

UPREIT Shares and Tacking under Rule 144

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Along with the explosive growth of Real Estate Investment Trusts (REITs) has been a corresponding dramatic increase in their tax favored sister entities called UPREITS. "Sponsors" who have contributed property in exchange for partnership units are now looking to "cash out" their units without selling them, or converting them into shares in the UPREIT, and thereby incurring the tax on the gain they avoided by contributing the property to an UPREIT in the first place.

One such source of liquidity are lenders who are prepared to take a pledge of the units as collateral for a loan. However, the lenders' willingness to accept, or to provide a reasonable advance rate with respect to, such collateral depends on a determination of the liquidity of the collateral in the event of foreclosure. As the following overview of the structure of typical UPREITS shows, the units are convertible into the publicly traded shares of the UPREIT after some agreed "lock-up" period and, upon such conversion, are as easily sold as any other publicly traded stock. However, UPREIT shares not registered under the Securities Act of 1933 are subject to transfer restrictions of which "sponsors" and lenders should be aware.

Limited Partnership

An UPREIT (Umbrella Partnership Real Estate Investment Trust) as used herein is a REIT, whose assets are interests in a partnership which holds title, directly or indirectly, to the real estate. A typical UPREIT begins with the formation of a limited partnership by "sponsors" who transfer property to the limited partnership in exchange for limited partnership interests characterized as "units."

Simultaneously, a REIT raises capital through an initial public offering of its shares and contributes this capital to the limited partnership in return for a general partnership interest and a share of limited partnership units based on the value of the properties contributed by the "sponsors" as against the amount of capital contributed by the REIT. After the REIT acquires the interest in the limited partnership, it is referred to as an UPREIT and the limited partnership is referred to as the UPREIT's Umbrella Partnership.

Umbrella Partnership units are issued by the Umbrella Partnership, not the UPREIT, and holders of the Umbrella Partnership units have governance rights that differ from those of UPREIT shareholders. Nonetheless, typically, each unit in the Umbrella Partnership is the economic equivalent of one UPREIT share.

The total number of outstanding shares in the UPREIT equals the total number of Umbrella Partnership units owned by the UPREIT. Thus, each share of common stock represents the same indirect percentage claim to the assets of the operating partnership as each Umbrella Partnership unit. In addition, cash distributions made on each Umbrella Partnership unit mirror the cash distributions made on each UPREIT of the Umbrella Partnership share. Finally, the holder of each Umbrella Partnership unit is usually given the right, after a designated period of time, to "put" (i.e. require the purchase of) its partnership units to the Umbrella Partnership. The limited partner then receives either a number of UPREIT shares equal to that of its partnership units or the cash equivalent.

The primary reason for organizing a REIT as an UPREIT is to facilitate the REIT's acquisition of property by providing tax benefits inherent in the UPREIT structure. A REIT is an "investment company" for tax purposes, and under the tax code, a transfer of property to an investment company is fully taxable to the transferor if it results in diversification of the transferor's interest. However, there is no similar provision of the tax code applicable to partnerships that are not investment companies. Thus, by providing a means for owners of property to transfer the property to a partnership in return for partnership units instead of directly to the REIT, the UPREIT's organizational structure allows the property owners to defer the taxation of a sale to the REIT. It is only when the limited partner sells its Umbrella Partnership units or "puts" them to the Umbrella Partnership in exchange for shares in the UPREIT or cash that a taxable transfer of ownership of the property takes place. As a result, a sale or a put of the units does not usually occur until the property owner is willing to incur the tax consequences or until after the owner's death.

Restrictions on Transfer

Pursuant to the Securities Act of 1933 and the rules and regulations of the Securities and Exchange Commission (SEC), there are transfer restrictions on securities in certain situations, including restrictions on unregistered securities. These transfer restrictions may be triggered by the nature of the party attempting to transfer the unregistered securities (e.g. an affiliate of the issuer) or by the nature of the transaction in which the holder acquired the unregistered securities (e.g. directly from the issuer in a transaction not involving a public offering). If the UPREIT shares received by a limited partner in exchange for Umbrella Partnership units put to the Umbrella Partnership are not registered under the Securities Act of 1933, they will be subject to these transfer restrictions.

