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# Conflicts of Interest in the Structure of REITs

Lynne B. Sagalyn

*University of Pennsylvania*, [lsagalyn@pobox.upenn.edu](mailto:lsagalyn@pobox.upenn.edu)

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## **Abstract**

When the surge of equity REIT initial public offerings (IPOs) came to market in 1993 and 1994, the quality as well as an obvious increase in the quantity of newly securitized real estate (approximately \$15.1 billion in the first two years of this bull market), defined a new REIT marketplace. By the end of 1995, the implied market capitalization of equity REITs had reached \$59 billion, fourfold its size in 1992, and these real estate companies controlled approximately \$83 billion in real estate.

## **Comments**

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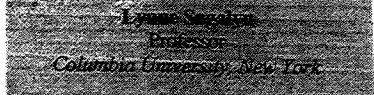
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# CONFLICTS OF INTEREST IN THE STRUCTURE OF REITs

Lynne B. Sagalyn

*is professor and coordinator of the M.B.A. real estate program at Columbia University Graduate School of Business in New York.*

When the surge of equity REIT initial public offerings (IPOs) came to market in 1993 and 1994, the quality as well as an obvious increase in the quantity of newly securitized real estate (approximately \$15.1 billion in the first two years of this bull market), defined a new REIT marketplace. By the end of 1995, the implied market capitalization of equity REITs had reached \$59 billion, fourfold its size in 1992, and these real estate companies controlled approximately \$83 billion in real estate.<sup>1</sup>

From among the eighty-nine IPOs in these three years, three themes were central to the reemergence of the REIT: growth potential, experienced management, and alignment of interests between managers and shareholders. Each targeted a critical issue for marketing REITs to institutional investors who, coping with depressed property values and real estate illiquidity, might reasonably be shy about new real estate investments. Many institutional investors remember the REIT crash of the 1970s, when REIT management fees were often a function of asset size and not performance (Solt and Miller [1985]). Improved alignment of interests, in particular, played a key role in the resurgence. By virtue of their corporate governance format and restructured managerial relationships, the new REITs promise to be more accountable to shareholders.

The major change in management structure is an industry wide shift from an external advisor to internal management, the self-advised and self-managed model,<sup>2</sup> which seeks to eliminate many of the past conflict-of-interest (COI) situations. By internalizing the

management function at both the portfolio and property level, the new REITs aim to side-step the worst abuses of the advisor-affiliate relationship, which tarnished the REIT industry's reputation in the 1970s (Schulkin [1971], SEC [1975]), and affected investment performance as well (Solt and Miller [1985]; Hsieh and Sirmans [1991]); Howe and Shilling [1990]; Wei, Hsieh, and Sirmans [1994].

Management by a "dedicated" team and creation of a full-service real estate company promises operating efficiencies and alignment of interests (Campbell [1993]). The new managerial format also counters, by way of contrast, the same problem of misaligned interests between institutional investors and advisor managers recently called at fault in the critique of the commingled real estate fund vehicle (IREL [1992a, 1992b]).

## **Successful REITs: Aligned Interests, Better Management, More Liquidity**

The emphasis on aligned interests and an absence of conflicts reflects a strong consensus among Wall Street underwriters, buy-side analysts, marketplace commentators, and legal experts as to what makes for a "successful" REIT (see Kidder Peabody [1994]). The equity REITs brought to market in the 1990s also eliminate the most troublesome COI situations.

Still, as the financial media noted frequently (Vinocur [1992-1993], Parcellle [1994]), *the new REITs did not emerge conflict-free*. Familiar COIs reappeared in traditional fee REIT structures, and, driven by federal income tax considerations

affecting the formation of REITs, new COIs surfaced in the new umbrella partnership (UPREIT) structure. The scope of the new REIT marketplace and hopes for an even larger market capitalization have created a compelling context for reanalysis of the REIT COI issue, though there has been little to date.

### Corporate Governance and COI Questions

Among institutional investors there is a proven, familiar logic behind the REIT's corporate-like organization and governance structure. Unlike the commingled real estate fund or limited partnership, where the advisor or general partner controls the management of the investment irrespective of the ownership percentage held by investors, the REIT is accountable to shareholders by vote and through its governing body, the board of directors (or trustees), a majority of which must be independent.<sup>3</sup> State securities regulations dictate the structure for most REIT offerings, and also address potential COIs by requiring approval for certain transactions by a majority of the independent directors (also known as outside directors) not otherwise interested in the transaction.<sup>4</sup>

REITs operate under a set of stringent federal tax code regulations<sup>5</sup> designed to deny managers control over the timing of taxes and restrict REITs to the role of a passive investor. Thus, it is possible to argue, as one scholar has, that these agency problems are less serious for special-purpose entities like REITs than for business corporations in general<sup>6</sup> (Kanda [1991]). Perhaps, but *the typical legal and financial complexity of real estate investments makes detection of serious managerial misbehavior difficult, imposing still substantial agency costs on REIT sponsors and investors.*

The new UPREIT format further compounds the burden of meaningful disclosure and effective monitoring. Real estate consolidations of partnerships and affiliated entities typically possess two common characteristics: complexity and conflicts of interest (Davis, Chadwick, and Kohorst [1994]). If this makes a 100% conflict-free REIT hard to achieve, at the IPO stage, whether and how sponsors have created mechanisms of mitigation within the REIT structure becomes essential to assessing the severity of this agency issue.

### Questions

How effective is corporate governance likely to be as a mechanism for managing the diverse range of COIs evident in equity REITs? In what ways is governance called upon to monitor additional COI problems associated with the new UPREIT structure? What other strategies exist to mitigate COIs? What should investors look for when evaluating the organizational and managerial structures of equity REITs — what might be called the institutional infrastructure of investment performance?

COIs in the management of real estate manifest themselves in distinct and diverse ways. Not all are alike. Some are unique to the REIT format, others arise from the particular character of the real estate business, and still others are common to owner-manager situations in general.

The impacts of COIs differ as well, some being more problematic than others. If significant, COIs would become a drag on performance; if prevalent across the REIT sector, they might undermine investor confidence in the vehicle; if troublesome in theory but not in practice, they might merely confound the agency debate and fuel the arguments of skeptics.

