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A Theory of the REIT

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 are forbidden from reinvesting 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. 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-induced lock-ins 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, illustrating how an overlooked business form sheds light on some of the fields' central debates.

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INTRODUCTION

Real Estate Investment Trusts (REITs) are companies that raise money from the public to invest in real estate.[1] Unlike all other companies, REITs exhibit two unusual governance characteristics: REITs are immune to hostile takeovers[2] and prohibited from reinvesting their profits.[3] These REIT features defy the scholarly consensus on good corporate governance. Corporate law permits takeovers because they serve an important role in holding 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, one might expect investors to shun REITs. Yet, investors clamor to buy REITs. Every year, REITs grow.[7] Thirty years ago, they barely existed. In the intervening decades,

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* Section 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. *See infra* Section I.B.
3. *See infra* Section 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, 480 (2017) (arguing that the possibility of takeovers increases share prices). 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 M. LOPUCKI & ANDREW VERSTEIN, BUSINESS ASSOCIATIONS: A SYSTEMS APPROACH 200-02 (2021).
6. *See, e.g.*, OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 143-48 (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*, 117 HARV. L. REV. 1102, 1109 (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, 319-26 (1976). But nobody has ever urged an industry-wide ban on reinvestment.
7. *See REITs by the Numbers*, NAREIT (Feb. 2022), https://www.reit.com/data-research/data/reits-numbers [https://perma.cc/NQ8Q-AGRH].

America's public REITs have doubled in size nearly every four years.[8] Almost half of American households own REIT stock.[9] REITs hold more than $4.5 trillion in assets,[10] approximately 3% of all of America's wealth,[11] and make up 5% of the S&P 500.[12] Further, 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 still 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

8. *See FTSE Nareit Real Estate Index Historical Market Capitalization, 1972-2020*, NAREIT, https://www.reit.com/data-research/reit-market-data/us-reit-industry-equity-market-cap [https://perma.cc/QJ7L-XAVD] [hereinafter *FTSE Market Capitalization*] (listing 1974 REIT market capitalization as $712.4 million); *REIT Industry Financial Snapshot*, NAREIT, https://www.reit.com/data-research/reit-market-data/reit-industry-financial-snapshot [https://perma.cc/38PE-UY6R] (indicating March 2023 REIT market capitalization at $1.2 trillion). This is akin to more than 25% annual growth on average—with quite a few bear years along the way.

9. *See Percentage of American Households Owning REIT Stocks Nearly Doubles Since 2001*, NAREIT (Jan. 2021), https://www.reit.com/data-research/research/nareit-research/percentage-of-american-households-owning-REIT-stocks [https://perma.cc/X8HH-SFH4] (reporting that 145 million Americans live in a household with direct or indirect REIT investment); *see also The United States*, NAREIT (Oct. 14, 2022), https://www.reitsacrossamerica.com/united-states [https://perma.cc/WZ94-3F7W] (reporting that 44.9% of American households are invested in REITs).

10. *See The United States*, *supra* note 9. 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 Graph*, FED. RSRV. BANK OF ST. LOUIS (Apr. 12, 2023), https://fred.stlouisfed.org/graph/?graph_id=369801 [https://perma.cc/M6EE-HXX7] (estimating U.S. wealth at approximately $151 trillion).

12. *See REITs by the Numbers*, *supra* note 7. Nareit reports that twenty-eight 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 $1.3 trillion, *id.*, while the whole S&P 500 is about $37 trillion, *S&P 500 Market Cap*, YCHARTS (June 2023), https://ycharts.com/indicators/sp_500_market_cap [https://perma.cc/6G2S-98PB].

13. These REITs are 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. Langbein, *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 eighteen scholarly citations. *See* Note, *Understanding REITs, UPREITs, and Down-REITs, and the Tax*

(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 "pass-through theory" of REIT success: REITs enjoy tax benefits attractive enough for investors to tolerate suboptimal corporate governance.

Yet, upon closer scrutiny, the pass-through theory fails to account for investor enthusiasm for REITs. Any tax advantage is small,[17] and may even be negative.[18] Moreover, other pass-through entities, such as the Master Limited Partnership structure, confer better pass-through tax treatment without REIT-like restrictions.[19] Yet, real estate investors have largely ignored those other vehicles.[20] More generally, the pass-through theory fails to link federal tax policy to

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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. *See, e.g.*, David M. Einhorn, *Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies*, 51 TAX LAW. 203 (1998); Terrence Floyd Cuff, *Issues in Section 1031 Exchanges for Real Estate Investment Trusts*, 31 REAL EST. TAX'N 113 (2004); Amy S. Elliott, *The Expanding Universe of REITs*, 137 TAX NOTES 707 (2012) (commenting on C corporations 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); 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); Richard M. Nugent, *REIT Spinoffs: Passive REITs, Active Businesses*, 146 TAX NOTES 1513 (2015); David F. Levy, Nickolas P. Gianou & Kevin M. Jones, *Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles*, 94 TAXES 205 (2016).

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

17. A "traditional" corporation that makes $100 in profit from real estate will pay $21 in corporate taxes before distributing the remaining $79 to shareholders, who must pay a 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 REIT investors.

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

19. REITs are not true pass-throughs 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 pass through losses to investors. Nevertheless, the term "pass-through" is commonly applied to REITs. *See, e.g.*, BankBoston Corp. v. Comm'r of Revenue, 861 N.E.2d 450, 451 (Mass. App. Ct. 2007) ("Congress . . . created REITs as another variation of so-called 'pass-through' entities such as mutual funds and Subchapter S corporations.").

20. *See infra* Section VI.A.

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, and so none has ventured an explanation.[21] The few corporate-law articles about REITs make at most a passing reference to the tax benefits and reinvestment rules—they leave those for the tax lawyers.[22] Despite thousands of articles about mergers and acquisitions 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.[23] By 1999, REITs were given the choice of internal or external management.[24] And over time, the IRS has relaxed what counts as "real estate," including, among other things, prisons, cell-phone towers, and mortgage-backed securities.[25] Most recently, in 2017, REITs were authorized to reinvest more of their profits.[26]

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

22. *See, e.g.*, Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583, 584-87, 615 n.200, 641 (2016) (discussing a corporate-governance dispute at a REIT without noting REIT-specific issues such as takeover resistance or tax); Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 158-59 (1998) (discussing briefly REITs as a tax-and-liability-avoidance strategy); Cathy Hwang, *Collaborative Intent*, 108 VA. L. REV. 657, 683-84 (2022) (using REITs as part of an example asset purchase and noting briefly that REITs may avoid entity-level taxes).

23. *See* I.R.C. § 856(d)(2)(C) (1996).

24. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 663, 100 Stat. 2085, 2302 (providing REITs with some opportunity for internal management); Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, § 542, 113 Stat. 1860, 1941 (permitting taxable REIT subsidiaries to perform services for REIT tenants).

25. Throughout the 1990s and 2000s, the IRS issued increasingly liberal private letter rulings on the REIT definition of "real estate." *See* Definition of Real Estate Investment Trust Real Property, 81 Fed. Reg. 59849 (Aug. 31, 2016) ("After these published rulings were issued, REITs invested in various types of assets that are not directly addressed by the regulations or the published rulings, and some of these REITs received letter rulings from the IRS concluding that certain of these various assets qualified as real property."). In 2016, Treasury Regulation § 1.856-10 formalized this liberal approach.

26. 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. *See* Rev. Proc. 2017-45, 2017-35 I.R.B. 216 (making stock dividends deductible for REITs if shareholders are given the option

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 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 is a timely examination. Recent turmoil in the REIT markets—most notably the struggles of Blackstone's BREIT—have underscored a theoretical gap. Why do REITs exist? When should a real estate venture be organized as a REIT?

This Article provides the first theory of the REIT. While the Article itself explains this theory at length, we sketch it out here.

The taxation of real estate poses distinctive challenges for collective investment. Tax law incentivizes owners to avoid cash sales of their real estate.[27] Yet, the social costs of chilling property transfers are also substantial.[28] 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.[29] 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 who have strikingly different interests.[30] 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

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, 2021-51 I.R.B. 887 (reducing the minimum amount of cash to 10%).

27. *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.

28. *See* THOMAS W. MERRILL & HENRY E. SMITH, PROPERTY: PRINCIPLES AND POLICIES 860 (2d ed. 2012) ("[T]ransfer enhances owner autonomy [and] . . . promotes the 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* 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).

29. *See infra* Part III.

30. *See infra* Part IV.

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.[31] There, the investors are shareholders who largely want the corporation to make profitable decisions. Henry Hansmann explains 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.[32] Yet, heterogeneous ownership of real estate ventures cannot be avoided. Because of the tax code, it can only be mitigated.[33]

And mitigation is sensitive. 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. On the other hand, allowing some form of majority rule can devolve into a tyranny of the majority.[34] 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.[35] These managers generally protect the tax interests of individual contributors—if they did not, 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 could not take any profitable actions. REIT law makes this balancing possible by entrenching managers against takeover.[36] No takeovers means managers do not have to capitulate to any investor faction's demands.[37]

Of course, this entrenchment places 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.[38]

31. *But see* Saul Levmore & Hideki Kanda, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 213 (1991) (arguing that incorporation mitigates the conflict among investors with different tax rates regarding the disposition of assets).

32. 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, 771 (2017) (extending Hansmann's theory).

33. *See infra* Part V.

34. Worse yet, the tyranny is not stable. *See infra* note 120 and accompanying text.

35. *See infra* Section V.A.

36. *See infra* Section V.B.

37. Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 42 (Alan J. Auerbach ed., 1988).

38. *See infra* Section V.C.

With large distributions, managers know that they cannot coast on internal growth. If they wish to grow their empire, they must go back to property contributors or the capital markets with their hats out. REITs have disabled the corporate-shareholder vote as a channel for accountability, but they have institutionalized exit.[39]

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. Pass-through taxation is necessary to put REITs on level footing again.[40] Our theory shows that the pass-through theory gets things precisely backwards. Investors do not come for the pass-through taxation and tolerate the governance restrictions; they come for the governance restrictions and stay for the pass-through taxation. This observation explains why REITs have outperformed other pass-through structures in real estate.[41]

A viable theory of REITs gives us a toehold in the various governance debates that REITs implicate. First, corporate theorists have long understood the power of interest payments[42] and the value of prohibited shareholder distributions,[43] 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.[44] 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 nonshareholder interests, but it staunchly refuses to vindicate those interests with legal claims on the board.[45] REITs chart a way forward by backstopping a right with

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39. Organizations protect their members through some combination of exit (the ability to get one's investment back and leave), voice (political control), and liability (also known as loyalty, the ability to hold managers personally responsible). *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970) (establishing exit, voice, and loyalty as three mechanisms by which organizations protect their members); 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 Hirschman's framework to corporate governance).

40. *See infra* Section V.D.

41. *See infra* Section VI.A. This observation likewise explains why REITs grow, despite trading at a discount. *See infra* Section VI.C.

42. Jensen & Meckling, *supra* note 6, at 332. Like REIT distributions, interest payments are mandatory.

43. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter *Nonprofit Enterprise*].

44. *See infra* Section VIII.A.

45. *See infra* Section VIII.B.

an economic (rather than legal) remedy. Third, REITs give new perspective to the much-debated value of takeover defenses.[46] 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 rarely studied or 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. From a corporate-law perspective, REITs are rare in being structurally resistant to takeovers. Finally, it took thirty years for REITs to find any traction among investors, but since the 1990s, investment in REITs has exploded. These distinct features ultimately inform our broader theory of REITs, as discussed in later Parts.

46. *See infra* Section VIII.C.

A. *Tax Law*

Congress enacted REIT legislation in 1960 to allow ordinary investors access to diversified real estate investments.[47] 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.[48] 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 do not have enough money to buy an entire shopping center or commercial office building. Buying REIT shares allows an investor to diversify their real estate holdings, while achieving roughly the same tax result as owning that real estate directly.

Following mutual funds,[49] the tax rules mandate that REITs distribute 90% of their taxable income each year.[50] This requirement sharply limits a REIT's ability to grow through internal reinvestment. However, 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%.[51] 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.[52] This is often referred to as "pass-through" taxation because the REIT income "passes through" and is taxed to REIT shareholders.[53] REIT shareholders are taxed at ordinary-income rates on REIT dividends. For domestic individuals, this means that the top tax

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47. *See* 106 CONG. REC. 15017 (1960) ("In the commercial real estate field, the size of the required investment makes it difficult to secure the necessary funds from one or two investors. The pooling of a large number of investors is necessary and it is reasonable to provide a technique for this pooling of investment funds without incurring an additional level of income taxes.").

48. On the value of diversification, see HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS 5 (2d ed. 1991). On the value of mutual funds to diversification, see Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise, and Failure of Financial Indices*, 30 YALE J. ON REGUL. 1, 7-8 (2013); and Ian Ayres & Edward Fox, *Alpha Duties: The Search for Excess Returns and Appropriate Fiduciary Duties*, 97 TEX. L. REV. 445, 448-49 (2019).

49. I.R.C. § 852(a)(1) (2018).

50. *Id.* § 857(a)(1).

51. *Id.* § 11(b).

52. If a REIT distributes 100% of its income, the dividend-received deduction ensures that the REIT will have no corporate income and pay no corporate tax.

53. *Pass-through Business*, TAX FOUND., https://taxfoundation.org/tax-basics/pass-through-business [https://perma.cc/Z72E-RNMZ].

rate on REIT income will vary between roughly 30% and 40% depending on the state.[54]

Tax law requires REITs 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.[55] There are two income tests. Put simply, the first requires that 95% of a REIT's gross income come from passive sources like dividends, interest, and rents from real property.[56] Second, 75% of a REIT's gross income must come from a shorter list of real estate sources, namely rents from real property, interest on mortgage securities, gains from the sale of real property, and dividends from subsidiary REITs.[57] 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, such as developing and then selling condominium units.[58] The combination of these requirements means that REITs are passive real estate investment vehicles as opposed to real estate development companies.

Especially relevant for our discussion of corporate governance, tax law applies a special prohibition against concentrated ownership of REITs. A REIT must have at least 100 shareholders,[59] and the REIT cannot be "closely held"—that is, the five largest shareholders cannot own more than 50% of the value of REIT stock.[60] The original purpose of these requirements seems to have been practical concerns regarding tax administration,[61] but this limitation effectively prevents hostile takeovers, as the next Section shows.

