

## Activist Investors Seeking REIT Spinoffs After IRS Change

By **Andrew McIntyre**

*Law360, Los Angeles (February 26, 2015, 2:29 PM ET)* -- As shareholder activists increasingly set their sights on real estate investment trusts, they are also targeting companies that may have REIT-eligible assets and pressuring boards to use the IRS' broadening definition of real property to unlock additional value through spinoffs.

While many REITs have skyrocketed and others have posted less-than-stellar results, activist investors are increasingly looking to the latter category, seeking to place new members on boards.

"The conventional wisdom was that REITs were not fertile ground for activists. It's hard to find a REIT that has an undiscovered pot of gold in the backyard," said Yoel Kranz of Goodwin Procter LLP. "The run-up in REITs over the last few years has really put a spotlight on those REITs that are underperforming."

But activists are also targeting companies that may be able to spin off assets into REITs to maximize shareholder value, following the IRS' recent broadening of the definition of real property for REIT purposes.

"If [companies] are underperforming, that's where [activists] can see the opportunity," said Michael L. Hermsen of Mayer Brown LLP. "One way to do that is to spin off their real estate assets into a REIT."

Such transactions can help companies lower their corporate income taxes because REITs, which by definition distribute at least 90 percent of their taxable income to shareholders, don't pay corporate income tax on those distributions.

And proposed IRS regulations issued last summer advising that assets like wiring, billboards and data centers can qualify as real property for REIT purposes have given activist investors something to chew on, lawyers say.

The IRS guidance "expands the universe of companies that [activists] might be able to try to encourage to take some steps in this regard," Hermsen said. "To that extent, what the IRS has done lets them get into other areas."

REITs, though, have historically been a difficult target for activists. For one, they have ownership restrictions that limit how much of the company any one individual can own.

And lawyers also say the fact that most are incorporated in Maryland, what Kranz calls a "board-friendly state," makes them more difficult targets for activists.

But thanks in part to a savvy group of investors, that's changing.

"You're getting activists today who are sophisticated. People who understand the business," Kranz said. "When one guy is agitating and nobody else thinks that there's value in the agitation, you don't get critical mass. When the activist creates a chorus of other institutional investors who are willing to play, all of a sudden you have pressure."

Lawyers are dispatched to both sides when an activist makes a move on a REIT or a company that may have REIT-eligible assets. Those representing the activist help to identify areas in the company that may be weak and pose opportunities. Lawyers also help the activist to get a sense of the legal profile of the company.

And lawyers representing the company advise the board on its fiduciary duties and convey to the board what sorts of flexibility it has to make changes in company structure. If a REIT spinoff is part of the discussion, another group of specialized corporate, real estate and tax lawyers comes in.

"Spinoffs have become very big. The activist believes that every line of business needs to sort of stand on its own," said Blake Hornick of Seyfarth Shaw LLP. "Activists are using that option to spin their real estate operations off," Hornick said.

Certain sectors of REITs, for example the hotel sector, have become targets from groups like labor unions, said Patricia McGowan of Venable LLP. Unite Here, for one, has pursued a variety of governance-related activist attempts at REITs, McGowan said.

And while REIT investors have traditionally often been known for making relatively quick entries and exits, more investors are now seeing the value of holding long-term, lawyers say.

"You are having more conversations with some long-term investors who are interested in having more of a say in the company," McGowan said.

While the increased shareholder activism is on the one hand prompting more and more companies to consider REIT spinoffs, activist shareholders could also spur more mergers and acquisitions, effectively acting to "stir the pot" of M&A activity, Kranz said.

"What you're seeing is that the activists are more sophisticated, attracting a chorus of larger and more sophisticated investors," Kranz said. "Once that coalesces ... and you get some critical reaction, the train leaves the station and it's very hard to stop that freight train."

--Editing by Jeremy Barker and Mark Lebetkin.