GOODWIN

REIT ALERT

GOODWIN INSIGHTS

2019 Update: Corporate Governance Trends in the Public REIT Sector

In April 2017 we released our Alert Corporate Governance Trends in the Public REIT Sector: An Evolving Landscape, which measured and reported on an array of corporate governance metrics currently in use, under consideration and/or being monitored in the public REIT market today. We noted that while the public REIT sector compared favorably to the larger market in key governance areas (e.g., classified boards, shareholder rights plans), there were also areas where the MSCI US REIT Index (RMZ) as a whole diverged from larger-cap indices (e.g., the ability of many Maryland REITs to unilaterally classify their boards under the Maryland Unsolicited Takeover Act (MUTA)).

As we head into the 2019 proxy and annual meeting season, corporate governance for public REITs continues to be front and center. In recent years, a large number of REITs have adopted an array of important governance enhancements – in part by doing what is asked of them by shareholders, but also by embracing the business case for improved governance – and we expect that this practice will continue in the years to come, as in corporate America generally.

We emphasized in our Alert — as we do now — that in our view, corporate governance is not a "one-size-fits-all" proposition. We do not recommend any particular set or subset of governance positions as a blunt instrument approach for all public REITs. Rather we recommend that the board of each public REIT regularly evaluate the company's corporate governance profile in light of all relevant facts and circumstances to determine whether it provides the board, in its business judgment, with the tools and flexibility to fulfill its overarching duty to maximize shareholder value over the long term.

To provide context to REIT boards when undertaking this evaluation anew in 2019, in the table below we have provided updates on select metrics originally included in our 2017 Alert. We have reviewed data on these metrics as of January 2019. Percentages of the 152 REITs in the RMZ are listed below.

	April 2017	January 2019
Has a Classified Board	17%	17%
Separate CEO and Chairman Roles	55%	59%
Percentage of all REIT Board Members that are Women	13%	19%
Majority Voting or "Plurality Plus" Standard	76%	82%
Current Shareholder Rights Plan	7%	6%
Proxy Access (any formulation)	19%	32%
Shareholder Right to Amend Bylaws (any formulation)	47%	69%
Opt Out of MUTA (or non-Maryland)	42%	48%
Exclusive Forum Provision (any formulation)	36%	41%
Dual Class Voting Structure	5%	5%

CURRENT GOVERNANCE HIGHLIGHTS

- *Board Gender Diversity.* Diversity in the boardroom rightfully continues to be a focus across industries and sectors, including among public REITs. As of January 2019, approximately 19% of all directorships across RMZ-constituent companies were held by women, up from approximately 13% in 2017. Moreover, just over one-half of all new directors elected by REITs in 2018 were women.[1] Out of 152 current members of the RMZ, over 92% have at least one woman on their boards and 49% have two or more women directors. Gender diversity percentages were largely consistent in the 19% range across the various REIT subsectors, ranging from 22% in the healthcare sector to 14% in the industrial sector.

  2018 also saw significant shareholder activity relating to gender diversity on boards, as influential investors, such as BlackRock, State Street Global Advisors, CalSTRS and CalPERS have incorporated board diversity into their voting policies, and shareholders have shown a willingness to vote against boards that do not show a commitment to gender diversity. California has adopted legislation mandating quotas for women on the boards of publicly traded companies headquartered in the state. New Jersey has introduced legislation similar to California, and Colorado, Illinois, Massachusetts and Pennsylvania have adopted non-binding resolutions that encourage board diversity for companies doing business in the state.

- *Environmental and Social ("E&S") Criteria.* Institutional investors are increasingly committed to "high-performance sustainable real estate" and are evaluating management through E&S metrics. With a collective portfolio of over 500,000 properties in the United States, representing trillions of dollars in gross real estate assets, the REIT industry accounts for a significant environmental footprint. We expect that a sophisticated approach to E&S practices will increasingly be critical for REITs in attracting and retaining capital resources. REITs are being scored on energy efficiency, carbon footprint reduction and conservation policies, as well as employee engagement, community involvement and corporate ethics, among others. ISS, specifically, scores companies on E&S criteria by measuring and identifying risk in environmental and social areas of concern based on its analysis of company disclosure.[2] We expect 2019 E&S disclosures by public REITs to continue to be more robust and to provide useful insights into how REITs implement and communicate their commitment to integrating E&S practices into their business strategies.