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54. The top federal rate is 37%, I.R.C. § 1 (2018), but REIT dividends qualify for the pass-through deduction of 20%. *Id.* § 199A. 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 is 13.3% in California, 11% in Hawaii, and 10.9% in New York. Timothy Vermeer, *State Individual Income Tax Rates and Brackets for 2023*, TAX FOUND. (Feb. 21, 2023), https://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets [https://perma.cc/4P4C-KT95].

55. I.R.C. § 856(c)(4)(A) (2018).

56. *Id.* § 856(c)(2).

57. *Id.* § 856(c)(3).

58. *Id.* § 857(b)(6); Treas. Reg. § 1.857-5(a).

59. I.R.C. § 856(a)(5) (2018).

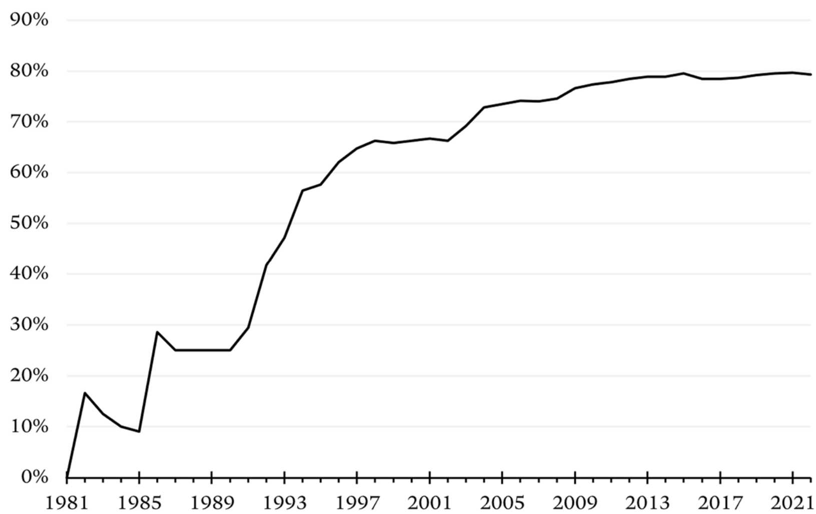
60. *Id.* §§ 542(a)(2), 856(a)(6), 856(h)(1)(A).

61. Partnerships are the standard vehicles for pass-through 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 pass-through taxation becomes crucial. The dividends-paid deduction is a simpler approach that requires less bookkeeping.

B. Corporate Law

Although "REIT" is a federal tax status, all REITs must also register as entities formed under state law. Interestingly, most REITs are formed as Maryland corporations and statutory trusts.[62] Figure 1 depicts Maryland's rise and dominance.[63]

FIGURE 1. PUBLICLY TRADED REITS INCORPORATED IN MARYLAND



REITs' preference for Maryland may be surprising. For most large business enterprises, Delaware corporations lead the race as the preferred state and entity type.[64] Maryland's dominance arose largely because of legal changes in the 1990s, when Maryland legislated to effectively prevent hostile takeovers of

62. The "T" in REIT stands for "trust." And until 1976, Congress required REITs to be formed as trusts. *See* Pub. L. No. 86-779, § 856(a), 74 Stat. 998, 1004 (1960). These statutory trusts function much like corporations. They are owned by investors who elect management. Additionally, Corporate REITs are now permitted. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1604(f), 90 Stat. 1520, 1751.

63. Our datasets will be made publicly available upon the Article's publication at the *Yale Law Journal*'s Dataverse page: https://dataverse.harvard.edu/dataverse/ylj.

64. *See Annual Report Statistics*, DEL. DIV. CORPS., https://corp.delaware.gov/stats [https://perma.cc/P6QY-C3JM]. Delaware remains a second choice in the REIT game—chartering about 10% of REITs, compared to Maryland's 80%.

REITs. Some barriers to takeover are applicable to non-REIT companies.[65] But the more interesting takeover protections are unique to REITs. As already discussed, tax law requires REITs to avoid concentrated ownership.[66] By itself, this poses some impediment to takeovers.[67] Maryland law amplifies this tax-based ownership restriction by authorizing special "excess-share" provisions in their fundamental documents.[68] All REITs utilize these prophylactic provisions.[69] Excess-share provisions prevent individuals from acquiring a large block of shares in the REIT. If an individual investor is capped at a tiny number of shares, that individual can never acquire enough votes to unilaterally change the board. Although the original purpose of excess-share provisions 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.[70]

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65. Delaware allows corporate directors to serve overlapping three-year terms, slowing an acquirer's assertion of electoral control. *See* Del. Code Ann. tit. 8, § 141(d) (2023). Maryland permits five-year terms. Md. Code Ann., Corps. & Ass'ns § 2-404(b)(2) (West 2014 & Supp. 2022) (slowing a hostile takeover by a year, effectively).

66. I.R.C. §§ 542(a)(2), 856(a)(6), 856(h)(1)(A) (2018).

67. This protection is limited because it operates on a look-through basis, so that a fund with multiple owners could easily buy a majority of shares. *See id.* § 544(a)(1).

68. Md. Code Ann., Corps. & Ass'ns §§ 2-105(a)(12), 8-203(a)(6) (West Supp. 2022) (authorizing restrictions on share transfer). These transfer restrictions are binding even if added after the shares' 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, Gilbert G. Menna, Mark Schonberger & John T. Haggerty, *Barbarians at the (REIT) Gates: REITs Should Be Prepared for a New World Order of Shareholder Activists, Hostile Overtures and Proxy Fights*, Goodwin (Feb. 4, 2015), https://www.goodwinlaw.com/publications/2015/02/02_04_15-barbarians-at-the-reit-gates-reits-should-be-prepared-for-a-new-world-order [https://perma.cc/F6U2-5EQV].

69. By the mid-1990s, it was possible to say "[v]irtually 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: What You Need to Know Now 77, 82 (1994); *see also* Kranz et al., *supra* note 68 (asserting that in a sample of fifty publicly-traded REITs from 2014, all included such ownership-limitation provisions in their charters).

70. *See* Md. Code Ann., Corps. & Ass'ns §§ 2-105(a)(12), 8-203(a)(6) (West Supp. 2022). Courts had already established that 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. of Am., CIV. No. 89-2503, 1989 WL 214477, at *3 (D. Md. Oct. 27, 1989). Nothing changes in the context of a takeover, *see* Md. Code Ann., Corps. & Ass'ns § 2-405.1(h) (West 2014 & Supp. 2022), as Maryland rejects the *Revlon* doctrine, which imposes a duty on a company's board of directors to make a reasonable effort to obtain the highest price for the company in the event of a hostile takeover. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

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 outstanding shares, the corporation distributes bargain-priced shares to everyone else. This distribution makes the unwelcome investor's purchase relatively less valuable, dramatically raising the cost of buying a majority. The poison pill has been called "the most powerful defense against hostile takeovers."[71] Yet, as we explain, excess-share provisions are even more powerful.[72]

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.[73] 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.[74] If ownership is capped at 5%, a 5% owner simply *cannot* acquire any more shares.[75]

Second, excess-share provisions restrict ownership to far lower levels than poison pills. The least aggressive of excess-share provisions is as constraining as

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

72. 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. *Compare* Third Point LLC v. Ruprecht, C.A. No. 9469, 2014 WL 1922029 (Del. Ch. May 2, 2014) (validating an anti-activist pill), *with* Williams Cos. Stockholder Litig., C.A. No. 2020-0707, 2021 WL 75459 (Del. Ch. Feb. 26, 2021) (invalidating an anti-activist pill). At a minimum, it is possible for REITs to exceed pills at their limits.

73. Acquirers may willingly suffer a pill's costs if they expect to be able subsequently to void the pill as invalid. *See, e.g.*, Selectica, Inc. v. Versata Enters., Inc., C.A. No. 4241, 2010 WL 703062, at *7-11 (Del. Ch. Feb. 26, 2010).

74. 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* I.R.S. Priv. Ltr. Rul. 96-27-017, at 23-38 (Apr. 5, 1996) (discussing the workings and tax implications of excess-shares trusts); *see also* PETER M. FASS, MICHAEL E. SHAFF & DONALD B. ZIEF, REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 4.02[6][b], at 4-13 to -15 (1998) (discussing other issues raised by excess-shares trusts).

75. 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, e.g.*, I.R.S. Priv. Ltr. Rul. 95-52-047 (Dec. 29, 1995); *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 to -61 (1994) ("The IRS has ruled privately that . . . an ownership limit, together with an excess shares provision, is intended to protect REIT status and, as such, is not an impermissible restriction on transferability [and] an ownership limit, together with an excess shares provision, prevents a REIT from violating the five or fewer rule . . . .").

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 any single investor from acquiring 10% of the stock.[76] 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.[77] 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 that already own more than 5%. Consider Kimco, a large REIT that went public in 1991. Kimco already had three shareholders who collectively owned 40.9% of the stock, and whom Kimco wished to grandfather.[78] Kimco accordingly implemented an excess-share provision prohibiting anyone from acquiring 2% more of Kimco stock.[79] No Vice Chancellor could abide a 2% threshold for a poison pill, but REITs have had them for decades.[80]

The fact that these provisions render REITs takeover-proof is confirmed by the dearth of hostile-takeover attempts and the failure of nearly all attempts. To our knowledge, there has been only a single successful REIT takeover.[81]

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

77. David M. Einhorn, Adam O. Emmerich & Robin Panovka, *REIT M&A Transactions—Peculiarities and Complications*, 55 BUS. LAW. 693, 701 (2000) ("[P]ills 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%. *See, e.g.*, *Versata*, 2010 WL 703062, at *6. Interestingly, the *Versata* pill was also motivated by thresholds set by the tax code, specifically the 5% shareholder definition in Section 382. I.R.C. § 382(k)(7) (2018). Versata argued that the 5% threshold was necessary to protect against limitations on corporate net operating losses. *See generally* Ofer Eldar, Tanja Kirmse & Michael D. Wittry, *The Rise of Anti-Activist Poison Pills* (Eur. Corp. Governance Inst., Working Paper No. 869, 2023), https://ssrn.com/abstract=4198367 [https://perma.cc/JQ45-7Z95] (concluding that pills with a 5% trigger are especially effective at deterring acquisition by activist hedge funds).

78. Goff & Anabtawi, *supra* note 75, at 21-59.

79. *Id.* 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 at 2% ownership (grandfathering the existing shares) would about suffice.

80. 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 higher. Bing Han, *Insider Ownership and Firm Value: Evidence from Real Estate Investment Trusts*, 32 J. REAL EST. FIN. & ECON. 471, 478 (2006).

81. 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, Although this fact has gone largely unnoticed by legal scholars, it is widely appreciated and confirmed by financial economists.[82]

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.

Yet, in the 1990s, investors somehow learned to love REITs, despite their peculiar restrictions. Since that time, many new REITs have been created.[83] The

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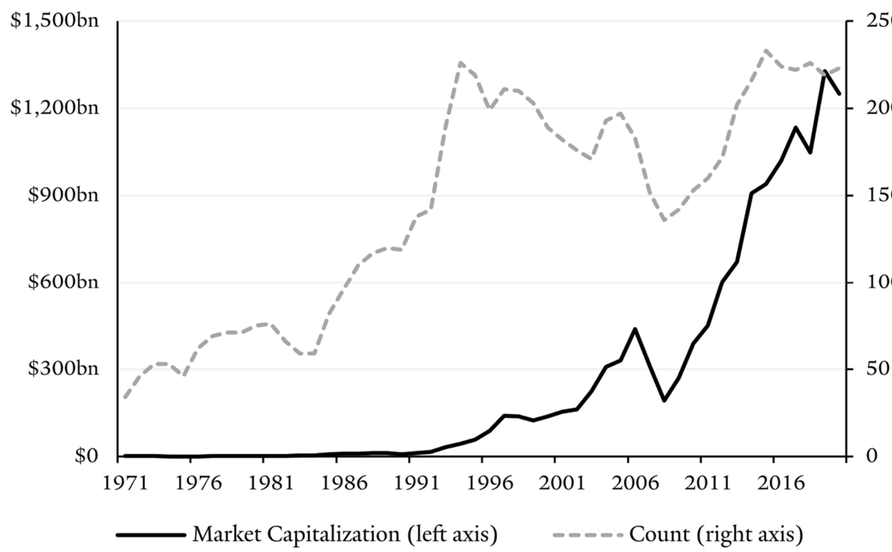
including Sam Zell and Carl Icahn. *See* Julie Creswell, *Legal Battle Lifts Profile of a Quiet Empire*, N.Y. TIMES (July 23, 2013), https://www.nytimes.com/2013/07/24/business/legal-battle-lifts-profile-of-a-quiet-empire.html [https://perma.cc/F3TW-7FNC]; Erin Carlyle, *Related and Corvex Win Shareholder Vote to Oust Commonwealth REIT Board*, FORBES (Mar. 19, 2014), https://www.forbes.com/sites/erincarlyle/2014/03/19/related-and-corvex-win-shareholder-vote-to-oust-commonwealth-reit-board [https://perma.cc/722Y-S4TZ]. 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. *Corvex and Related Send Letter to CommonWealth REIT Shareholders Calling for an End to Value Destruction*, PR NEWSWIRE (Apr. 18, 2013, 8:30 AM ET), https://www.prnewswire.com/news-releases/corvex-and-related-send-letter-to-commonwealth-reit-shareholders-calling-for-an-end-to-value-destruction-203578011.html [https://perma.cc/9KHZ-VVMP]. 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." Jim Sullivan, *The Portnoy REITs—What It Means to be 'Uninvestable,'* GREEN ST. ADVISORS (Mar. 1, 2013) (on file with authors). 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.

82. One study examined eighty-five 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, 369 (2001). *See generally* SU HAN CHAN, JOHN ERICKSON & KO WANG, REAL ESTATE INVESTMENT TRUSTS: STRUCTURE, PERFORMANCE, AND INVESTMENT OPPORTUNITIES (2003) (attributing the lack of hostile activity to excess-share provisions).

