

Client Alert

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SEC Interpretive Guidance Permits Tacking of Rule 144 Holding Period for REIT Common Stock Acquired Upon Redemption of OP Units in an UPREIT Structure

On March 14, 2016, the Staff of the Division of Corporation Finance of the Securities and Exchange Commission (the “SEC”) issued interpretive guidance (the “Guidance”) affirming that, in a traditional UPREIT structure, the holding period for shares of REIT common stock acquired upon the redemption of OP units commences on the date that the underlying OP units are acquired for purposes of Rule 144.¹ The ability to “tack” the holding period of OP units to that of shares of REIT common stock represents a significant change from the way that Rule 144 historically has been interpreted by the SEC Staff and has substantial implications for REITs going forward, including with respect to the registration rights of existing OP unit holders and the structure of future OP unit transactions.

BACKGROUND

UPREIT Structure

Many publicly traded real estate investment trusts (“REITs”) utilize the traditional umbrella partnership REIT (“UPREIT”) structure, in which the REIT serves as (or controls) the general partner of an operating partnership subsidiary that, in turn, owns all of the REIT’s real estate assets and through which the REIT conducts its business. The REIT’s only material assets are partnership units in its operating partnership (“OP units”). The REIT’s operating partnership typically issues OP units to sellers in private unregistered offerings as consideration for contributions of real estate assets. By contributing real estate assets to the operating partnership in exchange for OP units, sellers of real estate assets are able to defer taxes payable on the gains from the sale of the real estate assets until the OP units are sold or are redeemed by the REIT for cash or REIT common stock.

In the traditional UPREIT structure, each OP unit is the economic equivalent of one share of REIT common stock. Generally, following a one-year holding period, OP units may, at the holder’s option, be tendered to the operating partnership for redemption for cash or, at the REIT’s option, for shares of the REIT’s common stock on a one-for-one basis (or such other fixed ratio such that economic parity is maintained between the OP units and the REIT common stock). There is typically no public market for OP units, and they are generally deemed “restricted securities” for purposes of Rule 144 under the Securities Act of 1933, as amended (the “Securities Act”).² In

¹ Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated, SEC Staff Letter (March 14, 2016).

² “Restricted securities” include, among other things, securities acquired directly or indirectly from an issuer or an affiliate of an issuer in a transaction or chain of transactions not involving any public offering.

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addition, the partnership agreement of the operating partnership typically contains significant restrictions on the transferability of OP units.

Rule 144 Holding Period

Rule 144 under the Securities Act provides a safe harbor for public resales of “restricted securities” without registration under the Securities Act. If all of the applicable conditions of Rule 144 are met, a person selling restricted securities is deemed not to be engaged in a distribution, and therefore not an “underwriter” (as defined in Section 2(a)(11) of the Securities Act) and may rely on the Section 4(a)(1) exemption from registration for transactions by persons other than issuers, underwriters and dealers.

Rule 144(b) provides the conditions that must be met in order to rely on the Rule 144 safe harbor. Generally, non-affiliates of an issuer may publicly resell restricted securities once the applicable holding period in Rule 144(d)(1) has been satisfied.³ Rule 144(d)(1) requires (a) a six-month holding period for restricted securities of an issuer that has been a reporting company under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), for a minimum of 90 days and that is current in its reporting obligations, and (b) a one-year holding period for restricted securities of an issuer that has not been a reporting company under the Exchange Act for 90 days or is not current in its reporting obligations.

The Rule 144(d)(1) holding period commences on the date a person pays the full purchase price for a security. In certain circumstances, a holder who receives a security in a transaction not involving a sale is permitted to “tack” its holding period to that of the initial holder. In addition, Rule 144(d)(3) provides that a holder is permitted to “tack” the holding period of securities acquired in exchange for other securities of the same issuer such that the holding period for the new securities would begin on the date on which the initial securities were acquired. However, if the issuer of the new securities is not the same as the issuer of the initial securities (such as when REIT common stock is issued upon redemption of OP units), the SEC Staff historically has permitted tacking only in very limited circumstances. This position is based on the SEC Staff’s view that (a) the holding period requirement is satisfied only if the holder has been at full economic risk with respect to the securities for the entirety of the holding period and (b) the economic risk relating to securities of different issuers is typically different.

Under the SEC’s historical position, a holder who received shares of REIT common stock upon redemption of their OP units would not be entitled to “tack” the period during which they held the OP units and, therefore, the shares of REIT common stock would become subject to a new holding period before they could be sold. To address this issue, many REITs entered into registration rights agreements pursuant to which the REIT agreed to file with the SEC a registration statement to register the issuance of the REIT common stock upon redemption of the OP units (a so-called “redemption shelf”). As discussed below, the SEC’s position articulated in the Guidance may obviate the need to file a redemption shelf now that the holding period of the REIT common stock will be deemed to commence at the time the OP units are initially acquired.

