REIT IPOs – Déjà vu All Over Again

Sponsors of institutional private real estate funds have had difficulties accessing new equity during the past year. In fact, the second quarter of 2009 saw the lowest amount of equity capital raised by private real estate funds in any quarter since 2004. By contrast, public REITs have had great success in issuing their shares, having generated gross proceeds of almost $23 billion in new equity during 2009, the largest amount of equity capital raised in a single year since 1997. The ability to raise capital publicly, coupled with the current depressed prices of real estate and the looming maturities of debt secured by real estate, have real estate fund sponsors and real estate operators thinking about going public. The conditions are reminiscent of the conditions prevalent during the early 1990s, during which real estate sponsors accessed the public markets to gain access to capital, deleverage their assets and grow their businesses.

Real estate sponsors that might wish to undertake an IPO will need to consider a wide variety of issues and begin to take action long before the first filing with the SEC. As an initial matter, sponsors should have a clear understanding of their goals in going public as well as the monetary and other costs of accomplishing those goals. In addition to ceding a portion of control of their companies to the public and being subjected to public scrutiny, the added costs of operating a public company, compared to operating privately, can be significant.

While the SEC registration and offering process may take three or four months, sponsors can expect the process of going public to take significantly longer from beginning to end, depending upon the complexity of the transactions needed to combine the disparate ownership of the controlled assets. The issues that must be considered and addressed by the various constituencies involved include basic structuring, fiduciary concerns, third party consents, the impact of income taxes and real property transfer taxes and assessments and liquidity issues.

One of the first issues to work out is how to combine the disparate ownership of the assets into a single entity and the form of that entity. Sponsors will need to decide whether the REIT should be formed under state law as a corporation, a trust or other non-corporate entity. In some states being a trust or non-corporate entity can result in savings of income and franchise taxes, while forming in other states may lend greater certainty on governance matters. Maryland is typically the most favored state for formation of a REIT because of the state's developed corporate and trust REIT statutes. Additionally, forming a REIT in Maryland can offer significant annual savings in state franchise tax as compared to forming as a corporation in various other states, including Delaware.

Unless a sponsor's assets are held by a single or small number of investors, it will likely structure the REIT as an UPREIT, or umbrella partnership real estate investment trust. In this structure, the REIT owns all of its assets through an operating partnership in which the REIT acts as general partner. An UPREIT structure can facilitate the contribution of assets to the operating partnership on a tax-deferred basis. All partners of the operating partnership, including the REIT, are entitled to pro rata distributions and the limited partnership interests in the operating partnership are convertible into REIT shares.

The process of combining the disparate ownership of the assets into a single entity may be the most complicated part of the process. Depending on the existing ownership structure this process may involve a significant number of separate transactions, each of which could require separate partner and third party consents or approvals. For example, because many, if not all, of the properties to be transferred into the REIT or operating partnership are likely to be encumbered by debt, the consent of some or most of the applicable lenders could be required. Similarly, if the lenders are being asked to exchange their debt for equity in the operating partnership (or are being asked to forgive a portion of their debt as part of the transaction) those lenders will likely insist upon some input into the structure of the REIT and the operating partnership. Additionally, because the ultimate ownership of the properties will change as part of the contribution transactions, local transfer taxes may be triggered and the value of the properties may be reassessed, resulting in ongoing, increased operating costs for the REIT. Finally, in negotiating the contribution or acquisition of additional properties, sponsors should be aware of the SEC financial reporting requirements for contributed or acquired properties and ensure the ability to audit the historical operations of the properties.

If properties to be contributed to a new REIT in conjunction with an IPO are to be contributed by partnerships or other entities which are affiliated with, but not wholly owned by, the sponsor, in addition to the consent issues noted above, the sponsor, as a fiduciary to the other owners, will need to address the fairness of the allocation of the consideration to be issued in the IPO among the various contributing entities. The sponsor should consider establishing a consistent methodology for valuing properties that has a reasonable basis, and, in addition to receiving the consent of the other owners for the formation transactions, may wish to consider having the methodology reviewed and critiqued by an independent party.

