

Considerations for REITs in Adopting a Poison Pill in Response to the COVID-19 Crisis

REIT management and boards of directors should review their defensive profile and consider whether to prepare a rights plan.

Key Points:

- Unprecedented market volatility and investor uncertainty due to the coronavirus pandemic provide an opportunity for activist investors and hostile acquirers to seek to exploit recent macroeconomic conditions and gain control without paying stockholders a full control premium.
- REITs experiencing significant declines in stock prices and valuations should review the benefits and limitations of their structural defenses and early warning systems, including any REIT ownership limit.
- Taking into account their specific circumstances, REITs should consider preparing and potentially implementing a stockholder rights plan (a so-called “poison pill”) to protect against unattributed significant stock accumulations, activist approaches, and unsolicited bidder interest.

This *Client Alert* examines some of the key considerations that real estate investment trusts (REITs) and their boards should account for when considering a stockholder rights plan as a defensive measure in response to the impact of COVID-19. While this *Client Alert* outlines REIT-specific considerations, REITs should be mindful of other factors to consider when deciding whether to prepare or adopt a rights plan in the current environment, including the nature and underlying conditions of any perceived threats to the REIT, whether the rights plan is structured appropriately in response to those perceived threats, and investor and proxy advisor reactions. For further discussion on these topics, see Latham’s *Client Alert Proactively Adopting a Poison Pill in Response to the COVID-19 Crisis*.

The Impact of COVID-19 on REIT Vulnerability

Over the last 10 weeks, many REITs have experienced sharp declines in stock prices due to unprecedented market volatility and investor uncertainty in connection with the coronavirus pandemic (COVID-19). Notwithstanding conventional wisdom, REITs are similar to other public companies in that they too are susceptible and vulnerable to coercive or abusive tactics from activist investors and hostile acquirers seeking to exploit recent macroeconomic conditions and gain control without paying stockholders a full control premium. As REITs and their boards continue to grapple with the immediate

and long-term implications of COVID-19, they should consider whether to prepare defensive measures so they are equipped to proactively combat shareholder activism and hostile takeover activity.

Indeed, three REITs, American Finance Trust, Inc., Global Net Lease, Inc., and Whitestone REIT, have recently adopted rights plans in response to significant drops in stock price in connection with the COVID-19 crisis, while other REITs have put rights plans “on the shelf.” In each of these adoptions, the REIT board set the trigger threshold for the rights plan at 5% or lower, which is less than the customary non-REIT rights plan trigger threshold of 10% to 20%. While this provides additional defensive protection for these companies, the lower trigger threshold may increase the concerns of proxy advisory firms and institutional investors as discussed below.

Considerations for REITs in Adopting a Rights Plan

In order to qualify as a REIT, among other requirements, not more than 50% of the value of the company’s shares may be beneficially owned by five or fewer individuals during the last half of each taxable year. To comply with this and certain other requirements for qualification as a REIT for tax purposes, REITs have generally adopted ownership limits in their charters that prohibit stockholders from owning more than a specified percentage of shares (generally 9.8%) without obtaining a board waiver. The ownership or transfer of shares in violation of the applicable ownership limits will be subject to remedies set forth in the charter and, under certain circumstances, the transfer will be void (collectively, REIT Ownership Limits).

In some cases, REIT Ownership Limits apply with respect to actual and beneficial ownership by a person for tax purposes only. In other cases, REIT Ownership Limits will apply more broadly, including to a “group” as that term is used for purposes of Section 13(d)(3) of the Securities Exchange Act of 1934, as amended.

Restrictions on REIT Ownership Limits as a Takeover Defense

Even though REIT Ownership Limits may limit stock accumulations in many circumstances, boards should consider the effectiveness of such provisions with respect to defending against unattributed significant stock accumulations, activist approaches, and unsolicited bidder interest. In particular:

- REIT Ownership Limits may not deter all activist investors and hostile acquirers, since REIT provisions in charters generally authorize (and, in some cases, require) the board to provide a stockholder with an excepted holder limit (prospectively *or* retroactively), which permits the holder to own in excess of the applicable ownership limit, provided the board determines in its sole discretion that the proposed investment would not jeopardize the REIT’s tax status.
- REIT Ownership Limits remain largely untested in takeover litigation as anti-takeover measures, and, as a result, it remains uncertain whether courts will permit the use by REIT boards of REIT Ownership Limits as defensive mechanisms, particularly in circumstances in which stock accumulation by an activist investor or hostile acquirer would not jeopardize the REIT’s tax status.
- Unlike traditional rights plans, which focus on beneficial ownership for securities law purposes, REIT Ownership Limits of some REITs limit beneficial ownership of REIT stock for tax purposes only, and those REIT Ownership Limits may not prevent a stockholder from acquiring and exercising voting control over shares in excess of the REIT Ownership Limit in a manner that does not implicate the tax status of the REIT.

- In addition, unlike a traditional rights plan, where exceeding an ownership threshold results in significant dilution of the entire stake of the triggering stockholder, REIT Ownership Limits generally provide that the ownership or transfer of shares in violation of the applicable ownership limits would only result in such excess shares being forfeited and transferred to a charitable trust or, in some cases, the transfer being void, resulting in less economic impact to the stockholder violating the REIT Ownership Limit.

