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Major Issues in REIT Preferred Stock Terms

From 2001 through 2007, real estate investment trusts ("REITs") conducted a total of 272 public offerings of preferred stock, an average of nearly 39 per year. In 2008, the number dropped to nine and, in 2009, not even a single REIT issued preferred stock in a public offering.

However, during the last year and a half, preferred stock offerings by REITs have been making a comeback. In 2010, there were 17 and, thus far in 2011, there have been more than 20. How the current market turmoil will affect these offerings for the remainder of the year is unclear.

In the past, the principal issues involving the terms of REIT preferred stock have primarily involved dividend and voting rights. More recently, the focus has shifted to privatization and change-of-control protections. Based on our experience in many preferred stock offerings and a recent survey of REIT preferred stock terms, we would like to call your attention to some of these issues.

Restrictions on Distributions on Other Stock When Preferred Stock Dividends Are in Arrears. Typically, preferred stock terms restrict distributions – including dividends, redemptions and repurchases – on both junior and parity stock when dividends on the preferred stock are in arrears.

It was once common for REITs to undertake (in the preferred stock terms in the charter) not to pay a common stock dividend on a different day than the preferred stock dividend for the same period without simultaneously paying (or setting apart for payment) a stub dividend on the preferred stock in an amount equal to the dividends accrued on the preferred since the last preferred dividend payment date (*i.e.*, common stock dividends were prohibited unless preferred stock dividends for both past full periods and the then current partial period were also paid or set apart for payment). Failure to pay (or set apart for payment) the stub dividend on the preferred could result in the common stock dividend being deemed preferential by the Internal Revenue Service, thus threatening REIT qualification. The same issue arises when REITs with the "current period" provision issue multiple classes or series of parity preferred stock, each with different dividend payment dates. The recent trend, however, has been to not include the "current period" formulation in the terms of preferred stock in order to avoid a preferential dividend claim if the REIT elects to pay a common stock dividend on a different day than the preferred stock dividend for the same period but inadvertently fails to pay (or set apart for payment) a concurrent stub dividend on the preferred. Most preferred stock investors recognize that they will also be harmed if an issuer fails to qualify as a REIT and conclude that any benefit that they derive from receiving the stub dividend is outweighed by the risk of an inadvertent violation of the requirement that it be paid (or set apart for payment) before paying the common stock dividend.

Even today, however, it remains common for the terms of a class or series of preferred stock to prohibit all cash repurchases or redemptions of parity or junior stock when *dividends* on such class or series are in arrears. This restriction prevents REITs with multiple classes or series of parity preferred stock on which *dividends* have not been paid from repurchasing or redeeming shares for cash in a tender offer made on the same terms to all holders of all classes or series of the parity preferred stock. This may not be the best result for investors whose dividends are in arrears and who would therefore be prevented from benefiting from a redemption or repurchase. It is also inconsistent with the ability of most REITs with just a single class or series of preferred stock outstanding (and regardless of whether dividends have been paid) to repurchase shares of that class or series for cash in a tender offer made on the same terms to all holders. For example, if a REIT is delinquent in the payment of *dividends* on two outstanding series of parity preferred stock (even if the terms of each series permit cash redemptions or repurchases in a tender offer made on the same terms to all holders), cash redemptions or repurchases would nevertheless be prohibited as a result of the restrictive *dividend* provisions in the other series.

<u>Treatment of Liquidation Preferences as Liabilities</u>. Under Maryland law, a liquidation preference is generally treated as a liability in determining balance-sheet solvency as a pre-condition to making a distribution (whether by dividend or by redeeming or repurchasing shares). However, the Maryland statute permits the terms of preferred stock, as contained in the charter, to provide otherwise. Although the treatment of liquidation preferences as liabilities would appear to benefit preferred stockholders as it limits, dollar for dollar, an issuer's ability to make distributions on junior stock, it is more common than not to include the opt-out in the terms of REIT preferred stock, thus increasing the amount of assets available for distribution to junior stockholders. This is because preferred stock investors often agree to the opt-out because they realize that not opting out makes it more difficult for the REIT to raise junior equity.

<u>Source of Redemption Funds</u>. It was commonplace a decade ago to require that preferred stock be redeemed only out of the proceeds from the sale of other equity but this requirement has deservedly become obsolete in recent years.

<u>Call Protections</u>. The terms of most preferred stock prohibit redemptions (other than redemptions necessary to maintain REIT status) for five years after issuance and thereafter permit redemption of some or all of the preferred stock at liquidation preference plus accrued but unpaid dividends. Some investors have pushed for longer call protection periods and redemption price step-ups in the years immediately following the expiration of the call protection period but these provisions are, in our experience, rare.

<u>Restrictions on Redemptions, Purchases or Other Acquisitions of Preferred Stock When Dividends Are in Arrears</u>. Most preferred stock terms prohibit both the REIT and subsidiaries of the REIT from redeeming, purchasing or otherwise acquiring shares of a class or series of preferred stock for cash when dividends on that class or series are in arrears. As discussed above, there may be an exception for the purchase or acquisition of shares based on an offer made on the same terms to all holders but, if the REIT has more than one class or series of preferred stock outstanding, restrictions contained in the terms of another class or series may prevent such purchases or acquisitions.