REIT formation transactions with existing partners and other contributors of property will also likely involve significant negotiations with those parties as to the tax impact of those transactions on the contributors. As mentioned above, one of the benefits of an UPREIT structure is that property owners may contribute properties to the operating partnership on a tax deferred basis. However, because the sale of contributed a property may result in a taxable event to the contributor without the operating partnership making any special distribution of cash to enable the contributor to pay the related tax, most contributors will insist on a prohibition on taxable sales of the property for some period unless the REIT indemnifies the contributor against any tax liability.

An additional area for negotiation occurs when properties that are subject to debt are contributed to an operating partnership. The debt of a partnership will generally be allocated to all partners in accordance with their percentage interests, unless a contrary agreement is made. If the amount of debt allocated to the contributing partner results in the amount of debt being less than the contributor's basis in the contributed asset, the contributing partner will recognize gain to the extent of the excess. As a result, contributors will likely insist on a special allocation of debt or that they be offered the opportunity to provide a "bottom" guaranty of the debt to avoid possible gain recognition.

The formation transactions described above must be coordinated with the SEC registration process. If properties are held through a large number of different vehicles or vehicles with a large number of investors, the sponsor needs to ensure that aggregating all of these vehicles and investors into a single entity is done in accordance with applicable securities laws. Most often, sponsors will structure the transactions in a manner that does not require registration of the issuance of securities to the contributors under the Securities Act. In order to accomplish this, the sponsor will limit the investors who can take equity in the new entity to those who are accredited investors in order to avoid registration and/or burdensome disclosures. Sponsors also need to consider whether the number of partners in the operating partnership is so large that the partnership itself will have ongoing public reporting obligations.

Once the issues surrounding the formation and structuring of the REIT have been resolved, the REIT and its prospective shareholders and partners of the operating partnership will need to address liquidity issues with respect to REIT shares and operating partnership units. Generally, the sponsor and other contributors of properties who hold REIT shares and operating partnership units will not be permitted to sell their interests in the IPO process, and those investors will be subject to a "lock-up" (*i.e.*, a restriction on their ability to sell) imposed by the underwriters for six months or longer. Depending on the extent of their ownership of REIT shares, the sponsor and other contributors may also face restrictions in the number of REIT shares that they will be permitted to sell, and the manner of such sale, after that initial lock-up period.

Partners in the operating partnership face additional restrictions. The transfer of the operating partnership units will be restricted by the partnership agreement as well as applicable securities laws, and there will be no market for those units. Similarly, the REIT shares they receive on conversion of operating partnership units will not be registered and will be subject to transfer restrictions under the Securities Act. To alleviate this problem, contributors will generally seek to negotiate registration rights that will require the REIT either to register the conversion of the units (making the REIT shares immediately freely tradable) or register the resale of the REIT shares issued on conversion (making the REIT shares tradable when the holder chooses to sell).

Once the IPO is completed, the REIT will be subject to ongoing disclosure obligations, including disclosures about the compensation of officers and directors, financial information and material contracts. As result of the disclosure obligations and Sarbanes-Oxley and exchange rules, the public REIT will face additional expenses. Additional, recurring expenses not faced by private companies include the annual preparation of proxy materials and annual reports, the preparation of other periodic reports to be filed with the SEC, the costs and expenses of complying with the controls and procedures requirements of Section 404 of Sarbanes-Oxley, the cost of a transfer agent and registrar and the listing fees of the exchange.

Additionally, the management of the REIT will be responsible to the public shareholders and will therefore lose some flexibility in managing the business of the REIT. Similarly, as a result of Sarbanes-Oxley and the rules of the securities exchange on which the REIT shares are listed, control of the company will ultimately rest in the hands of a board of directors, a majority of whom are "independent" of the company, its management and its key shareholders.

As evidenced by the foregoing, there are meaningful challenges and costs to a successful REIT IPO. However, a well-structured and planned IPO process will address these challenges, and the ability to access capital, deleverage assets and grow the business achieved through an IPO can outweigh the costs of going public.

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