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Abstract. Real Estate Investment Trusts (REITs) are companies that raise money from the public to invest in real estate. Despite REITs being a vast and growing part of the economy, legal scholars have paid them almost no attention. Accordingly, no one has noticed that REITs possess several unique and puzzling legal characteristics. REITs are the only American business form that is forbidden to reinvest their profits. They are also uniquely immune to hostile takeovers. Since reinvestment and takeovers are thought to be good for investors (at least on average), REIT law would seem to be an obstacle to REIT growth. Yet, REITs have grown feverishly for decades.

We offer a theory to account for the growth of REITS. In essence, we suggest that REITS succeed because of – not despite – their mysterious legal attributes. We argue that their superficially inefficient rules that bar reinvestment and takeovers interlock as part of an efficient solution to tax problems and investor conflicts inherent in real estate markets.

Our theory is important because it clarifies the underlying logic of REIT law, which is highly technical and may appear arbitrary. Clarity allows us to evaluate reforms to the real estate sector. Our theory also links the REIT back to mainstream corporate governance and tax scholarship, showing how an overlooked business form sheds light on some of the fields' central debates.

A THEORY OF THE REIT

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Real Estate Investment Trusts are companies that raise money from the public to invest in real estate.¹ Distinct from all other companies, REITs exhibit two unusual governance characteristics. REITs are immune to hostile takeovers² and prohibited from reinvesting their profits.³ These REIT features flaunt the scholarly consensus on good corporate governance. Corporate law permits takeovers because they serve an important role in keeping managers accountable.⁴ Likewise, corporate law affords management vast discretion over whether or not to reinvest profits,⁵ because reinvestment is often the cheapest way to grow viable businesses.⁶

With accountability and growth potential diminished, investors should shun REITs. Yet investors clamber to buy REITs. Every year, REITs grow (both as an asset class and individually).⁷ Thirty years ago, they barely existed. In the intervening decades, America's public REITs have doubled in size essentially every four years.⁸ Almost half of American households own REIT stock.⁹

¹ Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It*, 56 TAX L. REV. 329, 448 (2003) ("A REIT is essentially a mutual fund that invests in real estate rather than in financial instruments.").

² Put most simply, tax law forbids any five investors (even those acting independently) from collectively owning a majority of the stock. See *infra* Part I.A. And state law permits REITs to impose even more restrictive ownership caps on individual investors. As a result, no investor can own enough stock to make a takeover rational or practical. *Infra* Part I.B.

³ See *infra* Part I.A.

⁴ See, e.g. Matthew D. Cain, Stephen B. McKeon, & Steven Davidoff Solomon, *Do Takeover Laws Matter? Evidence from Five Decades of Hostile Takeovers*, 124 J. FIN. ECON. 464 (2017) (arguing that the possibility of takeovers increase share price). Managers may need some protection from shareholder pressure, but courts and scholars have rejected full entrenchment. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988) ("The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters.").

⁵ LYNN LOPUCKI & ANDREW VERSTEIN, BUSINESS ASSOCIATIONS: A SYSTEMS APPROACH, 200-202 (2020).

⁶ See, e.g. OLIVER WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975) (arguing that internal capital markets can overcome information asymmetry costs to outside investors); George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 177 HARV. L. REV. 1101 (2004). To be sure scholars debate how firms should manage their free cash. Some scholars praise the disciplining effect of a lean enterprise. See, e.g. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). But nobody has ever urged an industry-wide ban on reinvestment.

⁷ NAREIT, *REITs by the Numbers*, <https://www.reit.com/data-research/data/reits-numbers> (Feb. 2022) (stating that REITs raised \$25 billion from investors in 2022 alone).

⁸ NAREIT, *FTSE Nareit Real Estate Index Historical Market Capitalization, 1972 - 2020*, <https://www.reit.com/data-research/reit-market-data/us-reit-industry-equity-market-cap> (last visited Aug. 17, 2022) [hereinafter *FTSE Market Capitalization*] (listing 1974 market capitalization as \$712 million); NAREIT, *REIT Industry Financial Snapshot*, <https://www.reit.com/data-research/reit-market-data/reit-industry-financial-snapshot> (last visited Aug. 16, 2022) (May 2022 snapshot indicating REIT market cap at \$1.5 trillion). This is akin to more than 30% growth on average – with quite a few bear years along the way.

⁹ See *id.* (reporting that 145 million Americans live in a household with direct or indirect REIT investment). See also <https://www.reitsacrossamerica.com/united-states> (reporting 44.9% of American households are invested in REITs).

REITs hold more than \$4.5 trillion in assets,¹⁰ approximately 3% of all of America's wealth.¹¹ They make up 5% of the S&P 500.¹² REITs span a large variety of industries: there are REITs that own a quarter-billion square feet of shopping centers, communication towers that span the globe, and over \$100 billion of mortgages.¹³

How can REITs exhibit such "bad" governance characteristics and yet remain an investor favorite?

No one has ever seriously tried to offer an answer. Legal scholars have had little to say about REITs.¹⁴ Most REIT scholarship comes from tax scholars, who (understandably) focus on the arcane REIT tax rules.¹⁵ Thanks to a unique dividends-paid deduction, REITs are effectively exempt from corporate-level taxes.¹⁶ That gives them an edge over some other investment structures. Call this the "passthrough theory" of REIT success - REITs enjoy tax benefits attractive enough for investors to hold their noses.

¹⁰ See *id.* This gross ownership runs higher than the market capitalization of these REITs in part because some of these assets were financed by debt instead of equity.

¹¹ See FRED ECON. DATA, https://fred.stlouisfed.org/graph/?graph_id=369801 (last visited Aug. 16, 2022) (estimating U.S. wealth at approximately \$149 billion).

¹² See NAREIT, *supra* note 7. Nareit reports 29 REITs are in the S&P 500, which means that REITs are almost 6% of the companies in the index. *Id.* The market capitalization of those REITs runs about 1.6 trillion, while the whole S&P 500 is about \$36 trillion, just under 5%. *Id.*

¹³ Simon Property Group, American Tower Corporation, and Annaly Capital Management, respectively. Other large REITs own timber, prisons, public storage units, and advertising billboards.

¹⁴ Among law review articles that mention "REIT" ten times, the most cited one devotes just three contiguous sentences to REITs. See John H. Langbeim, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 171 (1997). Among papers that actually focus on REITs, the most cited of all time is a student note that has garnered only 18 scholarly citations. See Russell J. Singer, *Understanding Reits, Upreits, and Down-Reits, and the Tax and Business Decisions Surrounding Them*, 16 VA. TAX REV. 329 (1996). While legal academics have neglected REITs, "hundreds of articles about REITs are published in accounting, finance, and economics journals, including articles in the leading journals of each of those disciplines." Bradley T. Borden, *Reforming REIT Taxation (or Not)*, 53 HOUS. L. REV. 1, 9 (2015). The attention paid to REITs by other scholars vindicates their significance, but it in no way suggests that the important legal questions have been answered. Scholars in other disciplines have understandably neglected our quintessentially legal inquiry.

¹⁵ Amy S. Elliott, *The Expanding Universe of REITs*, 137 TAX NOTES 707 (2012) (commenting on C Corps converting into REITs); Lee A. Sheppard, *Can Any Company Be a REIT?*, 140 TAX NOTES 755 (2013) (discussing recent trends in IRS rulings on REIT status); Richard M. Nugent, *REIT Spinoffs: Passive REITs, Active Businesses*, 146 TAX NOTES 1513 (2015); David M. Einhorn, *Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies*, 51 TAX LAW. 203 (1999); Terrence Floyd Cuff, *Issues in Section 1031 Exchanges for Real Estate Investment Trusts*, 31 REAL EST. TAX'N 113 (2004); Simon Johnson, *Part I—The Search for Limiting Principles Necessary to Distinguish Active from Passive Rents and the Nature of REIT Rents*, 42 REAL EST. L. J. 132 (2013); David F. Levy, *Modern REITs and the Corporate Tax*, 94 TAXES 205 (2016).

¹⁶ REITs can zero-out their corporate tax liability by simply distributing their income. See *infra* Part I.A.

Yet on closer scrutiny, the passthrough theory fails to account for REIT investor enthusiasm. Any tax advantage is small,¹⁷ and may even be negative.¹⁸ Moreover, other passthrough entities, such as the Master Limited Partnership, confer better passthrough tax treatment without REIT-like restrictions.¹⁹ Yet real estate investors have largely ignored those other vehicles.²⁰ More generally, the passthrough theory fails to link federal tax policy to the other curious features of REITs: prohibited reinvestment and resistance to takeover.

At least tax scholarship has theories about REITs. By contrast, no corporate law scholar has ever noticed that REITs possess takeover defenses more potent than the most aggressive poison pill, so none has ventured an explanation.²¹ The few corporate law articles about REITs make at most passing reference to the tax benefits and reinvestment rules – they leave those for the tax lawyers. Despite thousands of articles about M&A and corporate governance, no one has asked what REITs' success might signify.

Lacking a theory of REITs, we also have no ability to evaluate changes to the REIT regime, of which there have been many. At first, REITs could own real estate, but they had to hire an external company to operate it for them.²² In 1999 REITs were given the choice of internal or external management.²³ Over time, the IRS has relaxed what counts as “real estate,” including, among others, prisons, cell phone towers, and mortgage-backed securities.²⁴ In 2017, REITs were authorized to reinvest more of their profits.²⁵ Are these good changes? Absent a theory, we have no principled basis for evaluation, nor any theoretical basis to generate new reform proposals. We need a theory of what

¹⁷ A “traditional” corporation that makes \$100 profit from real estate will pay \$21 in corporate taxes before distributing the remaining \$79 to shareholder, who must pay dividend tax of \$15.80, for a total tax of \$36.80. A REIT that makes and distributes the same sum pays no corporate tax – though the investor must pay a 29.6% tax on her ordinary income. That is a 7.2% tax advantage to the REIT.

¹⁸ Non-REIT corporations can defer the second shareholder tax by delaying their distributions. A corporation that defers dividends for roughly 12 years will have a lower effective tax rate than a REIT (using a 5% discount rate).

¹⁹ REITs are not true passthroughs like partnerships. The taxation of REITs is actually worse for investors. The entity-level tax is only avoided if distributions are paid, and REITs cannot passthrough losses to investors. Nevertheless, the term “passthrough” is commonly applied to REITs. *See, e.g.* *BankBoston Corp. v. Comm'r of Revenue*, 68 Mass. App. Ct. 156, 157, 861 N.E.2d 450, 451 (2007) (“Congress . . . created REITs as another variation of so-called “pass-through” entities such as mutual funds and Subchapter S corporations.”).

²⁰ *See infra* Part VI.A.

²¹ A poison pill is a legal technology used to deter hostile takeovers. REITs also possessed these defense twenty-five years before Delaware first blessed the poison pill in *Moran v. Household Int'l*, 500 A.2d 1346, 1353-54 (Del. 1985).

²² *See* I.R.C. § 856(d)(2).

²³ *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (providing REITs with some opportunity for internal management); *see also* REIT Modernization Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (permitting taxable REIT subsidiaries to perform services for REIT tenants).

²⁴ Throughout the 1990s and 2000s, the IRS issued increasingly liberal private letter rulings on the REIT definition of “real estate.” In 2016, Treas. Reg. § 1.856-10 formalized this liberal approach.

²⁵ In the past, the mandatory dividend requirement could only be met through cash dividends. Recent IRS guidance allows REITs to give shareholders an election to receive stock or cash even if the cash component is limited in the aggregate. To the extent shareholders elect (or are forced to receive) stock, the REIT is reinvesting profits. Rev. Proc. 2017-45 (stock dividends are deductible for REITs if shareholders are given the option to receive cash or an equivalent value of stock but only if at least 20% of the aggregate value of the distribution is cash); *see also* Rev. Proc. 2021-53 (reducing the minimum amount of cash to 10%).

REITs are all about, and how their parts fit together. With such a theory, we could decide whether regulatory changes support or undermine the logic of REITs. We could perceive that some apparently pro-REIT changes actually spell their downfall, while other seemingly burdensome rules could actually save the industry from itself.

This Article provides the first theory of the REIT. While the Article itself explains this theory at length, it is worth a few paragraphs to sketch it out right now.

The taxation of real estate poses distinctive challenges for collective investment. Tax law incentivizes owners to avoid cash sales of their real estate.²⁶ Yet the social costs of chilling property transfers are also huge.²⁷ Accordingly, the tax code overcomes this impediment by letting owners transfer their real estate tax-free to partnerships, so long as the partnership avoids certain sale, refinancing, and merger activities.²⁸ (If the partnership takes any of those actions, the former real estate owner immediately owes the taxes she thought she had avoided).

The problem with this solution is that growing partnerships snowball with many different partners with strikingly different interests.²⁹ Suppose that a partnership gets an attractive offer to sell a plot of land. Most of the partners will favor this sale, but the property contributor will be starkly opposed. That partner faces a huge tax liability if the partnership sells the plot. Similar conflicts arise if the partnership gets an attractive offer to repay the debt linked to the plot or to undertake a merger that would divest the partner of her partnership status. Conflicts arise in both everyday and momentous decisions. The key issue is that a property contributor bears 100% of the tax downside of these actions but shares pro rata the economic upside.

These conflicts do not arise to the same degree in familiar publicly traded corporations.³⁰ There, the investors are shareholders who mostly just want the corporation to make profitable decisions. Henry Hansmann explained that this is no accident: firms usually end up with a single homogenous body of owners precisely in order to minimize the cost of inter-owner conflicts.³¹ Yet heterogeneous ownership of real estate ventures cannot be avoided. Because of the tax code, it can only be mitigated.³²

²⁶ See *infra* Part II. Briefly, real estate can appreciate in value for decades, and the tax code makes no adjustment for inflation. Sales trigger taxes on gains, both real and inflationary. At the same time, individuals can completely avoid these taxes if they hold an asset until they die.

²⁷ See THOMAS W. MERRILL & HENRY E. SMITH, *PROPERTY: PRINCIPLES AND POLICIES* 860 (2d. ed. 2012) (“[T]ransfer enhances owner autonomy [and] . . . promotes efficient allocation of resources.”). Liberal transfer of property is one of the main ways in which our current economic order distinguishes itself from feudalism. See generally, Claire Priest, *Creating an American Property Law: Alienability and Its Limits in American History*, 120 HARV. L. REV. 385, 392-94 (2006) (discussing the “decline of feudalism” account of land alienability).

²⁸ *Infra* Part III.

²⁹ *Infra* Part IV.

³⁰ Saul Levmore & Hideki Kanda, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991).

³¹ HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE*, 97 (2000). See also Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017) (extending Hansmann’s theory).

³² *Infra* Part V.

And mitigation is a touchy thing. Give each partner a veto right on transactions that incur taxes for her, and the partnership will be hamstrung – it will be unable to undertake deals that even the affected partner would have approved were she still the direct owner of the plot. And a contrary norm, allowing some form of majority rule, may devolve into a tyranny of the majority.³³ Owners would be reluctant to join a collective real estate enterprise if they faced the risk of prompt expropriation by an existing clique.

REITs solve this problem by establishing a durable management team, which develops a reputation for mediating inter-investor conflicts.³⁴ These managers generally protect the tax interests of individual contributors – if they didn't, they would never convince new property owners to contribute to the REIT. But they do not always bow to the wishes of particular partners. They would likewise fail to entice new contributors if the enterprise cannot take any profitable actions. REIT law makes this balancing possible by entrenching managers against takeover.³⁵ No takeovers means managers don't have to capitulate to any investor faction's demands.³⁶

Of course, this entrenchment puts all investors at the mercy of the managers, who might overdo their compensation or otherwise abuse their privilege. REITs address this risk by forcing the REIT to pay large dividends every year.³⁷ With large distributions, managers know that they cannot coast on internal growth. If they wish to grow their empire, they must go back to the capital markets with their hats out. REITs have disabled the corporate shareholder vote as a channel for accountability, but they have institutionalized exit.³⁸

Mandatory dividends can discipline managers, but they expose REITs to surprisingly harsh tax consequences. Ordinary corporations lower their tax burdens by strategically timing their dividend payments, something REITs cannot do. Passthrough taxation is necessary to put REITs on level footing again.³⁹ Our theory shows that the passthrough theory gets things precisely backwards. Investors don't come for the passthrough taxation and tolerate the governance restrictions; they come for the governance restrictions and stay for the passthrough taxation. This observation explains why REITs have outperformed other passthrough structures in real estate.⁴⁰

A viable theory of REITs gives us a toehold on the various governance debates that REITs implicate. First, corporate theorists have long understood the power of mandatory interest

³³ Worse yet, the tyranny is not stable. *See infra* note 110.

³⁴ *Infra* Part V.A.

³⁵ *Infra* Part V.B.

³⁶ Andrei Shleifer and Laurence Summers, "Breach of Trust in Hostile Takeovers" in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES (Auerbach, ed. 1988), 42.

³⁷ *Infra* Part V.C.

³⁸ Organizations protect their members through some combination of exit (the ability to get one's investment back and leave), voice (political control) and liability (the ability to hold managers personally responsible). *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY (1970); *see also* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84 (2010) (applying this framework to corporate governance).

³⁹ *See infra* Part V.D.

⁴⁰ *Infra* Part VI.A. It likewise explains why they grow, despite trading at a discount. *See infra* Part VI.B.

payments,⁴¹ and the value of prohibited shareholder distributions,⁴² but little attention has been paid to the disciplining power of mandatory shareholder distributions. REITs highlight that distribution regulation can be, and often is, a nuanced tool for agency cost control.⁴³ Second, REITs offer a vision of governance that disrupts familiar assumptions in the debate about whether boards should cater to stakeholders (such as workers) or focus exclusively on shareholders. REIT law plainly anticipates that boards will protect non-shareholder interests, but it staunchly refuses to vindicate those interests with legal claims on the board.⁴⁴ REITs chart a way forward, by backstopping a right with an economic (rather than legal) remedy. Third, REITs give new perspective to the much-debated value of takeover defenses.⁴⁵ REITs require powerful entrenchment to succeed, but REIT law does not confer this boon without a price: REIT boards are subject to sharp expansion and reinvestment constraints. REITs offer a model of takeover defenses in which courts' validation of takeover defenses depends in part on managers' offer of voluntary self-limitation. Entrenchment is more acceptable when the entrenched board relinquishes the powers most easily abused while entrenched.

With that preview aside, what is to come? Part I of this Article introduces the key legal features of the REIT and their economic significance. Part II describes the tax problem endemic to real estate. Part III presents a clever structural solution developed in the early 1990s. Part IV explains the investor conflicts latent in that structural solution. Most succinctly, this structure created a pattern of heterogenous ownership, which had to be overcome for joint real estate ventures to thrive. Part V explains how REITs solve that problem. Part VI elaborates on the theory to address a number of REIT puzzles, including why no other solution is practical. Part VII considers policy implications to guide courts and policymakers as they ponder the future of the REIT. Changes to REIT law should be held up to the functional structure we have uncovered. If a reform helps investors and managers to balance necessarily heterogenous ownership, it is to be supported. Part VIII widens the lens to consider implications for governance theory more generally. And then we conclude.

I. A Rough Guide to REITs

REITs are a large and growing segment of the economy and the locus of many puzzles, but they are little studied and rarely discussed in legal scholarship. Accordingly, we begin by acquainting readers with three crucial facts about REITs: (A) their creation (and constraints) as a matter of tax law; (B) their formation and governance as a matter of corporate law; and (C) their position in the investment landscape.

Each of these stops highlights something peculiar. To maintain their tax status, REITs face severe restrictions in their business operations. REITs are rare in being structurally resistant to takeovers. Finally, it took 30 years for REITs to find any traction among investors, but since the 1990s, REIT investment has exploded.

⁴¹ Jensen & Meckling, *supra* note 6.

⁴² Henry Hansmann, The Role of Nonprofit Enterprise, 89 YALE L.J. 835 (1980) [hereinafter "Nonprofit Enterprise"].

⁴³ *Infra* Part VIII.A.

⁴⁴ *Infra* Part VIII.B.

⁴⁵ *Infra* Part VIII.C.

A. Tax Law

Congress enacted REIT legislation in 1960 to allow ordinary investors access diversified real estate investments. The legislation was heavily influenced by the rules governing mutual funds, also known as registered investment companies (RICs). Mutual funds allow small investors to diversify their investment portfolios and passively invest in a wide range of companies. Owners of a mutual fund are taxed as if they directly own a small piece of the companies owned by the fund. REITs were intended to achieve the same result for real estate investments. Most investors don't have enough money to buy an entire shopping center or commercial office building. Buying REIT shares allows an investor to own a small piece of many shopping centers and office buildings while achieving roughly the same tax result as owning that real estate directly.

Following mutual funds,⁴⁶ the tax rules mandate that REITs distribute 90% of their taxable income each year.⁴⁷ But REIT dividends are granted special tax treatment. REITs can take a deduction for dividends paid. As corporations or trusts, REITs would generally be subject to two levels of tax. When a corporation earns income, it is taxed at the corporate rate of 21%. Shareholders would be taxed on that income a second time if and when dividends are distributed. The dividends paid deduction effectively means that REIT income is taxed only once, at shareholder tax rates. This is often referred to as "passthrough" taxation because the REIT income "passes through" and is taxed to REIT shareholders. REIT shareholders are taxed at ordinary income rates on REIT dividends. For domestic individuals, this means that the top tax rate on REIT income will vary between roughly 30% and 40% depending on the state.⁴⁸

REITs are required to hold primarily real estate assets and to earn most of their income passively from those assets. The tax code requires that at least 75% of REIT assets consist of real estate assets, cash (including receivables), and government securities.⁴⁹ There are two income tests. Put simply, 90% of a REIT's gross income must come from passive sources like dividends, interest, and rents from real property.⁵⁰ 75% of a REIT's gross income must come from a shorter list of real estate sources.⁵¹ The 75% test includes rents from real property and interest on mortgage securities, gains from the sale of real property, and dividends from subsidiary REITs. The tax code also imposes a 100% tax rate on gains from "prohibited transactions." Prohibited transactions are any sales of property that would be considered inventory or property held primarily for sale to customers – e.g., developing and then selling condominium units.⁵² The combination of these requirements means that REITs are passive real estate investment vehicles as opposed to real estate development companies.

⁴⁶ I.R.C. § 852(a)(1).

⁴⁷ I.R.C. § 857(a)(1).

⁴⁸ The top federal rate is 37% but REIT dividends qualify for the passthrough deduction of 20%. I.R.C. § 199. This reduces the maximum overall federal tax rate on qualified REIT dividends to 29.6%. Depending on the taxpayer's residence, state taxes can add substantially to the burden – for example, the top tax rate in California is 13%, 10.75% in New Jersey, and 8.82% in New York.

⁴⁹ I.R.C. § 856(c)(4).

⁵⁰ I.R.C. § 856(c)(2).

⁵¹ I.R.C. § 856(c)(3).

