centered on Property Trust's adoption of a poison pill. The court reviewed the case under the business judgment presumption as if the REITs were normal corporations: "In Maryland . . . [t]he conduct of the corporation's affairs [is] placed in the hands of the board of directors and if the majority of the board properly exercises its business judgment, the directors are not ordinarily liable." *Id.* (quoting Mountain Manor Realty, Inc. v. Buccheri, 461 A.2d 45, 51 (Md. Ct. App. 1983)). Neither this case nor earlier Maryland cases dealing with REITs are helpful for our purposes, because the basic REIT structure does not engender the potential conflicts of interest created by the UPREIT structure. If these REIT cases reveal anything, it is that a court will apply the business judgment presumption broadly, without taking into account (at least in the written opinion) the specific nuances of the REIT/UPREIT structure.

¹⁷⁰ See discussion *supra* Part II.E.1-2.

any formal opinions on the litigation,¹⁷¹ the court strongly hinted that the ordinary business judgment standard of review should be applied to UPREITs.¹⁷² Considering the numerous conflicts of interest that the UPREIT structure engenders, however, this would very likely have been the wrong standard of review to apply.

Based on the number of potential conflicts inherent in UPREITs,¹⁷³ a more rigorous standard of review may be more often applicable to UPREITs than it would be to non-UPREIT corporations. Yet, the conflicts found in an UPREIT only make a conflict of interest situation more likely than it would be in a normal corporate structure. As with any conflict, they are potential until they are catalyzed by a specific transaction or decision.¹⁷⁴

Because it would be impossible to enact a specific standard of review for UPREITs in every scenario, the problem arises as to when the courts should apply a form of stricter scrutiny. Perhaps courts should begin with a general conceptual analysis of why UPREITs may require a stricter form of scrutiny than do other corporations. This analysis would provide the foundation for a court to realize why a standard stricter than business judgment may be applicable to UPREITs more often than to typical corporations.

The following discussion examines a number of conceptual reasons for applying a stricter form of scrutiny to UPREITs more frequently than to typical corporations. There is no hard-and-fast approach or rationale that will be equitable in every situation. Also, a certain level of scrutiny should not be outcome-determinative,¹⁷⁵

¹⁷¹ The lawsuit was eventually dropped by MHC. *See supra* note 103.

¹⁷² During a hearing on a motion for a temporary restraining order, the court stated: "Then there is the matter of considering whether [MHC]'s claims are likely to succeed on the merits. This hasn't been argued, but was in the papers with respect to the business judgment rule, and I think that is a substantial factor that clearly supports Chateau." Transcript From MHC's Motion for Temporary Restraining Order Hearing at 68, Chateau Properties, Inc. v. Manufactured Home Communities, Inc., No. WMN-96-2930 (D. Md. Sept. 26, 1996).

¹⁷³ *See* discussion *supra* Part II.C-E.

¹⁷⁴ What separates UPREITs from normal corporations is the much greater likelihood that conflicts of interest will occur. The basic structure of an UPREIT places the interests of limited partners at odds with the interests of the shareholders in numerous situations. *See* discussion *supra* Part II.C-E. This is not to say, however, that such conflicts will arise in every UPREIT transaction.

¹⁷⁵ *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995) ("[A]n initial judicial determination that a given breach of a board's fiduciary duties has rebutted the presumption of the business judgment rule... is... not outcome-determinative *per se*").

though in practice it often is.¹⁷⁶ In corporate litigation, the application of entire fairness or *Blasius*-like review sends strong signals that the decision of the board will face a difficult battle in court. In the context of UPREITs, application of the business judgment rule would bode well for the interests of the limited partners (especially when these individuals sit on the board of the REIT),¹⁷⁷ whereas stricter standards of review would likely signal success for the common stockholders.

In a practical sense, the relevant question as to what standard of review is most appropriate becomes a question of who the court should favor—the limited partners (who were responsible for contributing real estate to the UPREIT in order to realize personal tax advantages) or the common shareholders. The answer to this question is unclear and will vary, depending on the circumstances. What is apparent, however, is that courts need to recognize the complexities of the UPREIT structure and the greater likelihood that the decisions of a REIT board will require more scrutiny and less deference than the business judgment rule dictates.