- *Majority Voting and/or Director Resignation Policy.* Majority voting in uncontested elections continues to be a mainstay of REIT corporate governance, with over 80% of public REITs now having adopted either a majority voting standard or a director resignation policy (sometimes known as "plurality plus"). This prevents the election and/or calls for the resignation of directors in cases where a majority of votes cast have been cast AGAINST or WITHHELD from the nominee's election.

- *Proxy Access (any formulation).* Proxy access refers to bylaw provisions that enable shareholders to use the company's own proxy materials to nominate up to a specified number of director nominees. The number of REITs that have adopted a version of proxy access jumped significantly over the past 18 months, from 19% to 32%. More recently, among REITs and more broadly momentum has slowed as many of the larger companies that are most often the target of shareholder proposals have now adopted proxy access and the attention of institutional investors has shifted to other governance metrics at the moment, such as board refreshment, gender diversity and E&S criteria.

- *Shareholders' Ability to Amend Bylaws.* Over the last two annual meeting seasons, ISS has focused on the ability of shareholders to directly and unilaterally amend a company's bylaws. In response, a number of REITs have responded by adopting changes to their organizational documents that give shareholders this right. While most REITs permit shareholders bylaw amendment rights subject only to the same criteria necessary to submit other shareholder

[1] See FPL Associates, 2018 REIT Board Composition & Diversity Trends, which also notes that only 32% of all new directors elected in 2018 across the broader Russell 3000 index companies were women. www.fpl-global.com/wp-content/uploads/2018/06/2018-REIT-Board-Composition_Diversity-Trends-FINAL.pdf.

[2] See also Question 116.11 and Question 133.13 added on February 6, 2019 by the Staff of the Securities and Exchange Commission to its Compliance and Disclosure Interpretations (relating to proxy statement disclosure of self-identified diversity characteristics of directors and nominees such as race, gender, ethnicity, religion, disability and sexual orientation. www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm.

proposals (i.e., a shareholder must have held at least $2,000 worth of stock for at least one year), a significant minority, approximately 25%, believe that the gravitas of a binding bylaw amendment to the company as a whole warrants some minimal additional safeguards. These REITs have conditioned the right of shareholders to amend the bylaws on the proposal being received from a shareholder, or group of up to x shareholders, who must have continuously owned at least y% of the outstanding common shares for at least z years (with the most common formulation currently being 1-1-5).[3] Additional safeguards by some REITs have included limited "ringfencing" to protect the board from being divested of its power to amend the bylaws and/or to safeguard director and officer indemnification provisions, and in a minority of cases, requiring a super-majority of the outstanding to approve a shareholder-proposed amendment.[4]

- *Classified Board.* One of the most potent anti-takeover devices, directors on a classified board are typically divided into three classes, only one of which is elected each year. This means that even a super-majority of shareholders cannot replace a majority of the board in a single election season. The number of publicly-traded REITs employing this defensive structure has remained relatively constant in recent years, a distinct minority at 26 (or 17%), as compared to well over 40% among Russell 2000 companies.[5] We note that none of the 26 REITs in the RMZ that currently have a classified board have adopted this structure through a unilateral election to be subject to MUTA (see below). In the vast majority of cases, these boards have been classified from the time the companies first went public.

- *Opt Out of MUTA.* The Maryland Unsolicited Takeover Act ("MUTA"), among other things, permits public REITs incorporated in Maryland, notwithstanding any contrary provision in their charter or bylaws, to unilaterally elect to classify their board.[6] When including non-Maryland REITs, the number of REITs overall who currently do not have the ability to unilaterally classify their boards is approaching half, at 48%. Solely among Maryland REITs, which comprise 79% of all REITs in the RMZ, 34% to date have affirmatively opted out of MUTA.