<u>Right to Elect Directors Upon Dividend Default</u>. It is customary for the terms of preferred stock to provide preferred stockholders with the right to call a special meeting to elect additional directors when dividends on the preferred stock are in default for six or more quarterly periods, with such right (and the term of the preferred stock directors) automatically expiring when the dividend arrearage is cured.

Ten percent of the votes entitled to be cast is usually the percentage necessary to call the special meeting but many preferred stock terms require the calling of a special meeting upon the request of any holder. A few require requests by holders entitled to cast as much as 20% of all the votes entitled to be cast. The quorum requirement is normally a majority of the votes entitled to be cast but sometimes it is only one-third of the votes entitled to be cast. The vote required for election of directors also varies, with some preferred stock terms requiring a plurality of the votes cast and others requiring a majority of the votes cast or something else (*e.g.*, a majority of shares present).

Many preferred stock terms require the preferred stock director election to be held in conjunction with the annual meeting of the common stockholders if the special meeting request is received within a certain number of days (usually 90 or 120) before the date fixed for the annual meeting. However, somewhat surprisingly, the terms of the preferred stock often do not address whether a special meeting is automatically called if the REIT fails to comply with a valid request received from the preferred stockholders. Our view is that there is no right to call a special meeting and elect directors unless specifically so provided in the terms.

It has also been common to leave other issues unresolved relating to preferred director elections (*e.g.,* the record date for preferred stockholders entitled to notice of and to vote at the meeting, the applicability of advance notice bylaws, the qualifications for nomination or election as a director, the payment of costs of the special meeting and the solicitation of proxies for the special meeting). Given the recent experiences of several REITs in connection with special meetings of their preferred stockholders, we believe it is advisable to address these issues in the preferred stock terms.

Even if not addressed in the preferred stock terms, under Maryland law the duties of all directors of a Maryland corporation are the same, without regard to whether directors are elected by the holders of all classes of stock or by the holders of only one class of stock.

Right to Vote on Extraordinary Actions. The terms of most preferred stock provide preferred stockholders with the right to vote on charter amendments (or at least amendments to the preferred stock terms) that materially and adversely affect either the preferred stock or the preferred stockholders. (Our preference is the former.) Typically, this right extends to charter amendments by merger, consolidation or otherwise but is not a right to a direct vote on mergers, consolidations or similar transactions.

Questions often arise as to what constitutes a material and adverse effect. Most preferred stock terms explicitly say that leaving the preferred stock outstanding after a merger, with the terms materially unchanged or converting the preferred stock into a substantially identical security of the survivor (even if it is a different entity) does not constitute a material and adverse effect. Some further provide that the survivor may be a different form of entity (*e.g.*, a trust REIT or LLC instead of a corporation). The terms of most preferred stock are silent as to whether cashing out the preferred stock constitutes a material and adverse effect, although a few explicitly say that a cash-out is not material and adverse so long as the consideration received per share is at least equal to the greater of the current trading price or liquidation preference. For more information in this regard, see James J. Hanks, Jr. and Christopher W. Pate, "Preferred Stock Voting Rights," *Insights* (Sept. 2004).

Privatization/Change-of-Control Protections. Since the second half of 2010, most preferred stock terms have included certain protections in the event of a change of control as a result of which the common securities of the acquiring or surviving entity are not listed on a national securities exchange or quoted on an automated quotation system.

One such protection is the right to convert each share of preferred stock into a number of shares of common stock (unless, prior to conversion, the preferred stock is redeemed by the REIT pursuant to a change-of-control redemption right) obtained by dividing the liquidation preference plus accrued but unpaid dividends per share of preferred stock by the amount of cash consideration per share of common stock to be received by the common stockholders in the change of control (or, if the consideration to be received by the common stockholders does not consist solely of cash, by the average of the closing trading prices per share of common stock in the ten days prior to the change of control). Generally, the total number of shares of common stock issuable upon conversion of the preferred stock is capped at a number equal to the aggregate liquidation preference of the preferred stock divided by either 50% or 70% of the closing trading price of the common stock at the time of the preferred stock offering.

Another change-of-control protection is the right to continue receiving, after the transaction, information that would have been required to be filed with the Securities and Exchange Commission pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

A less common protection is a step-up in dividends on the preferred stock (up to a four percent increase in a couple instances) upon a change of control of the REIT or a delisting or deregistration of the REIT's common stock.

Under Maryland law, as in Delaware and other states, preferred stock rights are contractual and will be governed by the express terms of the charter. Stockholder claims as to rights that are not firmly grounded in the preferred stock terms, as provided in the charter, will be rejected. Thus, careful drafting, including awareness of applicable law and current practice, is critical.

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As always, we and our colleagues are available at any time to discuss these or other matters.

Jim Hanks
Chris Pate

This memorandum is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations for which Venable LLP has accepted an engagement as counsel.