

**REIT TAKEOVERS AND GOVERNANCE:  
HIGHLIGHTS FROM THE TENDER OFFER FOR TAUBMAN CENTERS**

The legislatively imposed resolution of the tender offer by Simon Property Group, Inc. and Westfield America, Inc. for Taubman Centers, Inc. has left unresolved a number of significant governance and takeover issues for Real Estate Investment Trusts and their investors and potential suitors. If these issues are not adequately and correctly addressed by the REIT community, there is a danger that the investment community will avoid or discount the REIT sector, notwithstanding potential investment opportunities posed by REITs.

- REIT Boards of Directors must not lose sight of their primary fiduciary responsibility — the protection of shareholders as a group. The REIT Board of Directors cannot allow relationships to particular constituencies to overshadow that fiduciary duty. In particular, in an UPREIT structure, directors who have a relationship with (or feel they have obligations to) the REIT’s founders or Operating Partnership unitholders must recognize and consider appropriate means of addressing potential conflicts of interest.
- Public shareholders of a REIT should understand whether they have the power to influence their fiduciaries — the REIT’s Board of Directors — or whether special rights have been accorded to other constituencies (such as founders or Operating Partnership unitholders) who may not owe any fiduciary obligations to the public shareholders. The extent of this “shareholder power” should be one element in a shareholder’s investment decision. Importantly, removal of this shareholder power without full and fair disclosure and shareholder approval should never be acceptable.
- In addition to the Board conflict of interest and “shareholder power” issues noted above, certain REIT-specific structural characteristics (such as “Excess Share” provisions) provide ample opportunity for obstructing takeover attempts. In considering takeover-related issues, REITs, REIT investors and potential REIT suitors must evaluate these REIT-specific structural characteristics together with all non-REIT-specific antitakeover protections.

*The Role of the REIT Board of Directors*

The Taubman takeover bid demonstrated that the interests of public REIT shareholders are not always served by the REIT/UPREIT structure. The UPREIT structure was originally adopted by REITs to allow company founders to access the public capital markets while avoiding adverse tax consequences. In a non-takeover context, the existence of the UPREIT structure ordinarily

should not interfere with the ability of a REIT's Board of Directors to serve the interests of all of its constituencies, including its primary constituency — the REIT's public shareholders. However, a REIT takeover bid can give rise to unique conflicts of interest between the REIT's public shareholders and holders of the Operating Partnership units. These conflicts of interest can pose special difficulties for the suitor and public shareholders in cases where a number of the Board's directors are also unitholders of the REIT's Operating Partnership (or are beholden to those unitholders).

The dilemma for REIT Board members in this situation will be addressing the conflicting interests of public shareholders, who may wish to accept a premium takeover bid, and the interests of holders of the REIT's Operating Partnership units, who may have little or no economic interest in the public company and may have tax or legacy reasons for opposing the takeover. Although the REIT's Board of Directors, in its capacity as general partner of the Operating Partnership, may have legitimate concerns about a fiduciary duty owed to the Operating Partnership unitholders by the REIT, the Board also must ensure that the personal interests of the REIT Board members do not prevent the REIT's Board from acting in the interest of the public shareholders. That obligation generally can be fulfilled only if the directors making the decision are truly independent of the founders, Operating Partnership unitholders and other influential constituencies, and are assisted by outside counsel and investment bankers independent of any conflicted constituency. This test for independence should be administered rigorously and should include an analysis not only of whether any material financial ties exist but also of whether there are any other non-economic motivations that would generate an unacceptable risk of bias.<sup>1</sup>

A REIT's Board of Directors should address conflicts of interest faced by individual Board members by appointing an active and truly independent special committee to consider matters relating to a tender offer or other transaction creating the conflict of interest. REIT Boards that are dominated or unduly influenced by Operating Partnership unitholders, however, may seek to avoid appointing an independent special committee. Thus, despite the tender of approximately 85% of Taubman Centers' common stock into the Simon Property/Westfield tender offer as of February 14<sup>th</sup>, 2003, no independent special committee with independent advisors contacted Simon Property and Westfield America. REIT Boards facing such conflicts of interest should bear in mind that the merits of the Taubman Centers Board's approach to addressing the conflict of interest were not adjudicated.

#### *Rights of REIT Shareholders vs. Other Constituencies*

Another issue highlighted by the Taubman tender offer is that REIT public shareholders (and potential suitors) must understand whether they have the power to effectively influence their fiduciaries - the REIT's Board of Directors - or whether such influence can be blocked through

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<sup>1</sup> See, e.g., In re Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

the exercise of special rights accorded to other constituencies (such as founders or holders of Operating Partnership units). Because the public shareholders' power (or lack thereof) is a significant element in a shareholder's investment decision, it is especially important that full and fair disclosure and appropriate shareholder approval rights accompany any actions by the REIT or its Board that adversely affect or limit that power. Although recent attention on corporate governance failures may have heightened scrutiny on Board actions that affect shareholder rights, shareholders must continue to pay special attention (including in a non-takeover context) to the possibility that REIT Boards might face pressure to advance the rights of other constituencies (such as founders or Operating Partnership unitholders) at the expense of the shareholders.