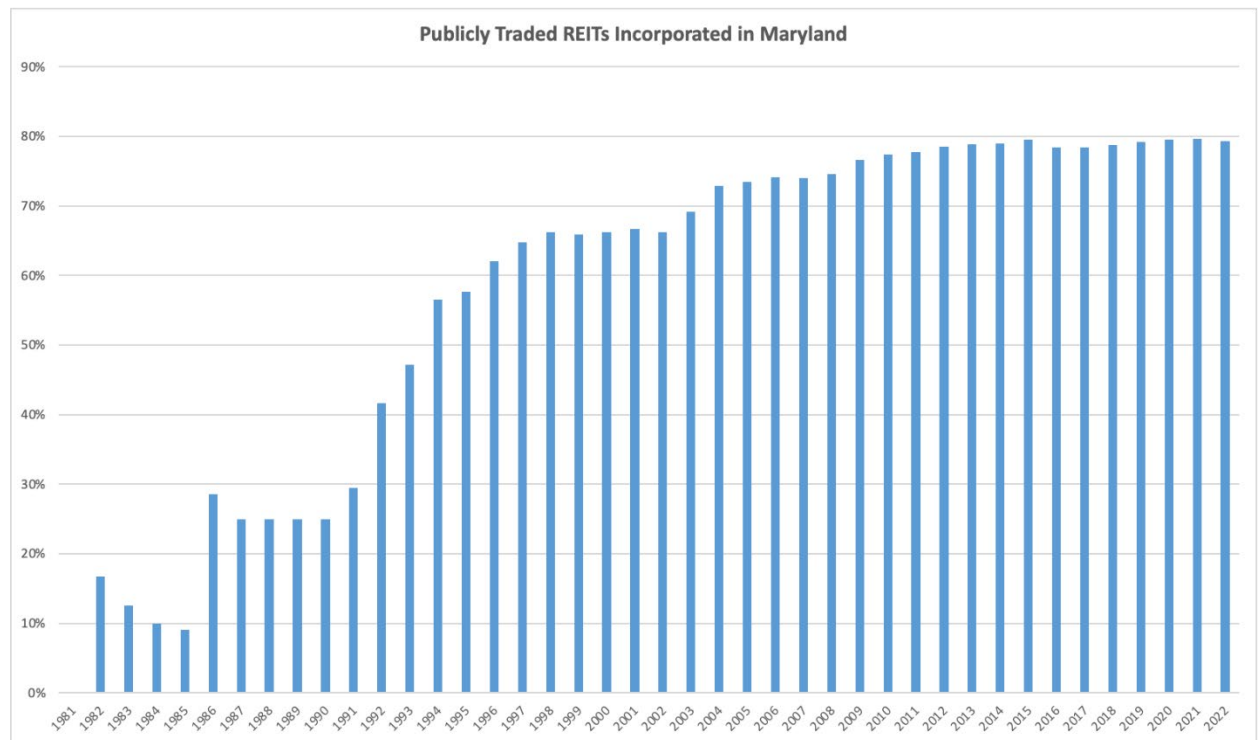
⁵² I.R.C. § 857(b)(6); Treas. Reg. § 1.857-5(a).

Especially relevant for our discussion of corporate governance, the tax law also prohibits concentrated ownership. A REIT must have at least 100 shareholders,⁵³ and the REIT cannot be “closely held” - the five largest shareholders cannot own more than 50% of the value of REIT stock.⁵⁴ The original purpose of these requirements seems to be practical concerns regarding tax administration,⁵⁵ but this limitation effectively prevents hostile takeovers, as the next section shows.

B. Corporate Law

Although “REIT” is a federal tax status, all REITs must also register as entities formed under state law. Most REITs are formed as Maryland corporations and statutory trusts.⁵⁶ Figure 1 depicts Maryland’s dominance and rise.

Figure 1



⁵³ I.R.C. § 856(a)(5).

⁵⁴ I.R.C. §§ 856(a)(6), (h).

⁵⁵ Partnerships are the standard vehicle for passthrough taxation. In a partnership, tax items like income or deductions retain their character and are passed through pro rata to the partners. This becomes administratively difficult once the number of partners gets large. When ownership is sufficiently diffuse, an alternative approach to achieving passthrough taxation becomes crucial. The dividends paid deduction is a simpler approach that requires less bookkeeping.

⁵⁶ The “T” in REIT stands for “trust.” And until 1976, Congress required REITs to be formed as trusts. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520. These statutory trusts function much like corporations. They are owned by investors who elect management. Corporate REITs are now permitted. *Id.*

REITs' preference for Maryland may be surprising. For most large business enterprises, Delaware corporations lead the race as the preferred state and entity type.⁵⁷ Maryland's dominance arose largely because of legal changes in the 1990s, when Maryland legislated to effectively prevent hostile takeovers of REITs. Some barriers to takeover are applicable to non-REIT companies.⁵⁸ But the more interesting takeover protections are unique to REITs. As already discussed, tax law requires REITs to avoid concentrated ownership.⁵⁹ By itself, this poses some impediment to takeovers.⁶⁰ Maryland law amplifies this tax-based ownership restriction by authorizing special "excess share" provisions in their fundamental documents.⁶¹ All REITS utilize these prophylactic provisions.⁶² Excess share provisions prevent individuals from acquiring a large block of shares in the REIT. Although their original purpose was to protect tax status, Maryland clarified in 1997 that they operate regardless of whether the acquisition would actually impair the REIT's tax status.⁶³ If an individual investor is capped at a tiny number of shares, that individual can never acquire enough votes to unilaterally change the board.

An excess share provision is like a poison pill, the most famous (and colorfully named) strategy to deter hostile takeovers. With a poison pill, if an unwelcome investor buys a large block of shares, the corporation distributes bargain-priced shares to everyone else. This makes the investor's purchase relatively less valuable, dramatically raising the cost of buying a majority. The poison pill

⁵⁷ See DELAWARE DIVISION OF CORPORATIONS, *Annual Report Statistics* <https://corp.delaware.gov/stats/#:~:text=93%25%20of%20U.S.,Delaware%20as%20their%20corporate%20home.&text=D,elaware's%20General%20Corporation%20Law%20is,formation%20statute%20in%20the%20nation> (last visited Aug. 16, 2022).

⁵⁸ Delaware allows corporate directors to serve overlapping three-year terms, slowing an acquirer's assertion of electoral control. See DGCL § 141 (d). Maryland permits five-year terms, MD. Corps. & Ass'ns Code Ann. § 2-404 (b)(2) (2021), which effectively slows a hostile takeover by a year.

⁵⁹ I.R.C. § 856(a)(6), (h)(1)(a).

⁶⁰ This protection is limited because it operates on a look-through bases, so that a fund with multiple owners could easily buy a majority of shares. See I.R.C. § 544(a)(1).

⁶¹ MD. Corps. & Ass'ns Code Ann § 2-105 (a)(12) (2022) (authorizing restrictions on share transfer); § 8-203 (a)(6) (same). These transfer restrictions are binding even added subsequent to the share's issuance. The embrace of excess share statutes, and their concomitant defense against takeovers, coincides both with Maryland's ascent and that of REITs in general. All observable REITs have implemented excess share provisions. Yoel Kranz et al., *Barbarians at the (REIT) Gates* https://www.goodwinlaw.com/publications/2015/02/02_04_15-barbarians-at-the-reit-gates-reits-should-be-prepared-for-a-new-world-order#1

⁶² By the mid-90s, it was possible to say "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." 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). See also Yoel Kranz et al., *supra* note 61 (asserting that 100% of publicly traded REITs include such ownership limitation provisions in their charters).

⁶³ See Md. Corps. & Ass'ns. Code Ann. § 2-105 (a)(12); § 8-203 (a)(6). Courts had already established boards have no duty to waive excess share provisions in favor of acquirers who can show that their purchases pose no threat to tax status. See *e.g.*, Realty Acquisition Corp. v. Prop. Tr. Am., No. CIV. JH-89-2503, 1989 WL 214477 (D. Md. Oct. 27, 1989). Nothing changes in the context of a takeover, as Maryland rejects *Revlon* doctrine. See Md. Corps. & Ass'ns. Code Ann § 2-405.1(h).

has been called “the most powerful defense against hostile takeovers.”⁶⁴ Yet, excess share provisions are even more powerful.⁶⁵

First, poison pills seek to deter acquirers by imposing costs on them, but they do not actually stop an acquirer who is willing to bear those costs.⁶⁶ By contrast, excess share provisions altogether prevent unauthorized acquisitions, such that even a determined acquirer cannot bypass the restrictions of a REIT’s excess share provision. That is because excess share provisions deem any disallowed purchase to fail as a matter of law.⁶⁷ If ownership is capped at 5%, a 5% owner *cannot* acquire any more shares.⁶⁸

Second, excess share provisions restrict ownership to far lower levels than poison pills. The least aggressive of excess share provisions is as constraining as the typical poison pill – and aggressive excess share provisions are far more aggressive than would be permitted under contemporary poison pill jurisprudence. To see this, recall that the ostensible rationale for excess share provisions is to insist that five or fewer investors never own 50% or more of the stock. The very weakest excess share provision capable of accomplishing its purpose is one that would prevent investors from acquiring 10% of the stock.⁶⁹ But a 10% cap is already positioned at the aggressive end of poison pills. Most courts and scholars agree that 10-20% is the range of acceptable pills in all but exceptional cases.⁷⁰ While 10% is aggressive for poison pills, it is tame for REITs.

REITs can restrict ownership even further if they wish to grandfather existing shareholders. Consider Kimco, a large REIT that went public in 1991. Kimco already had three shareholders who

⁶⁴ Julian Velasco, *Just Do It: An Antidote to the Poison Pill*, 52 EMORY L.J. 849 (2003).

⁶⁵ It may be argued that relative power is unimportant if poison pills are sufficiently impregnable. Yet pills plainly have limits: courts continue to refine the limits of poison pills to interfere with shareholder activism, for example. At a minimum, it is possible for REITs to exceed pills at their limits.

⁶⁶ Acquirers may willingly suffer a pill’s costs if they expect to be able subsequently void the pill as invalid. See e.g., *Selectica, Inc. v. Versata Enters., Inc.*, No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010).

⁶⁷ Excess share provisions are commonly written in one of two ways. One variation voids the sale, so that the seller retains title to the shares. A second variation causes any purportedly transferred shares to be instead held in trust, until they can be auctioned off to valid purchasers. See generally Priv. Ltr. Rul. 96-27-017 (Apr. 5, 1996) (discussing the workings and tax implications of excess shares trusts). See also PETER M. FASS ET AL., REAL ESTATE INVESTMENT TRUSTS HANDBOOK, § 4.02 [6][b], at 4-13 to - 15 (1998)(discussing other issues raised by excess shares trusts).

⁶⁸ The IRS has blessed excess share provisions in private letter rulings, ruling that the excess share provision does not cause the REIT to fail the transferability of shares requirement or the prohibitions on concentrated ownership. See Priv. Ltr. Rul. 92-05-029 (Nov. 5, 1991); see also Gregory W. Goff & Iman Anabtawi, *REIT Revival II: Competitive Real Estate Investment Vehicle for the '90s or Short-Lived Arbitrage Strategy*, 46 MAJOR TAX PLAN. 21-1, 21-60, 61 (1994).

⁶⁹ As long as no shareholder owns 10%, it is impossible for any five shareholders to own 50%.

⁷⁰ David M. Einhorn, Adam O. Emmerich & Robin Panovka, *REIT M&A Transactions—Peculiarities and Complications*, 55 BUS. LAW. 683, 701 (2000) (“pills typically are triggered upon acquisitions at substantially higher acquisition levels (15% to 20%) than are excess share provisions (9.8% or less”). Corporations can sometimes push the envelope by implementing a pill that triggers as low as 5%. Versata, 2010 WL 703062, *supra* note 66. Interestingly, the Versata pill was also motivated by thresholds set by the tax code, there the 5% shareholder definition in Section 382. I.R.C. § 382(k)(7), Versata argued that the 5% threshold was necessary to protect against limitations on corporate net operating losses. See generally, Eldar, Ofer and Kirmse, *The Rise of Anti-Activist Poison Pills* (November 7, 2022) <https://ssrn.com/abstract=4198367>.

collectively owned 40.9% of the stock, and whom Kimco wished to grandfather.⁷¹ Kimco accordingly implemented an excess share provision prohibiting anyone from acquiring 2% more of Kimco stock.⁷² No Vice Chancellor could abide a 2% threshold for a poison pill, but REITs have had them for decades.⁷³

The fact that these provisions render REITs takeover proof is confirmed by the dearth of hostile takeover attempts and failure of nearly all attempts. To our knowledge, there has been only a single successful REIT takeover ever.⁷⁴ Although this fact has gone largely unnoticed by legal scholars, it is widely appreciated and confirmed by financial economists.⁷⁵

C. The Market for REITs

REITs face tax-based restrictions on reinvestment and business activities. Their managers sit comfortably immune to the market for corporate control. It is understandable that REITs went almost unused for decades. There was little reason to use this form, with all of its peculiarities, in order to invest in real estate. Authorized in 1960, REITs only began to attract serious investor attention in the 1990s.

⁷¹ Kimco Realty Corp., Form S-11 (Nov. 22, 1991).

⁷² See, e.g., *id.* (implementing a 2% limit). With 40.9% in three hands already, the REIT would be spoiled if the top five shareholders collectively acquired another 9.1%. A cap on each shareholder 2% ownership, (grandfathering the existing shares) would about suffice.

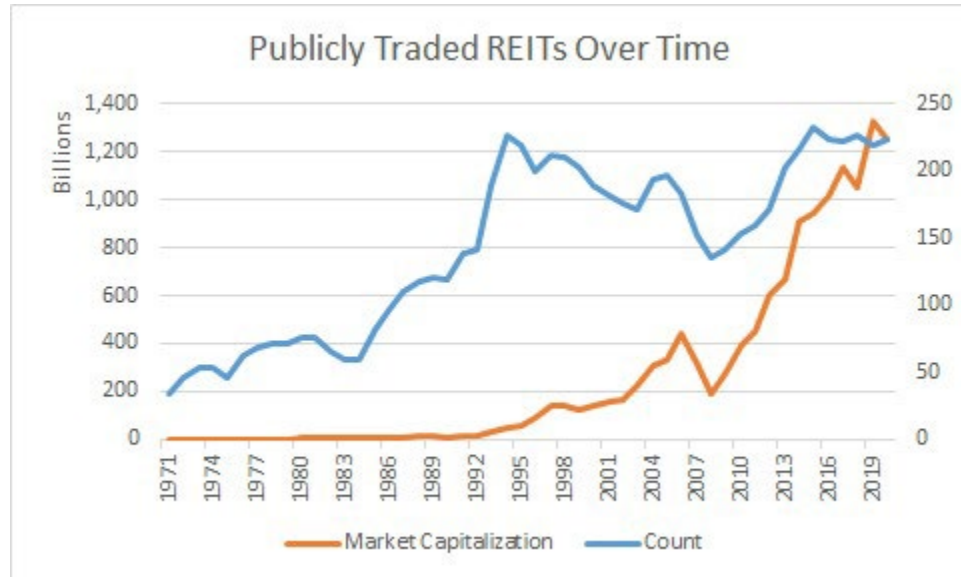
⁷³ Many REITs have substantial inside ownership, in 2000, a look at 156 REITs discovered a mean inside ownership of 20.9%, with a quarter of REITs having 28.4% inside ownership or more. Bing Ham, *Insider Ownership and Firm Value: Evidence from Real Estate Investment Trusts*, 32 J. REAL EST. FIN. & ECON. 471, 478 (2006).

⁷⁴ That takeover was of CommonWealth REIT in 2014. By all accounts, the case was exceptional. The incumbent management team attracted the ire of numerous name-brand activists, such as Sam Zell and Carl Icahn. See Julie Creswell, *Legal Battle Lifts Profile of a Quiet Empire*, N.Y. TIMES (July 23, 2013) <https://www.nytimes.com/2013/07/24/business/legal-battle-lifts-profile-of-a-quiet-empire.html>. Activists argued that the company traded at a 40% discount to peer REITs. They pointed out that the management team received \$336 million in compensation and engaged in \$2 billion in related party transactions during a period when the stock halved in value. During that period, the managers also managed five other REITs. CISION PR NEWswire, *Corvex And Related Send Letter To Commonwealth REIT Shareholders Calling For An End To Value Destruction* (Apr. 18, 2013, 8:30 AM) <https://www.prnewswire.com/news-releases/corvex-and-related-send-letter-to-commonwealth-reit-shareholders-calling-for-an-end-to-value-destruction-203578011.html>. A prominent research firm wrote that the payment to an external management company a fee with no performance component was a "dinosaur" that "stands out like a sore thumb." GREEN STREET ADVISORS, *The Portnoy REITs – What It Means to be 'Uninvestable'* (March 1, 2013). Even in that case, the buyers could only buy 9.2% of the stock. Since the REIT was worth \$25 billion, their gains from that "small" stake were likely enough to justify a proxy fight.

⁷⁵ One study examined 85 REIT mergers and acquisitions and found no hostile activity whatsoever. See Robert D. Campbell, Chinmoy Ghosh & C.F. Sirmans, *The Information Content of Method of Payment in Mergers: Evidence from Real Estate Investment Trusts (REITs)*, 29 REAL EST. ECON. 361, *passim* (2001); accord CHAN, ERICKSON & WANG, *REAL ESTATE INVESTMENT TRUSTS: STRUCTURE, PERFORMANCE, AND INVESTMENT OPPORTUNITIES* (2003) (attributing lack of hostile activity to excess share provisions).

Yet, in the 1990s, investors somehow learned to love REITs, despite their peculiar restrictions. Since that time, many new REITs have been started every year.⁷⁶ The growth is most obvious for publicly traded REITs,⁷⁷ which currently raise about \$3 billion a week from investors.⁷⁸

Figure 2



What changed in the 1990s?⁷⁹ We argue that REITs finally found a problem for which they were the right solution. Prior to that point, restrictions on reinvestment, business activities, and takeovers were all disadvantages of the form. But the 1990s taught that these weaknesses could be

⁷⁶ *FTSE Market Capitalization*, *supra* note 8.

⁷⁷ Other kinds of REITs exist. Some are not registered with the SEC and can only operate on a smaller scale. Others are registered, but not traded. Only imperfect data is available for private or non-traded REITs, but both appear to be a smaller portion of the market. Compare Beth Mattson-Teig, *Non-Traded REITs Continue to Grab Record Capital Inflows*, WEALTHMANAGEMENT.COM (May 23, 2022), <https://www.wealthmanagement.com/reits/non-traded-reits-continue-grab-record-capital-inflows> (non-traded REITs raised \$36.5 billion in 2022, up from a more typical \$10.9 billion in the previous year) with John Barwick, *REITs Set Record for Annual Capital Raising*, NAREIT (Feb. 11, 2022), <https://www.reit.com/news/blog/market-commentary/reits-set-record-annual-capital-raising> (\$126 billion raised for traded REITs in 2021). Our Article focuses on publicly traded REITs though some of our analysis bears on these other REITs.

⁷⁸ See Mattson-Teig, *supra* note 77; see also Barwick, *supra* note 77.

⁷⁹ The increase in REIT popularity coincided with changes enabling pension funds and other institutional investors to make larger investments in REITs. Su Han Chan, Wai Kin Leung & Ko Wang, *Institutional Investment in REITs: Evidence and Implications*, 16 J. REAL EST. RES. 357 (1998). This tax law change is only a partial explanation of the rise of the REIT, especially large public REITs. Even before 1993, pension funds could purchase sizable stakes in REITs (usually up to 10%). After 1993, very few institutional investors took advantage of the new rules to acquire more than 10% of any public REIT. *Id.* It seems that REITs became more attractive to institutional investors for reasons independent of their being able to buy larger stakes in REITs.

strengths in solving investor conflicts persistent in the real estate sector. We explain those problems in the coming sections, before showing how REITs proved to be an excellent solution.

II. The Tax Problem with Real Estate Investing

The problem begins with taxes inhibiting the sale and transfer of real estate. Put simply, investors face large tax incentives to avoid sales of real estate during their lifetimes.

When real property is sold, the seller must pay tax on the gain – the difference between the sale proceeds and her “basis” (her acquisition cost less any depreciation deductions). For a variety of reasons, that gain is often substantial.

One key reason is that the value of real estate tends to go up over time.⁸⁰ There is only so much land, particularly in growing metropolitan areas. Even as real estate value tends to increase, the tax code systematically reduces basis. The owner of a residential real estate building recovers the cost of that building in only 27.5 years.⁸¹ That means the owner gets a tax deduction every year, and after 27.5 years, the building has zero basis, meaning that essentially all of the sale proceeds are taxed as capital gains.

A second key reason is that real estate assets tend to be held for longer periods of time than other (e.g., financial) assets. Because real property is not fungible, locating a buyer and contracting for sale involve greater transaction costs than other assets like securities. There is no short-term trading in and out of real estate the way that hedge funds flip publicly traded securities. The longer you own real estate, the more time for built-in gain to accumulate.

With lots of taxes owing upon sale, owners have strong reasons to defer sale. First, because of the time value of money, deferring taxes is desirable.⁸² Second, the tax law “steps up” the basis of property (including real property) to fair market value upon the owner’s death.⁸³ Any built-in-gain escapes taxation if the owner of real estate simply holds until death.

Accordingly, taxes discourage owners from selling to buyers that might better manage or utilize the real estate. Yet it would obviously be inefficient if land and buildings were only sold once in a generation. The tax code locks real estate into the wrong hands.

To make these factors more tangible, consider an example drawn from the life of billionaire real estate investor Leona Hemsley, and former owner of the Empire State Building.⁸⁴

⁸⁰ The tax code makes no adjustment for inflation, so inflation also increases the price of real estate (and therefore the gain realized on sale).

⁸¹ I.R.C. § 168(c). Congress intentionally made the schedule of deductions faster than expected economic depreciation to spur investment. *See* I.R.C. § 168 (providing the depreciation schedules for tangible assets, called “modified *accelerated* cost recovery system” (emphasis added)).

⁸² Deferring liabilities (including tax liabilities) is valuable because the money can be invested and earn a return. This is the time value of money.

⁸³ I.R.C. § 1014(a).

⁸⁴ Leona Helmsley and her husband were two of the wealthiest real estate investors in New York City. She was dubbed the “Queen of Mean” by the press for her reputation for mistreating staff. The actual ownership of the Empire State Building was quite complicated, and we have simplified it for this example. She actually owned a

Helmsley and her husband owned the Empire State Building, but it had proven a headache, including years of litigation with Donald J. Trump.⁸⁵ Helmsley might have been happier to liquidate her \$1 billion investment,⁸⁶ but taxes posed a problem. Helmsley's group had acquired the famous structure in 1961 for \$65 million,⁸⁷ so her basis was almost certainly \$0. If so, a sale would trigger \$1 billion built in gain and she would owe something like \$300 million in taxes. Taxes gave Helmsley a powerful reason to hold on to the tower.⁸⁸

Yet society is poorly served by reluctant landlords. Part of Trump's case against Helmsley was that the building was being mismanaged. He claimed the building lacked safe fire sprinklers and that rodents infested the place.⁸⁹ Whatever the truth, it's generally inefficient for taxes to block transfers to those who have a plan to care for and improve real estate.

Ultimately, Helmsley held the building until death. But her estate soon found a way to prevent the problem from repeating - a REIT-based strategy to transfer the Empire State Building to new owners without prohibitive taxes.⁹⁰ We describe the strategy, now widely adopted, in the following Part.