83. *See generally FTSE Market Capitalization*, *supra* note 8 (demonstrating the increase in the number and market capitalization of REITs).

growth is most obvious for publicly traded REITs,[84] which raised about $3 billion a week from investors in recent years.[85]

FIGURE 2. PUBLICLY TRADED REITS OVER TIME



What changed in the 1990s?[86] We argue that REITs finally found a problem for which they were the right solution. Prior to that point, restrictions on

84. 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 nontraded 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 [https://perma.cc/4QEK-RQHD] (noting that non-traded REITs raised $36.5 billion in 2021, 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 [https://perma.cc/6GRX-B8CN] (noting that traded REITs raised over $126 billion in 2021). Our Article focuses on publicly traded REITs, though some of our analysis bears on these other REITs.

85. *See* Barwick, *supra* note 84; *see also* Mattson-Teig, *supra* note 84 (describing capital inflows into non-traded REITs).

86. The increase in REIT popularity coincided with changes enabling pension funds and other institutional investors to make larger investments in REITs. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13149(a)(3), 107 Stat. 312, 445 (looking through pension funds for purposes of applying concentrated-ownership restrictions). *See generally* Su Han Chan, Wai Kin Leung & Ko Wang, *Institutional Investment in REITs: Evidence and*

reinvestment, business activities, and takeovers were all disadvantages of the form. But the 1990s taught that these weaknesses could be strengths in solving investor conflicts persistent in the real estate sector. We explain those problems in the coming Parts, 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.[87] 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 through depreciation deductions.[88] 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.

Implications, 16 J. REAL EST. RSCH. 357 (1998) (detailing increasing investment in REITs since 1990). This tax-law change is only a partial explanation of the rise of REITs, especially large public REITs. Even before 1993, pension funds could purchase sizable stakes in REITs (usually up to 10% due to excess-share provisions). After 1993, very few institutional investors took advantage of the new rules to acquire more than 10% of any public REIT. *See id.* at 364-65 (explaining that even though aggregate institutional ownership increased after 1993, the size of individual institutional investments fell during that period relative to non-REIT firms). It seems that REITs became more attractive to institutional investors for reasons independent of their being able to buy larger stakes in REITs.

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

88. I.R.C. § 168(c) (2018). Congress intentionally made the schedule of deductions faster than expected economic depreciation to spur investment. *See id.* § 168 (providing the depreciation schedules for tangible assets, called "modified *accelerated* cost recovery system" (emphasis added)).

With significant taxes often owing upon sale, owners have strong reasons to defer sale. First, because of the time value of money, deferring taxes is desirable.[89] Second, the tax law steps up the basis of property (including real property) to fair market value upon the owner's death.[90] Any built-in gain escapes taxation if the owner of real estate simply holds it 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 regularly 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 Helmsley, former owner of the Empire State Building.[91] Helmsley and her husband owned the Empire State Building, but ownership had proven a headache, including years of litigation with Donald J. Trump.[92] Helmsley might have been happier to liquidate her $1 billion investment,[93] but taxes posed a problem. Helmsley's group had acquired the famous structure in 1961 for $65 million,[94] so her basis was almost certainly near $0 because of depreciation deductions for the building. If so, a sale would trigger

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

90. I.R.C. § 1014(a) (2018).

91. 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 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 or transfer of the Empire State Building, which is what we will assume for purposes of this example.

92. Through a partnership, Donald J. Trump and his associates owned the Empire State building subject to a master lease through 2075 controlled by Helmsley and her partners. *Trump Owns Half of Empire State Building*, L.A. TIMES (July 8, 1994, 12:00 AM PT), https://www.latimes.com/archives/la-xpm-1994-07-08-fi-13416-story.html [https://perma.cc/SKJ8-7VTY]. 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. Dana Schulz, *Donald Trump's Failed and Fraught Attempt to Own the Empire State Building*, 6SQFT (Apr. 18, 2016), https://www.6sqft.com/donald-trumps-failed-and-fraught-attempt-to-own-the-empire-state-building [https://perma.cc/VTK9-YJQR].

93. In 2012, the Empire State Building was appraised for $2.52 billion. The Helmsley stake in the Empire State Building and other assets was valued at $1.046 billion. Empire State Realty Tr., Inc., Registration Statement (Form S-4) 22, 34 (Feb. 13, 2012), https://www.sec.gov/Archives/edgar/data/1541401/000119312512054391/d283359ds4.htm [https://perma.cc/EPB2-X87W].

94. *Real Estate: Highest Finance*, TIME (Sept. 1, 1961), https://content.time.com/time/subscriber/article/0,33009,939859-1,00.html [https://perma.cc/CG86-GEMY].

$1 billion of built-in gain, and she would owe something like $300 million in taxes.[95] Taxes gave Helmsley a powerful reason to hold on to the tower.[96]

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.[97] Whatever the truth, it is 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 her death.[98] 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.[99] 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 that corporation. Such contributions can be nonrecognition events as a matter of corporate tax, meaning that the transfer does not trigger tax obligations.[100] Such a transfer would achieve many of the benefits of a sale—

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95. Capital-gains rates have varied dramatically over time. Here, we assume a combined state/federal rate of 30%, in order to remain consistent with similar assumptions made elsewhere in this Article.

96. This would have been particularly true for Helmsley. During a trial for tax evasion, her housekeeper testified that Helmsley had said, "We don't pay taxes. Only the little people pay taxes." *Maid Testifies Helmsley Denied Paying Taxes*, N.Y. TIMES, July 12, 1989, at B2.

97. Terence Cullen, *The Story Behind Trump's Sketch After Failing to Buy the Empire State Building*, N.Y. DAILY NEWS (Oct. 19, 2017, 7:00 AM), https://www.nydailynews.com/new-york/trump-sketch-failed-buy-empire-state-building-article-1.3573033 [https://perma.cc/2QHS-MQBC].

98. *See* James Sturcke, *Empire State Owner Dies Aged 87*, GUARDIAN (Aug. 20, 2007, 11:12 AM EDT), https://www.theguardian.com/business/2007/aug/20/usnews [https://perma.cc/7KXQ-33SN] (describing Helmsley as owner of the Empire State building and detailing her tax-evasion charges).

99. *Family that Controls the Empire State Building Overcomes Shareholder Objections to Making It Part of a REIT*, SARASOTA HERALD-TRIB. (June 3, 2013, 12:01 AM ET), https://www.heraldtribune.com/story/news/2013/06/03/family-that-controls-the-empire-state-building-overcomes-shareholder-objections-making-part-of-reit/29179305007 [https://perma.cc/3RY3-F9MF].

100. *See* I.R.C. § 351 (2018).

diversification and greater liquidity—without necessarily counting as a taxable sale.[101]

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.[102] Moreover, if encumbered property is contributed to a corporation, any excess of the debt over the transferor's basis is recognized as taxable gain.[103] 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.[104]

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.[105] That new structure interposed an additional structural layer: a limited partnership. This structural 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 3) raises cash from the public. That corporation creates a new entity: a limited partnership ("Operating Partnership" in Figure 3).[106] The corporation contributes the publicly raised cash to the limited partnership, in exchange for

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101. 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.

102. I.R.C. §§ 351(a), 368(c) (2018) (requiring the contributing shareholder(s) to be "in control" of the corporation immediately after the exchange for nonrecognition to apply and 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.

103. *See id.* § 357(c).

104. 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 such a transfer resulted in the diversification of the contributor's interest. *See id.* § 351(e); Treas. Reg. § 1.351-1(c)(1).

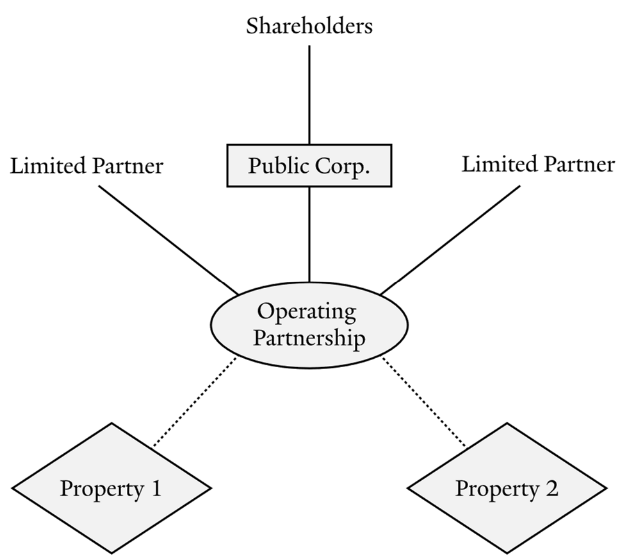
105. The first umbrella-partnership REIT (UPREIT) was Taubman Centers, Inc. *See* Goff & Anabtawi, *supra* note 75, at 21-65 & n.257.

106. A limited partnership (LP) 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.

partnership interests.[107] As the general partner of the limited partnership, the corporation manages the limited partnership.

The limited partnership (LP) 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 3, the Operating Partnership has acquired Property 1 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 Public Corp.'s shares or to put their limited-partnership interests to the partnership for cash.[108] Because the only asset that Public Corp. holds is the general-partnership interest, partnership interests and corporate shares are economic

107. 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. John C. Hart & Andrew B. Purcell, *The Umbrellas of Subchapter K*, SIMPSON THACHER & BARTLETT LLP 7 (Jan. 2020), https://www.stblaw.com/docs/default-source/related-link-pdfs/umbrellas-of-subchapter-k.pdf [https://perma.cc/9ERQ-4M72].

108. A put is a contractual right to force the partnership to redeem the partnership interest. *Id.* at 8.

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 Limited Partners fractional access to liquidity. Instead of selling the entire property if the contributor needs cash, a Limited Partner can simply convert and sell a few shares of the partnership and (importantly) only recognize a fraction of the built-in gain. A Limited Partner also diversifies their portfolio, spreading its 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 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 rules acknowledge that debts of the partnership are actually debts of the partners, and all partnership debts are allocated among the partners.[109] If a partner contributes 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,[110] 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

109. *See* I.R.C. § 752(a)-(b) (2018). The allocation of debt among the partners depends on whether the debt is recourse or nonrecourse. A debt is "recourse" if one or more partners are 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 "nonrecourse" – that is, debt for which there is no personal liability. Nonrecourse debt is allocated based on more complicated rules, but with careful structuring it is possible to allocate such debt to limited partners.

110. *See infra* notes 111-114 and accompanying text.

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 shift or eliminate all capital-gains taxes freely.[111]

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.[112] 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.[113] 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.[114]

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 inherent conflicts among its investors, who do not benefit (or suffer) from decisions equally.[115] To be clear, the umbrella partnership solves a tax problem, but only in such a way as to generate lingering investor conflict (for which the REIT will end up being the ideal governance solution).

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. Additionally, mergers and acquisitions differentially affect investors. Third, debt transactions (whether refinancing debt, repaying it,

111. 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.

112. I.R.C. § 704(c) (2018). Gains that accrue after contribution are indeed allocated among all the partners in accordance with the partnership agreement and § 704.

113. *See id.* §§ 722, 1001.

114. I.R.C. § 752(b) (2018) 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 a gain. *See id.* § 731(a).

115. This conflict has been central to practitioner and scholarly commentary from the very beginning. *See, e.g.*, Robert T. Kleiman, *Umbrella REITs: An Introduction*, 10 REAL EST. FIN. 33, 33, 38-39 (1993).

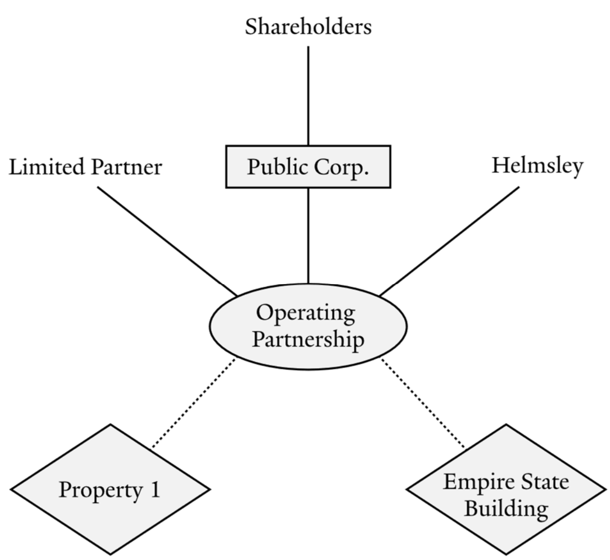
or borrowing more using property as security) can create conflicts among investors.

A. *Sale of Property*

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.[116]

Consider again the hypothetical example from above. Leona 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 precontribution gain of $1 billion would be taxable gain for Helmsley. Assuming that Helmsley

116. *See* Singer, *supra* note 14, at 335; Goff & Anabtawi, *supra* note 75, at 21-54 to -55.

has a combined federal and state tax rate of 30%, this liability is $300 million. 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* the Empire State Building's fair market value *still* imposes a net cost on Helmsley because she only captures 10% of the sale price.[117] In fact, Helmsley will be skeptical of any sale that values the $1 billion Empire State Building at less than $5.28 billion.[118] By contrast, the REIT's many retail investors, who bought public shares for cash, will be delighted to sell for anything above $1 billion as they would not face any taxable gain.[119]

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 it 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 because as participants in a repeated game, they might reasonably fear exploitation in the future. 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.[120]

B. Mergers and Acquisitions

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 on whether their corporation should undertake a fundamental transaction that may strip investors of their

117. Such a sale would entitle Helmsley 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 precontribution gain.

118. Such a sale would entitle Helmsley to an additional $300 million ($428 million surplus less $128 million tax), exactly offsetting her $300 million tax on precontribution gain.

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

120. 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* Christian List, *Social Choice Theory*, STAN. ENCYC. PHIL. (Edward N. Zalta & Uri Nodelman eds., Oct. 14, 2022), https://plato.stanford.edu/entries/social-choice [https://perma.cc/7TT6-BJ72] (discussing paradoxes of collective action).

premerger shares. Approval by a majority of investors binds the dissenting minority, triggering involuntary sale and any resultant tax.[121]

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—including $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: she will still pay much more in taxes than she gets in merger premium.[122]

C. *Debt Transactions*

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. Mortgage interest rates are often low relative to other borrowings 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 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.[123] That possibility bothers property contributors, who may resist otherwise efficient corporate borrowings.

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121. 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. DEL. CODE ANN. tit. 6, § 17-211 (2019). 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 214 and accompanying text.