A. Policy Behind the Creation of REITs and UPREITs

A court reviewing UPREIT litigation should first look at the purposes that compelled Congress to create REITs and allow the evolution of UPREITs. The tax laws which brought REITs into existence were enacted as a means to get small, middle-class investors involved in real estate investment.¹⁷⁸ These laws, which govern a basic REIT structure (not an UPREIT), have been kept substantially the same, while the basic structure and use of the REIT has undergone radical transformation.¹⁷⁹ Although Congress may not have had the UPREIT

¹⁷⁶ See *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) ("Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of [the] litigation.").

¹⁷⁷ See discussion *supra* Part II.C (discussing the prevalence of UP limited partners being elected to the board of the related REIT).

¹⁷⁸ See Haft & Fass, *supra* note 10, § 16.01, at 16-4 to -5 ("REITs were authorized . . . as a way for small investors to realize the financial benefits of real estate investments, previously available only to institutions and wealthier individuals."); McCarthy, *supra* note 41, at 14 ("REITs were created in 1960 by tax law changes to encourage investor participation in real estate.").

¹⁷⁹ While UPREITs have become the dominant form of REIT, the tax laws governing REITs have not substantially changed to reflect this evolution. As discussed

structure in mind when it passed laws allowing the basic REIT structure in 1960, courts must still bear in mind Congress's intent in creating the REIT structure and why it has not outlawed the UPREIT structure—to create incentives through tax subsidies for small investors to invest in real estate.¹⁸⁰

With the congressional policy underlying REITs in mind, a court should also take note of the types of individuals that make the controlling decisions of the UPREIT. UPREITs are generally controlled by "insiders"—limited partners in the UP who contributed their property to the partnership.¹⁸¹ These individuals originally joined the UPREIT for tax advantages. But, as "insiders," they also owe a fiduciary duty to the non-controlling shareholders.¹⁸² It is fair to assume that many of these individuals are experienced real estate investors, not the small-time investors REIT legislation was enacted to help. The fact that the sponsors had the knowledge and wherewithal to form and organize the UPREIT, as well as the fact that they held property in an individual capacity prior to forming the UPREIT, supports this assumption.

The motivations behind these "insiders" in forming UPREITs often lie in the various advantages that accrue to the insiders individually, such as relieving themselves of personal liability and deferring taxable gain. The motivations generally do not include aiding the cause of small investors.¹⁸³ The tax advantages sought by property contributors are legitimate vis-à-vis the Tax Code, but they arise out of the personal economic interests of the partners, not the fiduciary duty these individuals owe the stockholders. The fact that these individuals are in positions where they can make decisions that further their individual economic interests should weigh heavily in a

supra Part II.B, UPREITs differ from basic REITs in several significant ways—allowing investors essentially to circumvent the laws governing REITs. See, e.g., discussion *supra* Part II.B.3 on avoiding the "5/50 Rule." Congress, however, as evidenced by its inaction, has tacitly chosen to accept the UPREIT structure, at least for the time being.

¹⁸⁰ See *supra* note 11 and accompanying text.

¹⁸¹ In most UPREITs, the limited partners sit on the board of the managing partner REIT. Even when limited partners do not sit on the board, the limited partners wield considerable power over the strategic direction and decisions made by the REIT. See discussion *supra* Part II.C.

¹⁸² See *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1113 (Del. 1994) ("This Court has held that 'a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.'" (emphasis added) (quoting *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987))).

¹⁸³ See discussion *supra* Parts II.B, III.B.

court's consideration of whether the decisions of these individuals are consistent with the policy reasons behind the passage of the original REIT laws, and also with the fiduciary duties those individuals owe to the other shareholders.

B. Formalistic Interpretation of the UPREIT Structure

In addition to the congressional policy reasons for creating REITs, a court should also focus on the conceptual nature of the UPREIT structure without getting too caught up in the complicated Tax Code provisions. The core problem UPREITs pose concerns the two different types of parties that vie for control of the UPREIT in a merger or acquisition scenario. In simple terms, UPREITs involve both a partnership (the UP) and a corporation (the publicly held REIT which manages the UP).¹⁸⁴ This structure is complicated by the fact that the partners in the UP can convert their partnership interests to common stock in the corporate REIT.¹⁸⁵ Thus, in the UPREIT structure, a court is looking at two very different types of common shareholders: the common shareholders who purchased stock in the equity markets, and the common shareholders who received the stock by converting their limited partnership interests.

This dichotomy can be analyzed in a purely formalistic manner: Who owns the most stock? Whichever "type" of shareholder owns more of the common stock should be entitled to more favorable board decisions. If seventy percent of the common stock is owned by individuals who converted their partnership interests, then one could argue that the board's decisions should benefit these individuals—presumably, transactions that would allow the one-time partners to continue to defer the recognition of income on the properties they contributed. By contrast, if seventy percent of the stock is owned by individuals who simply purchased the stock in the open market in hopes of dividends and share appreciation, the board's decisions should reflect the wishes of these stockholders.