III. The Structural Solution to the Tax Problem

Tax practitioners have long sought clever means to allow clients to transfer property without triggering taxes. One early solution was for property owners to not "sell" their property but to instead contribute it to a corporation, in exchange for shares in the corporation. Such contributions are nonrecognition events as a matter of corporate tax law, meaning that the transfer does not trigger tax

substantial interest in an LLC that owned the Empire State Building. Her substantial stake in the LLC (57% after her husband's death) meant that the Empire State Building could not be sold or transferred without her approval. This veto right effectively gave her say over the sale/transfer of the Empire State Building, which is what we will assume for purposes of this example.

⁸⁵ Through a partnership, Trump owned the underlying land and a reversion in the building. He attempted to wrest control of the building away from Helmsley and her partners. Trump was ultimately unsuccessful and sold his interest back to Helmsley and her partners in 2002. <https://www.6sqft.com/donald-trumps-failed-and-fraught-attempt-to-own-the-empire-state-building/>

⁸⁶ In 2012, the Empire State Building was appraised for \$2.53 billion. The Helmsley stake in the Empire State Building and other assets was valued at \$1.04 billion. Empire State Real Estate Investment Trust S-4, at 34, <https://www.sec.gov/Archives/edgar/data/1541401/000119312512054391/d283359ds4.htm>.

⁸⁷ *Real Estate: Highest Finance*, Time (Sep. 1, 1961) <https://content.time.com/time/subscriber/article/0,33009,939859-1,00.html>

⁸⁸ This would have been particularly true for Helmsley. During a trial for tax evasion, her housekeeper testified that Leona had said, "We don't pay taxes. Only the little people pay taxes."

⁸⁹ Terence Cullin, The Story Behind Trump's Sketch After Failing to Buy the Empire State Building, N.Y. Daily News (Oct. 19, 2017), <https://www.nydailynews.com/new-york/trump-sketch-failed-buy-empire-state-building-article-1.3573033>

⁹⁰ Family that Controls the Empire State Building Overcomes Shareholder Objections to Making It Part of a REIT, Herald Tribune (Jun. 3, 2013), <https://www.heraldtribune.com/story/news/2013/06/03/family-that-controls-the-empire-state-building-overcomes-shareholder-objections-making-part-of-reit/29179305007/>

obligations.⁹¹ Such a transfer would achieve many of the benefits of a sale – diversification and greater liquidity – without necessarily counting as a taxable sale.⁹²

However, this particular solution was of limited use. To obtain tax-free treatment to a corporation, the transferor(s) of property must own 80% of the corporation immediately after the contribution.⁹³ Moreover, if encumbered property is contributed to a corporation, any excess of the debt over the transferor's basis is recognized as taxable gain.⁹⁴ Real estate is often subject to debt well in excess of basis. Basis reflects historical cost and depreciation deductions. The amount a lender will lend depends on (among other things) the property's fair market value. Finally, using a corporation would subject future income from the property to the corporate double tax. The *corporate* structure could not solve the tax problem on its own.⁹⁵

It was only in 1992 that lawyers devised a new structure that better allowed real estate owners to transfer their property tax-free to funds.⁹⁶ That new structure interposed an additional structural layer: a limited partnership. This structure pairing of a corporation and a limited partnership would come to be known as an "Umbrella Partnership." The umbrella partnership allows property owners to dispose of real estate and take investment interests in a large, diversified entity without triggering taxes.

In a typical umbrella partnership structure, a corporation ("Public Corp." in Figure 2) raises cash from the public. That corporation creates a new entity, a limited partnership ("Operating Partnership" in Figure 2).⁹⁷ The corporation contributes the publicly-raised cash to the limited partnership, in exchange for partnership interests.⁹⁸ As the general partner of the limited partnership, the corporation manages the limited partnership.

The limited partnership can acquire property using either cash or partnership interests. Property owners who are eager to avoid triggering built-in gain will opt for the latter and become limited partners of the partnership. In Figure 2, the Operating Partnership has acquired Property 1

⁹¹ See I.R.C. § 351.

⁹² For example, the contributor would no longer bear all the risk of the asset but would instead be an investor in a diversified company, whose shares she could sell.

⁹³ I.R.C. §§ 351(a), 368(c) (defining control as at least 80% of the voting power of all classes of stock entitled to vote and at least 80% of the number of shares of all nonvoting classes of stock). Simultaneous transferors can combine their share ownership to satisfy control. The control requirement is easy to satisfy for the initial contributors of property at a corporation's formation but often difficult for midstream investors.

⁹⁴ See I.R.C. § 357(c).

⁹⁵ We have explained that transfers to corporations could not suffice to overcome the tax problem, *in general*, without focus on the REIT in particular. But Congress simply prohibited nonrecognition for transfers to REITs if it resulted in the diversification of the contributor's interest. See I.R.C. § 351(e).

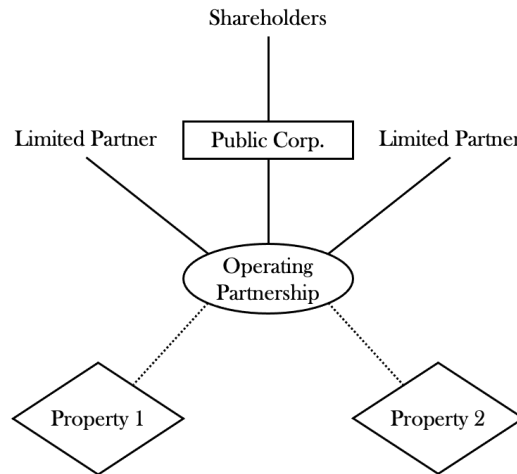
⁹⁶ The first UPREIT was Taubman Centers, Inc. Goff & Anabtawi, *supra* note 68, at 21-65.

⁹⁷ A limited partnership is a business form that provides limited liability for only some partners (the "limited partners"). By default, the limited partners have very little control over the businesses, leaving most power with the general partner. The general partner may itself be a corporation rather than a natural person.

⁹⁸ This limited partnership is known as the Umbrella Partnership because this entire structure involves higher level companies controlling or operating lower-level companies, like an umbrella shading the people underneath it. The partnership may also be called an "operating partnership" because it directly owns and operates many of the assets.

and Property 2 in exchange for LP interests. The prior owners of Property 1 and Property 2 are now Limited Partners of the Operating Partnership.

Figure 3: Umbrella Partnership Structure



The Limited Partners have the right to convert their partnership interests into the Public Corp.’s shares or to put their limited partnership interests to the partnership for cash.⁹⁹ Because the only asset that Public Corp. holds is the general partnership interest, partnership interests and corporate shares are economic equivalents and usually convert at a 1:1 ratio. This structure gives the Limited Partners easy access to liquidity; whereas real property can take months of work to sell, publicly-traded corporate shares can be sold with a click on Robinhood or any other securities trading platform. It also gives the contributor fractional access to liquidity. Instead of selling the entire property if the contributor needs cash, the contributor can simply convert and sell a few shares of the partnership and (importantly) only recognize a fraction of the built-in gain. The contributor also diversifies their portfolio – spreading their investment over all the real estate owned by the partnership.

The umbrella partnership solves the tax problems attendant to contributions to an entity because the partnership rules for contribution are much more permissive than the corporate analogues. Partnership tax law has no control requirement for nonrecognition. If a partner contributes appreciated property to a partnership in exchange for a partnership interest, that contribution qualifies for nonrecognition even if the partner owns a small fraction of the partnership.

The partnership rules are also more generous in dealing with liabilities assumed by the partnership. The partnership rule acknowledges that debts of the partnership are actually debts of the partners. All partnership debts are allocated among the partners.¹⁰⁰ If a partner contributes

⁹⁹ A put is a contractual right to force the partnership to redeem the partnership interest.

¹⁰⁰ The allocation of debt among the partners depends on whether the debt is recourse or non-recourse. A debt is “recourse” if one or more partners is personally liable for the debt. Recourse debt is generally allocated to the partner that is personally liable. This will usually (but not always be) the general partner. But most debt secured by real property is non-recourse, debt for which there is no personal liability. Non-recourse debt is

encumbered property to a partnership, that partner will only recognize gain if the *net* liability relief exceeds the partner's basis. Thus, when forming an umbrella partnership, contributors and the firm are careful to allocate enough debt to the contributing partner to avoid triggering gain.

The tax code places limitations on the umbrella partnership to prevent tax avoidance,¹⁰¹ but the structure affords investors powerful latitude to defer taxes even as they transfer real estate and build collective ventures for real estate investing.

IV. The Conflict Problem Created by the Structural Solution

The umbrella partnership structure—overcomes the tax problems that would otherwise prevent people from transferring property to collective investments in real estate. But the cooperation engendered is fragile. The taxes are avoided only provisionally. Under the tax code, several actions will trigger built-in gain for someone who contributed property to an umbrella partnership. Without these limitations, taxpayers could abuse partnerships to freely shift or eliminate all capital gains taxes.¹⁰²

First, when contributed property is sold, capital gains that accrued prior to contribution are not attributed to all the investors but are instead allocated solely to the original transferor of the property.¹⁰³ Second, a contributor's built-in gain will also be triggered if she sells her partnership interests or exercises her right to exchange them for publicly-traded corporate shares.¹⁰⁴ Finally, the built-in gain (or at least a portion thereof) will be triggered if the partnership repays too much of the debt allocated to the partner.¹⁰⁵

Some of these actions are under the contributor's control, and she can steer clear of them. However, several triggers are entirely out of the contributor's control and are instead in the hands of the general partner, the publicly-traded corporation. Frequently, the corporate managers can make a decision that is profitable for all the investors except for a single contributor whose taxes will be triggered. The defining problem for a collective real estate venture is managing the conflicts inherent among its investors.¹⁰⁶ To be clear: the umbrella partnership solves a tax problem, but only in such a way as to generate lingering conflict among investors (for which the REIT will end up being the ideal governance solution).

allocated based on more complicated rules, but with careful structuring it is possible to allocate such debt to limited partners.

¹⁰¹ See *infra* notes 102-105 and accompanying text.

¹⁰² The simplest strategy goes like this: the investor contributes a deeply appreciated asset to a partnership that is mostly owned by investors who do not pay income tax (such as pension funds and endowments). The partnership promptly sells the asset. If the built-in gain were passed through to all the partners pro rata, the IRS would collect no revenue from the tax-exempt investors.

¹⁰³ I.R.C. § 704(c). Gains that accrue after contribution are indeed allocated among all the partners in accordance with the partnership agreement and Section 704.

¹⁰⁴ See I.R.C. § 1001.

¹⁰⁵ I.R.C. § 752(b) treats a reduction in allocated liabilities as a cash distribution to the partner. If that deemed cash distribution exceeds the partner's basis in the partnership interest, she will recognize gain. See I.R.C. § 731.

¹⁰⁶ This conflict has been central to practitioner and scholarly commentary from the very beginning. *E.g.*, Robert T. Kleiman, *Umbrella REITs: An Introduction*, 10 REAL EST. FIN. 33, 39 (1993).

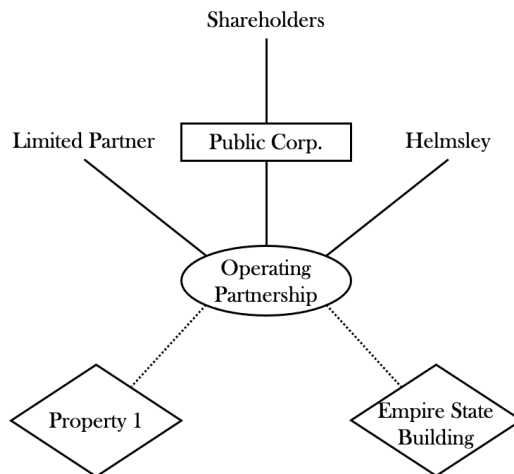
This Part describes three transactions in which real estate investors could come to conflict. The most familiar conflict concerns the sale of property, but this is just one of many transactions that can trigger huge tax consequences for a property contributor. Mergers and acquisitions differentially affect investors. Almost all debt transactions (whether refinancing debt, repaying it, or borrowing more using property as security) create conflicts among investors.

A. Sale

The most obvious transaction that might help a firm (and most of its investors) but harm a contributor, is a sale of the contributed property for a favorable price. The contributor pays taxes if the property is sold, so she will often prefer that the firm retain the property. All other investors straightforwardly want the firm to sell.¹⁰⁷

Consider again the hypothetical example from above: Helmsley owns an interest in the Empire State Building worth \$1 billion and has zero basis in the property. She contributes it to an umbrella partnership and receives a 10% limited partnership interest in the partnership that is exchangeable for shares in the publicly traded corporation. Figure 4 displays the resulting structure.

Figure 4: Example Umbrella Partnership



If the partnership sells the Empire State Building, the entire pre-contribution gain of \$1 billion would be taxable gain for Helmsley. Assuming that Helmsley has a combined federal and state tax rate of 30%, this liability is \$300 million dollars. Helmsley has good reason to oppose such a sale.

Conflict would remain even if the partnership were offered an above-market price for the real estate. An offer of *twice* Empire State Building's fair market value *still* imposes a net cost on Helmsley because she only captures 10% of the sale price.¹⁰⁸ Helmsley will be skeptical of any sale that values the \$1 billion Empire State Building at less than \$5.28 billion! By contrast, the REITs

¹⁰⁷ Singer, *supra* note 14, at 335; Goff & Anabtawi, *supra* note 68, at 21-55.

¹⁰⁸ Such a sale would entitle Leona to an additional \$70 million (\$100 million less a \$30 million tax obligation on the incremental gain). So, she gains \$70 million but still must pay the \$300 million tax on pre-contribution gain.

many retail investors, who bought public shares for cash, will be delighted to sell for anything above \$1 billion.¹⁰⁹

The challenge is much more significant when there are multiple property contributors. Each contributor's interest would be in conflict with the firm's public shareholders as described above, but they would also be in conflict with other property contributors. A sale of the Empire State Building would trigger taxes for Helmsley but no other limited partners (whose taxes are tied to other specific properties). Yet, at the same time, the property contributors *as a group* might understand their interests to be generally aligned against sale. The potential result is a complex conflict, with some property contributors standing together against a given sale and others peeling off to join with cash investors in supporting it.¹¹⁰

B. Merger

Contributing investors pay taxes if they sell their partnership interests. They can usually protect themselves against this trigger by just not selling. But some sales are involuntary. In a merger, investors vote whether their corporation should undertake a fundamental transaction that may strip investors of their pre-merger shares. Approval by a majority of investors binds the dissenting minority, triggering involuntary sale and any resultant tax.¹¹¹

It is easy to see that mergers can put investors into conflict. Consider Leona Helmsley again, whose partnership interest is worth about \$1 billion. Suppose that an acquirer contacts the firm and offers a merger whereby all investors will get a 15% premium over the current market price in cash - \$1.15 billion for Helmsley's interest. Many investors will find this offer appealing and vote for it, but Helmsley will see this offer as a disappointing loss: Helmsley will pay much more in taxes than she gets in merger premium.¹¹²

C. Debt

Debt plays a key role in every business enterprise. Borrowing can be a way to take advantage of low interest rates and to increase return on equity. That is particularly true for real estate-based businesses. The mortgage interest rate is close to the risk-free rate because lenders consider loans against land to be rather safe - land can never lose all of its value, and the creditor can seize it for resale with relative ease. The relatively benign act of borrowing against property creates a conflict for

¹⁰⁹ Indeed, if they anticipated a downturn in the real estate market, they might happily sell for less than \$1 billion.

¹¹⁰ Any bare majority could conspire to sell the assets of the minority, but any member of that minority might offer a bribe for admission to the ruling clique and the subsequent ejection of a prior member. No one could be assured fair treatment as the mob churns. This is a familiar outcome of cycling majorities in social choice theory. *See generally, Social Choice Theory*, STAN. ENCYCL. PHIL. (Dec. 18, 2013), <https://plato.stanford.edu/entries/social-choice/> (discussing paradoxes of collective action).

¹¹¹ Depending on the state law of the limited partnership and the terms of the partnership agreement, limited partners may be forced to go along with the merger. For example, the default rule in Delaware is that only a majority of limited partners need to approve a merger of a limited partnership, but that percentage can be increased or decreased by the partnership agreement. 2 DE Code § 17-211. Umbrella partnership mergers can be structured such that the limited partners do not recognize built-in gain. The key is that the limited partners receive limited partnership interests in the continuing partnership instead of cash, corporate shares, or other consideration. But not all mergers contemplate such continuation. *See, e.g., infra* note 190 and accompanying text.

¹¹² \$30 million in taxes on built in gains, plus another \$4.5 million in taxes on the \$15 million premium, for a total of \$34.5 million in taxes.

umbrella partnerships, because contributors are concerned with any transaction that increases the *mere possibility* of the contributed property being transferred in a taxable transaction. Entities that borrow are occasionally unable to repay their debts, leading the bank to foreclose on and sell assets. That possibility bothers property contributors, who may resist otherwise efficient corporate borrowings.

Conflicts also arise when debts come due. The balance of the benefits and detriments of debt vary over time, so debt ratios need not be stable. When debts come due, businesses can either refinance that debt or repay it. Real estate firm shareholders generally want managers to adopt whatever debt policy is best for the venture, but property contributors have an additional concern: their own tax consequences. If a contributed property was encumbered with debt, repayment may trigger taxes.¹¹³ To make this concrete, imagine that Leona Helmsley contributed the Empire State Building to the firm, at a time when the building secures a \$500 million adjustable-rate mortgage.¹¹⁴ After a year, the firm repays the mortgage, because it deems interest rates too high. This decision may be good for the firm, but it triggers a \$150 million tax bill for Helmsley.¹¹⁵

Refinancing debt can raise similar conflicts, because subtle changes in the terms of the debt can trigger tax for limited partners.¹¹⁶ Property owners often protect themselves by borrow on a non-recourse basis, meaning that a bank cannot try to recover from any of the investors in the firm. Banks charge more for a non-recourse loan. When a loan comes due, an easy way to save money is to borrow again without this protection. A firm that has gotten property from Helmsley may want to refinance on cheaper (but less protective) terms, with some other investor in the firm accepting liability. But converting debt on the Empire State Building from non-recourse to recourse will trigger taxes for Helmsley.¹¹⁷ She may prefer that the firm not lower its costs.

Nowhere is debt conflict starker than where the firm can clear away debts *for free*. When a business is insolvent, its creditors will often agree to forgive a portion of the business's debts. These "write-downs" or "workouts" can be in the mutual interest of creditor and debtor. But they are not in the interest of every property contributor. Suppose that the firm is in distress and its lender agrees to forgive the \$500 million loan linked to the Empire State Building. This is good news in an otherwise challenging moment, but Helmsley may not be so grateful. She will incur \$150 million in taxes, while

¹¹³ When encumbered property is contributed, debt is carefully allocated to avoid tax at the time of contribution. Repaying that debt can result in the recognition of gain. *See supra* note 100. Goff & Anabtawi, *supra* note 68 at 21-54 n. 227 (noting the potential conflict between shareholders and a limited partner who wants to maintain significant amounts of debt).

¹¹⁴ Contributing the property subject to a mortgage means that Leona will likely be credited with a \$500 million interest in the REIT, rather than \$1 billion; this does not affect our analysis. To avoid the recognition of gain on the contribution, the firm is careful to make sure that the \$500 million of (now) partnership debt is allocated to Leona.

¹¹⁵ $30\% \times \$500$ million gain. Leona's gain is \$500 million because she is relieved of a \$500 million obligation. I.R.C. § 752(b) treats this as if the partnership distributed her \$500 million. This deemed distribution exceeds her zero basis by \$500 million.

¹¹⁶ *Supra* note 100 and accompanying text.

¹¹⁷ Leona would be treated as receiving a deemed distribution of \$500 million. I.R.C. § 752(b). Leona would have to pay \$150 million in taxes.

her pro rata share of the debt-forgiveness only enriches her by a fraction of that sum.¹¹⁸ The umbrella partnership capital structure leads to conflict even when a free lunch is offered.

The forgoing example imagined that the firm was experiencing distress unrelated to Empire State Building, with the bank opting to forgive some debt as part of a broader agreement with the firm. But the workout could instead relate to a decline in the Empire State Building's value. In this case, too, investors come to conflict. Imagine that the Empire State Building serves as collateral for an \$500 million nonrecourse loan. But COVID hits and commercial real estate loses value. Assume that the Empire State Building is only worth \$400 million at the time that the debt matures. The firm could lawfully discharge its debt by transferring the "underwater" property to the bank. Most investors would prefer this strategy because it saves the firm \$100 million. But Helmsley prefers that the firm pay off the \$500 million debt in cash because she will owe \$150 million in taxes if the \$500 million loan is satisfied by the transfer of the Empire State Building. This tax dwarfs her share of the \$100 million savings.¹¹⁹

* * *

The umbrella partnership allows real estate owners to transfer their holdings to collective investment firms, but the result is a firm with many different types of investors. These investors share profits pro rata when things are going well, but they do not share tax liabilities proportionally.¹²⁰ This leads to conflict among investors. In other words, collective real estate naturally leads to a problem of heterogenous ownership that must be addressed.

V. The REIT as Solution

The umbrella partnership is a powder keg. Its success depends on finding a way to keep conflict from flaring.¹²¹ Our goal in this Part is to show why the REIT is uniquely suitable to handle the danger. The REIT ascended once it became clear that the curious features of a REIT could solve the problems of the umbrella partnership.

Our claim is that real estate investing naturally tends towards heterogeneous ownership due to tax considerations. To manage heterogeneous ownership, there must be a management team (such as a board of directors) tasked with balancing heterogenous interests. To effectively balance interests, management must be insulated from investor pressure and therefore must be entrenched. To avoid abuses by entrenched management, the management team must be on a short leash; it must be forbidden from expanding or altering the business without obtaining renewed investor support.

¹¹⁸ Per the forgoing, she is likely a 5.26% shareholder, so her share of the forgiveness is worth only \$26.3 million.

¹¹⁹ Under *Comm'r v. Tufts*, the property is sold for the amount of the outstanding nonrecourse liability. 461 U.S. 300 (1983). Thus, the gain is the excess of \$500 million over Leona's zero basis.

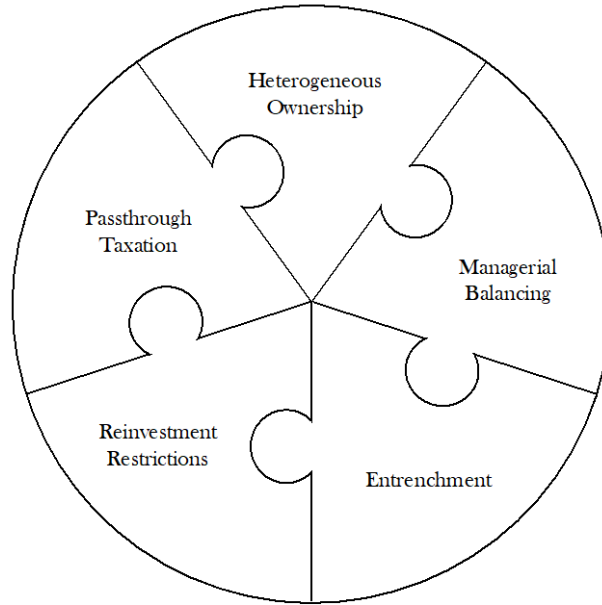
¹²⁰ As foreign, tax-exempt, and pension ownership of REITs has increased, the tax heterogeneity among investors has become even more pronounced. These shareholders are completely tax indifferent, even to post-contribution gain. Thus, the REIT is even more important as a structural solution to the problem of heterogeneous ownership.