122. $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.

123. *See, e.g.*, Bob Fernandez, *Struggling Philly Real Estate Owner PREIT Sells Vineland's Cumberland Mall*, PRESS ATL. CITY (Nov. 2, 2022), https://pressofatlanticcity.com/news/local/struggling-philly-real-estate-owner-preit-sells-vinelands-cumberland-mall/article_518347aa-5abd-11ed-a55c-d3c2fe966d5b.html [https://perma.cc/V27C-9VLH]; Jeff Shaw, *CBL Properties Staves Off Bankruptcy with Debt Restructuring, Loses Four Malls to Foreclosure*, SHOPPING CTR. BUS. (Aug. 19, 2020), https://shoppingcenterbusiness.com/cbl-properties-staves-off-bankruptcy-with-debt-restructuring-loses-four-malls-to-foreclosure [https://perma.cc/F6NC-U9Q3].

Conflicts also arise when debts come due. The balance of the benefits and detriments of debt varies 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.[124] 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.[125] 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.[126]

Refinancing debt can raise similar conflicts because subtle changes in the terms of the debt can trigger tax for limited partners.[127] Property owners often protect themselves by borrowing on a nonrecourse basis, meaning that a bank cannot try to recover from any of the investors in the firm. Banks charge more for a nonrecourse 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 nonrecourse to recourse will trigger taxes for Helmsley.[128] 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

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124. 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 gains. *See supra* note 109; Goff & Anabtawi, *supra* note 75, at 21-54 n.227 (noting the potential conflict between shareholders and a limited partner who wants to maintain significant amounts of debt).

125. Contributing the property subject to a mortgage means that Helmsley 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 Helmsley.

126. This represents 30% of the $500 million gain. Helmsley's gain is $500 million because she is relieved of a $500 million obligation. § 752(b) treats this as if the partnership distributed her $500 million. This deemed distribution exceeds her zero basis by $500 million. *See* I.R.C. § 752(b) (2018).

127. *See supra* note 109 and accompanying text.

128. Helmsley would be treated as receiving a deemed distribution of $500 million. *See* I.R.C. § 752(b) (2018). Helmsley would have to pay $150 million in taxes.

is good news in an otherwise challenging moment, but Helmsley may not be so grateful. She will incur $150 million in taxes, while her pro rata share of the debt forgiveness only enriches her by a fraction of that sum.[129] The umbrella-partnership capital structure leads to conflict even when a free lunch is offered.

The foregoing example imagined that the firm was experiencing distress unrelated to the 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 a $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.[130]

* * *

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.[131] This leads to conflict among investors. In other words, collective real estate naturally leads to a problem of heterogenous ownership that must be addressed. The REIT offers one such solution.

V. THE REIT AS A SOLUTION

The umbrella partnership is a powder keg. Its success depends on finding a way to keep conflict from flaring up.[132] Our goal in this Part is to show why the

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

130. Under *Commissioner v. Tufts*, the property is sold for the amount of the outstanding nonrecourse liability. 461 U.S. 300, 317 (1983). Thus, the gain is the excess of $500 million over Helmsley's zero basis.

131. As foreign, tax-exempt, and pension ownership of REITs have 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.

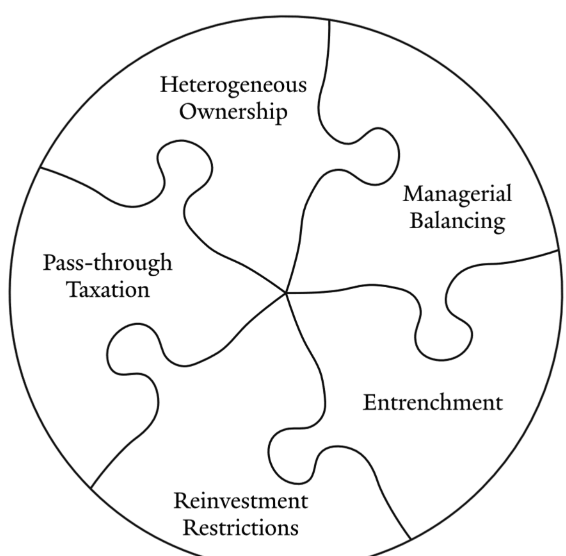
132. *See* Chan, Erickson & Wang, *supra* note 82, at 49 ("How to align the interests of the REIT shareholders and those of the partnership unit holders becomes an important issue.").

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.

In summary, our claim is as follows. 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 balance interests effectively, 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. Prohibited reinvestment requires special tax treatment to avoid penalizing the structure. And this special tax treatment, in turn, necessitates heterogenous ownership.[133]

This is our theory of the REIT: *REITs thrive because they offer this package*. Figure 5 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, but they make the public corporation a REIT in order

133. *See infra* note 181 (explaining how pass-through taxation would lead to tax avoidance if it did not preserve investors' heterogenous exposure to built-in gains).

to commit to REIT-like rules. The managers operate the business in their collective interest, giving due regard to the special tax needs of property contributors. From time to time, cash investors may spot business opportunities that would prove lucrative, despite imposing disproportionate costs on one or more property contributors. These investors may threaten to replace management if it does not 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.

The combination of the umbrella partnership and REIT proved utterly transformative. The combination of a REIT and umbrella partnership is called an "UPREIT."[134] 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.[135] By 1997 more than 80% of all public REITs were UPREITs.[136] That trend has only continued, with newly formed REITs almost

134. 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.

135. *See* Singer, *supra* note 14, at 334-37; Chan, Erickson & Wang, *supra* note 82, at 31 ("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 [https://perma.cc/S39T-MCJG]; Glenn L. Carpenter & Gary B. Sabin, *DownREITs: Now Everyone Can Do Tax-Free Exchanges*, 16 REIT Rep. 9, 9 (1996); *see also* Goff & Anabtawi, *supra* note 75, at 21-6 to 21-7 (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).

136. 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).

always employing the UPREIT structure,[137] particularly among the largest REITs.[138] 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.[139] From 1992 on, REITs rose significantly—and sometimes nearly doubled—every year (except for years in which market downturns set growth back).[140] 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 foregoing. Section V.A explains how managerial balancing is essential to address the problems of heterogenous ownership. Section V.B argues that such balancing requires entrenchment. Section V.C addresses the limits on business activities and reinvestment. Section V.D then explains why REITs need pass-through 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.[141] One that *could* take such actions would likewise face contributor skepticism, even if it did not plan to do so. 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

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

138. *See* Han, *supra* note 80, at 476.

139. *See supra* Figure 2. Most datasets, including our own, begin with 1971. Virtually no REIT activity occurred between 1960 and 1971.

140. *See id.*

141. *See* Shleifer & Summers, *supra* note 37, at 45.

contributors who want liquidity. Second, if the enterprise has no freedom to exploit its assets opportunistically, 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.[142] 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 in their personal capacity (and triggered taxes), even if they had never contributed the asset, the managers can go forward with it. For example, Cedar Realty Trust recently sold all of its assets for $29 per share in cash,[143] despite the fact that its limited partners presumably suffered adverse tax consequences.[144] But this represented a 70.6% premium to the trading price before Cedar announced its intention to find a buyer.[145] A great many property contributors would probably have been willing to sell their property at such a premium (despite the taxes), and even those who would prefer continued deferral should understand that this was not an ambush in which their interests were completely disregarded.

Property contributors do not need to win every fight to be happy, but they will not invest unless they are occasionally protected. Nor do enlightened cash investors wish to kill the golden goose by squeezing every penny out of every

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142. 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 Section VI.B. Empirically, we observe very few REITs using contracts to solve the heterogeneous-ownership problem. *See infra* note 204 and accompanying text. Managerial balancing seems to have prevailed in the REIT market.

143. *Cedar Realty Trust Announces Final Proceeds of $29.00 per Share to Common Shareholders Resulting from Sale of Assets and Merger*, CISION PR NEWSWIRE (Aug. 9, 2022, 9:46 ET), https://www.prnewswire.com/news-releases/cedar-realty-trust-announces-final-proceeds-of-29-00-per-share-to-common-shareholders-resulting-from-sale-of-assets-and-merger-301602563.html [https://perma.cc/RNT9-HGMW].

144. Cedar had limited partners. Cedar Realty Tr., Inc., Annual Report (Form 10-K) 4 (Mar. 2, 2023), https://www.sec.gov/ix?doc=/Archives/edgar/data/761648/000095017023005812/cdr-20221231.htm [https://perma.cc/3GA6-YCZK]. The limited partners were not subject to any protective covenants. Cedar Realty Tr., Inc., Proxy Statement (Form 14A) B-27 (Apr. 21, 2022), https://www.sec.gov/Archives/edgar/data/761648/000119312522113224/d328333ddefm14a.htm [https://perma.cc/F6Z4-C5RP].

145. Proxy Statement, *supra* note 144, at 39.

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.[146] The default rule in corporate law is that directors are elected by a majority of shareholders,[147] and they can be removed with or without cause.[148] 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.[149]

REIT managers are entrenched, and thus run afoul of orthodox corporate scholarship, but for good reason. REITs really do have diverse patrons whose interests must be honored.[150] 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 investors[151] and then vote for a merger that directly or indirectly divests property contributors of their entitlement on terms that do not offset their latent tax liabilities. The threat

146. On this debate, see 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); and Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PA. L. REV. 1475 (2018).

147. LOPUCKI & VERSTEIN, *supra* note 5, at 240.

148. *Cf. id.* at 267 ("Some public companies have adopted majority voting bylaws.").

149. For the essential debates on this subject, see generally Lucian A. Bebchuk, *Competing Views on the Economic Structure of Corporate Law*, 1 U. CHI. BUS. L. REV. 29 (2022); and Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020).

150. 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. 948 (2014). They describe voting caps at early corporations that were, essentially, consumer cooperatives. *Id.* at 953-54. A profit-maximizing investor could push the firm to degrade quality or raise prices to the detriment of consumer-shareholders. *Id.* at 954.

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

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 (MHC) made an all-cash offer for Chateau Properties, another REIT.[152] The cash offer of $26 per share was a 12% premium over the $23.25 trading price,[153] so cash shareholders were likely to approve. But accepting cash would trigger taxes for the property contributors of Chateau.[154] The precise amount would depend on the investor, but journalists took note that the chairman of Chateau was a major property contributor whose tax burden would exceed four dollars per share.[155] For such contributors, MHC's offer implied a merger premium of *negative* 19%.[156] 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.[157]

Entrenchment saved the property contributors. MHC could not purchase 51% of the shares because of an excess-share provision.[158] The most it could do was buy 7% of the shares and then intimate that the board might face a popular revolt of shareholders if it did not capitulate.[159] The board was not cowed, and

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152. 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 [https://perma.cc/6EMN-B56S].

153. *Id.*

154. *Zell's Bid for Chateau Raises a Lot of Questions*, REALTY STOCK REV. (Aug. 30, 1996) (on file with authors).

155. *Id.*; Pacelle, *supra* note 152 (noting that the chairman owned one-third of the operating partnership units).

156. MHC's bid permitted Chateau shareholders to perhaps avoid taxes by electing to receive MHC shares worth $21.28. Pacelle, *supra* note 152. While superior to an after-tax $19 bid, $21.28 is still a negative premium.

157. 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 reins and expropriate contributor interests.

158. *See supra* Section I.B.

159. 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 [https://perma.cc/CFB7-HJFC].

MHC gave up its hostile tender offer.[160] Takeover protection permitted the board to protect property-contributor interests if it wished, whether by proceeding as a going concern or structuring a different deal that was fairer to all constituencies.[161]

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."[162] In a sense, Zell was completely right. Board entrenchment cost MHC's cash shareholders a lot of money—instead of $26 per share from Zell, they got shares worth $21 from a merger partner committed to protecting property contributors from taxes.[163] 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.[164]

Zell's view jibes 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.[165] But these are ex post and myopic worries about whether the business is now taking the efficiency-maximizing decision in a

160. Mitchell Pacelle, *Zell Drops Bid for Chateau, Sweetens Merger Proposal*, WALL ST. J. (Nov. 8, 1996), https://www.wsj.com/articles/SB847412805408280000 [https://perma.cc/2HV9-DB2S].

161. As it happened, it had already negotiated a different deal with ROC Communities. *See* Strom, *supra* note 159.

162. *Id.*

163. *Chateau Communities, Inc.*, COMPANY-HISTORIES.COM, https://www.company-histories.com/Chateau-Communities-Inc-Company-History.html [https://perma.cc/49KK-RDY8].

164. *Cf.* Martijn Cremers, Robert J. Jackson, Jr. & John Morley, *The Value of Takeover Defenses: Evidence from Exogenous Shocks to Closed-End Mutual Funds*, GLOB. CORP. GOVERNANCE COLLOQUIA 1 (2016), https://gcgc.global/wp-content/uploads/2017/03/Robert-J.-Jackson-Paper.pdf [https://perma.cc/BE4Q-L37B] ("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 236. If the market liked entrenchment technology for the goose, it may well like it for the gander. *Cf.* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 254-55 (1999) (applying a "mediating hierarchy approach" and "team production analysis" to public-corporation law as an alternative to the principal/agent analysis to argue that corporate actors voluntarily submit themselves to a corporate hierarchy out of self-interest).

165. 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.

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 Mitigate 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.[166] Why would managers serve any of their investors if none of the investors 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 business has only inefficient projects to pursue.[167] They also redeploy business assets toward new and different business lines, which may pose different risks or be harder for investors to understand.[168]

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.[169] 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,[170] though

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166. *See generally* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-14 (1965) (explaining how the market for corporate control ensures efficiency among corporate managers).

167. *See* Jensen & Meckling, *supra* note 6, at 334-36.

168. 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 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.

169. *See supra* Section I.A (noting that REITs must distribute 90% of their taxable income each year).

170. *See, e.g.*, Fischer Black, *The Dividend Puzzle*, 2 J. PORTFOLIO MGMT. 5, 10 (1976); Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 652-56 (1984). Relatedly, the ability of investors to recover investments serves governance. *See generally* HIRSCHMAN, *supra* note 39, at 21-25 (discussing the disciplining power of withdrawal).

they have generally not gone so far as to call for *mandatory* distributions.[171] And while REITs are outliers in America, many other nations require distributions in order to address governance problems.[172] Even in America, there are some precursors to REITs' use of distributions as governance, such as mutual funds.[173]

REITs are also restricted in their permitted range of business operations.[174] 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 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.[175] This is a basic intuition that justified the

171. Two noteworthy exceptions are Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 917-31 (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. *See* Jensen & Meckling, *supra* note 6, at 337-38. But interest payments and dividends differ in important ways (e.g., bankruptcy risk) so as to distinguish mandatory dividends.