This approach is founded on the logical premise that, were every business decision of an UPREIT put to a shareholder vote, the group that owned the majority of the shares would always be able to put its

¹⁸⁴ See *supra* Part II.A.

¹⁸⁵ See *supra* Part II.C.

interests above those of the minority group. Such democratic principles underlie the foundations for all of corporate law.¹⁸⁶

This formalistic approach is problematic, however, in that controlling shareholders still owe the minority a fiduciary duty.¹⁸⁷ A controlling group of shareholders does not have the right to wield its power in a manner that causes discriminatory effects among shareholders.¹⁸⁸ A court following a purely formalistic approach to analyzing the UPREIT structure would be sanctioning such behavior. Although a formalistic approach is useful in the sense that it forces a reviewer to take a simplified overview of the UPREIT structure, it does not provide sufficient justification for a court to ignore the interests of the minority shareholders.

C. Shareholder Expectations

Judicial review of UPREIT litigation could also take into account the expectations of the two different types of UPREIT shareholders. The individuals who are initially limited partners, before converting their interests, presumably are well aware of the complex tax advantages that the UPREIT structure gives them because these are usually the individuals who organize and form the UPREIT. Assuming they are aware of the tax advantages, they are also likely to be aware of the potential conflict between their interests and the interests of the common shareholders. In contrast, many of the common shareholders who purchase their REIT shares in the open market are probably not aware of the complexities of the UPREIT structure, at least not to the extent the limited partners are.

One could argue that a shareholder should bear the risk when she voluntarily makes an informed purchase of any investment

¹⁸⁶ See *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. . . . [I]t is clear that [the shareholder vote] is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.").

¹⁸⁷ However, the controlling shareholders must hold a majority of the shares. See *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987) (holding that controlling shareholders owe a fiduciary duty to minority shareholders).

¹⁸⁸ See *id.*; *Singer v. Magnavox Co.*, 380 A.2d 969, 975 (Del. 1977) ("It is a settled rule of law in Delaware that . . . the majority stockholder . . . owe[s] to the minority stockholders of the corporation a fiduciary obligation in dealing with the latter's property."); see also *supra* note 145 (discussing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971)).

vehicle, even an exotic vehicle like an UPREIT.¹⁸⁹ This risk assumption may be true with respect to the risk that the company will underperform the market. However, the investor should not be forced to assume the risk that the company's board will ignore the its fiduciary duties or act against the shareholders' interests. Investors purchasing shares in a REIT are entitled to the presumption that, because they are shareholders, the directors representing their rights as shareholders will be making decisions that are in the shareholders' best interests.¹⁹⁰

In analyzing shareholder expectations, a court should also recognize the effects of the limited partners becoming shareholders through their convertible partnership interests.¹⁹¹ This convertibility feature has two effects in relation to the expectations of the other shareholders. First, shareholders purchasing REIT shares in the

¹⁸⁹ An argument could be made that the Efficient Capital Market Hypothesis ("ECMH") mitigates the need to protect shareholders from the UPREIT's complexities. The ECMH posits that efficient capital markets are those in which "prices at any time 'fully reflect' all available information." Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970). See generally RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 135-81 (1995) (explaining the underpinnings and limitations of the ECMH through a survey of current academic articles). If this were the case, the argument could be made that the risks inherent in the UPREIT are already incorporated into the current market prices of UPREIT securities. Therefore, added protection for shareholders through greater public disclosure or enhanced judicial scrutiny would be unnecessary, or significantly less so, based on the fact that the UPREIT's market values have already been adequately discounted for their added risk to shareholders.

The basic premise of the ECMH, that prices reflect information, has generally been accepted by both the economic and legal academic communities. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549-50 (1984) (recognizing that the ECMH is "the context" for debating corporate and securities law and policy). However, the extent to which markets are truly efficient has been, and continues to be, a matter of heated debate. See generally Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546, 549 nn.8-9 (1994) (providing an extensive list of academic articles that have challenged the validity of the ECMH). At the very least, there is widespread empirical evidence that there are factors besides the ECMH at work in the securities markets. See Leslie P. Norton, *The Outliers: Refusing to Run with the Herd Can Be Dangerous, but Can Pay Off*, BARRON'S, May 20, 1996, at 43 (recognizing that the ECMH has failed to explain a number of significant anomalies in the stock market's behavior). In the case of UPREITs, their relatively recent introduction into the securities and mergers and acquisitions markets, as well as to the tenets of corporate law, cautions against depending entirely on the ECMH as a protection for REIT shareholders. Pursuing the applicability of the ECMH to UPREITs is beyond the scope of this Comment.