Generally, Rule 144, which was promulgated by the SEC under authority of the Securities Act of 1933, requires that a holding period of at least "one year must elapse between the later of the date of the acquisition of the [unregistered] securities from the issuer or from an affiliate of the issuer, and any resale of such securities . . . for the account of the acquiror or any subsequent holder of those securities. . . for the account of the acquiror or any subsequent holder of those securities." The holding period prior to resale is said to be "essential . . . to assure that those persons who buy . . . have assumed the economic risks of investment, and therefore are not acting as conduits for sale to the public of unregistered securities, directly or indirectly, on behalf of the issuer."

Nonetheless, there are certain limited situations in which an acquiror of restricted securities may "tack" the time that he held other securities to the holding period for his newly acquired securities. He may thereby fulfill the one year holding period requirement without actually holding the newly acquired securities for one year.

Neither Rule 144 nor the no-action letters under Rule 144 specifically addresses the issue of whether a limited partner in an Umbrella Partnership who puts his partnership units in exchange for UPREIT shares may tack the period he was a limited partner to the holding period of the UPREIT shares he acquires.

Of the no-action letters, the closest analogy to an exchange of Umbrella partnership units for UPREIT shares is a conversion transaction. However, in order to be able to tack holding periods in a conversion situation, (1) no consideration may be given for the exchanged securities aside from new securities, and (2) both the securities being sold and those being acquired must be issued by the same issuer.

Typically, in putting the Umbrella Partnership units to the Umbrella Partnership there is no consideration except for the partnership units and the UPREIT shares being exchanged.

Although Rule 144 requires that the exchanged securities be of the same issuer, the SEC staff has interpreted the words "same issuer" somewhat broadly in certain circumstances. In a series of no-action letters, the staff has permitted holders of securities in a parent corporation acquired upon conversion of the debt securities of a wholly-owned subsidiary to tack the holding period prior to the conversion.

In John D. Elliot (available June 11, 1990), the holder of a convertible note issued by a subsidiary was permitted to tack his holding period for the note to the holding period of parent common stock acquired upon conversion of the note. Similarly, in Whittaker Corp. (Olayan Investment Co. Establishment) (available February, 1981), the holder of a convertible note issued by a wholly-owned subsidiary was permitted to tack his holding period for the note to the holding period for the parent's stock acquired on conversion.

Aside from requiring that a parent/subsidiary relationship exist between the two issuers, these letters have required that the parent company guarantee the subsidiary's obligations to the holders of the debt security. In each of these letters, it was unlikely that the subsidiary, without the parent's guarantee, would have been able to fulfill its obligations. For example, in John D. Elliot, the subsidiary had a negative net worth and it was doubtful that the subsidiary would become profitable before the notes matured. To induce the investors to invest in the subsidiary's notes, the parent company committed itself to make any capital contributions necessary to enable the subsidiary to pay the notes.

In accepting the securities of the subsidiaries in these cases, the investor was relying on the creditworthiness of the parent company. This is important because, as mentioned earlier, the justification for Rule 144's holding period requirements is that the acquiror of restricted securities should assume the economic risks of the investment. In those cases where the parent guarantees the subsidiary's obligations, the acquiror of the securities bears the risk of an investment in the parent's securities from the time he acquires the securities of the subsidiary. Thus, upon conversion of the subsidiary's securities, he is continuing his investment in the parent instead of making a new decision to invest in the parent.

The SEC staff has extended this line of letters to include situations involving an exchange of equity securities of a subsidiary for shares in its parent. In William A. Shaw (available June 11, 1993), the staff permitted holders of special shares in a subsidiary that were convertible into shares of its parent to tack their holding periods.