172. *See, e.g.*, Jairo L. Procianoy & Daniel F. Vancin, Minimum Dividend Payout Obligation Special Feature: The Brazilian Case 10 (May 20, 2017) (unpublished manuscript), https://ssrn.com/abstract=2808798 [https://perma.cc/T8P5-9RQA] (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, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Agency Problems and Dividend Policies Around the World*, 55 J. FIN. 1, 1 (2000). Likewise, comparative studies of corporate law have frequently noted these features. *E.g.*, Merritt B. Fox, *Ongoing Issues in Russian Corporate Governance*, 52 COLUM. J. TRANSNAT'L L. 435, 450-51 (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, 31-32 (2019).

173. Mutual funds are subject to mandatory distributions, similar to REITs. I.R.C. § 852(a)(1) (2018). 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 39, at 102; *see also* Andrew Verstein, *Enterprise Without Entities*, 116 MICH. L. REV. 247, 284 (2017) (describing some unincorporated insurance firms as "perpetually liquidating in response to payouts of surplus" (internal quotation omitted)).

174. *See supra* Section 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.

175. *See generally* Elizabeth Pollman, *The History and Revival of the Corporate Purpose Clause,* 99 TEX. L. REV. 1423, 1429-30, 1448-52 (2021) (explaining the extensive history and continual relevance of the corporate-purpose clause).

breakup of midcentury conglomerates.[176] 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.[177]

D. Pass-through Taxation Is Essential to Restricted Reinvestment

The pass-through theory of REITs posits that investors flock to REITs because of pass-through taxation, with restrictions on business, reinvestment, and takeovers as unfortunate problems to be endured. Our theory is that the latter "problems" are a REIT's distinctive benefit, solving problems inherent in the umbrella partnership structure most suitable for real estate. Our theory has a place for pass-through 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 pass-throughs 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 pass-through 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 pass-through 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

176. *See* Tarun Khanna & Krishna G. Palepu, *Why Focused Strategies May Be Wrong for Emerging Markets*, HARV. BUS. REV. (1997), https://hbr.org/1997/07/why-focused-strategies-may-be-wrong-for-emerging-markets [https://perma.cc/XAJ7-HA6P].

177. *See* Ofer Eldar & Andrew Verstein, *The Enduring Distinction Between Business Entities and Security Interests*, 92 S. CAL. L. REV. 213, 215-16 (2019) (describing the role of business entities focusing creditor attention on distinct pools of assets); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 51-53, 57-59 (1982) (describing the incentives and costs of secured creditors to monitor particular assets); *cf.* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1143 (1979) (noting that the value of securitization lies in protecting the creditor from claims of other creditors with respect to particular assets).

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 pass-through income. Pass-through taxation is not just a perk REITs enjoy, it is necessary because their governance needs would otherwise generate prohibitively high taxes.[178] Again, the parts of a 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 pass-through and corporate taxation.[179] 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 pass-through 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 pass-through taxation in explaining the rise of REITs.[180]

* * *

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 pass-through taxation. Coming full circle, pass-through taxation requires heterogeneous ownership to prevent tax avoidance of built-in gain.[181] This logic cycle is our general theory of the REIT.

178. Steve Bank argues that corporate tax is a necessary consequence of capital lock-in, a desirable feature in many business enterprises. Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 891-92 (2006). We are arguing the converse is also true: pass-through taxation is a necessary consequence of forced mandatory distributions.

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

180. Moreover, the REIT has dominated other (pure) pass-through entities that do not have mandatory distributions and that have the advantage of passing through losses. *See supra* Section VI.A.

181. Pass-through 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 111-114 and accompanying text. Thus, Section 704(c) of the Internal Revenue Code and heterogeneous interests are essential to pass-through taxation.

VI. UNPUZZLING REITS

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

First, REITs dominate public investment in real estate even though there are alternative business forms that benefit from more generous tax treatment. Section VI.A employs our theory to argue that these alternatives lack REITs' 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. Section VI.B explains why the REIT structural solution has displaced the contract.

REITs generally trade at a value below the fair market value of their assets, suggesting investor apprehension. Yet, investors also flock to REITs. Section VI.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. Section VI.D uses our theory to explain how other countries' piecemeal implementation of the REIT has failed.

Finally, 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. Section VI.E applies our theory to show the structural weakness of nontraded 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), for example, is a publicly traded limited partnership.[182] A single general partner (usually itself a corporation) manages a business on behalf of itself and a number of limited partners.

MLPs have thrived in the oil and gas industry.[183] One could easily imagine them succeeding for real estate investment, since they offer even better tax

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182. Most publicly traded partnerships are treated as corporations and subject to the corporate double tax. I.R.C. § 7704 (2018). Section 7704(c) excepts partnerships that predominantly have passive income and allows these master limited partnerships (MLPs) to be taxed as pass-throughs. Thus, a real estate venture could organize as a MLP, be publicly traded, and get pass-through taxation, just like a REIT.

183. Tim Fenn, *Master Limited Partnerships (MLPs): A General Primer*, LATHAM & WATKINS 20-21 (Apr. 2014), https://www.lw.com/admin/Upload/Documents/Latham-Master-Limited-Partnership-Primer-2014.pdf [https://perma.cc/5GAJ-5FUJ].

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.[184] 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 pass through to taxpayers as well, something REITs are unable to do.[185]

And MLPs enjoy substantial additional freedom. The MLP has no restrictions on concentrated ownership – and it also has looser requirements on gross income.[186] 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.[187] 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.[188] There is no asset test for the MLP; an MLP can do what a REIT does and more.

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.[189]

Yet, investors do not generally use MLPs to organize large real estate ventures to compete with REITs. At the time that this Article was authored, a search yielded only two examples of existing MLPs with market caps over $1 billion that were arguably involved in real estate: 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 a 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

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184. I.R.C. § 721 (2018).

185. MLPs are taxed as Subchapter K partnerships and are allowed generally to pass-through losses. *Id.* § 702.

186. *Id.* § 7704(c)-(d).

187. Qualifying income includes gains from the sale of real property even if the MLP is a developer. *Id.* § 7704(d)(1)(D).

188. *Id.* § 857(b)(6).

189. Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 580-81 (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).

hybrid REIT-limited partnership.[190] In any case, it went private in 2021.[191] So, once again, REITs reign as undisputed champions of real estate investing.[192]

Hence a puzzle: if MLPs are like REITs but more flexible, why do not 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.[193] And with good reason: both cash and property investors have something to worry about with MLPs.

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190. Brookfield Property had a REIT subsidiary "that [was] structured to offer economic equivalence to an investment in BPY in the form of a U.S. REIT security." *2020 Annual Report*, Brookfield Prop. Partners L.P. 1 (2020), https://bpy.brookfield.com/sites/brookfield-ir/files/brookfield/bpy/annual-reports/bpy-2020-annual-report-final.pdf [https://perma.cc/VX5C-7BAG].

191. Press Release, Brookfield Prop. Partners, Brookfield Asset Management Completes Privatization of Brookfield Property Partners (July 26, 2021), https://bpy.brookfield.com/press-releases/bpy/brookfield-asset-management-completes-privatization-brookfield-property-partners [https://perma.cc/2HR8-NHZF].

192. *See* William M. Gentry, *Taxes and Organizational Form: The Rise and Fall of Publicly Traded Partnerships*, 84 Nat'l Tax Ass'n-Tax Inst. Am. 30, 32 (1991) ("The other side of the decline of PTPs [(MLPs)] is that many PTPs have converted to other organizational forms . . . . Of the 134 PTPs formed between 1981 and 1990, fewer than ninety still trade as PTPs. While some . . . have converted into real estate investment trusts . . . .").

193. 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 the relative tax-filing simplicity of REITs. Goff & Anabtawi, *supra* note 75, at 21-8 to -10. But our sense is that if the only advantage is one of less administrative cost in tax filing, the MLP's flexibility would seem to dominate the REIT's 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). *Id.* at 21-8. 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* Michael Bolotin, *Why Private Investment Funds Are Using REITs to Invest in Real Estate*, Tax Notes Federal 1087, 1095 (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 [https://perma.cc/6JB6-9M2L]. 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 UBTI issues for tax-exempt investors.

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 partnership interests cannot result in any change in management,[194] a risk remains that the general partner is taken over. 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.[195]

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. That is bad for cash investors who count on those mechanisms to limit powerful managers; the investors 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 MLP's 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, and a declaration that most lines of business are ultra vires. If they did, it would further confirm that parties appreciate the benefit of these interlocking features.[196]

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194. 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. *See* UNIF. LTD. P'SHIP ACT § 301(b) (Unif. L. Comm'n 2013) (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. *Id.* § 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).

195. 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.

196. We do observe that MLPs devote substantial contractual attention to forcing distribution. *See* Fenn, *supra* note 183, at 5-7. But contractual practice "clearly gives the general partner wide discretion." *Id.* at 6.

Importantly, there is no need for them to do the work of replicating REIT-type restrictions since REITs have these features "off the rack." REITs 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. Further, the limited partners of a REIT 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.[197] Insofar as REITs are intended to be passive investments for 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.[198]

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 foregoing Section asked why parties use REITs rather than MLPs. 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 Section 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

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197. 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 200-02.

198. 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).

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.[199]

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.[200] 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),[201] and real estate lawyers stand ready to negotiate them.[202] They are sometimes even used in REITs.[203]

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.[204]

199. Of course, this sort of balancing is precisely what is predicted and recommended by stakeholder theorists. *See generally* Blair & Stout, *supra* note 164 (discussing the team production approach to corporate governance).

200. 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 I.R.C. § 704(c). Of course, investors are never quite homogeneous. *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577-93 (2006) (identifying heterogenous interests within shareholder group community).

201. For example, this TPA addresses each of the concerning transactions we discussed *supra* Part IV. Empire State Realty Tr., Inc., Tax Protection Agreement (Form S-4: Exhibit 10.6) (2012), https://www.sec.gov/Archives/edgar/data/1541401/000119312512054391/d283359dex106.htm [https://perma.cc/6HBM-V5TU].

202. *See generally* Blake D. Rubin, Andrea R. Macintosh, & Jonathan I. Forrest, *Tax Planning for the Property Owner in REIT Acquisitions (Part 1)*, 16 PRAC. REAL EST. LAW 25 (2000) (discussing REITs and umbrella partnerships).

203. 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* Section VI.A.

204. We studied U.S. REITs that were large either in terms of gross assets or market capitalization. For the gross asset list, see *Top 100 Real Estate Investment Trust Rankings by Total Assets*, SWFI, https://www.swfinstitute.org/fund-rankings/real-estate-investment-trust [https://perma.cc/JA6A-7FMQ]. For the market cap list, see *Largest Companies by Market Cap*, COS. MARKET CAP, https://companiesmarketcap.com/reit/largest-reits-by-market-cap [https://perma.cc/H9TM-HAXP]. Of the top 20 largest REITs by assets, sixteen are from the United States. 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

Seventeen of the largest REITs granted no TPAs, and the other three REITs each protect just one or two properties in this way.[205] And, when TPAs are granted, they often offer protections that are plainly inadequate if they are an investor's sole defense.[206]

The market has spoken: contracts compete as an investor-protection technology, but property owners do not usually rely on such contracts. Hence a

Law's EDGAR database. First, the advanced search criteria were 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 zero 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 zero 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) 97-98 (Jan. 2, 1998), https://www.sec.gov/Archives/edgar/data/1037540/0000927016-98-000005.txt [https://perma.cc/CT4D-5PEF].

205. Boston Properties once had as many as 27 different TPAs in effect. *See* Boston Props. Inc., Annual Report (Form 10-K) 115-16 (Mar. 16, 2005), https://www.sec.gov/Archives/edgar/data/1037540/000119312505050590/d10k.htm [https://perma.cc/6575-QAB6]. 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) 22 (Feb. 25, 2022), https://www.sec.gov/ix?doc=/Archives/edgar/data/1037540/000165642322000013/bxp-20211231.htm [https://perma.cc/2SSV-ZT9L]. VICI Properties has only a single TPA as well. VICI Props. Inc., Business Combination Prospectus (Form 425: Exhibit J) (Aug. 5, 2021), https://www.sec.gov/Archives/edgar/data/1691299/000170569621000156/mgpacquisition-transactiond.htm [https://perma.cc/J66C-3346]; *see* VICI Props., Inc., Tax Protection Agreement (Form 8-K: Exhibit 10.3) (Apr. 29, 2022), https://www.sec.gov/Archives/edgar/data/1920791/000119312522134159/d291163dex103.htm [https://perma.cc/A48G-FHLP] (presenting the 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: Exhibit 2.1) (Aug. 13, 1999) (on file with authors); Simon Prop. Grp., Registration Statement (Form S-4) 72 (Aug. 13, 2004), https://www.sec.gov/Archives/edgar/data/1063761/000104746904026534/a2141654zs-4.htm [https://perma.cc/EL46-CQ5G]. Starwood had one TPA, but it has since expired. Starwood Prop. Tr., Annual Report (Form 10-K: Exhibit 10.17), (Feb. 29, 2018), https://www.sec.gov/Archives/edgar/data/1465128/000155837018001216/stwd-20171231ex101768785.htm [https://perma.cc/4WKR-C7EP]. 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* Section 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.

206. 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%).

puzzle. Why is managerial balancing deemed essential—and usually sufficient—to protect property contributors? Why are contracts 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 deadweight loss.

In our example concerning Leona Helmsley's $1 billion interest in the Empire State Building, such a promise would cost the firm $430 million in indemnification payment if taxes were ever triggered.[207] 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 million loan workout,[208] nor sell the assets for a 35% profit,[209] nor undertake a merger with a 40% premium.[210] These are all efficient actions that a property contributor like Helmsley would probably have happily undertaken when she was sole owner of the asset.[211] 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,[212] or they may succeed only after considerable litigation effort. Consider the case of *Stender v. Archstone-Smith Operating Trust*, a sprawling litigation involving twenty-three written opinions over thirteen years (in addition to at least one written

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

208. *See supra* Section IV.C.