In this article I clarify the nature of the COI issue by identifying the types of conflict situations inherent in three areas affecting alignment of interests: ownership structure, governance arrangements, and contractual service relationships. What we really want to know is how COIs are likely to impact management decision making, market pricing, and, ultimately, investment risk and return. A few more years of performance data are necessary to get a solid reading on the empirical relationships; however, understanding the conceptual linkages between REIT structures and COIs is a necessary first step.<sup>7</sup>

### Sources of Conflict in REIT Structures

Conflicts of interest refer to situations where the interests of management and shareholders are misaligned: acting on their self-interests, managers make decisions that will not be in the best interests of shareholders. In every IPO *prospectus* there is a section on *risk factors* that includes statements of *conflicts of interest*. However, other conflicts not explicitly noted in this section may exist within the

## Exhibit 1

### Explanation of Conflict Types

Conflict Type	
Allegiance	Agents for the REIT are related parties to the formation transactions in which they have economic interests. Acting upon such interests might mean failure to enforce the terms of agreements <sup>1</sup> underlying the acquisition of REIT portfolio properties from individual partnerships and corporations in which agents either serve or control as general partners. This situation would conflict with the interests of persons acquiring REIT shares, the outcome of which could result in monetary loss to the REIT.
Sponsor Control	Sponsor management has control of the REIT (and its operating partnership in the case of an UPREIT) through significant minority ownership <sup>2</sup> ; as a result, its interests and those of residual shareholders of the REIT may not be aligned.
Outside Partners	Decisions regarding certain major transactions (such as mortgage refinancing) and rights of first refusal, first offer, or buy-sell provisions may be dependent upon the approval of "outside partners" whose interests may not be aligned with those of REIT shareholders; or, the situation may require REIT management to make decisions at a time that is disadvantageous to the REIT.
Over-compensation	<p>Contracts for services from an affiliated entity are not negotiated at arms' length; the terms of such transactions may be more than what the REIT would have to pay if priced through competitive market processes.<sup>3</sup></p> <p>Similarly, if under an advisor or affiliated-management situation, fees are tied to some percentage of gross invested assets, the agent has an incentive to increase the size of the REIT ("self-enriched growth"), even though such actions may not be in the best interests of REIT shareholders.</p>
Resource Allocation	<p>Agents for the REIT have ownership interests in property and/or in related businesses (such as land held for development, department stores, mall stores) outside the REIT; there is a potential conflict in the duties and responsibilities of agents who might allocate a disproportionate amount of time and effort ("overmanagement") to those outside investments to the detriment (competition, loss of profits) of the REIT.</p> <p>Under an advisor or affiliated-management structure, the potential conflict involves the allocation of investment opportunities — the agent might take the best, leaving the REIT with the inferior ones.</p>
Competitive Affiliates	Affiliates of the REIT (or of the operating partnership of an UPREIT) have business opportunities or own interests in and perform services ("multiple-hat" service contracts as property managers, leasing agents, acquisition agents, developers, construction supervisors) for other properties that might be competitive with the REIT.
Tie-In Business	Affiliates may have businesses that sell different types of services (such as insurance and mortgage brokerage) to real estate developers and investment managers; in order to sell such services, the affiliate might offer favorable terms from the REIT, a potential conflict situation more likely under an advisor or affiliated management format.
Self-Dealing	The REIT enters into a transaction (acquisition, disposition, loan, joint venture) with an inside related party (advisor, trustee/director, affiliate) or a related party conducts business as a tenant in REIT property; potential conflict exists if the underlying transactions are not conducted at arm's length and the REIT offers "sweetheart" terms and conditions for lease agreements.
Captivity	Post-offering transactions (acquisitions, dispositions, loans, joint ventures) between the REIT and its sponsors (and affiliates) occur on preferential terms that it could not obtain from other sources ("trans-

## Exhibit 1 (continued)

action bias"). As defined herein, the captivity scenario is a special case of self-dealing under the advisor-administrated REIT format.

Tax Timing	Due to the "built-in gain" and debt paydown federal tax liability for sponsors who contributed property to the REIT, agents of the REIT (including interested management and certain members of a board) may have different objectives regarding the appropriate pricing and timing of any sale or refinancing. That is, they may not have an incentive to sell or refinance properties contributed to the REIT, even though such a transaction might otherwise be financially advantageous for the REIT. In addition, the paydown of debt may be less than what economic considerations would indicate as appropriate.
Expense Preference Behavior	A generic agency problem in which employees or contractors have little incentive to control costs, but rather gain utility/additional compensation through the self-provision of "perks."
Malingering	A generic agency problem, the flip side of expense preference behavior, in which employees have little incentive to maximize performance.

<sup>1</sup>Examples include indemnification provisions and the remedy provision for breaches of representations and warranties.

<sup>2</sup>Minority ownership interests can accrue without equity investment through the granting of "founder shares" or the gifting or earning of shares at attractive prices (possibly prior to IPO). If these are considerable, there may be related hidden conflicts in lower advisor fees or contractual payments for services. The sponsor control situation occurs most frequently when a closely held entity seeks the benefits of going public without giving up control over investment decision making.

<sup>3</sup>Overcompensation is also a potential problem in REIT employment situations, particularly among executive compensation.

Source: Author's files.

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structure of the REIT.

From a review of the *prospectus* for each equity REIT that came to market in 1993 (and several in 1994), I have identified twelve types of COIs, described in Exhibit 1, and referenced by *italics* in the text. While several COI situations are generic to owner-manager structures, in particular those associated with the advisor-affiliate structure, the source of others can be attributed to the specific character of the REIT vehicle, regardless of whether publicly traded or privately held.

Four common sources of conflict are discussed next. As a group, the COIs cut across all spheres of REIT decision making: formation of the offering, investment management at the portfolio level, capital strategy, and day-to-day property management (see Exhibit 2). The broad scope in which interests of sponsor/managers and shareholders can diverge reflects the active, ongoing business character of REITs in the 1990s.

## Tax-Driven Motives and the UPREIT Structure

In the 1970s and 1980s, equity REITs were characterized as either advisor-affiliated or self-administered. Today, the more meaningful distinction is between a "fee" REIT and an UPREIT. A fee REIT refers to those corporations (or trusts) that directly own equity interests in real estate.

In contrast, in an UPREIT structure, which was first introduced in 1992 through the Taubman Centers, Inc. offering, real property is owned indirectly through a substantial investment in a consolidated property portfolio as a partner in a so-called umbrella partnership, which is the operating entity for the portfolio. The conventional format for privately held real estate assets has been the single-asset partnership. Therefore, it is not surprising that the UPREIT structure has proven to be the most common form for new REIT IPOs, accounting for more than 73% of the equity REITs formed between 1993 and 1995.



## Exhibit 2

### A Matrix Classification of Potential Conflicts of Interests

Type of Conflict	Offering Formation	Investment Management	Transaction Activity	Property Management
Allegiance			•	
Sponsor Control		•	•	•
Outside Partners			•	
Overcompensation		•		•
Resource Allocation		•		•
Competitive Affiliates		•		•
Tie-In Business		•		•
Captivity			•	
Self-Dealing		•	•	•
Tax Timing	•		•	
Expense Preference Behavior		•	•	•
Malingering		•		•

Source: Author's files.