¹²¹ See CHAN, ERICKSON & WANG, *supra* note 75 at 51 (determining "[h]ow to align the interests of the REIT shareholders and those of the partnership unit holders becomes an important issue.").

Prohibited reinvestment requires special tax treatment to avoid penalizing the structure. And this special tax treatment, in turn, necessitates heterogenous ownership.¹²²

This is our theory of the REIT: *REITs thrive because they offer this package*. Figure 5: Pieces of the REIT illustrates this cohesive internal logic.

Figure 5: Pieces of the REIT Puzzle



To make this concrete, diverse owners contribute property and cash to form an Umbrella Partnership structure, but they make the public corporation a REIT in order to commit to REIT-like rules. The managers operate the business in their collective interest, giving due regard for the special tax needs of property contributors. From time-to-time, cash investors may spot business opportunities that would prove lucrative, despite imposing disproportionate cost on one or more property contributors. These investors may threaten to replace management if it doesn't capitulate, but managers can proceed unfazed. The investors cannot buy a large enough stake in the REIT to unilaterally evict the board or run an effective proxy contest because of REIT-specific rules that prevent takeover. As a result, the board can safely protect property contributor interests even when it imposes a small cost on other investors. Doing so makes the REIT a trustworthy partner for future property contributors, which largely inures to the benefit of cash investors too. All the while, the board must make regular distributions to investors, so that investor returns are not locked into the REIT indefinitely. Only investors who trust managers' balancing act write a check for new shares in the future.

¹²² *Infra* note 161 (explaining how passthrough taxation would lead to tax avoidance if it did not preserve investors' heterogenous exposure to built-in gains).

The combination of the umbrella partnership and REIT proved utterly transformative. The combination of a REIT and umbrella partnership is called an “UPREIT”.¹²³ Between 1992 when the first UPREIT was formed and 1996, two-thirds of newly formed REITs were UPREITs, and over half of the largest equity REITs were UPREITs.¹²⁴ By 1997 more than 80% of all public REITs were UPREITs.¹²⁵ That trend has only continued, with newly formed REITs almost always employing the UPREIT structure,¹²⁶ particularly among the largest REITs.¹²⁷ The 1992 introduction of the UPREIT marked the turning point in REIT growth. REIT growth by market cap had been essentially flat from 1960 to 1991. From 1992 on, REITs almost doubled every year (except for years in which market downturns set growth back). The modern REIT so owes its prominence to the umbrella partnership (and vice versa) that it makes more sense to simply think of REITs as UPREITs.

We argue that REIT law’s kluges interlock in a way that is essential. And despite being unexpected, each of these eccentricities is entirely consistent with corporate law theory. What remains is an elaboration on the forgoing. Part A explains how managerial balancing is essential to address the problems of heterogenous ownership. Part B argues that such balancing requires entrenchment. Part C addresses the limits on business activities and reinvestment. Part D then explains why REITs need passthrough taxation. Thus, our theory of the REIT makes sense of all the special characteristics of the REIT and ties them together to explain why the REIT prevails as the preferred structure for collective real estate investing.

A. Managerial Balancing is Essential to Heterogenous Ownership

If large real estate enterprises are to exist, they must find a way to balance the interests of investors at a reasonable cost. If cash investors always get what they want, the enterprise may take profitable business actions that impose devastating tax consequences on property contributors. An enterprise that was known to do this would be unable to attract property contributors.¹²⁸ One that *could* take such actions would likewise face contributor skepticism, even if it didn’t plan to do so.

¹²³ We should also mention the DownREIT, a sibling of the UPREIT. The DownREIT is very similar to the UPREIT except that instead of owning a single partnership, the REIT owns several different partnerships. The DownREIT provides greater flexibility in setting the relative rights of different contributing partners and allows for liability and asset partitioning. DownREITs are more complicated than UPREITs in setting conversion ratios because the limited partners of one partnership will not have the same economic exposure as the public shareholders or partners of another partnership. For our purposes, the UPREIT and the DownREIT present the same basic problem of a conflict of interest between public shareholders and limited partners.

¹²⁴ Singer, *supra* note 14, at 334-37; CHAN, ERICKSON & WANG, *supra* note 75 (“REITs could finally acquire property in a tax-efficient manner. In 1993 and 1994, 67% and 89%, respectively, of all new equity REIT capital was raised through IPOs that used the UPREIT vehicle.”); Tony M. Edwards, *Nareit Comments On Regs On Distribution Of Marketable Securities By A Partnership*, TAX NOTES (Mar. 12, 1996), <https://www.taxnotes.com/research/federal/other-documents/public-comments-on-regulations/nareit-comments-on-regs-on-distribution-of-marketable-securities-by/12t9h?h=%22PS-2-95%22> (Mar. 12, 1996); Glenn L. Carpenter & Gary B. Sabin, *DownREITs: Now Everyone Can Do Tax-Free Exchanges*, 16 THE REIT REPORT 9, 9 (1996). See also Goff & Anabtawi, *supra* note 68, at 21-1 (noting that the liberalization of REIT rules in the Tax Reform Act of 1986 and the Revenue Act of 1987 did not immediately result in increased investment in REITs and describing the expansion of REITs in the early 1990s).

¹²⁵ Zhilan Feng, S. McKay Price & C.F. Sirmans, *An Overview of Equity Real Estate Investment Trusts (REITs): 1993-2009*, 19 J. REAL EST. LITERATURE 307, 317 (2011).

¹²⁶ *E.g., id.* at 307 (finding that 73% of publicly held REITs are UPREITs as of 2009).

¹²⁷ Ham, *supra* note 73, at 476.

¹²⁸ See Shleifer and Summers *supra* note 36, at 45.

The enterprise would be forced to pay huge premiums to acquire any real property where the owner had huge built-in gain. Many efficient transfers would simply not occur.

But an enterprise that could never trigger taxes for even a single property contributor would be hamstrung, declining even the most prudent and profitable business strategies. Such a firm could never attract cash investors. It would also be undesirable for property contributors. First, having eager cash investors and publicly-traded stock is a significant motivation for property contributors who want liquidity. Second, if the enterprise has no freedom to profitably exploit its assets, then contributors are boarding a sinking ship. They are swapping their property for interests in the venture, but a hamstrung venture is not a good investment. For all properties except the one they personally contributed, the contributors are aligned with the cash investors, and they want the venture to be able to sometimes trigger taxes in order to operate efficiently.

Managers can solve this impasse through balancing.¹²⁹ They can take due regard of property owner tax obligations, declining superficially profitable projects that impose disproportionate tax costs on one or more property contributors. But they need not give contributors a full veto. When a business strategy is so profitable that property contributors would probably have undertaken it (triggering taxes) in their personal capacity if they had never contributed the asset, the managers can go forward with it. Property contributors don't need to win every fight to be happy, but they won't invest unless they are protected some of the time. Nor do enlightened cash investors wish to kill the golden goose by squeezing every penny out of every transaction. Managers must read evolving market conditions, tax consequences, and investor expectations in order to strike a balance.

B. Entrenchment is Essential to Managerial Balancing

Orthodox corporate scholarship praises managerial accountability to shareholders and questions the value of entrenchment.¹³⁰ The default rule in corporate law is that directors are elected by a majority of shareholders, and they can be removed with or without cause. Fear of activist investors and hostile acquirers helps align manager concerns with the interests of their shareholders. Corporate law does permit managers to inhibit this market for corporate control but only within strict limits, because entrenched managers can ignore shareholder interests and focus on self-serving projects.¹³¹

¹²⁹ There are potential alternatives to managerial balancing. Hansmann might predict that contract could homogenize the interests of cash investors and property contributors. We discuss the theoretical and practical limitations of the contractual approach in Part VI.B *infra*. Empirically, we observe very few REITs using contracts to solve the heterogeneous ownership problem. See *infra* note 180 and accompanying text. Managerial balancing seems to have prevailed in the REIT market.

¹³⁰ On this debate, see generally K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67 (2016); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009); Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PA. L. REV. 1475 (2018).

¹³¹ For the essential debates on this subject, see Lucian A. Bebchuk, *Competing Views on the Economic Structure of Corporate Law*, 1 U. CHI. BUS. L. REV. (forthcoming 2022); Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020).

REIT managers are entrenched, and thus run afoul orthodox corporate scholarship, but it is for good reason. REITs really do have diverse patrons whose interests must be honored.¹³² The balancing that is the sine-qua-non of REITs is only possible if the managers are insulated from internal and external investor pressure.

Without entrenchment, a single activist hedge fund could roam from REIT to REIT proposing strategies that liberate immediate profits but ruin the marketplace's ability to assure property contributors going forward. Or a private equity fund could buy a majority of shares formerly held by cash investors¹³³ and then vote for a merger that directly or indirectly divests property contributors from their entitlement on terms that do not offset their latent tax liabilities. The threat of takeover would force managers to favor the shareholder class and upset the balanced equilibrium required for REITs to exist.

Hostile takeovers have sometimes been attempted, and it is easy to see how they might succeed if boards were not sufficiently entrenched. In 1996, Manufactured Home Communities made an all-cash offer for Chateau Properties, another REIT. The cash offer of \$26 per share was a 12% premium over the \$23.25 trading price, so cash shareholders were likely to approve.¹³⁴ MHC's plan was to acquire control to liquidate Chateau. Doing so would benefit MHC, since Chateau's properties were worth more than Chateau itself. But liquidating would trigger taxes for the property contributors.¹³⁵ The precise amount would depend on the investor, but journalists took note that the CEO of Chateau was a major property contributor whose tax burden would exceed four dollars per share.¹³⁶ For such contributors, MHC's offer implied a merger premium of *negative* 19%.¹³⁷ MHC's offer effectively bifurcated the owners of Chateau, inviting the cash shareholders to help pillage the vulnerable property contributors for a share of the plunder.¹³⁸

Entrenchment saved the property contributors. MHC could not purchase 51% of the shares because of an excess share provision.¹³⁹ The most it could do was buy 7% shares and then intimate

¹³² Our argument here is in accord with Henry Hansmann & Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption*, 123 YALE L.J. 100 (2014). They describe voting caps at early corporations that were, essentially, consumer cooperatives. A profit maximizing investor could push the firm to degrade quality or raise prices – to the detriment of consumer-shareholders.

¹³³ A plurality will also suffice, if the remaining shares largely end up in the hands of pro-merger arbitrageurs.

¹³⁴ Mitchell Pacelle, *Chateau to Sweeten Terms For Proposed ROC Merger*, WALL ST. J. (Sept. 18, 1996, 12:10 AM), <https://www.wsj.com/articles/SB843012546216117500>.

¹³⁵ *Zell's Bid for Chateau Raises a Lot of Questions*, REALTY STOCK REV. (Audit Invs., Inc., Montvale, N.J.), Aug. 30, 1996 (August 30, 1996) (on file with author).

¹³⁶ *Id.*; Pacelle, *supra* note 134 (noting that CEO owned 1/3 of the partnership units).

¹³⁷ MHC's bid permitted Chateau shareholders to perhaps avoid taxes by electing to receive MHC shares worth \$21.88. While superior to an after-tax \$19 bid, \$21.88 is still a negative premium.

¹³⁸ Interestingly, MHC's plan could potentially work even if cash investors made up only a small minority of the capital structure. That is because property contributors ordinarily cannot vote on the public corporation's fundamental transactions or board elections unless they convert their partnership interests to shares, but such a conversion triggers the very tax the contributor was hoping to avoid. Property contributors face a tax hurdle the first time they vote their shares, and so they are unlikely to vote unless absolutely necessary. This voting hurdle makes property contributors even more dependent on entrenched management to represent their interest. Thus, a minority of REIT investors could allow an acquirer to seize the reigns and expropriate contributor interests.

¹³⁹ *Supra* Part I.B.

that the board might face a popular revolt of shareholders if it didn't capitulate.¹⁴⁰ The board was not cowed, and MHC gave up. Takeover protection permitted the board to protect property owner interests if it wished, whether by proceeding as a going concern or structuring a different deal that was fairer to all constituencies.¹⁴¹

MHC's CEO, the well-known real estate mogul, Samuel Zell correctly saw the Chateau deal as a referendum on the modern REIT. Zell's assessment was negative: "I think the REIT industry has an enormous amount to lose here. If the management of Chateau is able to thwart an all-cash offer for all the shares, then any REIT with any significant number of operating partnership units [i.e., property contributors] would be dramatically less valuable."¹⁴² In a sense, Zell was completely right. Board entrenchment cost MHC's cash shareholders a lot of money – instead of \$26 cash from Zell, they got shares worth \$21 from a merger partner committed to protecting property contributors from taxes.¹⁴³ But if Zell's point was that the industry would suffer, history has plainly shown the opposite. REITs grew fantastically in the months and years following the failed takeover. The market seemed to like entrenchment.¹⁴⁴

Zell's view jives with traditional corporate law and theory. It may seem worrisome when corporate management picks a lower offer to protect a non-shareholder constituency, particularly when the managers are themselves beneficiaries of the protection.¹⁴⁵ But these are *ex post* and myopic worries about whether the business is now taking the efficiency-maximizing decision in a particular transaction. From an *ex ante* and macro perspective, there would be no REITs to merge at all if the managers always sided with shareholders.

C. Restricted Investment is Essential to Entrenchment

To exist as heterogeneous teams, REITs must entrench managers, but entrenched managers are themselves a problem. The market for corporate control plays a vital role in disciplining managers.¹⁴⁶ Why would managers serve any of their investors if none of them have the practical power to remove them? Managers could instead close the spigot on dividends, using the corporation's cashflows to build an empire that befits their ego or transition to new business strategies that are unfamiliar to investors and offer more chances for self-dealing.

Entrenchment is dangerous in a conventional corporation because capital is locked in, and managers have plenary authority in redeploying it. Managers tend to reinvest profits even when the

¹⁴⁰ Stephanie Strom, *Zell, in a Bid to Buy REIT, Says Managers Have a Conflict*, N.Y. TIMES (Sept. 11, 1996), <https://www.nytimes.com/1996/09/11/business/zell-in-a-bid-to-buy-reit-says-managers-have-a-conflict.html>.

¹⁴¹ As it happened, it had already negotiated a different deal with ROC Communities.

¹⁴² Strom, *supra* note 140.

¹⁴³ *Chateau Communities, Inc.*, COMPANY-HISTORIES.COM, <https://www.company-histories.com/Chateau-Communities-Inc-Company-History.html> (last visited Aug. 23, 2022).

¹⁴⁴ Cf. Martijn Cremers et al., *The Value of Takeover Defenses: Evidence from Exogenous Shocks to Closed-End Mutual Funds*, <https://gocg.global/wp-content/uploads/2017/03/Robert-J.-Jackson-Paper.pdf> (last visited Aug. 23, 2022) ("We find, in other words, that closed-end fund shareholders *liked* the poison pill). REITs are a kind of closed end fund. See *infra* discussion at note 211. If the market liked entrenchment technology for the goose, it may well like it for the gander. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253-55 (1999).

¹⁴⁵ Many property contributors are also managers, and vice versa. Though it is our sense that the majority of property contributors do not hold or obtain manager roles.

¹⁴⁶ See generally Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

business has only inefficient projects to pursue.¹⁴⁷ They also redeploy business assets toward new and different business lines, which may pose different risks or be harder for investors to understand.¹⁴⁸

REITs magnify this problem by entrenching management but defuse it by limiting capital redeployment. REITs are not allowed to shut off their dividends. They must distribute their earnings every year, regardless of how much managers might want to retain them.¹⁴⁹

Although this dependence on distributions is unusual, it is consistent with governance theory. Scholars have long recognized the potential for dividends to control agency costs,¹⁵⁰ though they have generally not gone so far as to call for *mandatory* distributions.¹⁵¹ And while REITs are outliers for America, many other nations require distributions in order to address governance problems.¹⁵² Even in America, there are some precursors to REITs' use of distributions as governance.¹⁵³

REITs are also restricted in their permitted range of business operations.¹⁵⁴ They are not allowed to pivot into crypto or get into the recording business (signing the CEO's son as their first big bet). For the most part, they must focus on passive real estate investment, and every new real estate

¹⁴⁷ See Jensen & Meckling, *supra* note 6.

¹⁴⁸ This problem is called "asset substitution." Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEG. STUD. 1, 11 (1981). It is often discussed with a focus on creditor-investors as the victims, on the theory that shareholders want more risk. But investors can lose from asset substitution can harm shareholders too, who wish higher or lower levels of risk than managers, or who fear mismanagement and graft may hide behind opaque investments.

¹⁴⁹ *Supra* Part I.A.

¹⁵⁰ E.g. Fischer Black, *The Dividend Puzzle*, 2 J. PORTFOLIO MGMT. 5 (1976); Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV., 650 (1984). Relatedly, the ability of investors to recover investments serves governance. ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970) (discussing the disciplining power of withdrawal).

¹⁵¹ Two noteworthy exceptions are Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881 (1995) and Ilya Beylin, *Tax Authority As Regulator and Equity Holder: How Shareholders' Control Rights Could Be Adapted to Serve the Tax Authority*, 84 ST. JOHN'S L. REV. 851, 856 (2010). Relatedly, the canonical approach to limiting free cash – encumbering the business with debt – entails mandatory payments to financiers. Jensen & Meckling, *supra* note 6. But interest payments and dividends differ in important ways (e.g., bankruptcy risk) that make mandatory dividends somewhat different.

¹⁵² See, e.g., Jairo L. Procianny & Daniel F. Vancin, *Minimum Dividend Payout Obligation Special Feature: The Brazilian Case*, 10 (2016) (Explaining that Brazil entitles shareholders to dividends of at least 25% of adjusted net profits.). Mandatory dividend laws played a central role in some of the canonical articles in the Law & Finance literature. E.g., Rafael La Porta et al., *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1 (2000). Likewise, comparative studies of corporate law have frequently noted these features. E.g. Merritt Fox, *Ongoing Issues in Russian Corporate Governance*, 52 COLUM. J. TRANSNAT'L L. 435, 450 (2014); Mariana Pargendler, *How Universal Is the Corporate Form? Reflections on the Dwindling of Corporate Attributes in Brazil*, 58 COLUM. J. TRANSNAT'L L. 1, 31 (2019).

¹⁵³ Mutual funds are subject to mandatory distributions, similar to REITs. 26 U.S. Code § 852(a)(1). Morley and Curtis explain how an additional mutual fund feature – the ability of investors to demand a return of pro-rata share of the fund – likewise disciplines. See Morley & Curtis, *supra* note 38. See also, Andrew Verstein, *Enterprise without Entities*, 116 U. MICH. L. REV. at 284 (2017) (describing some unincorporated insurance firms as "perpetually liquidating in response to payouts of surplus.")

¹⁵⁴ *Supra* Part I.A. The obligation to pay dividends is itself a restriction on business lines, since cash-strapped managers have less capacity to chart new territory.

investment requires the REIT to convince some investor – whether a cash investor or the property’s contributor – that the project is rational and the management sound.

While unusual, this requirement is also consistent with prevailing theory. The idea that businesses might bond themselves by focusing on a single line of business, which is easily evaluated, and about which investors might develop specialized knowledge, is hardly new.¹⁵⁵ This is a basic intuition that justified the breakup of mid-century conglomerates.¹⁵⁶ REIT law responds by simply making the conglomerates illegal to start. It is also the basic idea animating all forms of secured financing and securitization more broadly.¹⁵⁷

D. Passthrough Taxation is Essential to Restricted Reinvestment

The passthrough theory of REITs posits that investors flock to them because of passthrough taxation, with restrictions on business, reinvestment, and takeovers as unfortunate problems to be endured. Our theory is that the latter “problems” are the REIT’s distinctive benefit, solving problems inherent in the umbrella partnership structure most suitable for real estate. Our theory has a place for passthrough taxation, too, but it is to accommodate these peculiar governance features.

In a typical corporation, income is taxed twice, once when earned by the corporation and a second time when dividends are distributed to shareholders. This combined tax burden is nominally higher than the tax burden for firms organized as partnerships or other passthroughs where income is taxed only once at the investor-level. However, non-REIT corporations can be strategic about the timing of their distributions, delaying the (taxable) act of returning cash for long periods of time, reinvesting within the firm. For careful firms, the total tax can be even lower at a corporation, rather than much higher. Thus, corporations and passthrough entities compete on a roughly equal playing field with respect to taxes. But that equal playing field depends on a corporation’s ability to defer the dividend tax.

That parity would be upset if corporations were forced to pay out a dividend every year – then they would be at a pure tax disadvantage to passthrough entities. This is the position REITs would be in without the dividends paid deduction. They are forced to pay large annual dividends. If taxed as typical corporations, REITs would face truly prohibitive overall taxes; they would be crowded out by other investment vehicles. This was especially true under the rate structure that prevailed between 1990 and 2017, a period of substantial REIT growth. Before 2017, the corporate rate was 35% and the top rate on dividends was 20%. If corporate earnings were distributed immediately each year, the combined tax rate was 48%, much higher than the top rate of 39.6% imposed on passthrough income. Passthrough taxation is not just a perk REITs enjoy, it is necessary because their governance

¹⁵⁵ See generally Elizabeth Pollman, *The History and Revival of the Corporate Purpose Clause*, 99 TEX. L. REV. 1423 (2021).

¹⁵⁶ T. Khanna & K. Palepu, *Why Focused Strategies*, 75 HARV. BUS. REV. 41 (1997).

¹⁵⁷ See Ofer Eldar & Andrew Verstein, *The Enduring Distinction Between Business Entities and Security Interests*, 92 S. CAL. L. REV. 213 (2019); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 51-53, 57-59 (1982).

needs would otherwise generate prohibitively high taxes.¹⁵⁸ Again, the parts of the REIT fit together to make an integrated whole.

It is also interesting to note that REITs have continued to grow since 2017 when the Tax Cuts and Jobs Act narrowed the tax gap between passthrough and corporate taxation.¹⁵⁹ The corporate tax rate is now 21% and the top rate on dividends is 20%, yielding a combined rate of 36.8% (if dividends are distributed immediately). The top passthrough rate is 29.6%. The purported tax advantage of REITs has shrunk and yet REITs continue to grow. This observation suggests that we are right to deemphasize passthrough taxation in explaining the rise of REITs.¹⁶⁰

* * *

In an important sense, the story of REIT success starts and ends with tax. It starts with a tax problem: built-in gain results in heterogeneous investors. Heterogeneous investors require managerial balancing. Managers can only balance interests if they are entrenched and protected from pressure from shareholders. Entrenchment is itself dangerous and requires restrictions on reinvestment. Restricted reinvestment and mandatory distributions can only work if REITs are granted passthrough taxation. Coming full circle, passthrough taxation requires heterogeneous ownership to prevent tax avoidance of built-in gain.¹⁶¹ This logic cycle is our general theory of the REIT.

VI. Unpuzzling REITs

We have already addressed the mystery of why REITS have grown wildly, despite peculiar governance features. This Section demonstrates the utility of our REIT theory by using it to explain five puzzling observations about REITs.

REITs dominate public investment in real estate even though there are alternative business forms that benefit from more generous tax treatment. Why? Part A employs our theory to argue that these alternatives lack REIT's distinctive requirements.