In Shaw, Marcam Canada, the wholly-owned subsidiary of Marcam, acquired ShawWare through a share for share exchange in which ShawWare stockholders received special shares in Marcam Canada that were convertible into shares of Marcam. Marcam Canada did not have any business operations or assets other than its investment in ShawWare. It had been incorporated solely for the purpose of providing the shareholders of ShawWare with a way to hold an investment in Marcam through a Canadian corporation for tax reasons.

The special shares did not grant the special shareholders any right to, or interest in, the assets or operations of Marcam Canada or its subsidiary, ShawWare, other than those attributable to Marcam common stock. In addition, the dividend, liquidation and voting rights of the special shares were wholly derivative of or related to the dividend liquidation and voting rights of Marcam common stock. Because the value of the special stock had so little relation to the value of Marcam Canada's assets and was so extensively linked to the rights associated with Marcam stock, the SEC staff concluded that "the special shareholders assumed the full economic risk, in all respects, of owning Marcam stock directly." The special shareholders were therefore permitted to tack their holding periods.

Holders of securities in a parent acquired upon conversion of its subsidiary's securities have not been able to tack holding periods in cases where the holder did not assume the risk of investing in the parent company when he originally acquired the subsidiary's securities. For example, in Taro Vit Industries Limited (available June 13, 1991), the wholly-owned subsidiary of Taro Vit sold, as a unit, subordinated notes and warrants to purchase shares in the parent company. The notes were payable by the subsidiary.

In terms of creditworthiness, the subsidiary had a substantial business of its own, representing over a quarter of Taro Vit's operating income and over twenty percent of Taro Vit's assets. Taro Vit did not guarantee the notes, but it did indicate that it would accept the notes at their face value as payment of the exercise price of the warrants.

In the Taro Vit no-action request, counsel argued that the subsidiary was a "significant subsidiary" of Taro Vit and that the parent and the companies were so interdependent that each company's ability to repay debts to third parties was dependent on the other company's ability to repay intercompany debt. Because their investment was contingent on payments by Taro Vit to the subsidiary, counsel argued the investors in the subsidiary had assumed the risk of investing in Taro Vit.

The staff of the SEC decided that this was not a situation in which the exchanged securities were issued by the same issuer. Taro Vit did not explicitly guarantee the subsidiary's notes, and the subsidiary was in an economic position where it could have performed its obligations under the notes independent of Taro Vit. Thus, the risk of holding the notes was related solely to the performance of the subsidiary and the holder of the subsidiary notes had not assumed the economic risks of an investment in Taro Vit stock.

While the exchange of Umbrella Partnership units for shares in the UPREIT would not exactly fit into this line of parent/subsidiary conversion cases, one could argue, based on the typical UPREIT organizational structure in which the UPREIT has no assets or liabilities other than limited partnership units in the Umbrella Partnership and in which the UPREIT is the general partner (or controls the general partner) and owns a substantial percentage of the limited partnership units, that the Umbrella Partnership is a subsidiary of the UPREIT. Thus, the exchange of partnership units for UPREIT shares would be comparable to an exchange of shares in a subsidiary for shares in the parent.

Although the exchange of Umbrella Partnership units into UPREIT shares does not involve a guarantee, as was the case in the Elliot and Whittaker no-action letters, so long as the UPREIT is obligated to exchange Umbrella Partnership units for UPREIT shares at a fixed ratio (or pay the cash equivalent), there is an explicit link between the risk of investing in the Umbrella Partnership and investing in the UPREIT similar to the link between investing in the subsidiary and investing in the parent set forth in the no-action letters described above.

In addition, one could argue that the near or absolute identity of the risk of investing in a subsidiary and the risk of investing in its parent that is necessary for tacking is present in the UPREIT organizational structure. The typical UPREIT has no assets aside from its partnership interest in the Umbrella Partnership and is obligated to exchange Umbrella Partnership units for UPREIT shares (or their cash equivalent) on a pro rata basis. In this

situation, the total value of the UPREIT is identical to the value of the UPREIT's share in the Umbrella Partnership.