- *Exclusive Forum Provision.* A significant minority of REITs, now over 40%, have adopted bylaw provisions that require shareholder derivative and similar law suits to be brought in a specific forum, typically the jurisdiction of incorporation. The intent behind these provisions is to ensure that any such litigation be handled as efficiently as possible.[7]

- *Shareholder Rights Plan.* Shareholder rights plan (or "poison pills") continue to be rare among public REITs, with usage even falling slightly since 2017. As we have discussed in detail elsewhere,[8] the organizational documents of almost all REITs already include a mechanism pursuant to which a shareholder whose actual and/or constructive share ownership surpasses stated ownership limits will have its shares automatically transferred to a trust and resold into the public market.

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[3] We note that ISS nevertheless continues to recommend AGAINST/WITHOLD votes from the members of the nominating and corporate governance committees of REITs that have added any additional safeguards. We note that in 2018, all of these nominees were comfortably re-elected nonetheless.

[4] Many non-Maryland REITs, such as those incorporated in Delaware, have long had supermajority requirements with respect to shareholder-proposed bylaw amendments. For reasons unclear to us, ISS' recent policy has been to recommended against directors of Maryland REITs that have newly-adopted a shareholder right to amend the bylaws subject to a supermajority voting requirement but not to recommend against directors of non-Maryland REITs that have the same supermajority voting requirement.

[5] Source for Russell 2000: SharkRepellent.net.

[6] In addition, MUTA permits public REITs incorporated in Maryland, notwithstanding any contrary provision in their charter or bylaws, to (i) require a two-thirds super-majority vote requirement for removing a director; (ii) require that the number of directors be fixed only by vote of the directors; (iii) require that a vacancy on the board be filled only by the remaining directors; and (iv) require that no less than a majority of shareholders may call a special meeting of shareholders. Most REITs organized in Maryland have opted out of the "business combination" and "control share acquisition" provisions of the Maryland General Corporation Law, the state's other two primary anti-takeover statutes.

[7] We note that a recent Court of Chancery decision in Delaware (Sciabacucchi v. Salzberg, C.A. No. 2017-0931-JTL (December 19, 2018) declared that provisions in certificates of incorporation of Delaware companies that purport to require claims under the Securities Act of 1933, as amended, to be brought in federal court are ineffective and invalid under Delaware law. The defendants in this case have appealed the Chancery Court's decision to the Delaware Supreme Court. See our Alert *"Court of Chancery Declares Federal Forum Provisions Invalid"*, December 20, 2019.

[8] See our REIT Alert *"Waivers of Ownership Limitation Provisions in REIT Charters"*, June 8, 2016.

- *Dual Class Voting Structure.* A small number of REITs (5%) continue to maintain a dual-class voting structure whereby pre-IPO investors or sponsors hold a class of "high vote" stock that commands a disproportionately higher voting power than the class of stock held by the investing public. In most of these situations, the dual-class structure was implemented to permit holders of operating partnership units to vote their full economic interest at the parent REIT level.

CONCLUSION

The public REIT sector has continued its thoughtful focus on improving overall corporate governance. We believe that REITs generally have engaged and thoughtful boards who regularly take action with the aim of maximizing shareholder value over the long term and have over-reacted to the growing focus on corporate governance issues. As we noted in our 2017 Alert, we believe that the right approach to REIT corporate governance is a subjective, case-by-case analysis, rather than a check-the-box exercise.[9] REIT boards must be aware that shareholders will not always necessarily be better off with a "cookie-cutter" permissive governance profile that enables one subset of shareholders to effectively hijack the company to the detriment of other shareholders. An optimal corporate governance profile is one that strikes the right balance between owners and management and that will ultimately inure to the benefit of the long-term value proposition that prompted the REIT's creation in the first place.

[9] See, e.g., our Alert *"Why Green Street Should Rethink Its One-Size-Fits-All Approach on Corporate Governance"*, June 1, 2015.

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