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## Recent Case Raises Questions Affecting Ownership Limits In Publicly Traded REITs

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In *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.*, the Southern District of New York turned a spotlight on derivatives trading and raised significant issues about what it means to “beneficially own” shares of a public corporation in a world in which financial institutions and investors routinely structure synthetic positions that shift the benefits and risks of being a holder of traditional equity securities for a wide variety of reasons.

While CSX raises questions the entire securities industry needs to confront, these issues are of special concern to publicly traded real estate investment trusts because of the ownership limits that most REITs include in their charters. Do these ownership limits apply to various types of derivatives or synthetic instruments, and as a matter of policy, should they apply? CSX suggests that the answers to these questions may be in flux, which puts REITs and REIT investors into an unsettling position with potentially undesirable outcomes.

### THE CSX CASE

In CSX, two hedge funds took positions in CSX Corporation, operator of one of the nation's largest rail systems, with hopes of influencing the company. In lieu of purchasing shares of CSX stock, the funds acquired total return swaps, a type of derivative security that provided the funds

with the economic equivalent of owning CSX stock but did not confer voting rights. By their terms, the swaps were to be settled in cash and not through the delivery of CSX shares.

The standard for beneficial ownership laid out in Rule 13d-3 focuses on whether the holder “directly or indirectly, through any contract, arrangement, understanding or relationship, or otherwise has or shares” voting or investment control over the shares. No formal contract existed by which the funds had the right to control the voting of any CSX shares or the right to obtain actual CSX shares. Accordingly, the funds did not publicly disclose their ownership on a Schedule 13D despite acquiring an economic interest equivalent to holding more than five percent of the company's shares.

The funds initially attempted to influence CSX's strategy through a direct dialogue with management, but were unable to effect all of the changes they desired. After failing to reach a mutually satisfactory resolution with CSX, the funds decided to nominate a short slate of directors and engage in a proxy contest, at which point holding actual voting power became critical irrespective of exposure to the economic risks/benefits of ownership. The funds unwound some of the swaps and allowed their counterparties to settle through the delivery of CSX shares (despite the terms only providing for cash settlement).

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In its decision, the court engaged in a long and detailed analysis of the nature of total return swaps and the market for these securities. The court emphasized that, while no formal contractual arrangements may have been in place, the funds were aware that the large investment banks acting as counterparties were not in the business of taking such “stupendously” large risks by betting against individual companies; as a matter of market practice, the counterparties would hedge their risk by directly purchasing shares in the applicable company. The court suggested that these instruments could as a practical matter permit the funds to own derivative economic interests that could be transformed into direct share ownership with full voting rights through a voluntary decision to settle the swaps for the counterparties’ directly owned shares. Through these financial instruments the funds could build an economic position without reporting their position to the SEC and then transform their interest into actual shares if they wish to put pressure on a company to take certain actions.

The court, however, did not conclude that the total return swaps constituted “beneficial ownership.” After carefully considering the argument that the funds’ swap position may constitute beneficial ownership in light of the purposes of Section 13(d), the court sidestepped the issue. Instead, the court found that these funds had, in this specific situation, violated Section 13(d), but on the basis that the swaps were part of an arrangement with the purpose or effect of evading Section 13(d), *i.e.*, using the antifraud provisions.

In addition to analyzing the funds’ ownership of total return swaps, the court also closely reviewed the relationship and conduct between the two funds to assess whether they had formed a “group.” Under the Section 13(d) rules, two or more parties will have their beneficial ownership attributed to one another if they have formed a “group.” The determination of “group” status is a highly fact-dependent analysis that has historically been difficult to apply. Based on the two funds’ pattern of communication and the timing of certain other actions (*e.g.*, certain purchases), the court found that they had formed a “group” prior to the time at which the two funds had concluded that a group existed.

### WHAT DOES THIS MEAN FOR PUBLICLY TRADED REITS?

Publicly traded REITs protect their REIT qualifications through, among other ways, specific ownership limits in their charters. A typical ownership limit will prohibit anyone from owning in excess of 9.8 percent of the REIT’s outstanding stock. The ownership limit is designed to protect the REIT’s

ability to meet what is commonly referred to as the 5/50 test—essentially five or fewer individuals may not own more than 50 percent of the stock during the second half of any year. By prohibiting any one holder from owning more than 9.8 percent, it is impossible for any five to reach 50 percent. A stockholder whose share ownership surpasses the limit will have its shares *automatically* converted into “excess stock,” *i.e.*, shares are effectively confiscated from the shareholder and held in trust for the benefit of some designated charity until the shares are sold in the marketplace. From a technical perspective, ownership limits come in a variety of forms, and often with subtle yet significant differences. The subtleties arise in defining who is a holder (*e.g.*, do you “look through” entities to the actual individuals indirectly holding?) and what constitutes ownership (*e.g.*, whose shares get attributed to whom?).

These charter provisions have a broader sweep than the tax rules; the flexibility that might accompany a more surgical application of the tax rules does not lend itself to serving as an effective protective device against a violation of the tax rules or an effective deterrent against unsolicited and coercive bids in the context of a publicly traded REIT that may have thousands of shares changing hands each day. As a safety valve, most REITs allow for the Board of Directors to grant discretionary waivers in appropriate circumstances.

Many modern publicly traded REITs incorporate the definition of beneficial ownership from Rule 13d-3 directly into their ownership limits. If holding total return swaps referencing a publicly traded REIT’s equity were found by a court to constitute beneficial ownership for 13d-3 purposes, then investors who acquire a greater than 9.8 percent economic position through swaps may, by the terms of the REIT’s charter, have a portion of their economic stake *automatically* converted into “excess stock,” a potentially disastrous result for the investor. A swap holder owning no actual shares might challenge whether, as a matter of law, the charter provisions can be enforced against it; however, a strict reading of many charters would trigger a conversion to excess shares. Alternatively, the shares held by the counterparty for hedging purposes could be converted into “excess stock,” an equally unsettling consequence.

Even outside of Section 13(d), the tax rules themselves are beset by uncertainties in this area. As a general rule, the tax rules governing REIT qualification look to whether the holder has acquired the benefits and burdens of owning a share when determining beneficial ownership. All of the arguments laid out by the court in CSX could apply equally to the tax analysis. However, taken to their logical conclusion, these arguments

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would force publicly traded REITs to confront the possibility that derivatives trading in a market with little to no transparency could trigger a REIT disqualification event.

Until greater clarity comes to the treatment of derivatives in determining beneficial ownership, REIT investors are advised to proceed with extreme caution and avoid situations in which the ownership limits contained in the REIT's charter are implicated in connection with any actual or synthetic investment.

Faced with pressure from investors who want a company to take actions not in the best interest of all of its stockholders, a REIT could consider the arguments raised by the CSX case in the context of determining whether an investor has exceeded the REIT's 9.8 percent ownership limit. Additionally, if two shareholders appear to be acting together in pressuring a company, a REIT could consider whether these shareholders have formed a "group" and thereby exceeded the 9.8 percent ownership limit.

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