REITs use governance to protect property contributors from adverse tax consequences. One can imagine dispensing with the REIT and employing contracts instead. Yet empirically we rarely see contractual protection for contributing partners. Why? Part B explains why the REIT structural solution has displaced the contract.

¹⁵⁸ Steve Bank argues that corporate tax is a necessary consequence of capital lock-in, a desirable feature in many business enterprises. Steve Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 G'TOWN L.J. 889 (2006). We are arguing the converse is also true: passthrough taxation is a necessary consequence of forced mandatory distributions.

¹⁵⁹ Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054.

¹⁶⁰ Moreover, the REIT has dominated other (pure) passthrough entities that do not have mandatory distributions and that have the advantage of passing through losses. See *infra* Part VI.A.

¹⁶¹ Passthrough taxation requires a mechanism to allocate pre-contribution built-in gain. Otherwise partnerships would be a simple vehicle for gain shifting and tax avoidance. See *supra* notes 102-105 and accompanying text. Thus, Section 704(c) and heterogeneous interests are essential to passthrough taxation.

REITs generally trade at a value below the fair market value of their assets, suggesting investor apprehension. Yet investors also flock to REITs. Why? Part C employs our theory to harmonize these apparently contradictory observations of the market's enthusiasm for REITs.

REITs have taken off in the U.S., and yet have made few inroads abroad. Why? Part D uses our theory to explain how other countries' piece-meal implementation of the REIT has failed.

Some of the most prominent REITs are not listed for trading on a stock exchange. These REITs have faced problems that have not befallen the exchange-traded REITs that are the focus of our discussion. Why? Part E applies our theory to show the structural weakness of non-traded REITs.

A. The Master Limited Partnership Puzzle

REITs are not the only business form capable of investing in real estate. Other structures superficially resemble REITs and should compete with them for capital. A Master Limited Partnership ("MLP") is a publicly traded limited partnership.¹⁶² A single general partner (usually itself a corporation) manages a business on behalf of itself and a number of limited partners.

MLPs dominate oil & gas ventures, proving that they are basically viable. One could easily imagine them thriving for real estate investment, since they offer the even better tax benefits than REITs without the governance restrictions. A property owner can contribute property to an MLP without triggering taxes, just as they can to a REIT.¹⁶³ MLPs that invest in real estate are able to avoid corporate "double taxation" on income, just like REITs. Even better, MLPs also allow valuable losses to passthrough to taxpayers as well, something REITs are unable to do.¹⁶⁴

And MLPs enjoy substantial additional freedom. The MLP has no restrictions on concentrated ownership. The MLP has looser requirements on gross income.¹⁶⁵ An MLP does not have mandatory distributions. Although MLPs can focus just on passive interests in real estate, they can buy passive interests in non-real estate ventures too (like oil and gas). And they can engage in some apparently "active" real estate projects forbidden to REITs.¹⁶⁶ Unlike a REIT, an MLP could develop condominiums for sale or sell subdivided lots in a development tract because these are not "prohibited transactions" for an MLP.¹⁶⁷ There is no asset test for the MLP. An MLP can do what a REIT does and more.

¹⁶² Most publicly-traded partnerships are treated as corporations and subject to the corporate double tax. I.R.C. § 7704. 7704(c) excepts partnerships that predominantly have passive income and allows these MLPs to be taxed as passthroughs. Thus a real-estate venture could organize as a MLP be publicly traded and get passthrough taxation, just like a REIT.

¹⁶³ I.R.C. § 721.

¹⁶⁴ MLP's are taxed as Subchapter K partnerships and are allowed generally to passthrough losses. I.R.C. § 702.

¹⁶⁵ I.R.C. § 7704(c)-(d).

¹⁶⁶ Qualifying income includes gains from the sale of real property even if the MLP is a developer. I.R.C. § 7704(d)(1)(D).

¹⁶⁷ I.R.C. § 857(b)(6).

MLPs are also more flexible in terms of governance. Unlike REITs, they have no ownership concentration restrictions, so it is possible for an acquirer to buy a majority of the voting shares of an MLP. On the other hand, limited partnership law also permits entrenchment of management.¹⁶⁸

Yet investors do not generally use MLPs to organize large real estate ventures to compete with REITs. A recent search yielded only two examples of existing MLPs with market caps over \$1 billion that were arguably involved in real estate. These were Cedar Fair (market cap of \$2.34 billion), and StoneMor Partners (market cap of \$2.71 billion). Cedar Fair owns and operates amusement parks while StoneMor Partners owns and operates cemeteries. Because these are active operating businesses, neither could be organized as REIT. The only example we could find of an MLP that could perhaps operate as a REIT was Brookfield Property LP. Even that entity was a hybrid REIT/limited partnership. In any case, it went private in 2021. So, once again, REITS reign as undisputed champions of real estate investing.

Hence a puzzle: if MLPs are like REITs but more flexible, why don't REIT investors move their money over to MLPs? Why do investors stick with the inferior product? Our theory finds confirmation in its ability to solve this puzzle.

If investors have preferred REITS to MLPs for real estate, despite the former's many restrictions, it suggests that investors like the restrictions.¹⁶⁹ And with good reason: both cash and property investors have something to worry about with MLPs.

Property contributors to an MLP face the same conflict between themselves and other investors and a similar vulnerability to manager-triggered gain. But MLPs provide little assurance to property contributors. Although MLPs can be structured so that purchase of a majority of limited

¹⁶⁸ Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555 (2012) (Stating that eighty-four percent of public limited partnerships did not give the limited partnership's investors the right to elect the limited partnership's board).

¹⁶⁹ There are two other potential explanations: tax compliance and treatment of tax-exempt investors. REITs report income to their investors on 1099-DIV rather than Form 1099. Goff and Anabtawi argue that the REIT structure has dominated the MLP in part because of REITs provide simpler the relative tax-filing simplicity of REITs. Goff & Anabtawi, *supra* note 68, at 21-8-21-10. But our sense is that if the only advantage is one of less administrative cost in tax filing, the MLPs flexibility would seem to dominate the REITs restrictions. REIT's (inflexible) combination of resistance to takeovers, mandatory distributions, and limits on business activities is exactly what makes it an attractive vehicle for overcoming investor conflicts.

Another explanation for the REIT's dominance over the MLP is the treatment of tax-exempt investors. Although tax-exempt investors generally are not subject to income tax, they do pay tax on unrelated-business taxable income (UBTI). Goff & Anabtawi, *supra* note 68, at 21-9. Income related to a trade or business of the MLP will be treated as UBTI. Tax-exempt partners in the MLP would be forced to file tax returns and pay income tax, a result that tax-exempt investors are eager to avoid. The REIT blocks UBTI for tax-exempt shareholders. *see also* Michael Bolotin, *Why Private Investment Funds Are Using REITs to Invest in Real Estate*, TAX NOTES (Feb. 17, 2020), <https://www.taxnotes.com/tax-notes-federal/rics-reits-and-remics/why-private-investment-funds-are-using-reits-invest-real-estate/2020/02/17/2c2zt>. This is an important observation, but it is hard to attribute the success of REITs to this MLP limitation that applies to only a single class of investors. The MLP is a very popular structure for oil and gas investment despite raising the same UBIT issues for tax-exempt investors.

partnership interests cannot result in any change in management,¹⁷⁰ a risk remains that a takeover of the general partner. Unlike at a REIT, a hostile acquirer can buy out the corporate general partner and cause it to undertake transactions that impose disproportionate cost on one or more limited partners.¹⁷¹

And whoever the managing partner ends up being, that managing partner has plenary control over the business. Limited partnership law provides no default mechanism to force distributions or limit business scope. Limited partners are just along for the ride. By contrast, REITs couple the entrenched management with limited business activities and mandatory dividends. An MLP manager can reinvest the MLPs profits however she likes, but a REIT manager must give it back to investors who have the option (but not the obligation) to reinvest in similar easy-to-monitor real estate transactions. MLPs match REITs in many ways, but they lack the useful combination of giving managers strong armor but a short leash. Investors seem to prefer the package REITs offer.

Our analysis does not require us to claim that REIT law is the *only* path by which investors can obtain this package of restriction. Perhaps an MLP could include in its partnership agreement a set of provisions that track REIT provisions: an excess share provision, mandatory distributions, a declaration that most lines of business are ultra vires. If they did, it would provide further confirmation that parties appreciate the benefit of these interlocking features.¹⁷²

Importantly, there is no need for them to do the work of replicating REIT-type restrictions, since REITs have these features “off the rack.” They also enjoy widespread support from Maryland’s caselaw and area-expert judiciary.

Moreover, we suspect that REITs are in fact essential in ways that MLPs cannot match. Importantly, REITs enjoy cheaper and more credible commitment to these promises than an MLP can offer. REIT law’s restrictions arise out of the tax code and are enforceable by tax authorities. If REIT managers illegally hold back dividends or expand into new business activities, the IRS may catch them; the limited partners do not need to monitor for compliance nor sue to force compliance; the government does that for them. By contrast, an MLP partnership agreement promising distributions or restricting business activities requires limited partners to monitor and discipline managers – no cheap or easy task.¹⁷³ Insofar as REITs are intended to be passive investments for

¹⁷⁰ Indeed, the default rules for a Uniform Act Limited Partnership achieve this effect. First, buyers of limited partnership interests gain no voting power unless they are separately admitted as partners. ULPA 301(b)(listing admission criteria that do not include mere purchase of interests). Second, limited partnership interests allow votes on only a few issues – none of which include the ongoing composition of general partners. ULPA 603 (listing conditions by which a general partner can be removed from office, none of which involve a vote of a majority of limited partners).

¹⁷¹ This is not possible if the MLP general partner is a private corporation or an individual. If the general partner is a private corporation, the managers are accountable to the general partner’s shareholders, whose demands may change with their own preferences or as private sales of the stock shift control. Only with a REIT is it impossible for a control block to form and reform.

¹⁷² We do observe MLPs devote substantial contractual attention to forcing distribution. See <https://www.lw.com/admin/Upload/Documents/Latham-Master-Limited-Partnership-Primer-2014.pdf>, 5-7. But contractual practice “clearly gives the general partner wide discretion.”

¹⁷³ Additionally, the decision to pay a dividend is a business decision by the board of directors, and courts are reluctant to deprive boards of this substantive discretion. LOPUCKI & VERSTEIN, *supra* note 5 at 200-202.

ordinary investors, such oversight is impractical. For that reason, we are drawn to the thought that REITs dominate MLPs because *only* REITs can credibly commit to the package investors need.¹⁷⁴

A party that wanted REIT-like structures without the REIT would have little reason to try to rebuild it with an MLP, nor would they likely succeed. The only reason to switch to an MLP would be to avoid the mandatory rules within REITs, and there seems to be no appetite for that.

B. The Contracts Puzzle

The forgoing Section asked why parties use REITs rather than master limited partnerships. It concluded that REITs come with constraints that investors seem to value, and which MLPs cannot get by contract, or can only get with considerable difficulty. This part again queries the puzzling lack of interest in REIT alternatives, and thereby vindicates our theory of the REIT.

We have argued that REITs solve problems of heterogenous ownership by facilitating managerial balancing. Managerial balancing is surely *a* solution to the problem of heterogenous ownership, but is it an *essential* solution? After all, *every* business must assure a variety of patrons that their interests will be adequately protected. A bank will not lend to a business if it fears that the managers will ruthlessly plow the proceeds into risky projects rather than repay the loan. A worker will not buy a house near her employer, nor invest in job training, if her employer usually slashes the wages of workers who are now “stuck.” But most businesses do not engage in some special kind of managerial balancing, much less the sort that justifies thoroughgoing entrenchment.¹⁷⁵

Instead, most firms reassure non-shareholders with contracts. Banks demand protective covenants. Workers bargain for job security or sufficient salary to do without it. In parallel, if real estate funds promised to pay any tax liabilities they trigger for their contributors, then all investors would seem to be homogeneous again.¹⁷⁶ Conflict would subside, and the complex balancing solution would be unnecessary.

As a threshold matter, umbrella partnerships sometimes do make such promises. They are called “tax protection agreements” (“TPAs”),¹⁷⁷ and real estate lawyer stand ready to negotiate them.¹⁷⁸ They are even used at REITs.¹⁷⁹

¹⁷⁴ If we are right, then it would be fair to say that the REIT’s essential role is to address investor conflicts in real estate. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 416 (2000) (using the term “essential” to refer to a role filled by one legal technology that could not be fulfilled by any other).

¹⁷⁵ Of course, this sort of balancing is precisely what is predicted and recommended by stakeholder theorists. See generally Blair & Stout, *supra* note 144.

¹⁷⁶ Also sufficient would be for real estate businesses to simply contractually reallocate from the contributing partner to the partnership or all the partners, but this is prohibited by IRC § 704(c). Of course, investors are never quite homogeneous. See Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 U.C.L.A. L. REV. 562 (2006) (identifying heterogenous interests within shareholder group community).

¹⁷⁷ For example, this TPA addresses each of the concerning transactions we discussed *supra* Part IV. <https://www.sec.gov/Archives/edgar/data/1541401/000119312512054391/d283359dex106.htm>

¹⁷⁸ Blake D. Rubin, *Tax Planning for the Property Owner in REIT Acquisitions* SL033 ALI-ABA 1373, 1.05.

¹⁷⁹ The analysis below examines REIT TPAs, but it is worth remarking that we find TPAs to be similarly rare in structures that could compete with REITs, such as master limited partnerships. On MLPs see *supra* Part VI.A.

Yet TPAs are rare. Large REITs only protect a small fraction of their investors in this way. We scoured the public filings of America's largest publicly traded REITs and found evidence of only four TPAs currently in effect.¹⁸⁰ Seventeen of the largest REITs granted no TPAs, and the other three REITs each protect just one or two properties in this way.¹⁸¹ And when TPAs are granted, they often offer protections that are plainly inadequate if they are an investor's sole defense.¹⁸²

¹⁸⁰ We studied U.S. REITs that were large either in terms of gross assets or market capitalization. For the gross asset list, see SWFI, *Real Estate Investment Trust Rankings by Total Assets*, <https://www.swfinstitute.org/fund-rankings/real-estate-investment-trust> (last visited Sep. 24, 2022). For the market cap list, see <https://companiesmarketcap.com/reit/largest-reits-by-market-cap/>. Of the top 20 largest REITs by assets, sixteen are U.S.. We supplemented this list with the largest U.S. REITs that were not on the gross asset list to arrive at a total of 20 large U.S. REITs. To locate evidence of TPAs, we searched Bloomberg Law's EDGAR database. First, the advanced search criteria was limited to a particular REIT. Next, the search term "tax protection" was entered into the advanced search criteria. If this led to any search results, those results were reviewed to find TPAs that the REIT had previously entered into. If "tax protection" returned 0 results, then a search was conducted for "contribution agreement", "partnership agreement", "OP units", "tax indemnification", "tax sharing", "tax indemnity", and "tax allocation." If all the aforementioned searches returned 0 results, then that REIT was determined to not have used a TPA. This method does not ensure that TPAs are absent; it is possible that they exist but go undisclosed. But material contracts must be disclosed, and TPAs are often discussed in connection with other transactions. *E.g.*, Boston Props. Inc., Registration Statement (Form S-11/A; E:C), 97-8 (Jan. 2, 1998) <https://www.sec.gov/Archives/edgar/data/1037540/0000927016-98-000005.txt> (registration statement).

¹⁸¹ Boston Properties once had as many as 26 different TPAs in effect. See Boston Props. Inc., Annual Report (Form 10-K), 97 (March 16, 2005) <https://www.sec.gov/Archives/edgar/data/1037540/000119312505050590/d10k.htm>. Boston Properties has since curtailed the use of TPAs dramatically, with only a single TPA outstanding as of 2022. Boston Props. Inc., Annual Report (Form 10-K), 21-2 (Feb. 25, 2022) <https://www.sec.gov/ix?doc=/Archives/edgar/data/1037540/000165642322000013/bxp-20211231.htm>. VICI Properties has only a single TPA as well. VICI Props., Business Combination Prospectus (Form 425), (Aug. 5, 2021) <https://www.sec.gov/Archives/edgar/data/1691299/000170569621000156/mgpacquisitiontransactiond.htm>; see <https://www.sec.gov/Archives/edgar/data/1920791/000119312522134159/d291163dex103.htm> (full text of the TPA). Simon Property Group has only two TPAs despite regularly using limited partnership interests to acquire property. See Simon Prop. Grp., Quarterly Report (Form 10-Q; EX-2.1), (Aug. 13, 1999) https://www.bloomberglaw.com/product/blaw/document/X5CQFRV72D0001?documentName=ex-2_1_2&search32=I-9BT0wLso2U98uDMZiRFQ%3D%3DQPIIn2hMq9sdNsJxE8Oh2mZUAIGEP8s21GgQSL7RNAmyqXEAi5O_4Dk66LhOPfpymDVk5aMkLi44bc3UwH6Yj3QUvmAh8kvAkRph6Uc9bEaHiDcXSSaizP8zXVI79-5Da (Management and Portfolio Agreement); Simon Prop. Grp., Registration Statement (Form S-4), 72 (Aug. 13, 2004) <https://www.sec.gov/Archives/edgar/data/1063761/000104746904026534/a2141654zs-4.htm>. Starwood had one TPA, but it has since expired. Starwood Prop. Tr., Annual Report (Form 10-K; EX-10.17), (Feb. 29, 2018) <https://www.sec.gov/Archives/edgar/data/1465128/000155837018001216/stwd-20171231ex101768785.htm>, Annexes A-E. Four of the REITs studied (Annaly Capital Management, AGNC Investment Corp, Blackstone Mortgage Trust, and Two Harbors Investment Corp) are mortgage REITs. Consistent with our theory, none of the mortgage REITs had TPAs. See discussion *infra* Part VII.A. These REITs were on the gross asset list, but were quite small by market cap. By market capitalization, the largest mortgage REIT (Annaly) is not even in the top 30..

¹⁸² A quite common clause would entitle the investor not to a full repayment of all tax-related expenses, but a far more modest payment compensating the investor for some of the lost deferral value. For example, a transaction that triggered a \$300,000 tax would not result in a \$300,000 payment. It might instead trigger the value of deferring a \$300,000 payment for (say) ten years, or roughly \$87,000 (assuming an interest rate of 3%).

The market has spoken: contracts compete as an investor-protection technology, but property owners don't usually rely on such contracts. Hence a puzzle. Why is managerial balancing deemed essential and, usually, sufficient to protect property contributors? Why are contacts insufficient or unnecessary in most cases?

Put simply, these contractual protections are inefficient. The only contract that credibly protects property contributors is one that grants full indemnification for any taxes they suffer. But this is an expensive promise, so expensive as to discourage productive transactions and generate dead-weight loss.

In our example concerning Helmsley's \$1 billion interest in the Empire State Building, such a promise would cost the firm \$430 million indemnification payment if taxes are ever triggered.¹⁸³ A firm that granted such a protection would be unable to undertake any taxable activity that generated less than a 43% return on investment. It would not claim the free money of a \$300 loan workout,¹⁸⁴ nor sell the assets for a 35% profit,¹⁸⁵ nor undertake a merger with a 40% premium.¹⁸⁶ These are all efficient actions that a property contributor like Helmsley would probably have happily undertaken when she was sole owner of the asset.¹⁸⁷ For real estate to transfer efficiently, a more flexible governance solution is needed. Managers need the power to sometimes (but not always) take actions adverse to property contributors.

Second, even where contracts would be helpful, they may not be credible. Clauses that appear to protect the investor may prove unenforceable,¹⁸⁸ or they may succeed only after considerable litigation effort. Consider the case of *Stender v. Archstone-Smith Operating Trust*, a sprawling litigation involving 23 written opinions over 13 years (in addition to at least one written arbitration decision).¹⁸⁹ The heart of this case concerned a merger that triggered taxes for REIT property contributors to one of the nation's largest REITs.¹⁹⁰ These property investors had bargained for tax protection agreements and sought to exercise them, but the clauses failed to protect them, and they recovered nothing.

¹⁸³ The indemnification payment would include \$300 million and an additional amount necessary to compensate her for the taxes due on the indemnification payment.

¹⁸⁴ See *infra* Part IV.C.

¹⁸⁵ See *infra* Part IV.A.

¹⁸⁶ See *infra* Part IV.B. See also Justin Salon et al., *Frequently Asked Questions About UPREITs And OP Unit Transactions*, MORRISON FOERSTER (June 12, 2019), <https://media2.mofo.com/v3/assets/blt5775cc69c999c255/blt3107a3a3a5411876/627311764d9f892971290015/190612-faqs-upreits.pdf> (asserting would-be acquirers are deterred by TPAs); cf. Einhorn, Enmerich & Panovka, *supra* note 70, at 695-96 (explaining that this complexity inhibits mergers).

¹⁸⁷ If someone had offered Helmsley \$1.4 billion for her interest in the building, she probably would have sold it rather than contribute it to the REIT. If her contract with the REIT locks up the asset in a way that an otherwise efficient transaction cannot occur, the result is substantial allocative inefficiency.

¹⁸⁸ When a breach of contract has forced a taxpayer recognize gain that was expected to be deferred, at least one court has held that damages regarding the value of deferral are too speculative to be awarded. *Chen v. Huang*, 990 N.Y.S.2d 436 (2014).

¹⁸⁹ *Stender v. Archstone-Smith Operating Tr.*, 2017 WL 3676473, (D. Colo. Aug. 25, 2017).

¹⁹⁰ A merger of the public corporation need not trigger taxes for the property contributors; they are partners of the subsidiary operating partnership and need not lose their interests in the merger. However, the parent corporation will usually have the power to trigger a merger of the operating partnership too. See *supra* note 111 and accompanying text; e.g. *Stender*, *supra* note 189, at *4.

The agreement looked protective enough. It promised payment if a merger or similar transaction “results in [the investors] being required to recognize part or all of the gain that would have been recognized for federal income tax purposes upon a fully taxable disposition of one or more Protected Properties.”¹⁹¹ But the merger proponents spotted vulnerability in that word “required.” They gamely offered a choice in merger consideration: either cash or a basket of securities. The securities were carefully structured to preserve the tax status of any investor who selected them, but they were otherwise problematic. At the time of the offer, the securities were worth at least 20% less than the cash.¹⁹² In the words of the objecting investors, the securities offer, “was so economically inferior that it provided no reasonable alternative to the cash option,” and so the claimants were effectively “required to take the cash, thereby recognizing taxable gain.”¹⁹³ The arbitrator disagreed, determining that the securities option “was a bona fide investment alternative, and, therefore, the merger did not result in Claimants being required to recognize taxable gain by choosing the cash option.”¹⁹⁴ By forcing (without forcing) the investors to opt for the taxable cash-sale, the acquirer eluded the TPA.

Going forward, investors must realize that any TPA can be gutted by giving the investor a Hobson’s Choice: force the investor to pick between authorizing a taxable event or else suffering some adverse consequence. Perhaps the next litigant will be more successful in arguing that a coercive offer triggers the TPA. But *Archstone* is the only decided case interpreting TPAs, so future investors must at least predict uncertainty and cost in claiming on their contractual protections. More generally, the capacity of a concerted management team to undermine contractual protections must never be underestimated.¹⁹⁵ At the point that contract-beneficiaries must also depend on a measure of solicitude from managers, some may decide to do without the contract and focus more directly on managers committed to balancing.