The UPREIT consists of two entities: the REIT and the operating partnership (OP, alternatively called the umbrella partnership). The two-tiered design evolved in direct response to two major structuring issues faced by sponsors when converting private, closely held real estate interests into a REIT: 1) effectuating a tax-free transfer or contribution of properties, which are already in existing partnerships and carried at a low tax basis, and 2) combining institutional-grade assets into a "critical mass" portfolio while still meeting the 5/50 REIT qualification rule (Robinson and Menna 1992).<sup>8</sup>

For control purposes, the REIT is typically the general or managing general partner of the operating partnership. The proceeds from the offering (the cash contributed by the REIT shareholders) flow from the REIT to the operating partnership where

they are used to repay debt, provide working capital, and possibly purchase assets. (Cash may also go back to the sponsors, but recent IPOs have avoided large direct and immediate cashouts.) The original investors holding partnership interests exchange them for units in the operating partnership and receive certain rights to convert these units to REIT shares, a fully taxable event to the original partners (Robinson and Menna [1992], Brody and Raab 1994).

The deferral of a federal income tax liability for the original partners lies at the heart of the UPREIT structure. The ability to time the exchange of partnership units for REIT shares also provides important additional flexibility for individual partners (Frank [1993]).<sup>9</sup> The financial benefits to sponsors of tax timing, however, create at least three COI situations unique to the UPREIT structure: *allegiance*, *outside partners*, and *tax timing*. Two aspects of *tax timing* illustrate the potential conflict.

#### Transaction Bias and Recognition of the Built-In Gain

Timing specific property dispositions to defer a federal income tax liability is the most commonly cited UPREIT COI situation. The conflict arises if the REIT receives an attractive offer to sell some of the operating partnership properties. Management, as owners of partnership units, may be hesitant to accept such an offer because of the negative personal tax implications that may result. Selling the properties, however, might be in the best interests of the REIT shareholders. The potential misalignment of interest comes from what, in tax parlance, is referred to as the "built-in gain" problem, and it stems from the sponsor's initial decision about how to transfer the owned real estate interests to the REIT.<sup>10</sup>

The built-in gain is defined as the excess, at the time the REIT election becomes effective, of an asset's fair market value over its adjusted tax basis. When there is a transfer of property from a non-C corporation into an investment company such as a REIT, the transaction is taxable under IRC Section 351(e). For real estate that has been held long enough for the adjusted tax basis to be low relative to its fair market value, the built-in gain is typically quite significant. REITs must choose between paying tax on the built-in gain up-front at the time S-corporation status is elected,<sup>11</sup> or when specific

properties are sold or otherwise disposed of in the ten years following the REIT election.

This is not the case, however, under the UPREIT structure. Under partnership conversion into an umbrella partnership, the IRC requires that persons contributing properties to a partnership bear the tax liabilities for those properties.<sup>12</sup> Compared to the treatment of built-in gain for the fee REIT, the partnership provision affecting the formation of UPREITs, in effect, provides the new investors (the UPREIT shareholders) with a "guarantee" that this liability will be put back to the original partners.

In contrast, there is a potential hidden liability put to fee REIT shareholders if a property is sold prior to the ten-year date. Still, the tax timing differential of the two-tier ownership structure creates a singular agency problem for the UPREIT because the decision regarding when to sell properties will have a greater impact on the contributing partners' tax position than new shareholders.<sup>13</sup> In similar fashion, refinancing decisions can be affected by the *tax timing* conflict — that is, who controls the continued deferral of the sponsor's built-in gain.

### Reluctance to Pay Down Debt

The second COI situation in the UPREIT structure involves decisions about the level of debt in the newly formed operating partnership. When property (or partnership interest) is contributed to the operating partnership, the sponsor may be required to recognize gain under Section 752 of the Internal Revenue Code, to the extent the sponsor's tax basis in the property (or partnership interest) is lower than the principal amount of debt on the property (or share of partnership debt). In addition, a paydown of debt by the operating partnership would separately cause a Section 752 gain if the decrease in liability (deemed a distribution) reduces the tax basis below zero (see Deutsch [1993], Mount [1994]).

The complexity of the IRC regulations on this point precludes discussion here, but the potential COI is clear: driven by tax considerations, sponsors might not paydown outstanding debt of the operating partnership to the level economic considerations would suggest appropriate. Although similar to the built-in gain conflict, the debt paydown conflict may present a more serious potential problem. Tax-driven debt levels will be difficult to delever, in the

opinion of some analysts, and thus will intensify the drive for REIT growth through issuance of new shares. Moreover, the tax implications of refinancing have become more complicated with the goal of many REITs to move away from secured debt to unsecured, rated debt instruments (see Menna [1995, p. 26]).

Though the UPREIT structure was controversial when it first appeared (Vakalopoulos [1993]), it has not only become more acceptable, but widely viewed as an important vehicle for REIT growth. With continual equity securitizations as well as merger and acquisition activity, the UPREIT structure has undergone refinements; while some, though not all of the inherent tax-driven COIs, have not proven to be actual conflicts (Menna [1995]).

The appearance of conflict remains potentially burdensome, and the UPREIT's legal and accounting complexity generates monitoring costs for investors, apart from the *tax timing* conflicts. Because the REIT does not own the property directly, financial accounting is less transparent, making it more difficult for investors to analyze the economic fundamentals of the underlying real estate assets and monitor management's actions. These agency problems in the UPREIT structure heighten the role of governance as a mitigation strategy, but, as I explain further later, governance is unlikely to be a sufficient mitigation strategy.

### The Advisor-Affiliate Structure and a Multitude of Caveats for Investors

Investment management through an external advisor structure, in both publicly traded and private investment vehicles, has been troublesome because of its close association with conflict-of-interest situations. Advisors are in the key position to influence decisions about the timing and terms of capital improvements, acquisitions, dispositions, and tenant leases, as well as contracts for property management services and debt financing, including whether some of those services are provided by affiliated entities.

The potential for conflict, *self-dealing*, exists when a transaction occurs with a related party or affiliated entity whereby the affiliate receives favorable or "sweetheart" terms and conditions from the entity on the basis of non-arms'-length negotiations. Transactions of this type raise the specter that man-

agement, in dealing with affiliated entities in which they usually have a material economic interest, may be making deals that are not in the best long-term interests of shareholders.

In the REIT sector, the potential for *self-dealing* has been linked historically to "captive" relations (*captivity*) resulting from the sponsor's role as an external advisor to the REIT. The advisor-affiliate format, however, also suffers from other potential conflicts — *sponsor control*, *overcompensation*, *resource allocation*, *competitive affiliates*, and *tie-in business*.

For example, as manager of several clients' property interests in the same highly competitive space market, in which client's building do you place a major multiyear tenancy, or in whose portfolio do you place an attractive acquisition? When an advisor has multiple clients, the potential COI problem is structural, a question of *resource allocation* — how to allocate management time and/or potential investment and business opportunities among competing clients of the advisor. A resource allocation conflict similarly exists when agents for the REIT have ownership interests in property or related businesses outside the REIT, and might devote a disproportionate amount of time and effort (overmanagement) to those investments to the detriment of REIT business.