In addition, the limited partner and the UPREIT shareholder both depend on the same source (the Umbrella Partnership's assets) for the return on their investment. Because profits and losses of the Umbrella Partnership are allocated proportionally between the limited partners and the UPREIT based on the units each owns, and because the UPREIT's share is subsequently distributed to UPREIT shareholders based on the number of shares owned by the shareholder, distributions to limited partners and to UPREIT shareholders always mirror each other. Thus, the return on an investment in the Umbrella Partnership corresponds with the return on an investment in the UPREIT and, arguably, these investments entail the same risk.

The argument for tacking could not be made where the UPREIT has a non-typical organizational structure such as, for example, where the UPREIT has assets in addition to its interest in the Umbrella Partnership, or where the Umbrella Partnership is only one of several used by the UPREIT to hold different properties.

In these cases, both the returns and risks associated with the two investments would differ. In addition, there is a possibility that even in the case of a typical UPREIT, where the risks and returns associated with investing in the Umbrella Partnership mirror those associated with investing in the UPREIT, the SEC staff will take the position that there are different risks inherent in partnership interests and equity interests.

The SEC staff has taken an unfavorable view of the exchange of partnership for equity interests in the context of tacking under Rule 144(d)(3)(i), which applies to recapitalizations. Tacking has not been permitted under that provision of the Rule in cases where partnership units are exchanged for common stock in a corporation formed to take the partnership public, even though the business and management remained unchanged.

The SEC staff's rationale for not permitting tacking in this situation has been that the exchange constitutes a shift in the economic risks of the limited partners' investments. In explaining this rationale, one treatise states that, in this situation, the limited partner relinquishes all of the attributes implied by his status and a significant change takes place in his rights as a security holder. If the same rationale is applied to an exchange of Umbrella Partnership units for UPREIT shares, tacking would not be allowed.

The only way to be assured that tacking of the holding periods for limited partnership units with that for UPREIT shares is permissible would be to obtain an SEC staff ruling. An alternative, eliminating any need to establish tacking, would be to assure that a shelf registration for the UPREIT shares distributed upon conversion of a limited partner's units in the Umbrella Partnership is and remains in effect at all times until the UPREIT shares are resold.

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1.) The UPREIT shares received in exchange for the Umbrella Partnership units may be registered under a shelf registration, in which case, depending on the type of registration, the shares may be freely tradable (1) only by non-affiliates of the UPREIT or (2) by all recipients, regardless of affiliation. The issuance of UPREIT shares upon the conversion of Umbrella Partnership units may be structured as an offering registered under the Securities Act of 1933. In that case, the recipient receives shares that are freely tradeable unless the recipient is an "affiliate" of the UPREIT. Menna, *supra* note 1, at 233. Alternatively, the issuance may be structured as a private placement, with the recipient receiving restricted securities, followed by a registered resale of the restricted securities. In that case, if the recipient is included as a selling shareholder in the resale prospectus, the recipient's shares are freely tradeable regardless of the seller's affiliation with the UPREIT. Menna, *supra* note 1, at 233. If there is no shelf registration, to enhance the liquidity of their interests, Umbrella Partnership unit holders are usually granted, at a minimum, demand registration rights which require the UPREIT to register the UPREIT shares according to one of these two methods. Menna, *supra* note 1, at 234; Gross, Yaakov M. et al., *REITs, Real Estate Investment Trusts, Are Once Again Hot Investments*, N.Y.L.J., June 14, 1993, at S-1.

2.) Rule 144 (d)(1).

3.) Rule 144, Prelim. Note.