209. *See supra* Section IV.A.

210. *See supra* Section IV.B; *see also* Justin Salon et al., *Frequently Asked Questions About UPREITs and OP Unit Transactions*, MORRISON & FOERSTER 3 (June 12, 2019), https://media2.mofo.com/v3/assets/blt5775cc69c999c255/blt3107a3a3a5411876/627311764d9f892971290015/190612-faqs-upreits.pdf [https://perma.cc/U3C8-7W2Z] (asserting would-be acquirers are deterred by TPAs); *cf.* Einhorn, Emmerich & Panovka, *supra* note 77, at 695-96 (explaining that this complexity inhibits mergers).

211. 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.

212. When a breach of contract has forced a taxpayer to 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, No. 3847/12, 2014 WL 1344413, at *1 (N.Y. Sup. Ct. Mar. 31, 2014).

arbitration decision).[213] The heart of this case concerned a merger that triggered taxes for REIT property contributors to one of the nation's largest REITs.[214] 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.

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."[215] 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.[216] 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.'"[217] 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."[218] 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

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213. Stender v. Archstone-Smith Operating Tr., No. 07-CV-2503, 2017 WL 3676473, at *9 (D. Colo. Aug. 25, 2017).

214. 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. *E.g.*, *Stender*, 2017 WL 3676473, at *4; *see supra* note 121 and accompanying text.

215. *Stender*, 2017 WL 3676473, at *9.

216. *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).

217. *Stender*, 2017 WL 3676473, at *9 (quoting Defendant Archstone's Motion to Confirm Arbitration Final Award in Archstone's Favor at 4, Stender v. Cardwell, No. 07-CV-02503 (D. Colo. Mar. 26, 2013), ECF No. 184-1).

218. *Id.*

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.[219] 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 enough higher priority debts. Real estate ventures such as REITs operate with high levels of leverage, which means even small declines in value can render them insolvent.[220] Real estate is a cyclical asset, and the value of individual parcels can be highly correlated.[221] Occasional periods of declining real estate values do result in REIT bankruptcies.[222]

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,

219. 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.

220. 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.

221. *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, 43-44 (2001).

222. CBL & Associates, the Pennsylvania Real Estate Investment Trust (PREIT), and Washington Prime Group (WPG) all filed for bankruptcy thanks to the COVID-19 pandemic, which battered commercial real estate. *See* Adam Levine-Weinberg, *2 REITs Declare Bankruptcy, but the Outcomes Will Be Much Different*, MOTLEY FOOL (Nov. 3, 2020, 7:26 AM), https://www.fool.com/investing/2020/11/03/2-reits-declare-bankruptcy-but-the-outcomes-will-b [https://perma.cc/PHE8-AVVB]; Brad Moon, *32 Bankruptcy Filings Chalked Up to Covid-19*, KIPLINGER (July 27, 2021), https://www.kiplinger.com/investing/603194/bankruptcy-filings-chalked-up-to-covid-19-2021 [https:// perma.cc/J86G-6U4N]. In late 2010, following a "steep drop in U.S. commercial real estate prices," Petra Fund REIT Corp filed for bankruptcy. *Real Estate Investor Petra Files for Bankruptcy*, REUTERS (Oct. 21, 2010, 10:59 AM), https://www.reuters.com/article/petra-bankruptcy-idUKN2128689620101021 [https://perma.cc/KEB3-LY6E].

it can settle things with the aggrieved investor later. If things continue to decline, the insolvent firm will not 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 many 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.[223] Thus, TPAs should raise the firm's cost of capital.[224] 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."[225] 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 heterogenous 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 among property contributors. Many TPAs are written in favor of REIT board members, executives, 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.[226]

The Empire State Building provides an interesting example. Leona Helmsley never contributed her interest in the Empire State Building to a REIT. Perhaps,

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223. 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. Joseph T.L. Ooi, *The Compensation Structure of REIT Managers: Impact on Stock Valuation and Performance*, 26 J. PROP. RSCH. 309, 312-13 (2009). 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.

224. 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.

225. Salon et al., *supra* note 210, at 3.

226. 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 efficient actions that harm them personally. A TPA allows managers to work out debts, accept an attractive offer for a parcel, or undertake a 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. *See* Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager-Specific Investments,* 25 J. FIN. ECON. 123, 132 (1989).

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.[227] 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.[228]

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. It was Congress's intent to facilitate investments in real estate through a vehicle that looked like a mutual fund, in that it was passive, diversified, and decentralized.

But that popularity hides another puzzle. This puzzle concerns net asset value (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 closely equivalent to their market value.[229] Indeed, most operating companies have market capitalizations greatly in excess of the net value of the sum of their parts.[230]

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227. *See supra* note 99 and accompanying text; Adam Pincus, *The End of the Helmsley Era: The Estate of Harry and Leona Poised to Sell Their Final Two NYC Properties*, THEREALDEAL (Feb. 1, 2014, 7:00 AM), https://therealdeal.com/magazine/new-york-february-2014/the-end-of-the-helmsley-era-the-estate-of-harry-and-leona-poised-to-sell-their-final-two-nyc-properties [https://perma.cc/HNR8-2LQX].

228. *See* Empire State Realty Tr., Inc., Registration Statement (Form S-4) (Feb. 13, 2012), https://www.sec.gov/Archives/edgar/data/1541401/000119312512054391/d283359ds4.htm [https://perma.cc/EPB2-X87W]. Of course, at that point, the built-in gain for the Hemsley interest was mostly gone due to stepped-up basis. Thus, accessing liquid ESRT stock came at a much lower potential tax penalty even if the deferred gain was later triggered.

229. The exception is, of course, closed-end mutual funds. See *infra* note 236.

230. *Cf.* Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709, 1717 n.29 (2020) ("[A] firm has positive going-concern value when the whole of the business is worth more than the sum of its separate parts. A firm without going-concern value is one that should be liquidated . . . .").

But REITs are strange, often trading at a significant discount to NAV.[231] At the time of this writing, the median discount across the industry averages about 15%.[232] 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 off its contents. Common sense would have predicted the opposite.[233]

There is no academic consensus as to why REITs trade at a discount,[234] but one widespread explanation is that investors expect the REIT's management to

231. *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."); *Why REITS are Compelling Now: A Historical View on NAV Discounts*, Virtus Funds 1 (2023), https://www.virtus.com/assets/files/662/global_real_estate_5784.pdf [https://perma.cc/SRC6-3AD2] (describing "previous crisis lows" for REITS as "[including] a discount to NAV of 22% at the end of the dot.com bubble in December 1999; 17% in the GFC in February 2009; 15% in the Taper Tantrum of August 2023; and 19% in March of the 2020 Pandemic"); Arpita Banerjee & Ronamil Portes, *NAV Monitor: US Equity REITs See Discounts to Net Asset Value Fall in June*, S&P Glob. Mkt. Intel. (July 6, 2023), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/nav-monitor-us-equity-reits-see-discounts-to-net-asset-value-fall-in-june-76436075 [https://perma.cc/732G-2ZZY] ("Publicly listed US equity real estate investment trusts traded at a median 18.2% discount to their consensus net asset value per share estimates as of July 3 [2023], down from a 23.3% discount at the end of May [2023].").

232. *See* Ronamil Portes, *NAV Monitor: US Equity REITs Trade at 14.7% Discount to NAV at May-end*, S&P Glob. Mkt. Intel. (June 3, 2022), 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 [https://perma.cc/MFV4-D2S8].

233. REIT shares are more liquid than the underlying assets, so creating the shares should add value. *See* Lawrence Benveniste, Dennis R. Capozza & Paul J. 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 should trade at a discount to NAV. *See* Morley & Curtis, *supra* note 39, at 104-05.

234. *See* H. Swint Friday & G. Stacy Sirmans, *Board of Director Monitoring and Firm Value in REITs*, 16 J. Real Est. Res. 411, 412 (1998) ("An adequate explanation for these discounts in REITs has not been forthcoming.").

waste corporate assets prior to liquidation through, for example, excessive compensation.[235] Call this the "managerial waste" theory.[236]

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 would not have been formed in the first place.

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235. *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 (2008) (finding steeper discounts when REITs incorporate 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, 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, 397 (2005) (finding that institutional ownership does discipline REIT-CEO compensation).

236. 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 234, at 412; *Current & Historical Premium & Discounts for U.S. Closed End Funds,* CLOSED-END FUND CTR. (Apr. 7, 2023), https://www.cefa.com/newsarchive/content/discount/premiumdiscountarchive.fs [https://perma.cc/5JAF-85SK].

D. The Overseas-REIT Puzzle

More than forty jurisdictions across the world now permit REITs to form.[237] Approximately 30% of REIT market capitalization is located outside of the United States.[238] Yet, many REIT advocates are puzzled by the slow growth in some jurisdictions.[239] Why have REITs grown more slowly in other countries?

Perhaps one answer is that the entity varies so much from country-to-country, united only in its principal business focus: real estate. Some jurisdictions impose ownership-concentration restrictions, which impair takeovers.[240] Most do not.[241] Some require robust dividend payments.[242] Others do not.[243] If REITs have not taken off, it may be because jurisdictions adopt parts of the U.S. structure *à la carte* when REITs should actually be a *prix fixe* menu.

As Figure 5 suggests, there is a cohesive logic to the U.S. REIT. If real estate combinations in another country involve heterogeneous ownership,[244] 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: entrench managers or else managers will be forced to cow to cash investors and be unable to attract property contributors; limit reinvestment distributions or else the entrenched managers can run amuck; provide pass-through treatment or else the REIT's dividends are not viable from a tax perspective. There are

237. *See EPRA Global REIT Survey 2021*, EUR. PUB. REAL EST. ASS'N 2 (2021), https://prodapp.epra.com/media/EPRA_Global_REIT_Survey_2021_v5_1630572816126.0.pdf [https://perma.cc/35VZ-GXBT].

238. *See id.* at 251 (estimating U.S. REITs as comprising 68.35% of the Global REIT Index).

239. While REIT regulations in India "came into effect in 2017," *see* Brian Jones, Anton Kwang, Steve S. Shigekawa & Gillian Tiltman, *The Growing Case for Global REITs*, NEUBERGER BERMAN 4 (Sept. 2020), https://www.nb.com/handlers/documents.ashx?id=17040d90-4851-4865-bc4e-095f3d0b6112 [https://perma.cc/U5GP-3XEB], there are still only four REITs listed on the Indian stock exchanges as of May 2023. *See* PTI, *India Likely to See Listing of Four REITs in Next 18 Months: Property Stalwart Anshuman Magazine*, ECON. TIMES (May 26, 2023, 11:13 AM IST), https://economictimes.indiatimes.com/markets/stocks/news/india-likely-to-see-listing-of-four-reits-in-next-18-months-property-stalwart-anshuman-magazine/articleshow/100519524.cms [https://perma.cc/B9P5-TGX7]. Indonesia, whose REIT regulations date back to 2007, has only two listed REITs as "[t]he market has been slow to gain momentum." Mattson-Teig, *supra* note 84. The European market for REITs has also "lagged both the U.S. and Asia Pacific in market penetration." *Id.*

240. *See EPRA Global REIT Survey 2021*, *supra* note 237, at 199-211 (Canada), 58-69 (Germany), 451-61 (Israel).

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

242. *See id.* at 300-14 (India), 143 (Netherlands).

243. *See id.* at 121 (Lithuania), 131 (Luxembourg).

244. 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.

many ways for overseas REITs to offer an incomplete package, as they did in the United States for decades, and likewise fail to find much popularity.

We do not wish to overclaim. There could be many explanations for limited REIT growth in other jurisdictions.[245] Sound comparative legal research is no easy feat; it requires understanding a vast network of adjacent legal requirements and social expectations. We only suggest that policymakers and scholars in those jurisdictions consider the possibility that REITs are not simply synonymous with "real estate" investment; they exist to solve identifiable problems, and they will tend to thrive when they are built capable of solving those problems.

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.[246] But more than one-third of all REIT assets are held by REITs that lack any public trading.[247] Speaking broadly, illiquid REITs take up the poles of the REIT market.[248] Some of the most prominent REITs are not publicly traded on an exchange. The prime example is Blackstone's BREIT. Blackstone is the world's largest commercial real estate owner,[249] holding more than $100 billion in real estate assets. There is no public

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245. There may be other jurisdictions that appear to conflict with our theory by growing despite the attributes we deem essential. It likewise requires careful work to see if foreign REITs succeed *despite* the problems our theory would predict. For example, they may have other mechanisms to check managerial opportunism, such that mandatory dividends are unnecessary.

246. *See* I.R.C. § 856(a)(2) (2018) (REITs must have transferable shares); *id.* § 856(a)(5) (dictating that REITs must have more than 100 shareholders).

247. *See REITs Across America: The United States*, NAREIT (Oct. 14, 2022), https://www.reitsacrossamerica.com/united-states [https://perma.cc/WZ94-3F7W] (stating that private REITs own $1.5 trillion 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 to 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. RSCH. 59, 61 (2016).

248. 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.

249. *Blackstone Real Estate Income Trust*, BLACKSTONE REAL EST. INCOME TR. 1 (July 2023), https://www.breit.com/wp-content/uploads/sites/33/blackstone-secure/Fact-Card.pdf [https://perma.cc/JY8J-D6WM].

market for BREIT's shares.[250] 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.[251] Investors, fearing the REIT could be battered by rising interest rates, clamored for the redemption of billions of dollars' worth of securities, and panic set in when the fund started to block these requests in November 2022.[252] Blackstone's shares have plunged in value as investors question the health of one the company's most important divisions.[253]

Smaller illiquid REITs have faced their own problems. One recent study showed that nontraded REITs tended to produce net losses for investors relative to benchmarks.[254] They have also generated vast numbers of FINRA complaints.[255] They are associated with structures that may seem Ponzi-like, in which later investors finance returns for early investors.[256] The problem is severe

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250. *For Stockholders*, BLACKSTONE REAL EST. INCOME TR., https://www.breit.com/non-us-investor [https://perma.cc/25EB-PDYT] ("Since there is no public trading market for our common stock, repurchase of shares by us will likely be the only way to dispose of your shares.").