³ Affiliates are deemed to hold “control securities” under Rule 144 and are subject to additional conditions, including manner of sale and volume limitations. These conditions remain applicable to affiliates who receive shares of REIT common stock upon redemption of their OP units, unless the resale of the shares issued upon redemption has been registered under the Securities Act.

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NEW INTERPRETIVE GUIDANCE

The parties requesting interpretive guidance argued, among other things, that, in a typical UPREIT structure, each OP unit represents the same proportionate right to the assets of an operating partnership as a share of REIT common stock. Therefore, a holder of REIT common stock received upon the redemption of OP units should be able to “tack” its holding period to the date the OP units were acquired because the holder retains the same amount of economic risk and the same proportionate share of the underlying real estate assets both before and after the redemption. The SEC agreed that, in a typical UPREIT structure, the Rule 144(d)(1) holding period for REIT common stock acquired upon the redemption of OP units commences on the date the OP units were initially acquired and not on the date of the redemption. In making this determination, the SEC specifically noted the requesting parties’ representations that (a) the holder pays the full purchase price for the OP unit at the time such OP unit is acquired from the operating partnership, (b) each OP unit is the economic equivalent of one share of REIT common stock, representing the same right to the same proportional interest in the same underlying pool of assets, (c) the issuance of REIT common stock upon redemption of an OP unit is entirely at the discretion of the REIT and (d) no additional consideration is paid by the holder for the REIT’s common stock.

PRACTICAL IMPLICATIONS

Limited Need to Provide Registration Rights

Prior to the Guidance, the holding period for REIT common stock received upon the redemption of OP units was generally deemed to begin on the date of the redemption. This meant that holders of OP units who received REIT common stock upon the redemption of their OP units needed to wait the applicable holding period under Rule 144(d)(1) after the redemption date before their shares became freely tradeable. This additional holding period created a hardship for OP unit holders because the holders recognized taxable gain on the redemption date but could not sell shares to pay the resulting tax liability until the applicable holding period had elapsed. In order to provide immediate liquidity after the redemption and to induce holders to purchase OP units, REITs often have provided their OP unit holders with registration rights that obligate the REIT to file a registration statement relating to the issuance or the resale of the shares of REIT common stock that may be received upon redemption of OP units, which can be costly and time-consuming.

As a result of the Guidance, registration rights may no longer be necessary in many OP unit transactions because holders generally will be able to immediately sell any REIT shares received upon redemption of OP units. However, OP unit holders still may have good reasons for seeking registration rights, particularly if a significant number of OP units are being issued and the holders want the right to sell their shares in an underwritten offering or “piggyback” on an underwritten offering by the REIT. In addition, if OP units are being issued to affiliates, those affiliates may want registration rights because, even under the new SEC guidance, they still will be subject to the volume limitation and manner of sale requirement if relying on Rule 144 to resell their shares.

Expiration of Existing Registration Rights

Agreements governing registration rights often provide that such rights terminate in the event that the underlying securities become eligible for resale under Rule 144. Depending on the contractual terms of the registration

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rights relating to any existing OP units, these rights may have automatically fallen away as a result of the Guidance, thus relieving the REIT from the burden and expense of registration.

Tax Implications

The issuance of REIT common stock upon redemption of OP units causes the OP unit holders to recognize taxable gain on the redemption date. However, prior to the Guidance, absent registration or another applicable exemption, holders could not sell their shares of REIT common stock to cover the associated tax liability without waiting at least six months from the date of redemption (unless the shares were registered for resale). As a result of the Guidance, holders generally will be able to immediately sell any shares of REIT common stock received upon redemption of OP units to pay the tax liability recognized on any gain.

Limited Applicability

The new Guidance is limited to the UPREIT structure specifically described therein, including the requesting parties' representation that an OP unit is the economic equivalent of a share of the REIT's common stock, representing the right to the same proportional interest in the same underlying pool of assets. As a result, the SEC Staff did not address the ability to tack the holding period in other transaction structures, such as a "DownREIT" structure in which a REIT owns some, but not substantially all, of its assets. DownREIT units, like OP units, typically may be tendered for redemption at the holder's option for cash equal to the current market price of the REIT's common stock or, at the REIT's option, for shares of the REIT's common stock on a one-for-one basis. However, a DownREIT unit represents an interest only in the assets of the DownREIT whereas a share of REIT common stock represents an interest in all of the REIT's assets, including assets held outside of the DownREIT. The SEC Staff, therefore, may not allow a holder to tack the holding period of a DownREIT unit with that of a share of REIT common stock received upon redemption of the DownREIT unit. Accordingly, application of the Guidance to structures that deviate from the traditional UPREIT structure as described in the Guidance should not be undertaken in the absence of additional guidance from the SEC Staff.

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