Governance policy and board members who are truly independent can function as an effective monitor of *self-dealing* situations, especially when there are explicit policies governing decisions where conflicts exist. Mitigating the *resource allocation* conflict inherent in many advisory relationships, however, falls outside the reach of governance controls. In general, among *publicly traded* REITs, this later potential conflict-of-interest may appear to be less prevalent because of the change to self-administration among many existing equity REITs and the low frequency of recent equity REIT IPOs structured with an external advisor. In general, advisor relationships are more common for the smaller publicly traded REITs, which cannot support the costs of self-administration and privately held REITs.<sup>14</sup>

### Real Estate Interests Outside the REIT

The market dictum for equity REITs in the 1990s calls for real estate specialists with a "focused" business strategy evident in property-specific portfolios (apartments, shopping centers, regional malls,

office and industrial properties), and, preferably, a geographic focus. In many instances, the often diverse real estate interests of sponsors do not fully match up with these market preferences. Consequently, existing property assets or non-income-generating lands being held for development are excluded from the REIT portfolio. This is the case in most of the 1993 and 1994 equity REIT IPOs. In other instances, for the obvious reason that they might be a drag on performance, assets might have been excluded if they were distressed and non-performing.

When real estate assets are excluded from the REIT portfolio, a number of COI situations come into play. First, if management (or an affiliated interest) owns property investments outside the newly formed REIT, *resource allocation* is a potential conflict. Second, these property investments might be competitive with the REIT, in which case a *competitive affiliates* COI would exist. In either situation, management's interests are divided between serving the REIT and serving its other businesses.

Third, if in the future the REIT decides to acquire the asset — be it raw or improved land, a completed development project with tenants in place, or a performing but previously distressed shopping center or office building, a potential *self-dealing* situation exists in such related transactions. For example, in setting up the REIT, perhaps five existing assets and three parcels of land are excluded from the portfolio but continue to be managed by the REIT. As owners (full or partial) of these excluded assets, the sponsors have financial interests in the ongoing management and eventual sale of these excluded assets.

In some ways, the potential COIs generated by REIT structures in which real estate assets are excluded are not unlike that of the externally advised REIT; however, whether it is as problematic depends upon the extent of outside assets and the relative financial stakes involved. The question is, how much of management's time and effort goes to REIT business versus those outside where the potential return reward may be greater? Whether the outside interests are short term in duration and tied to specific assets (working out distressed assets or completing particular development projects), or generalized and of indeterminate duration (competitive properties or businesses), should also enter into any evaluation of this potential COI situation.

Governance structure and policy is the first

line of defense for monitoring and mitigating the types of COIs associated with excluded real estate assets. But, as in other cases, it may not be sufficient if the composition of the board of directors reflects few disinterested members among the independents, or if board policies with respect to related transactions are weak. The structures of many equity REIT IPOs appear to have been responsive to investor demands for more specific mitigations, namely through the inclusion of option contracts outlining terms and conditions to purchase the properties post-offering, and/or rights of first refusal on various option properties. Also, most REIT structures include some type of covenant not to compete, restricting management's outside real estate activity in some product areas or for specified time periods. However, if these covenants pertain only to future acquisitions or business, they may do little to specifically address the resource allocation problem tied to the management of existing excluded assets.

### The "Qualified Income" Requirements

To qualify for exemption from federal corporate income tax, a REIT must meet several requirements, two of which specify the sources from which, and in what percentages, a REIT can derive income. These are the "75%" and "95%" income tests.

The first test requires that at least 75% of a REIT's yearly gross income be derived directly or indirectly from investments relating to real property or mortgages on real property, including "rents from real property"<sup>15</sup> and mortgage interest and principal payments [IRC 856 (c)(3)]. The second test requires that at least 95% of the REIT's yearly gross income must be derived from real estate income, dividends, interest, and gain from the sale or disposition of securities [IRC 856(c)(2)].

The historic purpose of these requirements has been to restrict a REIT's role to that of a passive buy-and-hold investor, and prohibit it from deriving income from services not customarily provided to real estate tenants or, more generally, profits from an operating business. Though relaxed since 1986, the regulations still constrain the format for providing property management services. Also, and most dramatically, they impact the structure of hotel REITs. In both cases, maneuvering around the REIT-qualifying income tests sets up distinct COI situations.

### Conflicts in Business Subsidiaries

Going public with the profile of a fully integrated operating company has been an important component of the new REIT model. Focused on growth as well as current yield, investors have been seeking REITs with the capacity — a "franchise" — for creating value. They appear willing to pay a premium for REITs possessing management expertise across all or most sectors of the real estate business — property and asset management (including financial management, legal, and accounting skills), acquisition, leasing, construction, and development. Prior to going public, companies that had established operating businesses (a property management company, for example), had to consider how best to integrate those entities into the REIT structure — for that relationship shapes the potential for COIs.

For instance, if the business entity providing property management or development services is owned by the REIT (as opposed to the REIT itself), rents (and fees for service) received from tenants who are furnished certain services by the REIT are not included in "qualified" rents from real property under the IRC, unless the services satisfy various complex requirements (see Gross et al. [1993]). Sponsors with a fee-generating property management or development business are most affected by this problem because this income may be considered "tainted" under the complex requirements of the REIT income tests.

To avoid this possibility, the new organization structures property management or development operations through a corporate subsidiary of the REIT; technically, any management fee income is realized by the subsidiary, not by the REIT. Voting stock of the subsidiary is typically controlled by the sponsors, with the REIT (or operating partnership in the case of an UPREIT structure) owning non-voting preferred stock shares of the subsidiary company. Though the REIT (or operating partnership) does not have management control of this entity, economic benefit comes back to it through its ownership of the preferred stock.

This solution has spawned its own problems, according to some legal experts, because the subsidiary is an inefficient tax structure. Income realized by the subsidiary is taxed at both the subsidiary and REIT shareholder levels. If the REIT's management

operations are extensive, the fee income could be substantial, and so too the attendant tax liability. To reduce taxable income, operating expense obligations (including management salaries and bonuses), are shifted to the subsidiary (Gross et al. [1993]).

What this tax-induced solution does is set up a situation in which the potential exists for *overcompensation* and *expense preference behavior*.<sup>16</sup> Though the business subsidiary arrangement is not characteristic of most REITs, it is not uncommon among those recently formed; for example, it is evident in at least ten of the forty-three equity REITs brought to market in 1993.

Expert opinion on this two-tier structure varies. Some investment bankers see in it the elimination of potential COIs through the consolidation, at the operating partnership level, of a sponsor's complete real estate assets: properties, management company, development opportunities, and acquisitions. The presumed alignment of interests follows from a mutual incentive for the highest share price because every partner's economic interest is valued where the REIT trades (Kelly in NAREIT [1993b, p. 4]).

While plausible in the abstract, the specific structure of individual REITs can readily negate this logic. In this most recent wave of equity REIT IPOs, Wall Street marketing has avoided the word "affiliate," just as it has worked to impose discipline on the offering structures. Yet when business subsidiaries are controlled by the sponsor and rest several rungs removed from the REIT's governance structure, the line between "management affiliate" and "self-management" seems a bit blurred.