251. Miriam Gottfried, Peter Grant & Rebecca Feng, *Blackstone's Big New Idea Leaves It Bruised*, WALL ST. J. (Feb. 12, 2023, 8:59 AM ET), https://www.wsj.com/articles/blackstones-big-new-idea-leaves-it-bruised-d66de361 [https://perma.cc/D87L-7AJG].

252. Chibuike Oguh, *Blackstone Blocked Investor Withdrawals from $71 Billion REIT in February*, REUTERS (Mar. 1, 2023, 8:38 PM EST), https://www.reuters.com/markets/us/blackstone-blocked-investor-withdrawals-71-billion-reit-february-2023-03-01 [https://perma.cc/7PKX-RGLK] ("Blackstone has been exercising its right to block investors' withdrawals since November last year . . . .").

253. *See* Gottfried et al., *supra* note 251. The bleeding seems to have largely stopped after a large investment by the University of California, but the future remains uncertain. *Id.*

254. Jay C. Hartzell & Jung-Eun Kim, *Returns in the Nontraded REIT Industry: Evidence from Full-Cycle Events*, 29 REAL EST. FIN. 3, 3 (2012) ("Comparing the nontraded REITs to the benchmarks, the results are less positive. Five out of the 17 nontraded REITs outperformed their respective private benchmarks, and five outperformed their respective publicly-traded benchmarks (one outperformed both). Clearly, the fees associated with nontraded REITs account for some of these differences.").

255. Four hundred twenty-nine REIT-related investor complaints came before FINRA's arbitration panels in 2021. *See* Peter Grant, *Commercial-Property Funds for Small Investors Face Tougher Regulation*, WALL ST. J. (Aug. 30, 2022, 8:00 AM ET), https://www.wsj.com/articles/commercial-property-funds-for-small-investors-face-tougher-regulation-11661860805 [https://perma.cc/3NKT-VWGB]. Of the 429, "most complaints were related to nontraded REITs." *Id.*; *see also* A.D. Pruitt & Craig Karmin, *REITs Spring an Unnerving Surprise*, WALL ST. J. (Apr. 24, 2012, 6:12 PM ET), https://www.wsj.com/articles/SB10001424052702303459004577364110318098188 [https://perma.cc/S6H5-KTCT] (describing scrutiny of untraded REITs).

256. *See* Seguin, *supra* note 247, at 85.

enough that both FINRA and the SEC posted investor bulletins warning about the risks of investing in them.[257]

Our theory helps explain these illiquid-REIT problems. Essentially, public trading is a good fit for the REIT structure because it creates a source of liquidity outside of the firm. Investors in 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.[258] 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 are 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 problems if its investors demand cash that has been locked up in real estate. This is the 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.[259]

257. *Investor Bulletin: Non-Traded REITs*, SEC. & EXCH. COMM'N (Aug. 31, 2015), https://www.sec.gov/resources-investors/investor-alerts-bulletins/non-traded-reits [https://perma.cc/Y8YC-QHCZ]; *see* David Bodamer, *Nonlisted REITs Fight to Shake Misconceptions*, WEALTH MGMT. (Oct. 12, 2012), https://www.wealthmanagement.com/real-estate/nonlisted-reits-fight-shake-misconceptions [https://perma.cc/8UKX-86QD] (describing FINRA's bulletin).

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

259. The situation is different but no better if the REIT leans on TPAs to assure the property contributors. In that case, forced sales generate a tax liability not for the contributor but for the

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,[260] and to likewise permit REIT management to suspend redemptions.[261] 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 will not 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.[262] Yet, non-Blackstone LPs hold less than 1% of the umbrella-partnership interests of BREIT.[263] 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 taxable exchanges, where it operates at no comparative advantage.[264] 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 will not 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 itself. But if the REIT incurs new liabilities as it sells assets, then early redeemers do better than later redeemers. As redemptions occur, 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 is the same structural instability which characterizes and fuels bank runs.

260. Seguin, *supra* note 247, at 60.

261. *Id.* at 60-61. BREIT has limited investor withdrawals in months where redemption requests exceeded 2% of the fund's net asset value. *See* Andrew Bary, *Blackstone Caps BREIT Withdrawals in January After Large Redemption Requests*, BARRON'S (Feb. 1, 2023, 11:43 AM EST), https://www.barrons.com/articles/blackstone-caps-breit-withdrawals-large-redemption-requests-51675265136 [https://perma.cc/Q3TE-JJQT].

262. *See Prospectus*, BLACKSTONE REAL EST. INCOME TR., INC. 9 (April 18, 2023), https://www.breit.com/wp-content/uploads/sites/33/2022/03/BREIT-Prospectus-with-previous-supplements.pdf [https://perma.cc/26B9-Y3R7] ("Using an UPREIT structure may give us an advantage in acquiring properties from persons who want to defer recognizing a gain for U.S. federal income tax purposes.").

263. *See id.* at 225.

264. We can infer this because very few LP interests have been issued.

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.

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 many private REITs offer extremely limited redemption opportunities,[265] barring redemption "[e]ven if you're [d]ead."[266]

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 and 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. Instead, 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 REITs' obligatory dividends will amount to fixed income (perhaps even inflation-proof income).[267] Regardless of the merits of that investment rationale,[268] it finds an audience. Insofar as REITs provide an income stream that

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265. Seguin, *supra* note 247, at 69 (describing extremely limited redemption within his sample).

266. *Id.*

267. *See, e.g.*, E-mail from Mackenzie Connick, Legal Intern, Sec. Arb. Clinic, St. John's Univ. Sch. of L., Christine Lazaro, Professor of Clinical Legal Educ. & Dir. Sec. Arb. Clinic, St. John's Univ. Sch. of L., & Elissa Germaine, Exec. Dir. of John Jay Legal Servs. & Dir. of Fairbridge Inv. Rts. Clinic, Elisabeth Haub Sch. of L. at Pace Univ., to Andrea Seidt, Section Chair, NASAA & Mark Heuerman, Project Grp. Chair, NASAA 2 (Sept. 12, 2022), https://www.nasaa.org/wp-content/uploads/2022/08/NASAA-Comment-non-traded-REITs.pdf [https://perma.cc/CWY6-Y3AN] (describing this common misapprehension); *Request for Public Comment: Proposed Revisions to NASAA Statement of Policy Regarding Real Estate Investment Trusts*, N. AM. SEC. ADM'R ASS'N 4 (July 12, 2022), https://www.nasaa.org/wp-content/uploads/2022/07/Request-for-Public-Comment-on-Amendments-to-NASAA-REIT-Guidelines-2022.pdf [https://perma.cc/U244-V2FR] (describing the risk to elderly investors).

268. *See* Seguin, *supra* note 247, at 72-73 (finding that return stability is not higher for unlisted REITs than listed REITs).

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.[269]

One scholar estimates the value of exchange listing as contributing 12.1% to the value of a REIT.[270] 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 benefit of a theory is that it generates policy implications. We think our theory provides a principled basis for evaluating a litany of alterations of REIT law. Section VII.A discusses recent and possible future efforts to include new assets within the investable options for REITs. Sections VII.B and VII.C take a skeptical view of efforts to loosen reinvestment and "active business" restrictions.

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 serve the purpose of financing 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 to evaluate the scope of permitted assets: asking whether the asset has the sort of problem REITs are built to solve. This entails two key questions. First, whether there is a social benefit to combining the new class of assets in a venture. Some assets operate efficiently no matter who owns them, but others are much more productive when owned by the best owner. Sometimes this may be because of complementarities: two

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269. 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 nonprofits and ECI for foreign investors.

270. Seguin, *supra* note 247, at 81.

adjoining parcels can be combined to support a larger development project. Other reasons may be holdup problems, as one asset supplies inputs crucial to another—consider a parking lot associated with a sports stadium. If these are not owned jointly, the two owners may waste resources trying to get more of the surplus from the bilateral monopoly. Even considered individually, it may simply be that the current owner lacks the interest or ability to optimally manage the asset (as may have been the case for Leona Helmsley and the Empire State Building). REIT-like structures are valuable for assets when ownership can improve productivity.

But efficient ownership does not by itself require REIT-like structures, because it is usually easy to sell assets to the most efficient owner without a REIT. The second question thus looks to whether there is some obstacle to optimal alienation. The most important example is 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.[271] 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 did not 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.[272]

Although there is a thematic relationship to real estate (ownership of and loans based on real estate both represent financial interests in real estate), mortgage-debt instruments are quite different from the point of view of built-in gain. Mortgage-backed securities and other bonds are not ageless; almost all have a fixed maturity date, 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 *do not* own deeply appreciated mortgage bonds, which they would be inclined to keep until their

271. *See generally* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law,* 89 GEO. L.J. 439 (2001) (describing the broad uniformity in the law of the corporate form).

272. 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.

death unless given a tax-efficient way to collectivize the investment. Moreover, the social cost of illiquid real estate is high, but the value or productivity of a bond does not depend on the holder.[273] Altogether, there is no reason to expect that bond-investing funds are fundamentally inclined toward heterogenous ownership. Accordingly, bonds simply do not have the properties that justify the REIT structure, so there was no need to extend REIT treatment to funds that primarily trade mortgage bonds.

Our theory of the REIT identifies that 5% of the REIT marketplace—mortgage REITs—probably should not be organized as REITs at all. Market participants themselves may appreciate the poorness of 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.[274]

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 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 pass-through 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. In

273. In general, bonds are just rights to cashflows. They do not allow control or combination into ventures that are greater than the sum of their parts. Two small parcels can be combined to build a larger building, but two small bonds are just two cashflows.

274. The relative unpopularity of mortgage REITs might also be due to the Real Estate Mortgage Investment Conduit (REMICs), an alternative structure providing pass-through 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. § 860B (2018). REMICs can only have one class of residual interests. Holders of the residual interests are taxed on a pass-through basis on the income or loss of the REMIC. I.R.C. § 860C (2018).

2016, the Treasury Department promulgated regulations deeming these technological fixtures "real estate" akin to the land they sit on.[275] 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.[276]

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.[277] 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.

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) the assets have substantial built-in gain, and (2) the productivity of the assets depends on who owns them—strategic combinations matter. Expanding on the second criteria, the success of a shopping mall can vary dramatically depending on who owns and manages. By contrast the return on a bond does not depend on the identity of the bondholder at all.

Patents and software offer one interesting possibility. These assets have no connection to real estate and would therefore seem to be 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,[278] and (2) the productive use of a patent can depend greatly on who owns it.

275. *See* Definition of Real Estate Investment Trust Real Property, 81 Fed. Reg. 59849 (Aug. 31, 2016) (to be codified at 25 C.F.R. pt. 1).

276. *See* Broz v. Comm'r, 137 T.C. 25, 25-26 (2011).

277. I.R.C. § 168(k) (2018).

278. Many costs of developing intangible property (for example, many research and experimental expenditures) are currently deductible and therefore do not increase basis. *See, e.g.*, I.R.C. § 174 (2017). Moreover, the value of an inventor's time is not included in basis. *See Publication 551: Basis of Assets*, INTERNAL REVENUE SERV. (Dec. 2022), https://www.irs.gov/publications/p551 [https://perma.cc/X4WS-NJ7W].

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 intellectual-property 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.[279] 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%.[280]

These rules were first introduced to grant temporary flexibility to REITs during the financial crisis in 2008-2011.[281] It is theoretically possible that a REIT might have profits for tax purposes but no liquidity (due to challenges in credit markets), and so be unable to pay the designated sum.[282] Some temporary relief might be needed to prevent widespread insolvency or loss of tax status for otherwise viable enterprises.

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279. *See, e.g.*, Rev. Proc. 2017-45, 2017-35 I.R.B. 216, 216-18 (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, 2021-51 I.R.B. 887, 887-88 (temporarily extending the 10% relief through June 30, 2022).

280. Since only 20% of the mandatory 90% distribution must be made in cash, a REIT is only required to distribute 18% of its earnings in cash.

281. For the initial IRS publication offering relief to REITs, see Rev. Proc. 2008-68, 2008-2 C.B. 1373. The relief was subsequently extended through the end of 2011. Rev. Proc. 2009-15, 2009-11 I.R.B. 687; Rev. Proc. 2010-12, 2010-7 I.R.B. 410.

282. *See infra* Section VIII.A.

However, in 2017, the IRS made the relief permanent.[283] 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 18% of net income in cash (or even 9% in times of stress) eviscerates the mandatory dividend as a mechanism for controlling management.[284]

Importantly, it is not clear that parties who realize the importance of mandatory dividends can commit to dividends without the law mandating it. Monitoring for partnership-agreement violations and then litigating them is costly.[285] 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 they 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.[286] Activists

283. Rev. Proc. 2017-45, *supra* note 279.

284. 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.

285. *See supra* note 197 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. MD. CODE ANN. CORPS. & ASS'NS § 8-501 (West 2022). 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.

286. One study found only two hostile successes 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 Zhou, *A Review and Extension of Merger and Acquisition Research Between REITs and General Corporations*, 26 J. REAL EST. LITERATURE 225, 242-

signaled discontent with CommonWealth in 2013, citing, among other things, its low dividend payments.[287] After years of paying approximately 7% of its market cap as an annual dividend (and 20% through the Global Financial Crisis), CommonWealth dropped its dividend yield down to around 4%.[288] It is unlikely CommonWealth could have halved its dividend payments if it were still required to distribute 90% of its net income.[289] 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 10%.[290] 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 applecart.

C. *Making REITs Less Passive*

Similar arguments can be raised against expanding the scope of REIT activities. It is one thing to entrench managers to oversee a limited domain of activities, but 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

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43 (2018). Glascock, Zhang, and Zhou do not identify which transactions underly their coding, so it is not possible to determine which transaction they characterize as "hostile" apart from CommonWealth REIT. *See* supra note 81 (identifying just one hostile transaction)

287. Related Fund Management, LLC, *Corvex and Related Send Letter to CommonWealth REIT Shareholders Calling for an End to Value Destruction*, PR NEWSWIRE (Apr. 18, 2013, 8:30 ET), https://www.prnewswire.com/news-releases/corvex-and-related-send-letter-to-commonwealth-reit-shareholders-calling-for-an-end-to-value-destruction-203578011.html [https://perma.cc/Y38H-JR23] ("CommonWealth has seen its stock decline by over 49% and cut its dividend by 70%.").