¹⁹⁰ See *supra* note 126 and accompanying text.

¹⁹¹ See discussion *supra* Part II.C.

market may not understand the shareholder composition of the UPREIT. A shareholder would have no reason to expect that when she purchases REIT shares she could be joining other REIT shareholders who have conflicting economic interests. It would be tremendously unfair to a shareholder if she were to buy into a REIT controlled by individuals who were once limited partners in the UP and who intend to manage the UPREIT to promote their individual tax interests.

Second, there is the potential that limited partners can, on conversion of their interests, transfer their personal tax liability to the shareholders.¹⁹² Such a transaction was proposed in the *Chateau v. MHC* battle, where the Chateau board recast a merger agreement to allow the limited partners to convert their non-voting partnership interests and pass on the partners' personal tax liability to the other common shareholders of the merged entity.¹⁹³ Not only would this transaction have saddled shareholders with an unexpected tax liability, it would also have given the partners enough voting power to ensure that they would have prevailed in any shareholder vote.¹⁹⁴ In *Chateau*, such a transaction would have allowed the insiders to defeat the other shareholders in a vote to approve a stock-swap merger, which benefited the insiders and to reject MHC's higher-value cash tender offer, which was worth more to the common shareholders.¹⁹⁵ The economic surprises a REIT board could impose on investors should be an important factor in a court's analysis. The fact that the UPREIT form makes these transactions possible should be a strong reason for courts to scrutinize the decisions of an UPREIT, especially in contexts similar to the *Chateau v. MHC* takeover contest.

D. Economic Interpretation of the UPREIT Structure

A court should also consider the potential economic effects of ignoring the inherent conflicts of the UPREIT. Judicial opinions which allow REIT boards to run roughshod over the interests of

¹⁹² See discussion *supra* Part II.E.

¹⁹³ See discussion *supra* Part II.E.

¹⁹⁴ The limited partners' convertible interests could also deter shareholder action. Shareholders who realize that the limited partners have the power to convert their interests and become controlling shareholders might think twice before voting in a way adverse to the interests of the limited partners. This deterrent effect is exacerbated if shareholders realize the possibility of having to bear the personal tax liabilities of the individual partners. See discussion *supra* Part II.E.2.

¹⁹⁵ See *supra* note 107 and accompanying text.

common shareholders will make it difficult for UPREITs to attract potential investors.¹⁹⁶ This is dangerous because public offering dollars are especially important to UPREITs. As the managing partner of the UP, it is the REIT's role to contribute cash to the UP during the initial formation phase. The limited partners initially contribute real estate properties; however, future real estate acquisitions require cash. This need for cash, in light of the primarily illiquid assets of the UPREIT, necessitates the raising of capital, usually through the public market.¹⁹⁷ Thus, the success of an UPREIT in the equity markets and a good reputation among equity investors are vital to its existence.¹⁹⁸

V. EFFECT OF GREATER JUDICIAL SCRUTINY ON JUDICIAL REVIEW

If courts give UPREITs greater scrutiny without creating an entirely separate doctrinal framework, they are left with the problem of fitting this scrutiny within the confines of accepted corporate law doctrines.¹⁹⁹ This would raise the obvious question of whether litigation involving UPREITs should automatically trigger stricter scrutiny. The answer is "no." There is no need for a court to abandon the burden-shifting and procedural guidance that the business judgment

¹⁹⁶ See, e.g., Scherrer, *supra* note 46, at 42 ("Management's ability to meet projections and avoid conflicts of interest with the REIT are critical to raising capital and minimizing the cost of the capital.").

¹⁹⁷ See, e.g., *id.* at 44 ("Since REITs cannot retain capital for growth [because of the 95 percent dividend distribution requirement], they are forced to offer stock on the public market or issue debt. Offering stock on the public market is the preferred method for raising capital, since REIT success is based on leverage aversion."); Lipton, *supra* note 25, at 832 ("Because the traditional sources of capital for real estate have dried up, it has been necessary for real estate owners and developers to find alternative capital One of the few potential sources for such capital is the public securities markets").