### Conflicts in Hotel REITs<sup>17</sup>

The qualifying requirements for REIT tax status impact the structuring of hotel REITs in ways significantly different from other product-type REITs. Unlike other real estate, the IRS considers the operation of a hotel to be a business, not a service customarily provided in connection with the rental of real property. Because the IRS has ruled that the profit from the operation of a hotel does not qualify as "rent from real property"<sup>18</sup> for income test purposes, a hotel company that owns and operates its hotels will fail the income test requirements and not qualify for REIT tax status.

Consequently, the only qualifying structure for

the hotel REIT sponsor who seeks to own and continue to operate these assets is for the REIT (or operating partnership in the case of an UPREIT), to own the bricks and mortar assets, then lease them to another entity that operates the hotels for its own account.<sup>19</sup>

The income tests applied to hotels, in effect, preclude fully integrated hotel companies in the form of a REIT. Sponsors with integrated operations have typically split their companies into two distinct entities: a hotel ownership entity (the REIT), owned by public shareholders, and a leasing/hotel management entity, owned by affiliates of the REIT. "While the income test restrictions prohibit hotel REITs from capturing lease and management fee income," one buy-side analyst wrote, "they do not prohibit the sponsoring insiders from capturing this income. In this regard, the confluence of REIT legislation and a sponsor's desire to capture lease and management fee income has shaped the current structure of hotel REITs and created conflicts of interest which are potentially detrimental to shareholders" (Ramsey [1995, pp. 4-5]).

At least two COIs are prominent in these owner-operator structures: *self-dealing* in contractual relationships, and building affiliated companies with REIT money (a form of *captivity*). In the first instance, a conflict arises because the three key contracts — advisory, lease, and hotel management — are not negotiated at arms' length; rather, wearing two hats, REIT management is essentially negotiating these contracts with itself. All but three of the eleven publicly traded hotel REITs possess this conflict of interest, to one degree or another.

At first blush, this may not seem problematic if management is substantially invested in the REIT; however, ownership of REIT shares varies widely among sponsoring insiders, from a low of 4% to a high of 30%. To the extent inside ownership varies, the misalignment of interests also varies. Moreover, as another buy-side analyst concluded, as high as the insiders' REIT ownership may be, the sponsoring insider's percentage ownership in the lease and hotel management entities is typically much higher (Green Street Advisors, cited in Ramsey [1995]).

The second hotel REIT conflict flows from the first: the ability of the affiliated hotel management and lease companies to build their businesses with REIT money comes from their exclusive relationship with the hotel owner, the REIT. Consider

the following scenario. At the IPO, the sponsors of Vanilla Hotel, Inc. (VHI) divide their existing hotel business into three entities: Vanilla Hotel, Inc. (the REIT, a hotel leasing entity); Vanilla Management, Inc., (the lessee, a majority of which is owned by the sponsors); and Hotel Managers, Inc., (the hotel operating company, an indirect, wholly owned subsidiary of Vanilla Management, Inc.). At the IPO, the affiliated entities are awarded the lease and management contracts for the REIT's initial hotels, perhaps ten. As the REIT grows through acquisitions financed by follow-on equity issues, the majority of lease and management contracts are awarded to the affiliated companies. One year after the IPO, these entities operate more than three times as many, say, thirty-five, of the REIT's hotels.

Within a relatively short time, when the management company attains a size that makes it an attractive merger candidate, the sponsors, as majority owners of the privately held Vanilla Management, Inc., sell the management company to a non-affiliated major hotel operator ("Major") for a price in the double-digit millions, monetizing the value created by the REIT. Even though the REIT has financed the growth of the management and leasing companies through the awarding of contracts, REIT shareholders have no direct financial stake in the sale transaction. Depending on how these conflicts previously affected the pricing of VHI, shareholders might benefit from a post-transaction rise in the value of their shares if the presence of conflicts means that VHI had traded at a discount.

Does the sale resolve the conflicts of interest between the sponsors' interests in the management company and its management of the REIT? It depends on the terms and conditions of transaction as well as the sponsor's ownership interest in the newly merged hotel management entity relative to that in the REIT. For example, the decision to sell the management company lies beyond the control of the REIT board of directors. Yet, the board could influence the transaction's terms and conditions to benefit REIT shareholders if, as part of the transaction, the REIT is asked to sell the acquiring company rights of first refusal to lease all hotels acquired or developed by the REIT in the future.

### Mitigation Strategies

The art of dealing with potential conflicts of

interest lies in the design of mitigating mechanisms that safeguard shareholders. For sponsors and their investment bankers, alignment of interests issues are real and burdensome enough to influence both the structure of a deal and the level of disclosure. "Avoiding conflicts of interest and the appearance of such conflicts is likely to reduce investor and media speculation about such conflicts," two commentators remarked, "and, in conjunction with that, reduce the likelihood of shareholder litigation and governmental intervention" (Lapides and Torres [1994, p. 17]). Not surprisingly, insider ownership of REIT shares among sponsors and senior management, along with some type of stock "lock-up" provision, have been common features of the post-1992 crop of equity REIT IPOs.

A review of more than forty equity REIT offerings from the 1990s further indicates that sponsors counter COI situations most often by relying on disclosure, and, second, on governance structure and policies, in particular the role of independent directors (trustees). As is the case with non-REIT entities, however, the strength or weakness of governance as a strategy for monitoring potential COIs depends on more than just the majority presence of independent directors on the board. Many issues of governance among REITs are not unlike those confronting corporate America, and they are part of a broad concern about the effectiveness of the role boards play as watchdogs for shareholders. While such macro issues of corporate governance are beyond the scope of this article, a selective discussion of governance serves to highlight its role as a mechanism for managing potential COIs in REIT structures.

### Relying on the Independent Directors

To conform with state securities regulatory guidelines (NASAA Policy), REIT boards are structured with a majority of independent directors, whose approval is typically required for any transaction in which a director is an interested party. Although this regulatory standard as well as the listing requirements of the various securities exchanges are fairly clear, there is no uniform definition of an "independent director." NASAA standards for independent directors are more specific and more demanding than those of the AMEX, NYSE, or Nasdaq (the exchanges), but REITs listed on the ex-

changes are generally exempt from compliance with NASAA standards (see Lapides and Torres [1994]).

In practice, the *independent* director may not be a *disinterested* director in board votes on all corporate matters, and situations exist where an individual qualifies as an *outside* director but may have difficulty acting as an *independent* director. Consider, for example, the situation of an outside director who is employed by a major tenant of the REIT. REIT legal counsel, investment bankers, and other service providers also fall into this category. According to Lapides and Torres, these persons “can provide considerable insight about opportunities and threats facing the company and in the marketplace; but they may have problems being totally objective — due to real and perceived conflicts of interest” (Lapides and Torres [1994, p. 17]).

A governance policy calling for approval by a majority of the independents in “related transactions” (non-arms’-length acquisitions, dispositions, leases, loans, and investments between the REIT and affiliates, directors, or officers) acts as a check on *self-dealing*. A decision by REIT management to acquire an “excluded asset” would fall into this related transaction category. Where the policy is defined as a majority vote by the independents, it is termed a *weak* form of governance policy.