While REIT Ownership Limits provide REITs with an additional defense that is not available to the typical public company, REITs impacted by significant stock price declines should proactively consider whether a rights plan provides a more meaningful deterrent to protect against abusive takeover or control tactics by activist investors and hostile acquirers. Adoption of a rights plan has been consistently upheld in Delaware as a reasonable response to threats of abusive takeover or control tactics, even if no current takeover proposal is pending, and has been specifically validated by several state legislatures (including Maryland).

Putting a Rights Plan “On the Shelf” for Future Adoption

Putting a rights plan “on the shelf” refers to preparing the necessary documentation, educating board members on the purpose and function of a rights plan, reviewing board members’ fiduciary duties in the context of the adoption of a rights plan, and consulting advisors on the next steps in the process (but stopping short of adopting the plan). While rights plans can be unilaterally and swiftly adopted by the board without stockholder approval, quick implementation in response to rapid accumulations or other emerging threats is best facilitated, and the legal record in any subsequent litigation enhanced, by thoughtful board review in advance of adoption as to the purposes, benefits, and mechanics of a rights plan.

In the current environment, the ability of the board to act quickly in response to rapid changes in market conditions becomes even more important. Accordingly, REIT boards should consider putting a rights plan on the shelf in advance of any activist or takeover threat so that, if a threat does develop, the board is able to rapidly deploy the rights plan and provide time for the board to evaluate the identified threat and review and develop alternatives, and for stockholders to be informed of and evaluate those alternatives. REITs that already have a rights plan on the shelf should consider whether the materials should be updated and reviewed with the board. In connection with reviewing a rights plan currently on the shelf or putting a plan on the shelf for future adoption, REIT boards should also undertake a comprehensive review of the early-warning mechanisms and activism and takeover response plans and of teams they have in place in order to ensure they can respond effectively to rapidly changing conditions.

To that end, REIT Ownership Limits, and particularly those that cover beneficial ownership for securities law purposes, may serve as effective early-warning systems that enable the quick implementation of a rights plan on the shelf. Stock accumulations are capped by the REIT Ownership Limit until a waiver is granted by the board, at which time the board can swiftly adopt the rights plan on the shelf to constrain further accumulations above the higher trigger threshold (10%-20%) set forth in the rights plan.

Proxy Advisory Firm and Investor Reactions to Adoption of a Rights Plan

REITs adopting a rights plan should consider the customary concerns of proxy advisory firms, governance advisory groups, and leading institutional investors, whose policies traditionally disfavor proactive adoption of rights plans. Since their inception, rights plans have been targeted by proxy advisory firms, particularly Institutional Shareholder Services (ISS), as devices that entrench boards and prevent stockholders from exercising the right to make their own decision with respect to takeover proposals and to sell their shares.

On April 8, 2020, the ISS Benchmark Research Team, which issues recommendations for stockholder meetings, reiterated ISS' existing policy of considering on a case-by-case basis a rights plan adopted with a term of one year or less without stockholder approval, taking into account the board's rationale for the adoption and other relevant factors (such as a commitment to put any future renewal of the rights plan to a stockholder vote). ISS further indicated that a "severe stock price decline as a result of the COVID-19 pandemic is likely to be considered valid justification in most cases for adopting a pill of less than one year in duration," but cautioned that it would continue recommending "against" or "withhold" votes with respect to lead directors or entire boards at the next annual meeting if ISS determines that a rights plan does not comply with its benchmark policy. Although large institutional investors, such as BlackRock, have not issued similar guidance as ISS, recommendations made with respect to director elections in 2020 following rights plan adoptions suggest that these institutional investors are aligned with the spirit of ISS policy concerning rights plan adoptions.

However, ISS and institutional investors have yet to weigh in on the three REIT rights plan adoptions mentioned above, and will likely not do so until each REIT's next annual meeting in 2021, respectively. Considering ISS' recent voting recommendations and investor reactions, we expect that the historically low 5% or less trigger threshold in each of the three rights plans may increase the concerns of ISS and other proxy advisory firms and may result in ISS recommending and investors making "against" or "withhold" votes with respect to certain directors or entire boards at the next annual meeting.

As a consequence, REITs adopting rights plans with a limited duration (one year or less) should focus on articulating the board's rationale for adopting the rights plan and tailoring the rights plan to cover the specific and identifiable threats to the company without being overly expansive with respect to duration, trigger thresholds, and other terms. REIT boards should provide clear and detailed disclosures to stockholders showing how the company's governance structure and current takeover defense measures are insufficient to protect stockholder value from the specific threats leading to the adoption of the rights plan.

Conclusion

As market volatility and investor uncertainty have increased amid the ongoing pandemic, hostile takeovers and aggressive shareholder activism may follow. In light of this current environment, management and boards of directors of REITs with depressed stock prices should consider the protection a rights plan offers against exploitive tactics by activist investors and hostile acquirers beyond the protection offered by the REIT Ownership Limits. As noted above, REITs should prepare for such activist intervention by reviewing their existing REIT Ownership Limits and other takeover defenses and consider putting or refreshing a rights plan on the shelf for future adoption. REITs should take into account their specific circumstances when doing so, while carefully considering the issues discussed in this *Client Alert*.

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