Even enforceable TPAs are not credible protections in some of the cases the investor should fear most. TPAs promise payment for tax liabilities suffered. This entitlement makes the investor an unsecured creditor of the firm. Unsecured creditors may not fully recover if their debtor is insolvent, and they will recover nothing if a debtor owes lots of higher priority debts. Real estate ventures such as REITs operate with high levels of leverage, which means even small declines in value can render

¹⁹¹ Stender *supra* note 189, at *9.

¹⁹² 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).

¹⁹³ Stender, *supra* note 189, at *9.

¹⁹⁴ *Id.*

¹⁹⁵ This is one reason often cited to explain why shareholders of ordinary corporations are protected by fiduciary duties and electoral control but not detailed contracts. The shareholders are locked, vulnerable, and far less sophisticated than their managers. It is fruitless to negotiate the precise terms of the deal; all the safety lies in assuring yourself that you will have basically trustworthy managers.

them insolvent.¹⁹⁶ Real estate is a cyclical asset, and the value of individual parcels can be highly correlated.¹⁹⁷ Occasional periods of declining real estate values do result in REIT bankruptcies.¹⁹⁸

Most importantly, the events that lead to insolvency correlate with the events that might tempt a firm to violate a TPA. A firm that cannot repay its creditors may wish to sell assets for cash. Indeed, such a firm may be forced to do so; the bank with a mortgage on a property can force a foreclosure sale if the REIT misses enough payments. If a real estate venture faces bankruptcy, it has nothing to lose by violating TPAs. It gets the cash it needs now. If it returns to prosperity, it can settle things with the aggrieved investor later. If things continue to decline, the insolvent firms won't have to pay the full TPA amount anyway.

Finally, tax protection agreements may be disfavored because they impose information costs on investors who are not a party to them. If a firm has encumbered much of its assets with TPAs, the firm has far fewer efficient business strategies than it appears, and far more latent risk of default. Future investors would need to evaluate complex and individualized TPA commitments prior to investing, and they will bid less for the firm's shares knowing that they must undertake this scrutiny.¹⁹⁹ Thus, TPAs should raise the firm's cost of capital.²⁰⁰ The problems with using TPAs are well known among market participants, so it is no surprise that "tax protection agreements can be viewed negatively by investors and public market analysts."²⁰¹ Firms that avoid TPAs can lower the information cost to investors and their own cost of capital.

Given the challenges we have identified with contracts as a means of managing heterogeneous ownership, it is not surprising that non-contractual mechanisms must be deployed to overcome investor conflict. Indeed, our sense is that TPAs are not written with the goal of reducing the heterogeneity between investors. If anything, they often exacerbate the heterogeneity between different property contributors. Many TPAs are written in favor of REIT board members, executive and large shareholders. It may be that TPAs mostly exist not to force payments to powerless minority investors, but to instead permit payments to insiders.²⁰²

¹⁹⁶ REITs also risk insolvency because of maturity mismatch: they often borrow on a short-term basis in order to buy long-lived assets, such as real estate and mortgages. Such REITs can suffer if interest rates rise or if credit markets seize up.

¹⁹⁷ See, e.g., Jim Clayton & Greg MacKinnon, *The Time-Varying Nature of the Link between REIT, Real Estate and Financial Asset Returns*, 7 J. REAL EST. PORTFOLIO MGMT. 43 (2020).

¹⁹⁸ CBL& Associates and Pennsylvania Real Estate Investment Trust both declared bankruptcy in 2020 during the COVID pandemic. Washington Prime Group, another mall REIT declared bankruptcy in 2021.

¹⁹⁹ Investors who join in light of what they read cannot rest easy; they must monitor the firm to watch as new TPAs are signed. An investor must always fear that the newest real estate acquisition comes with costly strings attached. This risk is acute because of how managers are compensated. REIT managers are typically paid based on growth, assets under management, or profitability. Managers can cheaply grow the REIT by offering generous TPAs to potential contributors. The shadow costs of these TPAs are real, but costly for investors to evaluate.

²⁰⁰ A high cost of capital is especially costly for a REIT, given that its reinvestment restrictions will force it to actually bear those costs in external capital markets.

²⁰¹ Salon, *supra* note 186, at *3.

²⁰² Without a TPA, solicitude to the interests of insiders may be bad press or grounds for legal challenge. Yet indifference to their interest can be bad business. Insiders with contingent tax liabilities may be reluctant to take

The Empire State Building provides an interesting example. Leona Helmsley never contributed her interest in the Empire State Building to a REIT. Perhaps, the conflict with fellow investors made it impossible for the “Queen of Mean” to get comfortable with a structure that ultimately requires balancing, trust, and cooperation. Perhaps, she also understood the limitations of a tax protection agreement. Five years after her death, her trust finally contributed her interest in the Empire State Building to a REIT in 2012. The formation of the Empire State Real Estate Trust rolled up her interest in the Empire State Building and that of her rival and co-owner Malkin family into an UPREIT, in exactly the type of combination that this article contemplates. Perhaps it is no surprise that, the contribution by the Malkin family and the Helmsley Trust had no contractual protection for built-in gain on the Empire State Building.²⁰³

C. The Valuation Puzzle

REIT popularity is not itself a puzzle – it is the primary way in which most investors achieve diversified exposure to commercial real estate. This was Congress’s intent – to facilitate investments in real estate through a vehicle that looked like a mutual fund – passive, diversified, and decentralized.

But that popularity hides a puzzle. This puzzle concerns net asset value, or NAV. A company’s NAV represents the sum of the value of everything it owns (less any debt). Net asset value ought to act as a floor on a company’s value. Almost all mutual funds have net asset values that are equivalent to their market value.²⁰⁴ Indeed, most operating companies have market capitalizations greatly in excess of the net value of the sum of their parts.²⁰⁵

But REITs are strange, often trading at a significant discount to net asset value.²⁰⁶ At the time of this writing, the median discount across the industry averages about 15%.²⁰⁷ That means that a REIT holding a \$1 million hotel may be worth about \$850,000. An investor could make an instant profit by choosing nearly any REIT, buying its shares on the stock exchange then causing the REIT to sell of its contents. Commonsense would have predicted the opposite.²⁰⁸

efficient actions that harm them personally. A TPA allows managers to work out debts, accept an attractive offer for a parcel, or undertake profitable merger, even if it gores their own ox. TPAs are therefore analogous to golden parachute payments, designed to make sure managers are not biased against otherwise efficient mergers. Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager-Specific Investments*, 25 J. FIN. ECON. 123, 132 (1989).

²⁰³ ESRT S-4. Of course, at that point, the built-in gain for the Hemsley interest was mostly gone due to stepped-up basis.

²⁰⁴ The exception are, of course, closed end mutual funds. See *infra* note 211.

²⁰⁵ See Anthony J. Casey, *Chapter 11’s Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709, 1717 & n.29 (2020).

²⁰⁶ See, e.g., Dennis R. Capozza & Sohan Lee, *Property Type, Size and REIT Value*, 10 J. REAL EST. RSCH. 363, 371 (1995) (“On average REITs have traded at a discount of 8% from the net asset values of the properties”).

²⁰⁷ S&P GLOB. MKT. INTEL., <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/nav-monitor-us-equity-reits-trade-at-14-7-discount-to-nav-at-may-end-70652122> (June 3, 2022).

²⁰⁸ REIT shares are more liquid than the underlying assets, so creating the shares should add value. See Lawrence Benveniste, Dennis Capozza & Paul Seguin, *The Value of Liquidity*, 29 REAL EST. ECON. 633, 633 (2001) (creating liquid shares from illiquid real estate “increases value [for that real estate] by 12-22%”). Any discount must be enough to offset the liquidity premium we would otherwise expect. Also no ETFs or mutual fund trades at a discount to NAV. See Morley & Curtis, *supra* note 38.

There is no academic consensus as to why REITs trade at a discount,²⁰⁹ but one widespread explanation is that investors expect the REIT's management to waste corporate assets prior to liquidation through e.g., excessive compensation.²¹⁰ Call this the “managerial waste” theory.²¹¹

Our theory provides a different explanation. The liquidation value of a REIT ignores the tax cost of liquidation. Suppose a REIT's sole asset is a \$1 billion asset, contributed recently by a limited partner with zero basis. The net asset value of the REIT is \$1 billion, but if it were to liquidate its assets, the limited partner would incur almost \$300 million in taxes. A REIT management team that assigns any priority to protecting limited partners from taxes would refuse to promptly liquidate the asset for \$1 billion. In a sense, part of the discount *is* the built-in tax liability.

More generally, REITs trade at a discount precisely because managers are *not* trying to maximize shareholder value; manager entrenchment means that managers can resist pressure to maximize shareholder payouts at the expense of other constituents, such as limited partners. Shareholders therefore require a discount to invest cash in REITs.

REITs nevertheless grow because entrenchment makes possible a business structure that is ultimately quite efficient. They persuade real estate owners to transfer otherwise illiquid assets, to the benefit of cash investors who would otherwise be unable to invest in these assets on attractive terms. Modern REITs only exist because managers are empowered to balance competing interests. They exist specifically because they can resist pressures to liquidate and sell assets. Thus, comparing the value of a REIT to its net asset or liquidation value misses the point; if existing REITs could be liquidated for a quick gain, they wouldn't have been formed in the first place.

D. The Overseas REIT Puzzle

More than 40 jurisdictions now permit REITs to form.²¹² Perhaps 30% of the REIT market cap is located outside of the United States.²¹³ Yet many REIT advocates are puzzled by the slow growth in some jurisdictions. Why have REITS grown much more slowly in other countries?

²⁰⁹ H. Swint Friday & G. Stacy Sirmans, *Board of Director Monitoring and Firm Value in REITs*, 16 J. REAL EST. RES. 411, 412 (2020) (“An adequate explanation for these discounts in REITs has not been forthcoming.”).

²¹⁰ See, e.g., Jay C. Hartzell, Jarl G. Kallberg & Crocker H. Liu, *The Role of Corporate Governance in Initial Public Offerings: Evidence from Real Estate Investment Trusts*, 51 J.L. & ECON. 539, 541 (find steeper discounts where REIT incorporates in Maryland, “a state known to be management friendly. . .”) *see also* H. Swint Friday, G. Stacy Sirmans & C. Mitchell Conover, *Ownership Structure and the Value of the Firm: The Case of REITs*, 17 J. REAL EST. RSCH. 71 (1999) (finding no monitoring benefits from outside block holders); *but see*; Chinmoy Ghosh & C.F. Sirmans, *On REIT CEO Compensation: Does Board Structure Matter?*, 30 J. REAL EST. FIN. & ECON. 397 (2005) (finding that institutional ownership does discipline REIT CEO compensation).

²¹¹ This theory about REIT undervaluation has been imported from the literature on closed end funds, which suffer from agency costs and whose shares often trade at a discount. *See* Friday & Sirmans, *supra* note 209, at 412. *See also* CLOSED-END FUND CENTER, *Current & Historical Premium & Discounts for U.S. Closed End Funds*, <https://www.cefa.com/newsarchive/content/discount/premiumdiscountarchive.fs> (Aug. 12, 2022).

²¹² EUROPEAN PUBLIC REAL ESTATE ASSOCIATION, *EPRA Global REIT Survey 2021*, https://prodapp.epra.com/media/EPRA_Global_REIT_Survey_2021_v5_1630572816126.0.pdf (last visited Aug. 25, 2022).

²¹³ *Id.*

Perhaps one answer is that the entity varies so much from country-to-country, united only in its principal business focus: real estate. Some impose ownership concentration restrictions, which impair takeovers.²¹⁴ Most do not.²¹⁵ Some require robust dividend payments.²¹⁶ Others do not.²¹⁷ If REITs have not taken off, it may be because jurisdictions adopt parts of the U.S. structure a la carte when REITs are actually a *prix fixe* menu.

As Figure 4 suggests, there is a cohesive logic to the U.S. REIT. If real estate combinations in another country involve heterogeneous ownership,²¹⁸ foreign policymakers would be well served to adopt the REIT complete with all its curious features. Leave out any one of those features and the REIT breaks down. Fail to entrench managers, and managers will be forced to cow to cash investors and be unable to attract property contributors. Entrench managers but fail to limit reinvestment distributions, and the managers can run amuck. Limit reinvestment but fail to provide passthrough treatment, the REIT is not viable from a tax perspective. There are many ways for overseas REITs to offer an incomplete package, as they did in the US for decades, and likewise fail to find much popularity.

E. The Illiquid REIT Puzzle

Our discussion has so far focused on highly liquid REITs, for which investors can easily buy and sell shares. Liquid REITs make up a majority of the industry, and several tax rules encourage transferability.²¹⁹ But more than one-third of all REIT assets are held by REITs that lack any public trading.²²⁰ Speaking broadly, illiquid REITs take up the poles of the REIT market.²²¹ Some of the most prominent REITs are not publicly traded on an exchange. The prime example is Blackstone's BREIT. It is the world's largest commercial real estate owner,²²² holding more than \$100 billion in

²¹⁴ *Id.* at 199-211 (Canada), 58-69 (Germany), 451-61 (Israel).

²¹⁵ *See Id.*, at 325-37 (Japan), 175-86 (United Kingdom), 393-404 (Singapore).

²¹⁶ *Id.*, at 300-14 (India); *id.* at 143 (Netherlands).

²¹⁷ *Id.*, at 121 (Lithuania); *Id.* at 131 (Luxembourg).

²¹⁸ Foreign jurisdictions with income taxes similar to the U.S. income tax face the same problem of heterogeneous ownership due to the tax treatment of built-in gain.

²¹⁹ *See* [IRC § 856\(a\)\(2\)](#) (REITs must have transferable shares); (a)(5) (REITs must have more than 100 shareholders).

²²⁰ <https://www.reitsacrossamerica.com/united-states> (stating that private REITs own \$1.5 of the \$4.5 trillion in total assets). Private REITs have not registered their securities with the SEC. Accordingly, their shares can only be sold (or resold) pursuant limited exceptions, such as to relatively wealthy accredited investors. Roughly 18% of public REIT value is publicly traded but not traded on an exchange. Paul J. Seguin, *The Relative Value of Public Non-Listed REITs*, 38 J. Real Est. Res. 59, 61 (2016).

²²¹ U.S. securities law regulates the sale (and resale) of investment securities, such as the shares of REITs. If companies wish to raise money from the public, they must register the securities with the SEC and submit to periodic public disclosures. Shares of companies that do not undertake this registration are sellable only to relatively wealthy "accredited" investors and institutions. Companies must go further if they want their shares to be *easy* for investors to resell. To ensure a market for investment securities, a company must also contract with a stock exchange to "list" the security.

²²² BREIT, Prospectus, at 7, available at <https://www.breit.com/wp-content/uploads/sites/33/2022/03/BREIT-Prospectus-with-previous-supplements.pdf>.

real estate assets. There is no public market for its shares.²²³ At the other end of the spectrum, the shares of many of the smallest and least reputable REITs are also illiquid.

Both large and small illiquid REITs have recently been mired in problems. BREIT has faced a “crisis” of investor confidence since late 2022.²²⁴ Investors, fearing the REIT may be battered by rising interest rates, clamored for the redemption of billions of dollars of securities – panic set in when the fund started to block these requests in November 2022.²²⁵ BREIT’s shares have plunged in value as investors question the company’s health.²²⁶

Smaller illiquid REITs have faced their own problems. Recent studies have shown that nontraded REITs produce net losses for investors relative to benchmarks.²²⁷ They generate vastly more FINRA complaints.²²⁸ They are associated with Ponzi-like structures in which later investors finance returns for early investors.²²⁹ The problem is severe enough that both FINRA and the SEC posted investor bulletins warning investors to be wary of investing in them.²³⁰

Our theory helps us to explain these illiquid REIT problems. Essentially, public trading is a good fit for the REIT structure because it creates a source of liquidity outside the firm. Investors in an illiquid REITs are stuck looking to the business itself for liquidity. This is a structural weakness that undermines the internal coherence of the REIT. This puts illiquid REITs at a disadvantage and may lead to the exploitation of some investors.

As a general matter, business entities can only raise capital on competitive terms if investors have some assurance of liquidity.²³¹ Investors are reluctant to invest if they cannot recover their principal when they need cash. Companies can assure investors of liquidity in only two ways: facilitating a secondary market for their securities (so that early investors can sell to subsequent investors) or agreeing to redeem unwanted shares. Untraded companies constrained to the latter. Yet REITs face structural limits that inhibit the redemption of shares.

Redemption promises are dangerous for any real estate venture because redemptions may force the company to sell assets. For example, a real estate company that has 5% of its value in cash and 95% in property may have to sell property if 10% of its investors ask to redeem their shares. Real estate assets are illiquid, so prompt sale may not capture their fair value. Any real estate venture faces

²²³ <https://www.breit.com/non-us-investor/> (“There is no public trading market for our common stock and repurchase of shares by us will likely be the only way to dispose of your shares.”)

²²⁴ <https://www.wsj.com/articles/blackstones-big-new-idea-leaves-it-bruised-d66de361>

²²⁵ <https://www.reuters.com/markets/us/blackstone-blocked-investor-withdrawals-71-billion-reit-february-2023-03-01/>

²²⁶ <https://www.wsj.com/articles/blackstones-big-new-idea-leaves-it-bruised-d66de361>. The bleeding seems to have largely stopped after a large investment by the University of California,²²⁶ but the future remains uncertain.

²²⁷ Hartzell, J.C., J-E. Kim, V. Kimbrell, and J. Sprow. *Returns in the Nontraded REIT Industry: Evidence from Full-Cycle Events* (2012)

²²⁸ <https://www.wsj.com/articles/SB10001424052702303459004577364110318098188>

²²⁹ Seguin, *supra* note 220, at 62.

²³⁰ <https://www.sec.gov/resources-investors/investor-alerts-bulletins/non-traded-reits>. Bodamer, D. *Nonlisted REITs Fight to Shake Misconceptions*. NREI Online, October 10, 2012

²³¹ Richard Squire, *Why the Corporation Locks in Financial Capital but the Partnership Does Not*, 74 VAND. L. REV. 1787, 1792, 1815-21(2021).

problems if its investors demand cash that has been locked up in real estate. This is essential logic of a “bank run” and it applies to any real estate venture that would offer redemption rights to investors.

Yet the problem is worse at a REIT because the possibility of even moderate redemption pressure undermines the REIT’s reassurance of property contributors. Liquidating properties may trigger taxes. A REIT with redemption rights is therefore not a dependable partner for property contributors. No matter what assurances the managers make, and no matter how takeover-proof the REIT is, the managers may still be obliged to disregard property contributor tax needs in order to satisfy redemption requests from other investors.²³²

REIT promoters are aware of this problem and typically attempt to limit investor redemptions to a manageable scale. It is common to cap redemptions at some number, such as 5% of an investor’s capital per year,²³³ and to likewise permit REIT management to suspend redemptions.²³⁴ These limitations are a logical compromise between the desire to avoid fire sales of assets and the need to accommodate investors. But the compromise serves neither goal perfectly and won’t fully reassure would-be property contributors. Why take the risk that a REIT will be pressured to sell your property and trigger your taxes if another REIT is free from this risk, because it is publicly traded and offers no redemption rights?

Consistent with this theory, property contributors have shunned illiquid REITs even though many are set up as umbrella partnerships, capable of receiving assets from tax-sensitive property owners. BREIT, for example, is formed as an umbrella partnership, which its Prospectus explains was precisely in order to make deals with tax-sensitive property contributors.²³⁵ Yet non-Blackrock LPs hold less than 1% of the umbrella partnership interests of BREIT.²³⁶ We can infer that BREIT has made very few tax-deferred acquisitions using its LP interests. It has acquired nearly all of its \$100 billion assets through cash purchases, where it operates at no comparative advantage. BREIT has failed to take advantage of one of the defining benefits of the REIT structure.

Our theory would have predicted BREIT’s recent stumbles. It may yet succeed by virtue of good luck or good management, but the REIT structure won’t have helped. Our diagnosis of BREIT and other illiquid REITs is that they are at a disadvantage because they have adopted the challenging restrictions of REIT regulation, and resultant unfavorable redemption terms, without enjoying the quintessential benefit of being a REIT. We are not sure this mismatch is so great as to doom BREIT and its ilk, but if BREIT comes to prosper in the coming years, it will be more Blackstone’s success than the REIT form’s success.

²³² The situation is different but no better if the REIT leans on TPAs to assure the property contributors. Then, forced sales generate a tax liability not for the contributor but for the REIT itself. But if the REIT incurs new liabilities as it sells assets, then early redeemers do better than later redeemers. As redemption occurs, the net asset value of the REIT declines in proportion to its new tax liabilities. This encourages investors to redeem whenever they think other investors may do so. This instability is precisely that which is characteristic of bank runs.

²³³ Seguin, *supra* note 220, at 60.

²³⁴ BREIT suspended redemption temporarily, before resuming a capped redemption of 2% per month.

²³⁵ BREIT Prospectus at 235.

²³⁶ BREIT Prospectus at 230.

When we turn to smaller illiquid REITs, the problem is not danger for the REIT, but for the cash investors. If cash investors cannot sell their shares in a small, untraded REIT, then they depend wholly on the REIT's redemption obligation for liquidity. But in many smaller REITs, the manager is the sole or primary property contributor. The founder of such a REIT is personally quite sensitive to the tax consequences of forced sale. Small untraded REITs may therefore offer extremely limited redemption opportunities,²³⁷ barring redemption "Even if you're Dead."²³⁸

With small illiquid REITs, cash shareholders again face an environment of weak governance without any reason to think that managers will watch their interests. This explains why illiquid REITs have not come to dominate the market. It likewise explains why the problems with these REITs – poor returns for cash investors, extremely limited redemptions – are the problems they exhibit.

Nevertheless, the problem is not so bad that we are surprised that illiquid REITs remain. For one thing, many of these REITs are not bought, they are sold, in the sense that many illiquid REITs exhibit high "loads" or commissions to encourage brokers to market them. They are often marketed to unsophisticated or elderly individuals who are attracted to the implication that REIT's obligatory dividends will amount to fixed income (perhaps even inflation-proof income).²³⁹ Regardless of the merits of that investment rationale,²⁴⁰ it finds an audience. Insofar as REITs provide an income stream that some customers want, or that brokers believe it profitable to sell, there will be a market for illiquid REITs that are imperfect fits for the form.²⁴¹

One scholar estimates the value of exchange listing as contributing 12.1% to the value of a REIT.²⁴² That number is great enough that we are justified in focusing on the majority of REIT assets that are listed. However, it is small enough that some REITs may bypass it and nevertheless succeed, though our theory also identifies where the pain points will be on that path to success.

VII. Policy Implications for REITs

While clarity can be its own reward, one major benefit of a theory is that generates policy implications. We think ours provides a principled basis for evaluating a litany of alterations of REIT law. Part A discusses recent and possible future efforts to include new assets within the investable options for REITs. Part B and C take a skeptical view of efforts to loosen reinvestment and "active business" restrictions.

²³⁷ *Seguin*, *supra* note 220, at 69 (describing extremely limited redemption within his sample).

²³⁸ *Id.*

²³⁹ See <https://www.nasaa.org/wp-content/uploads/2022/08/NASAA-Comment-non-traded-REITs.pdf> at *2, describing this common misapprehension); <https://www.nasaa.org/wp-content/uploads/2022/07/Request-for-Public-Comment-on-Amendments-to-NASAA-REIT-Guidelines-2022.pdf> *4 (describing this risk).