4.) There are some secondary sources that assert that the tacking of holding periods in the context of an exchange of Umbrella Partnership units for UPREIT shares is not permitted. Menna, *supra* note 1, at 235; King, William B., *REITs as Legal Entities*, in *Real Estate Investment Trusts* 76 (Garrigan, Richard T. & Parsons, John F.C. eds., 1997); Gross, Yaakov M. and Pinover, Eugene A., *Securities 101 for Investors in REITs*, N.Y.L.J., June 6, 1994, at S1; Rosen & Dolan, *supra* note 9, at 5; Gross et al., *supra* note 17, at S-1. However, none of these sources offers any reasons or support for the assertion.

5.) Rule 144(d)(3)(ii). Rule 144 also allows tacking in cases of stock dividends, stock splits, recapitalization, contingent issuances of securities, pledged securities, gifts of securities, and securities received from estates or trusts. Rule 144 (d)(i)-(vii). The exception for recapitalization applies to some situations in which the securities of one issuer are exchanged for those of another. For example, the staff of the SEC has allowed tacking where a company reorganized into a holding company structure-i.e. it formed its own holding company-and the company's shareholders were required to exchange their shares in the company for shares in the holding company. See, e.g., Morgan, Olmstead, Kennedy & Gardener Capital Corporation (available January 8, 1988); EqualNet Corporation (available February 10, 1998). Tacking has also been permitted in situations where shareholders must exchange shares when a company reincorporates in another jurisdiction by merging into a subsidiary formed in the other jurisdiction. See, e.g., Costilla Energy, Inc. (available April 18, 1997). Another situation in which the SEC staff has approved of tacking is where a partnership distributes to its partners restricted shares that it holds. In allowing tacking in these situations, the staff has required that (1) the distribution be pro rata to the partner's interest in the partnership and (2) the partner bear the economic risk with respect to the securities distributed to him. See, e.g., Bear, Stearns & Company (available June 17, 1988); Marley Holdings, L.P. (available October 27, 1993). The rationale for permitting tacking in these situations is that each distributee partner is the true economic owner and bears the economic risk of its proportional interests in the securities, whether the investment is made directly or through a closely held entity.

6.) See, also, Progressive Corporation (available December 1, 1986); Banque Nationale de Paris (available September 1, 1986).

7.) See, also, Banque National de Paris, *supra* note 23; Whittaker Corp., *supra* at 9. 8.) The staff in Taro Vit found that tacking was not allowed under either Rule 144(d)(3)(i) or (ii), which deal with recapitalizations and conversions respectively.

9.) One could further argue that the REIT occupies a role analogous to that of a holding company that has no active business aside from the business of its subsidiary. In Bear, Stearns & Co. Inc. (available February 13, 1992) the SEC staff was presented with a situation similar to the one in Taro Vit where it had not allowed tacking under either Rule 144(d)(3)(i) or (ii). In the Bear, Stearns no-action letter, a subsidiary, Jenny Craig Weight Loss Centers, Inc. issued notes that were bundled with warrants for shares in the parent, Jenny Craig Inc. The staff of the SEC permitted the holders of shares received when the notes and warrants were converted to tack their holding periods under Rule 144(d)(3)(i). In its ruling, the staff specifically noted the fact that the parent existed solely as a holding company for the subsidiary and did not carry on any active business.

10.) It should also be noted that for the UPREIT to qualify as a UPREIT, the partnership agreement of its Umbrella Partnership must assure that the Umbrella Partnership will be managed as if it were a REIT assuring the similarity of rights between the limited partners and the UPREIT shareholders. King, *supra* note 20, at 88.

11.) See, U.S. Physical Therapy, Inc. (available December 3, 1993). Cf Hygeia Sciences, Inc. (available March 13, 1986)(permitting tacking in an analogous situation where the partners entered agreement at the time of the formation of the limited partnership which expressly contemplated the formation of a corporation and the transfer of assets to it at the sole discretion of the general partner).

12.) Hicks, *Resales of Restricted Securities* 5 (1996 ed.).

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