288. *Equity Commonwealth–33 Year Dividend History | EQC*, MACROTRENDS (Apr. 12, 2023), https://www.macrotrends.net/stocks/charts/EQC/equity-commonwealth/dividend-yield-history [https://perma.cc/2226-9YE6].

289. *See* Rubicon Associates, *CommonWealth REIT: Beware the Dividend Trap*, SEEKING ALPHA (May 15, 2012, 3:13 AM EST), https://seekingalpha.com/article/589071-commonwealth-reit-beware-the-dividend-trap [https://perma.cc/8A8E-LE4P]. Even as CommonWealth paid 10%, it paid only 55-65% of its funds from operations as a dividend. *Id.*

290. MACROTRENDS, *supra* note 288.

into a sensible balance, but for midstream 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. In 1999, Congress allowed REITs to provide a more complete range of services to its properties.[291] The change in law allowed REITs to own 100% of what is called a "taxable REIT subsidiary" (TRS).[292] The TRS 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.[293] 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.[294]

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291. Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, § 541-71, 113 Stat. 1860, 1940-1951.

292. *Id.* at § 543, 1943-44; I.R.C. § 856(*l*)(1) (2018).

293. *See, e.g.*, Rosemary Batt, Eileen Appelbaum & Tamar Katz, *The Role of Public REITs in Financialization and Industry Restructuring* (Ctr. for Econ. & Pol'y Rsch. Working Paper No. 189, 2022), https://doi.org/10.36687/inetwp189 [https://perma.cc/R3CM-A9HH] ("[T]he REIT has incentives to charge the TRS above market rent because higher rent leads to lower net taxable income for the TRS and in turn boosts REIT revenues and dividend payouts—making the REIT a more attractive investment vehicle. The IRS found Ashford Hospitality guilty of overcharging rent to its TRS and imposed a 100% excise tax on the excess amount—by $3.3 million for 2008 and a TRS adjustment of $1.6 million for agreeing to be party to the REIT's loan agreement. The IRS also found that La Quinta Corporation (a former REIT of La Quinta Holdings) overcharged rent to its TRS and imposed a 100% excise tax on the REIT of $158 million for 2010 and 2011.").

294. I.R.C. § 856(c)(4)(B)(ii) (2018).

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,[295] with even small investors sometimes successfully pressuring corporate managers.[296] The level of shareholder activism is similar for public REITs as for non-REIT public companies.[297]

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.[298] But our theory contributes 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,[299] in part because this tends to lead to shareholder gains.[300] It is

295. Mary Ann Cloyd, *Shareholder Activism: Who, What, When, and How?*, HARV. L. SCH. F. ON CORP. GOV. (Apr. 7, 2015), https://corpgov.law.harvard.edu/2015/04/07/shareholder-activism-who-what-when-and-how [https://perma.cc/62S9-HMCD] ("'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.").

296. Bernard S. Sharfman, *Looking at the 'Big Three' Investment Advisers Through the Lens of Agency*, OXFORD BUS. L. BLOG (Feb. 18, 2022), https://blogs.law.ox.ac.uk/business-law-blog/blog/2022/02/looking-big-three-investment-advisers-through-lens-agency [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.").

297. *See* David H. Downs, Miroslava Straska & H. Gregory Waller, *Shareholder Activism in REITs*, 47 REAL EST. ECON. 66, 66 (2019).

298. For just a few examples, see Lucian A. Bebchuk, Alon Brav & Wei Jiang, *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, 573-91 (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); and Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1083 (2007).

299. Downs et al., *supra* note 297, at 76 (finding that value demands like divesting assets are more often made by activist shareholders of REITs).

300. *Id.* at 95.

unsurprising that such proposals can benefit shareholders in an individual case, but it will undermine the logic of REITs if activists repeatedly 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.[301] 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.[302] 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 all public companies, is how to ensure activists apply good forms of pressure without killing the golden goose. There are obvious cases like forcing 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.[303]

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 which 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.

301. *Id.* at 78.

302. *Id.* at 87 (finding that activism is associated with lower prior-year excess returns).

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

A. Distributions

This Article has debunked a core myth about the purpose of mandatory distributions in REITs. The pass-through theory of REITs relegates mandatory distributions to an administrative mechanism for pass-through taxation. On that theory, REITs have mandatory dividends only because retaining earnings would not fit with Congress's vision of REITs as a 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 (specialized vehicles for investing in unregistered securities of small- and medium-sized companies) are subject to 90% profit-distribution rules.[304] 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 believe these inquiries will be fruitful.[305]

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,[306] our study of REITs illustrates the link between distributions and governance. For REITs, the law

304. *See supra* Section I.A. Oil-and-gas MLPs likewise commit in their fundamental documents to similar payouts. *See infra* note 319 and accompanying text.

305. 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, 113-14 (2010). Morley and Curtis argue that mandatory distributions lower the cost for fund shareholders to redeem their shares, relative to activism. *Id.* Their central thesis is that mutual-fund governance is defined by the dominance of redemption over activism. *Id.* at 88.

306. See, for example, MODEL BUS. CORP. ACT § 6.40(c) (AM. BAR ASS'N 2016), which 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.

requires dividends to control certain agency costs, but other areas of the law *forbid* dividends for similar purposes.

Nonprofit law is one such area. In his canonical article, *The Role of Nonprofit Enterprise*, Henry B. Hansmann argued that the "nondistribution constraint" allowed nonprofits to solve a variety of agency problems.[307] For example, someone desiring to fund aid to earthquake victims 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.[308] 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.

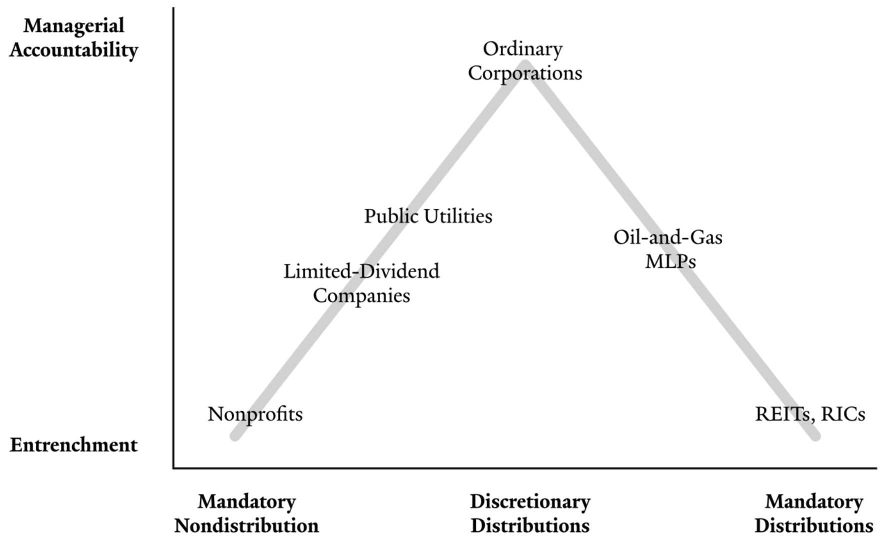
While both nonprofits and REITs are subject to regulated distributions, the regulations are the opposite of one another. Nonprofits are forbidden from paying distributions, while REITs are required to do so. Hansmann studied nonprofits to show that distributions can be dialed down to control agency costs. Our theory of the REIT demonstrates that distributions can also be dialed up to solve similar problems.[309] 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:

307. *Nonprofit Enterprise*, *supra* note 43, at 838, 843-45.

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

309. Similar to our theory of the REIT, Hansmann's theory of the nonprofit decenters tax incentives. *See Nonprofit Enterprise*, *supra* note 43, at 881-84.

FIGURE 6. THE DISTRIBUTION PYRAMID



We can think of distribution rules as existing on a spectrum from the nondistribution constraint (that characterizes nonprofits) to mandatory distributions (that characterizes REITs). In between is the broad discretion afforded most "ordinary" corporations under the business-judgment rule[310]: 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 nondistribution 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

310. *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 681-82 (Mich. 1919) (explaining the discretion of corporations in making distributions).

usually self-perpetuating, without an external stakeholder group empowered to govern the board democratically.[311] 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 raise 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 managers are naturally tempted to distribute too little. The entrenched board of a nonprofit that (counterfactually) is permitted to make distributions might be inclined to distribute too much.[312]

The foregoing possibility conceives of dividend policy following from entrenchment, but causation might run the other way: nonprofits 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 must also balance heterogeneity.[313] 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.

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311. *See* MICHAEL J. WORTH, NONPROFIT MANAGEMENT: PRINCIPLES AND PRACTICE 64 (2009).

312. 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.

313. Many nonprofits 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 them among all parishioners.

2. *New Distribution Regulations*

Second, theorizing distribution regulation as a spectrum allows us to imagine other points along the curve.[314] 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 permit some, but not all, profits to be distributed. One example is the limited-dividend partnerships that invest in low-income housing.[315] The main contracting problems are a need for capital and a concern that federal subsidies will be captured by investors.[316] 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.[317] 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.[318] REITs are the starting point for exploring the right side of this pyramid.

Right now, all forced-distribution entities 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

314. 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. *See Nonprofit Enterprise*, *supra* note 43, at 886. Public utilities are also different from most nonprofits in that utilities are capital intensive and therefore require substantial capital. *Id*. at 887.

315. Since Hansmann's article, the more popular form seems to have become the L3C, though even that has not taken off too far. *See* 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, 1315-17 (2011). One problem is that L3Cs have not been able to commit credibly to their status. *See* Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L.J. 681, 690 (2013) ("Importantly, if an L3C ceases to comply [with its charitable- or educational-purpose requirements], it simply and immediately transforms into an ordinary LLC.").

316. *See* Nonprofit Enterprise, *supra* note 43, at 887.

317. *See id.* at 887-88.

318. *See id.* at 884-90.

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.[319]

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 primacy").[320] A growing minority asks boards to balance the interests of stakeholders such as employees or customers

319. *See* Fenn, *supra* note 183, at 5-6.

320. *See generally* STEPHEN M. BAINBRIDGE, THE PROFIT MOTIVE (2023) (defending the shareholder-primacy school of thought); Lucian A. Bebchuck & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020) (detailing the shareholder-primacy school of thought).

("stakeholder theory").[321] This debate is largely orthogonal to our discussion of REITs. Although REIT 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.[322] 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.[323] 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.[324] That means that the property contributors to a Delaware UPREIT can sue the REIT managers for failing to sufficiently protect their interests.[325] Thus, Delaware law exposes directors of an UPREIT to suit from both REIT shareholders and from limited partners of the operating partnership.

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321. *See, e.g.*, *Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE (Aug. 19, 2019), https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationOctober2020.pdf [https://perma.cc/CMR8-WMXE].

322. *See* 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).

323. 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, 292-93 (1999) (describing shareholder derivative suits as serving the interests of the firm as a whole). Blair and Stout are stakeholder theorists who nevertheless spot the problem with widespread litigation standing among stakeholders.

324. *In re* USACafes, L.P. Litig., 600 A.2d 43, 50 (Del. Ch. 1991). For more on *USACafes*, see Andrew Verstein, *Upstream Liability, Entities as Boards, and the Theory of the Firm*, 74 BUS. LAW. 313, 317-20 (2019), which describes the "upstream duties problem."

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

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 on-going conflict," which is "a strange and unsettling position."[326] 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.

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.[327] Thus, property contributors cannot sue managers who disregard the contributors' tax interests.[328] 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 nonshareholders[329] yet also withholds from those beneficiaries any power to sue.[330] 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 stakeholders' rights to sue. Is there a market remedy that can substitute for the legal remedy? Whether employees should be allowed to

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

327. Maryland law did not promptly address *USACafe*, and subsequent judicial opinions have generally hewn to the traditional view of unitary duties. *See, e.g.*, Stender v. Gerardi, No. 07-cv-02503, 2008 WL 4452117 (D. Colo. Sep. 30, 2008); Hartman Com. Props. REIT v. Hartman, No. 06-cv-3897, 2007 WL 9751970 (S.D. Tex. Apr. 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, No. 03-C-06-008836, 2007 WL 7773589, at *4 (Md. Cir. Ct. June 5, 2007).

328. 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.

329. *See* MODEL BENEFIT CORP. LEGIS. § 301(a)(1)-(2) (2017).

330. *Id.* § 301(d).

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.[331] Others argue that takeover defenses are vital to protect businesses from short-termism and coercive offers.[332] Lately, an intermediate, contextual position has argued that the value of entrenchment depends on context.[333]

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.[334] 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

331. *See, e.g.*, Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409-33 (2005).

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

333. *See, e.g.*, Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PA. L. REV. 1475, 1478-80 (2018) (arguing that the desirability of a staggered board depends on firm characteristics).

334. Note that REITs do not just bundle entrenchment with something shareholders want, such as a merger. That practice is typical in many businesses. *See* Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549, 1553 (2010). Instead, REITs bundle entrenchment with actual checks on the entrenched managers.

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—allowing 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 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" 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).[335] 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."[336]

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

335. 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 197 and accompanying text.

336. Unocal v. Mesa Petroleum Co., 493 A.2d 946, 953 (Del. 1985) (beginning the line of cases evaluating the legality of takeover defenses).

preclusive or lawful.[337] Mostly, courts ask how strong the takeover defenses are and how much of a "threat" the acquirer poses.[338]

But REITs suggest a new variable that 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.[339] 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.[340] Likewise, courts are normally hostile to "dead hand" poison pills, but they have approved them in cases where the pill is of limited duration.[341] 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.

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337. *See id.* at 955-58.

338. Third Point LLC v. Ruprecht, C.A. No. 9469, 2014 WL 1922029, at *16 (Del. Ch. May 2, 2014).

339. 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.

340. Francis J. Aquila, *Adopting a Poison Pill in Response to Shareholder Activism*, PRAC. L., Apr. 2016, at 26.

341. *See, e.g.*, Davis Acquisition, Inc. v. NWA, Inc., CIV. A. No. 10761, 1989 WL 40845, at *6. (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." RONALD J. COLOMBO, LAW OF CORPORATE OFFICERS & DIRECTORS: RIGHTS, DUTIES & LIABILITIES § 6:13 (2022).

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 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 Article 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.[342]

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.

342. 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.