²⁴⁰ See *Seguin*, *supra* note 220, at 72-73 (finding that return stability is not higher for unlisted REITs than listed REITs).

²⁴¹ An interesting avenue for further inquiry is whether the 100 shareholder requirement should be expanded to encourage REITs to be publicly traded. This would force untraded REITs to reorganize as tax partnerships and take away the significant tax advantage of REITs which is blocking UBTI for non-profits and ECI for foreign investors.

²⁴² *Seguin*, *supra* note 220, at 81.

A. REITs without Real Estate

Over the past sixty years, Congress and the IRS have repeatedly expanded the classes of assets that REITs can own. REITs can now own mortgage-backed securities, interest rate swaps, private prisons, timberland, cell phone towers, management companies and more. Do these changes make sense?

Prior to this article, the most natural way to think about REIT reform was to focus on thematic linkage to real estate. REITs are to finance real estate. On this view, any asset that is “like” real estate should be permitted for REITS, and no others. Thus, mortgage-backed securities are permitted because they are debt investments in real estate. Prisons and timberland are permitted because they are real estate.

This Article offers a new and better way evaluate the scope of permitted assets: asking whether the asset has the sort of problem REITs are built to solve. The key questions are whether there is a social benefit to combining the new class of assets in a venture and whether those assets are likely to have substantial built-in tax gain, such that the REIT structure is necessary to solve the problems of heterogeneous ownership.

At a high level, we note that most business lines can be coherently undertaken in business forms that lack heterogeneous ownership. Most sandwich shops and manufacturing firms can and should be operated by a traditional shareholder-owned corporation.²⁴³ REITs’ Rube Goldberg governance structure is unnecessary for such ventures and would likely act as a drag on efficiency – needlessly entrenching managers and constraining growth.

For example, the earliest expansion of REIT technology, the mortgage REIT, allows REITS to buy debt linked to property. These new REITs didn’t buy apartment buildings and malls, they instead helped banks to lend money to homeowners and mall-owners (who may themselves be REITs) by buying mortgage debt instruments. Mortgage REITs are roughly 5% of the REIT market by market capitalization and have assets worth roughly 60 billion dollars.²⁴⁴

Although there is a thematic relationship to real estate (ownership, and loans based on, real estate both represent financial interests in real estate) they are quite different from the point of view of built-in gain. Bonds aren’t ageless; almost all have a fixed duration, after which the debt is extinguished. Bonds are not depreciable assets, so their basis does not decline over time. Bonds do not systematically appreciate in value. People generally *don’t* own deeply appreciated mortgage bonds, which they would be inclined to keep until their death unless given a tax efficient way to collectivize the investment. Moreover, the social cost of illiquid real estate is high, but the bond market does not face similar issues with liquidity. Altogether, there is no reason to expect that bond-investing funds are fundamentally inclined toward heterogenous ownership. Accordingly, bonds simply don’t have the properties that justify the REIT structure, so there was no need to extend REIT treatment to funds that primarily trade mortgage bonds.

²⁴³ Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

²⁴⁴ Authors’ calculations based on Ziman REIT Data, as of November 2022. If we include hybrid REITs that invest in real property and mortgages, the aggregate market capitalization is \$81 billion or roughly 6% of the REIT marketplace. For comparison, equity REITs have an aggregate market capitalization of \$1.25 trillion.

Our theory of the REIT identifies that 5% of the REIT marketplace – mortgage REITs – probably shouldn't be organized as REITs at all. Market participants themselves may appreciate the poor fit between the REIT structure and mortgage bonds. The relatively small size of mortgage REITs suggests that investors themselves have been wary of sacrificing managerial flexibility and accountability without any offsetting benefit.²⁴⁵

Still, we might wish to restrict REIT participation in those domains to paternalistically protect investors. Our theory of the benefits and detriments of REITs is, admittedly, complicated and novel, and it is possible that the few firms that have chosen the REIT form inappropriately have done so to the detriment of their public shareholders. And insofar as REITs enjoy any public subsidy in the form of passthrough taxation, it is in order to support an important project – overcoming law-created challenges to a liquid and accessible market for real estate – and it is a waste of public money to heap those same tax benefits where no such problem exists to solve.

Our theory does not just identify mistaken inclusion within REITs, it also identifies assets that would rightly be included in REITs, or a REIT-like entity. Any assets plagued by the problem of necessarily heterogenous ownership may benefit from a REIT-like vehicle – even if the asset does not remind us of land and buildings.

For example, we are more sympathetic towards some of the newest species of REITs, which devote their attention to cell phone towers or data centers. It took an act of Congress to deem these technological fixtures “real estate” akin to the land they sit on. As real assets, it is socially costly if taxes make them illiquid, since it matters who controls actual business components. A reluctant owner may be less efficient in operation than the would-be highest bidder. Of course, data centers and cell phone towers will eventually decay and erode. But their useful lives are much longer than their depreciation schedules. Cell phone support structures for example are depreciated over only 15 years.²⁴⁶

Moreover, many such investments benefit from COVID-related legislation that allowed even faster depreciation or even immediate deduction. Cell phone support structures that were placed into service between 2017 and 2023 are allowed to be expensed – their entire cost can be deducted in the year they are put into service.²⁴⁷ Owners of such assets would have zero basis and substantial built-in gain. This built-in gain would make combinations difficult absent a way to manage heterogeneous ownership.

²⁴⁵ The relative unpopularity of mortgage REITs might also be due to the Real Estate Mortgage Investment Conduit (REMICs), an alternative structure providing passthrough treatment for a pool of mortgage assets. A REMIC is only permitted to hold qualified mortgages. REMICs are generally organized as partnerships. A single entity can own the assets of multiple REMICs. REMICs can simply be a “segregated pool of assets.” Treas. Reg. 1.860D-1(c). Ownership interests in a REMIC are either regular interests or residual interests. Regular interests in a REMIC pay interest at a fixed rate and are treated as debt for the holder. I.R.C. § 860(B). REMICs can only have one class of residual interests. Holders of the residual interests are taxed on a passthrough basis on the income or loss of the REMIC. I.R.C. § 860(c).

²⁴⁶ *Broz v. Comm’r*, 137 T.C. 25 (2011).

²⁴⁷ I.R.C. 168(k).

Congress's recent expansion of bonus depreciation creates a whole host of new assets that have low or zero basis. This grows the potential role for REITs to the extent that combining those assets in ventures is socially desirable.

Our theory also provides a principled way to consider expansions of the REIT governance structure to assets completely unrelated to real estate. Good candidates share two key characteristics: (1) assets have substantial built-in gain and (2) strategic combinations matter - the productivity of the asset depends on who owns it.

Patents and software offer one interesting possibility. These assets have no connection to real estate, and would therefore seem an odd fit for the REIT. But patents and software have both key characteristics: (1) many patents or software developed by individuals have little to no basis, and (2) the productive use of a patent can depend greatly on who owns it.

Imagine a SPLIT - a "software and patent licensing investment trust." A SPLIT would own and license technology patents. The SPLIT would have the same governance and tax rules as a REIT. SPLITs could raise money from the public to purchase patents in taxable transactions, but they could also use an umbrella partnership structure to acquire assets tax-free. By tracking REIT governance rules, a SPLIT could manage inventor apprehension around built-in gain triggers. The structure would allow inventors to access partial liquidity and diversification in a way they could not through licensing the patent themselves. Everyday investors would get a different and tax-advantaged way to achieve portfolio exposure to royalty streams from patents and software.

We do not wish to be cavalier: perhaps there are reasons (maybe arising out of details of IP law) that make SPLITs unsuitable. Our main objective is to show that our theory is not just a gatekeeper, skeptical of all expansions of the REIT domain. It also gives a basis for principled regulatory innovation.

B. Liberalized Mandatory Distributions

The most resounding implication of our theory is to caution against ad hoc tinkering with the finely-balanced REIT structure. For example, consider rules permitting REITs to pay dividends in stock instead of cash.²⁴⁸ Recently, the IRS let REITs retain some cash profits if they issue new shares to investors. While this relief is available, REITs can distribute just 18% of their net income in cash instead of 90%.

These rules were first introduced to grant temporary flexibility to REITs during the financial crisis in 2008-2011.²⁴⁹ It is theoretically possible that a REIT might have profits for tax purposes but no liquidity (due to problems in credit markets), and so be unable to pay the designated sum.²⁵⁰ Some temporary relief might be needed to prevent widespread insolvency or loss of tax status for otherwise viable enterprises.

²⁴⁸ Rev. Proc. 2017-45 (allowing REITs to deduct dividends paid even if shareholders can elect stock or cash if at least 20% of the aggregate dividend is cash). Rev. Proc. 2020-19 (temporarily reducing the required cash component to 10% until the end of 2020). Rev. Proc. 2021-53 (temporarily extending the 10% relief through June 30, 2022).

²⁴⁹ Rev. Proc. 2008-68 (initial IRS publication offering relief to REITs). The relief was subsequently extended through the end of 2011. Rev. Proc. 2009-15; Rev. Proc. 2010-12.

²⁵⁰ See Part VIII.A *infra*.

However, in 2017, the IRS made the relief permanent.²⁵¹ The widespread and permanent increase in flexibility seems unwise. First, the REIT structure plainly has an internal coherence, where the various parts compensate for one another. Forcing dividends is a governance technique that prevents managers from running perpetually growing empires, divorced from performance and efficiency. Relaxing the dividend requirement threatens to collapse the whole structure. Being forced to pay only 9% or 18% of net income in cash eviscerates the mandatory dividend as a mechanism for controlling management.²⁵²

Importantly, it is not clear that parties who realize the importance of mandatory dividends can commit to it without the law mandating it. Monitoring for partnership agreement violations and then litigating them is costly.²⁵³ More importantly, even if parties could intentionally reconstruct obligatory dividends for REITs, they would likely only do so on a forward going basis. Existing REITs would be unlikely to equilibrate to the efficient structure since flexible dividend policy strips away one of the few points of leverage investors have in their negotiations with managers. Managers of a REIT with mandatory dividends must be responsive to constituents lest their empire waste away over time. But managers of REITs with optional dividends have no such vulnerability. On what basis can entrenched managers with a growing empire be brought to the bargaining table?

When investors buy into a REIT, they price the investment in light of strange but meaningful limits on agency costs. A relaxation of dividend rules unilaterally deprives those investors of a protection that had expected, to their detriment.

It may be no surprise that the relaxation of mandatory dividends immediately preceded the first and only hostile takeover of a REIT.²⁵⁴ Activists signaled discontent with CommonWealth in 2013, citing, among other things, its low dividend payments. After years of paying approximately 7% of its market cap as an annual dividend (and 20% through the financial crisis), CommonWealth dropped its dividend yield down to around 4%. It is unlikely CommonWealth could have halved its dividend payments if it were still required to distribute 90% of its net income.²⁵⁵ A sudden focus on reinvestment highlighted CommonWealth as a situs of agency costs and triggered a rare investor revolt. After the hostile takeover, CommonWealth returned to paying rich dividends – now above

²⁵¹ Rev. Proc. 2017-45.

²⁵² The *election* between cash and stock is not inherently problematic. If every shareholder that elected cash were entitled to it, the shareholders could decide whether to reinvest. The problem is that IRS guidance allows the cash component to be capped, meaning that shareholders can be forced to reinvest even if they would rather receive cash.

²⁵³ *Supra* note 174 and accompanying text. Nor is the promise remotely credible for most business trusts. For Maryland REITs, the deed of trust (akin to a corporate charter) can be amended unilaterally by the REIT's board. A REIT that promised investors a 90% dividend could rescind that promise once their money was invested. Without the law requiring a dividend, promises to provide it are not credible.

²⁵⁴ Glascock et al. find only one hostile success since 1980, though they also find six instances in which the ultimate acquirer was not initially solicited, out of a dataset of almost 900 deals. John L. Glascock, Ying Zhang & Tingyu, A Review and Extension of Merger and Acquisition Research Between REITs and General Corporations, 26 J. REAL ESTATE LIT. 223, 242-43 (2018).

²⁵⁵ See Rubicon Associates, *CommonWealth REIT: Beware the Dividend Trap*, SEEKING ALPHA (May 15, 2012, 3:13 AM), <https://seekingalpha.com/article/589071-commonwealth-reit-beware-the-dividend-trap> even as Commonwealth paid 10%, it paying only 55-65% of its funds from operations as a dividend.

10%.²⁵⁶ The rare hostile takeover proves the rule that investors are usually willing to live with entrenchment coupled with dividends. But a sudden change in balance may upset the apple cart.

C. Making REITs Less Passive

Similar arguments can be made against expanding the scope of REIT activities. It's one thing to entrench managers to oversee a limited domain of activities – it's another thing to give them free range over a variety of businesses. If managers are free to run services, speculate in securities, and invent new technologies, there become unlimited ways for the managers to self-deal and the information cost to investors to police these expansions are likewise unlimited. At a typical operating company, managerial freedom is prized – it is how profitable new ventures are discovered – but it is policed by a market for corporate control. With an emaciated market for corporate control, REITs necessarily must have a narrower range of exploration for their managers. An expansion of managerial power without an expansion of accountability will push the REIT out of balance. For new REITs, the parties may be able to draft back into a sensible balance, but for mid-stream REITs this change imposes risk and cost on investors without any compensating advantage.

Historically, REITs were limited in the services they could provide to their properties and tenants. The REIT Modernization Act of 1999 allowed REITs to provide a more complete range of services to its properties.²⁵⁷ The change in law allowed REITs to own 100% of what is called a “taxable REIT subsidiary.”²⁵⁸ The taxable REIT subsidiary can provide services that are otherwise impermissible. The income earned by the TRS is taxable at the corporate rate, and any dividends paid to REIT shareholders is qualified dividend income to the extent of the TRS's income. In simpler terms, the TRS structure allows a REIT to earn impermissible income but subjects that income to the corporate double tax. REITs are allowed to provide “customary real estate services” to tenants but providing more than a de minimis amount of noncustomary services like housekeeping at a property taints all of the rental income from the property for purposes of meeting the REIT income requirements.

Our analysis gives us reasons to be skeptical of these subsidiaries. They are ultimately answerable to the REIT management team, which is entrenched. Yet there is no business reason why these subsidiaries require entrenchment. Indirect entrenchment without justification is still presumptively inappropriate empire building. Worse yet, the subsidiary is not subject to any mandatory dividend payment. We therefore observe an ordinary operating company, subject to REIT-specific weaknesses in governance but without the compensating REIT-specific disciplining mechanism. We worry that these subsidiaries undermine REIT policy and decrease efficiency by letting REIT managers build empires beneath the floorboards. This concern is somewhat tempered by the tax requirement that the value of taxable REIT subsidiaries be no more than 20% of the value of the REIT.

²⁵⁶ MACROTRENDS, *Equity Commonwealth - 32 Year Dividend History / EQC*, <https://www.macrotrends.net/stocks/charts/EQC/equity-commonwealth/dividend-yield-history> (last visited Aug. 25, 2022).

²⁵⁷ REIT Modernization Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860.

²⁵⁸ I.R.C. § 856(l)(1).

D. Addressing Activism

REITs are essentially immune to hostile takeovers and proxy contests. But they are not immune to shareholder activism. Shareholder activism is on the rise across American corporations,²⁵⁹ with even small investors sometimes successfully pressuring corporate managers.²⁶⁰ The level of shareholder activism is similar for public REITs as for non-REIT public companies.²⁶¹

There is a rich and growing literature on shareholder activism, and this Article cannot address broader questions of how activism alters the landscape of corporate governance.²⁶² But our theory can make two observations relevant to the effect of activism on REITs.

First, shareholder activism is a broad category both in terms of its goals and methods. At the extreme, shareholder activism risks the very problems REITs are meant to address. If activists are able to pressure managers to undertake transactions with no regard for the tax interests of property contributors, such activism will undermine the logic of REITs. There is some evidence that this occurs. Activists are more likely to urge REITs to submit to a sale of their assets,²⁶³ in part because this tends to lead to shareholder gains.²⁶⁴ It is unsurprising that such proposals can benefit shareholders in an individual case, but it will undermine the logic of REITs if activists push REITs to disregard their property contributors.

Other activism is focused on core operational and governance problems, and REITs attract plenty of this sort as well.²⁶⁵ The best predictors of activism at a REIT seem to be that the REIT holds too much free cash on its books or that it generally shows bad financial performance.²⁶⁶ Both of those problems may be predictable, but unintended, consequences of entrenchment. Insofar as activism is able to put pressure on those problems, it will better help REITs realize their essential function.

The key question for REITs, and perhaps at all public companies, is how to ensure activists apply good forms of pressure without killing the golden goose. There are obvious cases like forcing

²⁵⁹ Mary Ann Cloyd, *Shareholder Activism: Who, What, When and How?* HARV. L. SC. FORUM ON CORP. GOV. <https://corpgov.law.harvard.edu/2015/04/07/shareholder-activism-who-what-when-and-how/> (“‘Activism’ represents a range of activities by one or more of a publicly traded corporation’s shareholders that are intended to result in some change in the corporation. . . . On the more aggressive end of the spectrum is hedge fund activism that seeks a significant change to the company’s strategy, financial structure, management, or board.”).

²⁶⁰ Bernard S. Sharfman, *Looking at the ‘Big Three’ Investment Advisers Through the Lens of Agency*, Oxford Bus. L. Blog (Feb. 18, 2022), <https://perma.cc/5G8A-2ZQR> (“Despite having only \$40 million worth of ExxonMobil common stock in hand and no specific recommendations to enhance shareholder value or move the company into profitable low carbon emissions, Engine No. 1 was still able to convince enough ExxonMobil shareholders to elect three of its four nominees to the board.”)

²⁶¹ David H. Downs et al., *Shareholder Activism in REITs*, 47 REAL ESTATE ECON. 66 (2019).

²⁶² For just a few examples, see *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1138 (2015); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 916 (2013); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021, 1083 (2007).

²⁶³ *Id.* at 76 (finding that value demands like divesting assets are more often made by activist shareholders of REITs).

²⁶⁴ *Id.* at 95.

²⁶⁵ *Id.* at 78.

²⁶⁶ *Id.* at 88 (activism is associated with lower prior year excess returns).

asset sales or preventing managerial waste that fall clearly into one or the other category. It is perhaps encouraging that shareholder activism seems to target the firms with the greatest discount to net asset value. A small discount to net asset value is consistent with our theory of the REIT, but too large a discount may reflect a poorly-run firm.²⁶⁷

Unfortunately, other situations are more complicated. As discussed in Part IV, many corporate activities – selling assets, mergers, and debt transactions – schism shareholders and property contributors. For example, imagine a shareholder activist pushing for more leverage. This could be a wise operational move for an underleveraged firm, increasing returns responsibly. But at an appropriately leveraged firm, the same proposal could unreasonably increase bankruptcy risk and the risk of triggering gain for property contributors through forced asset sales.

VIII. Theorizing Governance Beyond REITs

REITs are an experiment in unusual governance and ownership. The results of this experiment have generally been positive. This finding is important to at least three corporate law debates: the role of distributions, the duties managers owe, and the value of takeover defenses.

A. Distributions

This Article has debunked a core myth about the purpose of mandatory distributions in REITs. The passthrough theory of REITs relegates mandatory distributions to an administrative mechanism for passthrough taxation. On that theory, REITs have mandatory dividends only because retaining earnings wouldn't fit with Congress's vision of REITS as a pure conduit to the underlying assets. By contrast, our theory of the REIT elevates mandatory distributions as serving a critical purpose: they control the agency costs that arise from managerial entrenchment. Our specific argument focuses on REITs, but the bigger takeaway is that mandatory distributions can play an important role in corporate governance.

1. Theorizing Distributions.

Seeing that distribution policy is a governance technology in one domain raises the possibility it may serve a similar function elsewhere. Many non-REIT businesses are subject to REIT-like distribution requirements. For example, registered investment companies (such as mutual funds) and business development companies (a specialized vehicle for investing in unregistered securities of small and medium sized companies) are subject to 90% profit distribution rules.²⁶⁸ In each case, we can now wonder – are mandatory distributions controlling agency costs in these contexts? Though that exploration cannot be undertaken here, there is reason to think these inquiries will be fruitful.²⁶⁹

²⁶⁷ *Id.* at 87 (the median NAV discount for targeted firms was 15.7%, as compared to a smaller discount of 5.2% for untargeted firms).

²⁶⁸ Oil-and-gas MLPs likewise commit in their fundamental documents to similar payouts. *Supra*.

²⁶⁹ For example, Curtis and Morley's important article on mutual fund governance makes only a passing reference to mandatory distributions, but they find it supports the overall governance scheme for funds. John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 114-15 (2010). Curtis and Morley argue that mandatory distributions lower the cost for fund shareholders to redeem their shares, relative to activism. Their central thesis is that mutual fund governance is defined by the dominance of redemption over activism. *Id.* at 88.

Nor is our analysis limited to instances of *mandatory* dividends. Mandatory distributions are part of a broader category, *regulated* distributions. The law regulates distributions any time that it mandates or forbids distributions. While the law may regulate distributions for many reasons,²⁷⁰ our study of REITs illustrates the link between distributions and governance. For REITs, the law *requires* dividends to control certain agency costs, but other areas of the law *forbid* dividends for similar purposes.

Non-profit law is one such area. In his canonical article, *The Role of Nonprofit Enterprise*, Hansmann argued that the “nondistribution constraint” allowed nonprofits to solve a variety of agency problems.²⁷¹ For example, someone desiring to fund aid to earthquake victims in Turkey would rather contract with a nonprofit than a for-profit corporation, because the for-profit business might distribute the aid to shareholders or its managers, rather than devote it to the beneficiaries.²⁷² The nondistribution constraint solves the problem of monitoring hard-to-observe performance. In essence, Hansmann argued that dialing down distributions was a useful tool for solving a governance problem.

While both nonprofits and REITs are subject to regulated distributions, the regulations are the opposite of one another. Nonprofits are forbidden from paying distributions, while REITs are required to do so. Hansmann studied nonprofits to show that distributions can be dialed down to control agency costs. Our theory of the REIT demonstrates that distributions can also be dialed up to solve similar problems.²⁷³ Our theory of the REIT and Hansmann’s theory of nonprofits can be combined to generalize the role of regulated distributions in corporate governance. Consider Figure 6.

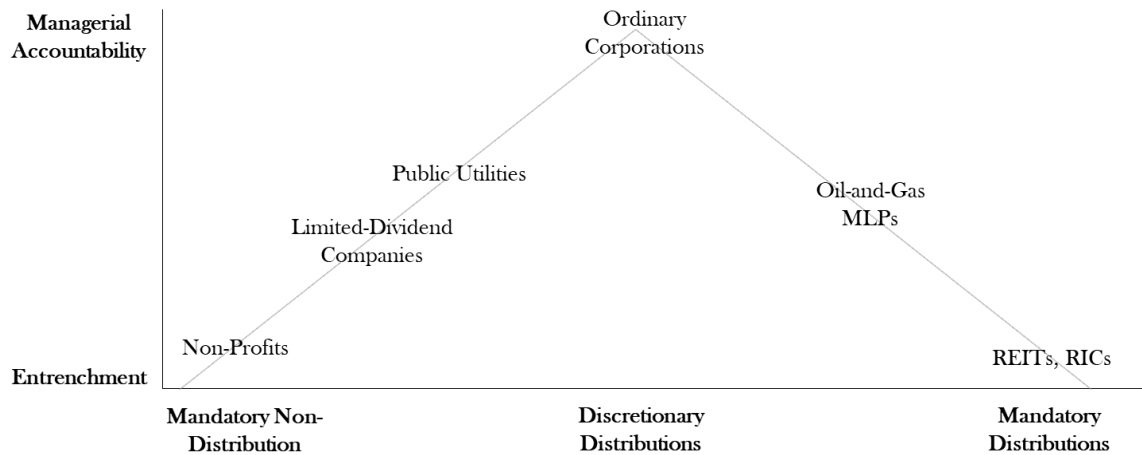
²⁷⁰ E.g. MBCA §6.40(c) prohibits dividends that would render the entity insolvent. The purpose here is also control of agency costs, but in favor of creditors, whose collateral might otherwise be dissipated.