The significance of such special rights was demonstrated in the Taubman Centers tender offer, where the Taubman family used a one-third voting position in the REIT to thwart proposed changes to the charter's Excess Share provision. The Excess Share provision prevented acquisitions of more than specified percentages of the REIT's equity interests. The proposed changes would have allowed the tender offer to proceed, but required approval by a two-thirds shareholder vote. Interestingly, the Taubman family's one-third voting interest had been obtained in a 1998 issuance of a new class of Series B voting preferred stock, made to the Taubman family and other unitholders for nominal consideration without shareholder approval and with only minimal disclosure *after* the issuance. Prior to this issuance, the Taubman family had no significant voting or economic interest in Taubman Centers, the publicly-owned REIT. After Taubman Centers' initial public offering, the Taubman family had held most of its interests at the partnership level, which allowed retention of valuable property-level control rights and tax benefits. The Series B Preferred Stock issued in the 1998 transaction thus gave the Taubman family a 30% voting interest in Taubman Centers, which at that time was a public company with public shareholders, even though the Taubman family continued to hold only a *de minimis* 1% economic interest in Taubman Centers. Through the issuance of the Series B Preferred Stock, the Taubman family was able to effectively eliminate the ability of Taubman Centers' public shareholders to amend the company's charter without the family's consent.

#### *Implications of Unique REIT Organizational and Corporate Governance Issues*

In addition to the Board governance and "shareholder power" issues noted above, other governance and structural issues unique to REITs are likely to emerge during the pendency of a takeover bid and should be evaluated in conjunction with all of the target's other, non-REIT-specific antitakeover protections. REITs, potential investors in REITs and potential suitors of REITs alike should carefully review whether a REIT has previously taken actions, or is considering taking actions, that shield the REIT from unsolicited takeover bids through manipulation of governance structures in ways unrelated to their original purposes. When a REIT conducts such a review of its own structures, a truly independent special committee of the Board should be involved.

In the bid for Taubman Centers, management and the Taubman family helped defend against consummation of a tender offer by relying on the Excess Share provision in the company's

corporate charter. Excess Share provisions were originally intended to protect REITs against unsolicited transactions that could potentially threaten their tax status. However, since the Taubman Centers bidders were both REITs themselves, the tax justification for the Excess Share provision did not exist. Instead, the Taubman Centers Board used the Excess Share provision as a shield against the interests of the REIT's public shareholders by stating that the combination of the Taubman family's control of one-third of the company's voting securities from the controversial 1998 issuance and the two-thirds approval requirement for charter amendments rendered the Board powerless to help effectuate the tender offer. REIT Boards considering potential takeover defenses based on Excess Share provisions or other mechanisms used for purposes outside of their original intent should bear in mind that the merits of the Taubman Centers Board's reliance on the Excess Share provision as a takeover defense were not adjudicated.

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Ultimately, the Taubman Centers bid highlights some important issues for REITs generally. Notwithstanding the consistent and overwhelming support of the Taubman Centers' public shareholders for the tender offer, the takeover bid was thwarted through a combination of local influence, key veto rights granted to the Taubman family without the informed consent and approval of other shareholders, a Board heavily influenced by the Taubman family and manipulation of REIT governance structures such as the Excess Share provision. On the other hand, since REITs currently are providing attractive returns for investors, investors have not shied away from the industry as a whole. However, if REITs become less attractive economically, the issues that arise from the REIT/UPREIT structure may play a role in investors' future investment decisions. For potential suitors of REITs, these issues raise both opportunities and concerns. For REITs themselves, Boards should consider evaluating structural issues earlier rather than later to deflect recent criticisms by REIT industry analysts. For example, in an August 13, 2003 review of the corporate governance of 68 REITs, Green Street Advisors, an independent REIT industry expert, recognized that the Taubman family's effective veto power over Taubman Centers' corporate governance is both unusual and injurious to public shareholders. In part for these reasons, Green Street ranked Taubman Centers as having the worst corporate governance in the REIT industry. The review rated REITs based on factors relating to their Boards of Directors, anti-takeover provisions and conflicts of interest. Indeed, the report noted that the corporate governance of many REITs generally can and should be improved.

If you have any questions concerning this memorandum, please call or email Steven A. Seidman (212-728-8763, [sseidman@willkie.com](mailto:sseidman@willkie.com)) or the partner who regularly works with you.

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December 2, 2003

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