In contrast, a *strong*-form policy would call for approval by a majority of *disinterested* directors. Under the incorporation laws of some states, the strong-form policy is the norm, while other REITs have, by choice, elected to put in place strong-form policies in structuring the IPO. Some sponsors have even extended the reach of governance policies to deal with the *tax timing* conflict inherent in the UP-REIT structure by requiring that “all decisions regarding the sale of any of the properties of the operating partnership contributed by any partner will be made by a majority of disinterested directors.” A careful reading of policies, bylaws, and covenants in the *prospectus* is in order, as the policy or bylaw could be written in such a way as to negate the appearance of a board-level safeguard.<sup>20</sup>

Some types of potential COIs’ governance cannot be dealt with easily, in part because they are difficult to monitor. The *tax timing* conflict tied to debt refinancing among UPREITs is one. If interest rates or corporate-level financing strategy suggest that secured debt on OP properties be refinanced,

and REIT management (acting in its self-interest as OP unitholders with significant tax liability exposure) does not propose such a refinancing, will a board be independent enough to push for a refinancing of properties when doing so might create a tax burden for other directors? The general question becomes, how many potential conflict situations actually fall within the governance arena?<sup>21</sup>

The point to emphasize is that the effectiveness of governance depends on several factors:

- The size and composition of the board of directors, including the number of independents on key board committees (executive and compensation, in particular).
- The scope of board decision-making powers.
- The presence (or absence) of specific policies designed to safeguard shareholder interests in conflict-of-interest situations.

These and other attributes are noted in Exhibit 3, which presents a checklist of items investors should review when evaluating the organizational and managerial structures of equity REITs.

### Structuring An Economic Alignment of Interests

Putting in place economic incentives for insider management to act in mutually beneficial ways for shareholders is the obvious complement to corporate governance as a strategy for mitigating COIs. This is especially so in situations where there are limits to the role of corporate governance, as is the case with *resource allocation* conflicts when REIT management may not be fully devoted to the REIT’s business. Among post-1992 REITs, this situation commonly arises when sponsors continue to own real estate assets and/or businesses outside the newly formed company. By structuring into the IPO explicit pricing mechanisms for dealing with excluded real estate assets (option contracts with specific formulas), sponsors can reduce the shareholder burden in monitoring management, which would be expected to show up in enhanced REIT share value.

An illustration of how IPO structuring can tie together several different strategies for managing the potential COI tied to excluded real estate assets is the Kimco Realty Corporation offering of 1991, the first major IPO of a non-healthcare REIT since

## Exhibit 3

### A COI-Based Checklist of Institutional Arrangements in REIT Structures

#### Institutional/Organizational Structure

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1. *Type of REIT:*
    - a) ownership interest: fee or UPREIT  
if UPREIT — hierarchy of control through ownership:
      - 1) number of general partners
      - 2) UPREIT's ownership % of operating partnership (OP)<sup>1</sup>
      - 3) OP % control of individual properties
    - b) investment (portfolio) management: advisor-affiliate or self-administered
    - c) property management: affiliate, self-managed<sup>2</sup>, or independent
  2. *Sponsor ("inside") interests:*
    - a) in REIT
    - b) in operating partnership
    - c) total economic interest
    - d) stock lock-up for principals and partners
  3. *Sponsor (including affiliates) properties owned outside the REIT:*
    - a) generally noted or specifically named
    - b) option to acquire, including specific pricing formula, other terms and conditions
  4. *Use of offering proceeds*
    - a) level of debt paydown
    - b) cash to sponsors
    - c) other (acquisitions, working capital)
  5. *REIT governance structure*
    - a) number (and percent) of independent directors
    - b) number (and percent) of disinterested directors
    - c) executive committee (to be formed) empowered to make decisions for the Board
    - d) composition of other committees (investment, audit, compensation, nomination)
  6. *Management policies and covenants*
    - a) pertaining to related transactions
    - b) pertaining to affiliated interests
- 

the late 1980s. The KIMCO offering presented a fully integrated real estate business with more than twenty years of in-house experience covering devel-

## Exhibit 3 (continued)

- c) requirements for a change in disposition policies and covenants
- d) sponsor's covenant not to compete

#### Contractual Arrangements

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7. *Management agreement — UPREIT and OP:*
  - a) nature of the relationship (wholly owned subsidiary, contractual; exclusive services or fee-generating business for UPREIT)
  - b) option to acquire outside competing business opportunities of affiliates
8. *Contractual services incentives:*
  - a) investment management: nature of agents' compensation (ongoing and reversionary; stock options, extent, depth into middle management, phase in and vesting)
  - b) property management: nature of agents' compensation

#### Disclosure

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9. *Ownership relationships and contractual arrangements*
  - a) formation transactions
  - b) management agreement (UPREIT and the operating partnership)
  - c) property management services
10. *Financial projections*
  - a) funds from operations (FFO), including details of expected changes in existing cash flows from operations, qualitative information on subleases, ground leases, and other such expenses and revenues with anticipated near-term adjustments;
  - b) pricing of IPO and its relationship to % insider ownership.

<sup>1</sup>Proximity to underlying real estate assets.

<sup>2</sup>For UPREITs, self-managed could mean either REIT ownership of property-management business or management control through the operating partnership (OP) that owns the property management business. Note whether contractual-services agreement limits property management services to OP or whether property manager can service other third-party interests.

Source: Author's files.

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opment, construction and renovation, leasing, and property management. Reflecting the industry's troubled times, the company's portfolio holdings



had to be restructured for the IPO to attract the desired institutional investors. Knowing that it had to be "pristine," with as few "problem properties" as possible, and that its maximum leverage should not exceed 50%, Kimco's key structuring problem centered on creating a "clean" REIT portfolio from its aggregate holdings. Echoing the good bank/bad bank format, the sponsors selected forty-five properties that had a major tenant in financial difficulty or participating debt or significant vacancies and placed them in a separate corporate entity, KC Holdings. If, in the future, they became part of the REIT, it would be under the terms and conditions of the "acquisition option."

The acquisition option, simply put, allowed the REIT to acquire the properties once certain performance levels were met. Exercisable for ten years, the option price for each of the properties (except where there was cross-collateralization by mortgagees)<sup>22</sup> was predetermined, and in most cases, equivalent to 110% of the current mortgage amounts on the properties. The option price would be payable in stock (unless issuance violated certain REIT laws, and then consideration might be in cash) at the higher of the IPO price or the market price at the time of exercise. As a governance check, the option could be exercised only after approval by the independent directors who do not own stock in KC Holdings.

A further requirement that properties meet a specific performance hurdle — a return at least as high as the then-existing dividend yield — reinforced the governance intent by preventing a transaction that would not make economic sense for the REIT in not being dilutive to yield.<sup>23</sup> Thus, the way in which the acquisition option was structured allowed these unattractive parcels to be put aside without having them sneak back in at terms too favorable to insiders.