¹⁹⁸ Some industry analysts predict that the conflicts of interest within the UPREIT structure will harm UPREITs in the equity offering markets: "The UPREIT structure adds a level of complication to the corporate governance that, over the long run, will prove a disadvantage A clean, simple ownership structure, with limited conflicts [of interest], should achieve a pricing advantage over the more complicated UPREITs." McCarthy, *supra* note 41, at 16 (quoting Rodney Dimock, Executive Vice President Cornerstone Properties). But see Copulsky, *supra* note 103 ("In the past, [e]ntrepreneurial REIT sponsors . . . never viewed the process of going public in terms of fiduciary responsibility to shareholders. REITs today have a much more corporate view, and are much more sensitive to the interests of shareholders.").

¹⁹⁹ See discussion of Delaware's doctrinal approach to the business judgment rule and entire fairness review, *supra* Part III.

rule provides²⁰⁰ simply because an UPREIT is involved. It would be a mistake, doctrinally and pragmatically, to urge the default application of a certain standard of review solely because litigation involves an UPREIT.

Delaware courts consistently have emphasized that corporate litigation is meant to be reviewed on a case-by-case basis.²⁰¹ Standards of review are neither meant to be outcome-determinative²⁰² nor meant to be applied on a *per se* basis to a specific type of corporate entity.²⁰³ In a situation that does not involve a conflict, it would be doctrinally incorrect for a court to apply a different standard of review just because the entity involved is an UPREIT. A court should proceed under the procedural framework that has evolved in the case law.²⁰⁴ If a plaintiff alleging a breach of fiduciary duty cannot prove that a REIT board stands on both sides of a transaction,²⁰⁵ or that a board has acted for the primary purpose of interfering with stockholder voting rights,²⁰⁶ then the business judgment presumption should be applied.

It is also impractical to urge the creation of an entirely separate set of judicial doctrines specifically for UPREIT litigation. UPREITs, although gaining in popularity, are still relatively rare when compared to the number of typical corporate entities.²⁰⁷ It would not be practicable to call for an exclusive "UPREIT standard of review" when the courts have not done so for other quasi-corporate entities such as S corporations, limited liability corporations, and REITs.²⁰⁸ The potential conflicts of the UPREIT also do not necessarily adversely affect other shareholders' interests.²⁰⁹ They may be irrelevant to the

²⁰⁰ See *supra* note 126 and accompanying text.

²⁰¹ See *supra* note 168 and accompanying text.

²⁰² See *supra* notes 175-76 and accompanying text.

²⁰³ See *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 662 (Del. Ch. 1988) ("[O]ur inability to foresee now all of the future settings in which a board might, in good faith, paternalistically seek to thwart a shareholder vote, counsels against the adoption of a *per se* rule.").

²⁰⁴ See discussion *supra* Part III.

²⁰⁵ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

²⁰⁶ See *supra* note 165 and accompanying text.

²⁰⁷ See, e.g., Johnson, *supra* note 2 (listing the number of registered REITs at 210 with a market capitalization of \$60.9 billion).

²⁰⁸ See *supra* Part III.C.

²⁰⁹ See *supra* note 174 and accompanying text.

litigation before the court, or they may not exist at all.²¹⁰ A court will need to examine the facts within their context.

The fact that a case involves the decision of an UPREIT should not change the fundamental application of accepted doctrine. What should change is the court's attention to the specifics of the transactions under review, due to the increased likelihood that a REIT board's decisions may not have been in good faith with respect to the shareholders who purchased their shares in the public market. This is not to say that an UPREIT's decisions can never be made in good faith; however, if insiders dominate the board and own the majority of the REIT stock, there is a substantially greater likelihood that the board is considering the interests of those insiders first, to the detriment of the other shareholders the REIT structure was created to help. A court should recognize, before applying the relevant doctrinal framework, that the UPREIT is a special type of corporation, one that must be adequately understood, before the conflicts involving the structure and its owners can be analyzed.

CONCLUSION

As UPREITs continue to grow in both property holdings and investor popularity, litigation concerning UPREITs and their various equity holders will increase. Thus far, courts have shown a propensity to treat these creatures as they would any other corporation—deferring to the business judgment of fiduciaries unless the plaintiff presents enough evidence to switch the burden and trigger heightened review. This default assumption concerning the similarity between UPREITs and other corporations is conceptually unwarranted, and is harmful to the interests of the common shareholders—the individuals the law in this area should be most concerned with protecting.

²¹⁰ See *supra* note 174 and accompanying text.

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