²⁷¹ *Nonprofit Enterprise*, at 838.

²⁷² The examples are not all about philanthropy. A student may prefer a non-profit educational institution because she doubts her ability to determine quality and fears that excessive payments may go to the shareholders rather than her education.

²⁷³ Similar to our theory of the REIT, Hansmann’s theory of the nonprofit decenters tax incentives. *Nonprofit Enterprise*, at 881-84.

Figure 6: The Distribution Pyramid



We can think of distribution rules as existing on a spectrum from the non-distribution constraint (that characterizes nonprofits) to mandatory distributions (that characterize REITs). In between is the broad discretion afforded most “ordinary” corporations under the business judgment rule.²⁷⁴ Managers of ordinary corporations can make distributions but do not have to.

Seeing this as a spectrum has two payoffs. First, it allows us to see and contemplate the linkage between managerial accountability and regulated distributions. As distributions become more discretionary, there is a greater need for managerial accountability. As distributions become more fixed, there is greater room for managerial entrenchment. This creates a pyramid. Mandatory non-distribution and mandatory distribution are similar in that both create space for managerial entrenchment.

Consistent with this, ordinary corporations link discretionary dividends with meaningful possibilities of proxy fights, hostile takeovers, and investor activism; if investors do not like a company’s dividend policy (or the business strategy in its shadow) they have practical options to change the board. By contrast, REITs and nonprofits are both associated with rather unaccountable management. REIT managers are entrenched. And the boards of nonprofits are usually self-perpetuating, without an external stakeholder group empowered to democratically govern the board. In either case, it is safer to entrench managers who lack power over distributions.

Still, questions remain. Why are REITs and nonprofits regulated with opposite polarity (one mandating and the other forbidding)? The connection deserves a more fulsome exploration in a dedicated article, but we are eager to tee up several interesting avenues of exploration. One possibility is that regulated distributions become necessary in low-accountability environments, but the polarity of the regulation differs based on the temptation presumed of the entrenched leadership. REIT

²⁷⁴ See, e.g. *Dodge v. Ford*.

managers are naturally tempted to distribute too little. The entrenched board of a nonprofit that (counterfactually) was permitted to make distributions might be inclined to distribute too much.²⁷⁵

The forgoing possibility conceives of dividend policy following from entrenchment, but causation might run the other way: non-profits need to ban dividends to solve agency problems, and low accountability boards are an entailment of the lack of distributions. With financial returns prohibited, no one has a strong incentive to hold boards accountable. For REITs, entrenched management is necessary to balance heterogeneous interests. By contrast, one might conclude that nonprofit entrenchment is just an unfortunate consequence of nondistribution.

Still, the REIT perspective highlights an unappreciated benefit of entrenchment. Many nonprofits also must also balance heterogeneity.²⁷⁶ For these nonprofits, the entrenchment of management is not just something we must tolerate as the price of optimal distribution regulation. Rather entrenchment is to be embraced as allowing for the balancing of heterogeneous interests. Take the example of a nonprofit university, for which the nondistribution constraint solves an agency problem for donors and students vis-à-vis university management. Nonprofit universities end up with rather entrenched presidents and trustees. But that entrenchment is not all bad. Insulating the leadership from being pushed out by a majority of students, donors, or faculty allows the university management to balance their heterogeneous interests.

2. New Distribution Regulations

Second, theorizing distribution regulation as a spectrum also allows us to imagine other points along the curve.²⁷⁷ Restricted distributions need not be completely forbidden, as with nonprofits, nor (almost) fully required, as with REITs. There are many points on the curve that might serve some function.

On the left side of the pyramid, Hansmann describes entities that operate that permit some, but not all, profits to be distributed. One example is the limited dividend partnerships that invest in low-income housing.²⁷⁸ The main contracting problems are a need for capital and a concern that

²⁷⁵ Perhaps this temptation would reflect the initial roster of directors selected to lead the shareholder-founded organization. If Microsoft founded a church, church leaders might pay healthy dividends out of the tithe, even if Microsoft no longer elected the board.

²⁷⁶ Many non-profits involve similar managerial balancing, between the interests of its donors and its beneficiaries, as when a church receives donations from only some parishioners but distributes it among all parishioners.

²⁷⁷ Public utility companies are not subject to the nondistribution constraint. Instead regulators set price ceilings. These ceilings effectively cap shareholder returns. Hansmann argues that price ceilings solve a specific set of contracting problems that arise with public utilities because they are natural monopolies that require substantial capital investment. Since price gouging is the primary concern for monopolies, price ceilings are a natural solution. Nonprofit Enterprise, at 886. Public utilities are also different from most nonprofits in that utilities are capital-intensive and therefore require substantial capital. Id at 887.

²⁷⁸ Since Hansmann's article, the more popular form seems to have become the L3C, though even that has not taken off too far. Tanya M. Marcum & Eden S. Blair, *The Value of Values: An Update on the L3C Entity, Its Uses and Possibilities*, 88 UMKC L. REV. 927, 928 (2020); Usha Rodrigues, *Entity and Identity*, 60 Emory L.J. 1257, 1316 (2011). One problem is that L3Cs have not been able to credibly commit to their

federal subsidies will be captured by investors.²⁷⁹ Too constrained in distributions, financiers will avoid the entity, but if too liberal, the government subsidy may be mulcted. An intermediate constraint may let the entity balance the need to raise private capital from investors while preventing them from capturing too much of the federal subsidy.²⁸⁰ Another example Hansmann considers is the public utility company. Regulators cap the company's prices, thereby limiting the extent of possible distributions. When he discussed such examples Hansmann took steps up the left side of this pyramid.²⁸¹

REITs are starting point for exploring the right side of this pyramid.

Right now, all forced-distribution entities now have a 90% distribution requirement, but we could dial-down mandatory dividends by lowering the required percentage distribution. Instead of requiring 90% of earnings to be distributed, one could imagine industries where 20% or 50% would make more sense. What would these industries look like? They would perhaps include industries in which raising public capital is more difficult or in which cash flows are less predictable than the real estate market. Forcing a company in a volatile industry to distribute all earnings would take away an important route for smoothing cash flow and could prevent companies from meeting its fixed costs in down years. Depending on the volatility of cashflows, 20%, 50%, or some other threshold would be the proper balance between the needs of the business and controlling managerial agency costs.

It is striking that all the forced-distribution entities force only 90% distributions. There is no pure analogue to nonprofits prohibited distributions, such that the entity must distribute 100% of its profits. Presumably, the reason pertains to the inconvenience created by multiple conceptions of "profit." An entity can have substantial profits by one measure and yet negative cash flow, such that a 100% distribution of "profits" would jeopardize the entity. The 90% requirement is intended to provide a little wiggle room. But that wiggle room is not needed in most cases (nor is it sufficient in some other cases). A better fit might be to permit entities, whose distribution obligations are directly linked to some conception of profitability that is more directly tied to liquidity. Then a 100% distribution entity would be feasible, further expanding the space of useful options.

An interesting candidate would be an accounting measure of cash flow. The problem with basing mandatory distributions on "taxable income" is that during times of economic distress, companies may have taxable income (because of tax accounting rules and depreciation) even when they have little cash on hand to pay distributions. Notably, many oil-and-gas MLPs already use this approach in their governing documents, tying distribution requirements to "cash flow" rather than taxable income.²⁸²

B. Duties

One enduring debate within corporate governance concerns whom the corporation and its managers should serve. The dominant school focuses on shareholders alone ("shareholder

status. See Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L.J. 681, 690 (2013) ("Importantly, if an L3C ceases to comply, it simply and immediately transforms into an ordinary LLC.").

²⁷⁹ Nonprofit Enterprise, at 888.

²⁸⁰ Nonprofit Enterprise, at 888.

²⁸¹ Nonprofit Enterprise, at 884-90.

²⁸² Tim Fenn, Master Limited Partnerships (MLPs): A General Primer, 5-6, available at <https://www.lw.com/admin/Upload/Documents/Latham-Master-Limited-Partnership-Primer-2014.pdf>.

primacy”).²⁸³ A growing minority asks boards to balance the interests of stakeholders such as employees or customers (“stakeholder theory”).²⁸⁴ This debate is largely orthogonal to our discussion of REITs. Although REITs managers balance diverse interests, all the claimants are equity investors.

Nevertheless, the mere fact that REITs thrive in balancing means they may have something to teach about *how* best to balance interests. In particular, REITs put pressure on a key assumption often held by partisans on both sides of the duties debate. That assumption is if someone’s interests matter, then that person should have the right to sue managers who fail to protect those interests. The simple logic is that fear of such suits would encourage managers to take account of the interest.

Thus, advocates of stakeholder theory argue that employees and other stakeholders should have a right to sue when directors disregard their interests.²⁸⁵ On the other side, advocates of shareholder primacy often argue that such duties would enmesh boards in an untenable thicket of litigation: whatever they do, some adversely affected constituent could sue.²⁸⁶ REITs help to show that not all rights need come with a remedy. To see this, let us contrast the approaches of Delaware and Maryland.

Delaware is usually associated with the position that only shareholders have legally cognizable claims against their managers, but the truth is somewhat more complicated in the context of umbrella partnerships. In 1991, Delaware courts began to hold that limited partners have standing to sue corporate managers for breach of fiduciary duty, when those managers are employed by the corporate general partner of a downstream partnership.²⁸⁷ That means that the property contributors to a Delaware UPREIT can sue the REIT managers for failing to sufficiently protect their interests.²⁸⁸ Thus, Delaware law exposes directors of an UPREIT to suit from both REIT shareholders and from limited partners of the operating partnership.

While intuitive, arming multiple groups with the power to sue paralyzes managers and deprives them of the freedom to balance. Delaware managers “find themselves in a position of ongoing conflict,” which is “a strange and unsettling position.”²⁸⁹ They know that any hard decision will embroil them in litigation. Delaware thus embraces the unstated assumption above – where a constituent matters, they should be able to sue – with the resulting trouble.

²⁸³ See, generally, STEPHEN BAINBRIDGE, *THE PROFIT MOTIVE* (2022); Lucian A. Bebchuck & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance* 106 CORNELL L. REV. 91 (2020).

²⁸⁴ See, e.g., Business Roundtable, Statement on the Purpose of Corporation (Aug. 19, 2019), <https://s3.amazonaws.com/brt.org/BRTStatementonthePurposeofaCorporationOctober2020.pdf> [<https://perma.cc/CMR8-WMXE>].

²⁸⁵ David Millon, *Redefining Corporate Law*, 24 IND L. REV. 223, 255-70 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 635-36 (1992).

²⁸⁶ By the Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2270 (1990). Cf. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 292 (1999). Blair and Stout are stakeholder theorists who nevertheless spot the problem with widespread litigation standing among stakeholders.

²⁸⁷ *In re USACafes, L.P. Litig.*, 600 A.2d 43 (Del. Ch. 1991). On *USACafes*, see generally Andrew Verstein, *Upstream Liability, Entities as Boards, and the Theory of the Firm*, 74 BUS. LAW. 313 (2019).

²⁸⁸ *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096, 1120 (Del. Ch. 2008).

²⁸⁹ *Brickell Partners v. Wise*, 794 A.2d 1, 4 (Del. Ch. 2001).

Maryland takes a different tack. Another way to encourage managerial balancing is to sufficiently protect managers from litigation so that they have the latitude to make decisions. Maryland follows this latter approach. Its courts have not recognized any downstream duties in umbrella structures.²⁹⁰ Property contributors cannot sue managers who disregard the contributors' tax interests.²⁹¹ Although downstream partners are properly the subject of managerial solicitude, they do not have a legal right to vindicate their interests through fiduciary duty suits against the upstream managers.

Maryland's dominance in REITs helps us to disentangle rights and remedies. REIT property contributors' interests must be considered, but those interests need not be vindicated through robust legal challenges to manager discretion. Rather, the market for new investment capital keeps managers solicitous of property contributors. Maryland's REIT success demonstrates the viability of entities that are not run for the sole benefit of shareholders, but in which only shareholders can sue to protect their interests. In one sense, this point is obvious. The model benefit corporation legislation explicitly recognizes legally constraining duties to non-shareholders yet also withholds from those beneficiaries any power to sue.²⁹² REITs help to naturalize what might otherwise seem an incoherent disconnect.

For stakeholder theory, the REIT example highlights an important and new variable in determining stakeholder's rights to sue. Is there a market remedy that can substitute for the legal remedy? Whether employees should be allowed to sue directors should depend in part on the fluidity of the relevant labor market. If employees can switch jobs easily, then the market will ensure that managers are solicitous to employee interests. But in stickier labor markets, there is a stronger argument to arming employees with the right to sue directors. Similarly, whether customers should be allowed to sue directors should depend in part on market concentration. If there are easily substituted alternative goods, it is much less important to give customers a right to sue corporate directors. The opposite is true if the company enjoys a monopoly.

C. Defenses

Takeover defenses, such as the poison pill and the staggered board, are mechanisms that make it more difficult to oust and replace a corporation's board. The social value of takeover defenses is one of the most important and enduring debates in corporate law. Some scholars argue that defenses protect bad managers whose ineptitude or cupidity harm shareholders.²⁹³ Others argue that

²⁹⁰ Maryland law did not promptly address *USACafe*, and subsequent judicial opinions have generally hewn to the traditional view of unitary duties. See *Stender v. Gerardi* WL 4452117 (D. Colo. Sep. 30, 2008); *Hartman Commer. Props. Reit v. Allen R. Hartman, Hartman Mgmt., L.P.* No. H-06-3897 2007 U.S. Dist. LEXIS 107752 * (Tex. S. D. April 6, 2007). More generally, Maryland law holds that "a claim for breach of fiduciary duty against a corporate officer or director may only be pursued as a derivative, and not a direct, action." *Carley v. Kopko*, 2007 WL 7773589 (Md.Cir.Ct. June 05, 2007).

²⁹¹ Only shareholders can bring derivative actions on behalf of a REIT. And even there the business judgment rule protects managers from any realistic challenge. REIT managers can balance multiple constituencies because only one has a legal claim on managers, and that claim is dampened by the business judgment rule.

²⁹² MODEL BENEFIT CORP. LEGIS. § 301(a)(1)-(2).

²⁹³ See, e.g., Bebchuk, Lucian A. & Cohen, Alma, *The Costs of Entrenched Boards*, J. Fin. Econ. 78, 409-433 (2005).

takeover defenses are vital to protect businesses from short-termism and coercive offers.²⁹⁴ Lately, an intermediate, contextual position has argued that the value of entrenchment depends on context.²⁹⁵

REITs support this third view. They are plainly a domain in which entrenchment offers some benefit; it is impossible to imagine a vibrant REIT market without entrenchment. At the same time, REITs are not operating companies that merely adopt takeover protections. Instead, REITs have a special and compelling need for entrenchment. More importantly, entrenchment arrives at the REIT alongside other interlocking changes: restrictions on business operations and reinvestment.²⁹⁶ It is safer to entrench managers when you also put them on a short leash.

REITs do more than support the contextual outlook on takeover defenses. Because context is not static, REITs also indicate what changes of context would help improve the efficiency and acceptability of takeover defenses. The success of REITs shows that shareholders can defer to managers to a greater degree when they are not completely at managers' mercy.

This suggests a bargain – allow managers more security with less freedom – that might efficiently suit other enterprises outside of the REIT domain. While it is somewhat speculative, we wonder whether some conventional, non-REIT corporations would be well-served by this bargain. Rather than opting for a pill or no pill, and rather than constructing doctrine that pushes boards toward one of those binary options, perhaps it would be efficient for firms to adopt a pill alongside REIT-inspired restrictions on managerial freedom. If managers wish to adopt a takeover defensive in order to protect a long-term project against myopic interruption, the board might simultaneously limit its freedom to pursue other projects. Self-constraints that limit mischief in the while under the protection of the pill can render more credible the board's assertion that it seeks to protect important projects rather than slacken or extract perquisites.

If there is anything appealing about this bargain, one could imagine two possible applications. First, states have recently proliferated many new entities, including hybrid entities (such as the benefit corporation). One could imagine state lawmakers or corporate draftspersons designing business entities built with this combination hardwired. Perhaps it would appeal to users in industries where manager continuity is essential. The idea is that a business could commit to a package of REIT-like constraints (restricted takeovers, mandatory dividends, and restricted growth channels, or some other package of constraints) without becoming a REIT for the purposes of the tax code, by electing a designated entity type. The new entity type could have a suggestive name like “Limited Discretion Company” (LDC), to signify that managers have limited discretion in their domain (business and distributions) and shareholders have limited discretion in their domain (turnover at the board).²⁹⁷

²⁹⁴ See, e.g., Cremers, K.J. Martijn & Sepe, Simone M., 68 *The Shareholder Value of Empowered Boards*, STAN. L. REV. 67-148 (2016).

²⁹⁵ See, e.g., Yakov Amihud et al., *Settling the Staggered Board Debate*, 16 U. PENN. L. REV. 1475 (2018) (arguing that the desirability of a staggered board depends on firm characteristics).

²⁹⁶ Note that REITs don't just bundle entrenchment with something shareholders want, such as a merger. That practice is typical in many businesses. Lucian A. Bebchuk, and Ehud Kamar, *Bundling and Entrenchment*, HARV. L. REV. 123, 1553 (2010). Instead, REITs bundle entrenchment with actual checks on the entrenched managers.

²⁹⁷ The state could couple those entities with REIT-like support structures, such as permitting the state attorney general to prosecute violations of the statute, to overcome collective action problems for shareholders. See *supra* note 174.

When these entities face shareholder challenges to takeover defenses, they could expect judicial deference under the business judgment rule, rather than the heightened scrutiny of Delaware's "intermediate standard."²⁹⁸

More intriguingly, perhaps the security/freedom bargain could be incorporated into ordinary corporate jurisprudence on takeover defenses. Hostile acquirers are permitted to challenge takeover defenses as unlawful. Courts consider numerous factors in deciding whether the defense are illegally preclusive or lawful.²⁹⁹ Mostly, courts ask how strong the takeover defenses are and how much of a "threat" the acquirer poses.³⁰⁰

But REITs suggest a new variable courts should consider: the degree to which the managers cede money or power to shareholders even as they pull up the drawbridge. Takeover defenses should be more acceptable under *Unocal* and its progeny if the managers do not lock themselves inside with all the cash. Courts could implicitly offer managers the choice of presumptively valid defenses paired with appropriate limitations on their freedom. For example, imagine if the warrants distributed as part of a poison pill were stapled to preferred stock. Management would then be required to make significant mandatory cash distributions for as long as the poison pill is active.³⁰¹ The forward-looking promise to distribute cash would make the managerial entrenchment enabled by the poison pill much less onerous and more legitimate.

Considering self-constraining mechanisms like this would expand the range of facts considered in the intermediate standard, but it would be of a piece with the existing legal norms. While early poison pills were once operative for long periods of time (ten years), contemporary poison pills usually expire after only one year.³⁰² Likewise, courts are normally hostile to "dead hand" poison pills, but they have approved them in cases where the pill is of limited duration.³⁰³ This reflects a sense that powerful defenses should be coupled with limitations that prevent against unlimited board latitude. Existing law and practice seem to limit the power of the defense itself, but REITs suggest that it may be appropriate to instead limit the powers managers may exercise while under the umbrella of the pill. Courts could encourage or recognize this point by weighing the strength and value of restrictive commitments alongside other factors in determining the validity of defensive technology.

²⁹⁸ *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) began the line of cases evaluating the legality of takeover defenses.

²⁹⁹ *Id.*

³⁰⁰ *Third Point LLC v. Ruprecht*, 2014 WL 19220029 (Del. Ch. 2014).

³⁰¹ A poison pill usually operates by granting existing shareholders an option or warrant to buy more shares at a discounted price. Perhaps such warrants should be stapled to preferred stock, with specified dividends promised at regular intervals.

³⁰² https://www.sullcrom.com/files/upload/Apr16_InTheBoardroom.pdf at 26

³⁰³ See, e.g., *Davis Acquisition, Inc. v. NWA, Inc.*, Fed. Sec. L. Rep. (CCH) P 95434, 1989 WL 40845 (Del. Ch. 1989). Dead hand pills "operate to prevent any directors from redeeming the poison pill unless the director was in office as of the date of the pill's adoption." § 6:13. Defensive tactics—Poison pills, Law of Corp. Offs. & Dirs.: Rts., Duties & Liabs. § 6:13 (2022-2023).

Conclusion

We have offered a theory of the REIT. Our theory posits that a real estate enterprise involves assembling a coalition of heterogeneous investors who will often not see eye-to-eye. Their disagreements about the best way to run the enterprise could lead to costly strife or could prevent the enterprise from being formed *ab initio*. This strife is mitigated through manager entrenchment. REIT managers need not cater to the interests of any single investor group, since none can remove them, and can instead take actions that balance the various constituencies. Yet manager entrenchment is itself concerning, since unaccountable managers can run the business in their own interests. Here, again REITs offer workable solutions to keep managers on a short leash: mandatory dividends and restrictions on REIT business activities. To grow the enterprise, managers must continually earn the trust of new investors. REITs are an emergent form that responds to the push and pull of these various pressures, resulting in an overall functional and popular structure.

REITS are a vivid example of the general theory of the second best at work in corporate governance. Each of its features departs from the first-best optimum: limited investor voice, reinvestment, and heterogeneous ownership interests. But if one accepts that joint real estate ventures would only exist if heterogeneous interests are accommodated, the optimal structure subject to this constraint looks very different on many dimensions.

For many readers, the most conspicuous assumption in our paper is that REITs are necessary to solve a fundamental problem with real estate investment and transfer, when in fact that “fundamental problem” is so contingently a problematic feature of our tax system. Our tax system allows individuals to defer gains until they sell assets, and then forgives those gains altogether if they can forgo sale until death. It is this combination that makes people reluctant to sell real estate and which necessitates REITs. And those features are much derided. REITs are, in an importance sense, further symptoms of a sick tax system, rather than deep solutions to deep problems.³⁰⁴

When we describe REITs as solving a deep problem with real estate transfers, we are describing problems that are enduring features of the world we live in, without apology for the hope of a better world that we can but dimly imagine. There may not be any REITs in heaven, but they are essential here.

³⁰⁴ Solutions to the problem of lock-in have been around for decades but have made little headway politically. These include repealing stepped-up basis, moving to a mark-to-market tax regime, or imposing deferral charges on gains once realized. If enacted these proposals would largely obviate the REIT as a solution for real estate lock-in.