The spin-off solution created Kimco's key agency problem:<sup>24</sup> while the REIT would assume the management of these properties, as one analyst's review succinctly put it, insiders would have "an economic incentive to 'overmanage' these properties that they effectively own 100% of, at the possible expense of the REIT's properties" (Green Street Advisors [1991, p. 4]). With the alignment of incentives and multiple safeguards built into the option to ensure that much of the upside potential would go

to the REIT (and none of the potential downside), the structuring of this acquisition option won high marks from independent analysts who saw the IPO, if not totally conflict-free, then blemished by only minor conflicts.

In their coverage of the IPO, Green Street Advisors noted that management favoritism would occur only if the properties' values were not far below their mortgage indebtedness because the option structure defined an upper limit to this area of temptation for insiders: once the value of the property exceeded the option price, presumably, that value would be realized by the REIT as opposed to the insider. Because the acquisition option gives insiders a preset 10% premium on the option price, the likelihood of insiders capturing 100% of the benefits exists only within a narrow band of value creation above the amount of debt and up to the option price.<sup>25</sup>

In dealing with its major structural conflict, Kimco's sponsor mitigated the agency burden through a carefully designed economic incentive geared to the anticipated concerns of potential institutional shareholders. This, in turn, was supported by governance check and disclosure and buttressed by a very substantial inside ownership position, just shy of 50% (in conformance with the 5/50 rule). Kimco's 1992 offering set the standard for other real estate companies contemplating the conversion from private to public ownership.

## Conclusions

Transforming a closely held private, entrepreneurial company into a public format begets both complexity and conflicts of interest. Real estate's particular attributes — ownership of complicated (and often) partial interests with contingent claims, businesses formed from a collection of single-asset partnership deals, and the non-recourse character of mortgage financing — all complicate the going public process. In this last wave of IPOs, the alignment of interest issue simultaneously caught the attention of Wall Street, buy-side analysts, and investors. This has meant that the post-1992 REITs are better structured than many in the past (especially the non-survivors), and that many of the agency issues surrounding REIT management may be no better or worse than those of corporate America, in general.

Still, conflicts of interest or the appearance of conflicts are burdensome. Not all COIs are equally problematic though, nor will all materially affect the REIT enterprise. Individually, some are potentially more burdensome to shareholders than others. In and of themselves, a small item of conflict may not be problematic, though many together compound the individual problem and monitoring function of the board of directors.

At least four strategies exist for managing COIs: governance structure; policies, by-laws and covenants; economic incentives; and disclosure. By itself, corporate governance, the mantra of institutional investors, is unlikely to be sufficient, because it cannot easily deal with all conflicts, in part because they are difficult to monitor, but also because the "oversight approval" approach cannot accomplish what an economic incentive might or what market "eyes" might through full and timely disclosure. As a result, the most effective strategies for mitigating COIs are likely to be those that represent an integrated approach — strength in governance structure through a board comprised of truly independent directors<sup>26</sup> and explicit policies and covenants and full disclosure and economic incentives that create mutual interests between insider management and shareholders — further safeguarded by relatively high inside ownership.<sup>27</sup>

An efficient market will price the relative severity of the conflict problem at the IPO and, subsequently, through market-trading differentials. One aim of this work is to descriptively identify the sources of COIs in REIT structures so that empirical researchers can better explore the pricing and investment performance impacts of this important agency issue. Much research remains to be done in this area, and it can only be done by examining publicly traded REITs, though the same range of potential COIs would appear in privately held REITs.

Some conflicts may be active, though no triggering event is bringing them to a board-level review. The performance impact of others may not yet be evident empirically because they are rooted in the provision of ongoing management services or future decisions concerning property-level refinancings or dispositions. On the other hand, growth in a REITs' portfolio holdings, the competitive forces of market pricing, and consolidation within the real estate industry through mergers and acquisitions make contin-

ual refinements to REIT structures a distinct possibility, and one might hope, potential COIs less common.

## Endnotes

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- <sup>1</sup> This figure is derived by adding to equity capitalization the debt outstanding and the implied market capitalization for operating partnership units of UPREITs (the non-traded shares issued at formation or later as part of acquisition transaction). At best this is an approximate figure because it does not account for the unknown amount of mortgage debt held by the operating partnerships, and includes a small amount of non-real estate assets held by REITs, such as cash and government securities. REITs are also valued for their management expertise and franchise value, and may hold management contracts for third-party owned assets, though we cannot ascribe a specific figure to the value of these management services.
- <sup>2</sup> By 1995, 82% of the publicly traded REITs were self-administered, compared to 45% in 1984 (NAREIT 1995). The new norm is most notable at the margin — of the eighty-nine equity REITs newly formed between 1992 and 1995, all but nine adopted a self-administered format. A 1986 amendment to federal tax policy facilitating self-management at the property (as opposed to investment) level gave further impetus to self-management. Prior to that time, prevailing legal opinion held that REITs should manage their assets through an external property manager (King [1993] and L'Engle [1987]).
- <sup>3</sup> As put forth by the North American Securities Administrators Association (NASAA), an organization of state securities regulators, in its statement of policy on REITs, independent directors are defined as "directors of a REIT who are not associated and have not been associated within the last two years, directly or indirectly, with the REIT's sponsor or advisor of the REIT" ("Statement of Policy Regarding Real Estate Investment Trusts" (NASAA Policy) as revised and adopted by the NASAA membership on September 29, 1993, Washington, D.C.). In practice, this definition is not binding, and individual REITs do provide their own definition of "independent director" in their Articles of Incorporation of the Company.
- <sup>4</sup> Most REITs are structured to conform to these regulations, even if the offering is exempt. The pressure

comes from investor demands for protection as well as from stock exchange listing requirements that are similar to state securities' regulations. These state regulations may impose organizational and operational requirements that must be included in the governing document of a REIT (unlike federal securities laws which focus on information disclosure). The NASAA guidelines include the following: 1) the company must have at least three directors or trustees, a majority of which must be independent directors (trustees); 2) the directors are subject to various conflict of interest rules that limit self-dealing and other activities that may be contrary to the interests of shareholders; 3) shareholder rights must be specified, including the power to elect and remove directors, the power to call shareholder meetings, and the right of access to company books and records; 4) if there is a contract for an investment advisor, board responsibility includes supervision and oversight of that advisor, including annual review and renewal of that contract as well as standards for determining compensation to the advisor; 5) limitations placed on the administrative expenses of the REIT; and 6) limitations and guidelines imposed on the investments and financing of the REIT (NAREIT [1989]).

<sup>5</sup> Created by Congressional legislation in 1960 as a mutual fund type vehicle for individual investors, the REIT pays no federal income tax and shareholders are taxed only on dividends received, provided that the REIT meets the following conditions: 1) it must pay out at least 95% of its ordinary taxable income as dividends; 2) it must organize as a corporation or business trust and govern through a board of directors or trustees; 3) its shares must be fully transferable; 4) it must have at least 100 shareholders; 5) no more than 50% of the shares can be held by five or fewer individuals during the last half of each taxable year (the so-called 5/50 rule); 6) at least 75% of total assets must be invested in real estate assets; 7) at least 75% of gross income must be derived from rents and mortgage interest; and 8) no more than 30% of gross income can be derived from the sale of properties held less than four years, securities held less than six months, or other prohibited transactions.

<sup>6</sup> Kanda argues that the regulations constrain managers' behavior "so that there is less room than in most corporations for conflicts to develop among investors regarding in-corporate decisions," and that the restrictions limiting investment in scope to real estate may reduce the costs of monitoring. In particular, he notes that "disposition decisions may all be of a kind and may be relatively easy to observe and to control through shareholder votes or contractual agreements, even though the number of investors is large. Serious managerial misbehavior will generally be linked to specific real properties, and suspicious, sophisticated investors can often readily detect such misbehavior by tracing real estate transactions" (Kanda [1991, pp. 20-

21], LEXIS printout).

<sup>7</sup> This article is the first stage of an ongoing research project on conflicts of interests within equity REITs. The second stage involves an empirical analysis of the impacts of COIs.

<sup>8</sup> Prior to 1994, no more than 50% of a REIT stock could be owned by five or fewer persons, making it difficult for pension funds to own sizeable positions in newly formed REITs. This rule has been significantly relaxed with passage of the Revenue Reconciliation Act of 1993. See Akselrad and Bernstein [1994].

<sup>9</sup> The liquidity of the UPREIT structure also enhances estate planning through the stepped-up basis at the time of death of the sponsor investor.

<sup>10</sup> The tax liability associated with the transfer of real property into a REIT depends upon where the real estate resides prior to the move and where it is going. The IRC contains a provision (Section 337) aimed at preventing capital gains tax avoidance of real estate transactions by moving them from a C corporation to a pass-through vehicle such as an S corporation or a REIT. A section of that provision [Section 337(d)] is applicable to REITs, making taxation of the so-called "built-in gain" the one major exception to the REIT exemption from double-entity taxation.

<sup>11</sup> This results in the property taken into the REIT with a stepped-up basis, with the REIT taking full depreciation on that new basis. In an UPREIT, this doesn't happen, because the basis for calculating depreciation is governed by different rules. See Mount [1994] and Deutsch [1993].

<sup>12</sup> "In addition, the IRC may require that depreciation deductions for properties contributed to the umbrella partnership be allocated disproportionately, or even entirely, to the REIT general partner, thereby decreasing or eliminating the depreciation deductions available to the contributing partners" (Brody and Raab [1994, p. 39]).

<sup>13</sup> Many within the REIT sector do not view the built-in gain on subsequent sale of the OP's real estate as a real conflict, for two reasons: first, most REITs generally do not regularly sell real estate; and second, as is the case with fee REITs, UPREITs that do dispose of real estate generally do so only through use of the IRC's Section 1031 like-kind exchanges, which result in a continued deferral of the built-in gain. This is, however, within the context of the initial control of the REIT general partner put in place by the sponsor (see Menna [1995, pp. 24-26]).

<sup>14</sup> See NAREIT [1993a] for a list of both types.

<sup>15</sup> For income test purposes, "rents from real property" include rents from interests in real property, rent attributable to personal property in connection with the lease of real property (not to exceed 15% of total rent under a lease), and charges for services customarily rendered in connection with the rental of real property [IRC 856(c)(2)].

<sup>16</sup> Consider the elements of the following arrangement

for a five-year contract for property management services: 1) for subcontracted property services to the subsidiary management company, a multimillion dollar payment intended to approximate the direct cost for these services; plus 2) a pro rata share of unallocated overhead equivalent to the direct expense payment. Such an arrangement could be costly to the REIT, if the second payment functions as a way to off-load a substantial amount of its unallocated overhead, which presumably could include both salaries and bonuses to senior REIT officers. This type of multiyear contract, especially if its termination could only be by cause, would represent a delegation by the REIT of its discretion as to how and to what extent it wants to incur discretionary overhead.

<sup>17</sup> This section draws heavily on the research of Ramsey [1995].

<sup>18</sup> "Rents from real property" are defined in a way that explicitly excludes "payments for the use or occupancy of rooms of other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses or apartment houses furnishing hotel services...." [IRC 856(c)(2)].

<sup>19</sup> The singular exception to the split owner-operator structure is Starwood Lodging Corporation (HOT), the entity created from the merger of hotels and related interests from Starwood Capital Group, L.P. and Hotel Investors Trust and Hotel Investors Corporation, a unique grandfathered paired share capital structure. Unlike other hotel REITs, HOT's shareholders benefit from returns from both hotel ownership and management, and the pairing of the REIT with the management company eliminates material COIs between management companies and shareholders.

<sup>20</sup> This point I owe to Mike Kirby, who cites the instance where, in an UPREIT structure, insiders have an effective veto over certain transactions because disposition of properties, at the OP level, requires approval by a majority of the OP unitholders.

<sup>21</sup> This illustration I owe to Chris Lucas.

<sup>22</sup> The conditions of these options varied. Seven of the properties were subject to property-specific options, while the thirty-eight others were subject to package options. See Kimco *prospectus*, p. 40.

<sup>23</sup> If performance hurdles were not achieved, the KC Holdings' properties could be purchased if non-insider shareholders approve.

<sup>24</sup> It is possible to argue that should the properties be sold after the IPO, when scrutiny would not be as high, the possibility for unfair terms would become a much greater reality than if these properties simply had been included in the public offering.

<sup>25</sup> "If, for example, one of the vacant anchor spots is filled, it may well increase the value of that property by, say 20%. In this example, the maximum benefit accruing to insiders would be only half that — the 10% premium on the option price — while the Company

shareholders would benefit on any value creation in excess of the option price" (Green Street Advisors [1991, p. 5]). As of December 31, 1995, KC Holdings' subsidiaries had conveyed fourteen shopping centers back to the REIT and had disposed of ten additional centers in transactions with third parties (Kimco [1995]).

<sup>26</sup> Drawing upon the empirical literature on the subject, one legal expert on corporate governance commented that boards with a majority of independent members — even imperfectly independent directors — perform better, on average, than other boards, yet only a minority of public companies have such boards (Black [1992, pp. 24-25]). REITs, in contrast, appear to stand as a special set of public companies. As Black further states, "We badly need more research on what makes for a good board, but the available evidence suggests that director independence is valuable."

<sup>27</sup> The size of the UPREIT's ownership interest in the OP indicates economic interest, but more important to the potential *tax timing* COI is the locus of management control over the OP and the overlap of ownership interests in the OP and the REIT. Similarly, evaluation of the role of inside ownership must be tempered, on a case-by-case basis, by an understanding of its relative financial importance of the sponsor's inside REIT position relative to the sponsor's holdings in outside affiliated interests.

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