As REITs Near Half-Century Mark Their Governance Structure Evolves

By Elizabeth Mullen

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As real estate investment trusts (REITs) approach their 50th anniversary, new government regulations and industry trends are poised to alter the world of the REIT director. A group of 30 REIT directors and governance experts gathered at the recent NACD Directorship 100 Forum in New York for a roundtable discussion. Since this year's annual shareholder meetings will be the first with some Dodd-Frank regulations in effect, directors expressed interest in planning for their impact on REIT boards. When REITs first emerged, most directors and CEOs were founders who had contributed property and therefore had a vested interest in the company's success, reassuring both management and investors that they would act in the company's—and shareholders—best interests.

John Napoli

"Although some of that still is true," said Blake Hornick of Seyfarth Shaw, "I think that's why boards are beginning to see every other company getting much more concerned about corporate governance and they have to do it as well."

The Dodd-Frank Act's "say-on-pay" mandates are especially foreboding, as many REITs do not have a standard formula for C-suite compensation and, given the nature of their business, do not have a reputation for aligning pay with performance. "The REIT industry has not yet evolved to the more direct, almost formulaic performance metrics behind compensation, to move in economic indicators," said Hornick, noting that REITs have avoided the grandiose pay packages that cause investors concern.

Patrick S. McGurn pointed out that ISS research had flagged concerns about REIT boards very infrequently, except when it came to compensation. "It was crazy. The vast majority of the REITs had medium or high concern levels in the compensation area and there were very few with low concern levels," he explained. Recalling a REIT roundtable he had participated in 10 years ago when there were myriad concerns, he said, "the governance of REITs was horrendous at the time."

Today, REITs have adopted governance standards that are more in line with other mid- and large-cap companies.

"The compensation issue is really on everyone's mind right now," said John J. Barry. "Some companies make a good case for the fact that the skill sets of the people are such that they really need to be compensated, even if performance isn't aligned with it."

Along with say-on-pay provisions, all companies will be faced with a "say-on-frequency" vote this year. Shareholders can choose to vote on say-on-pay every one, two or three years, or choose to abstain from voting on pay. Boards are free to make recommendations for any of the choices, but their recommendations may make more waves than the votes themselves, and sitting directors expressed concern that their choices may be skewed in the wrong direction.

"I think honest, intellectual discussions can lead committees to two or three years, because these plans are long-term," said Barry. "I think they're afraid in many instances to recommend it because it will be viewed as taking the easy way out."

Jonathan B. Weller observed that shareholders will come to expect an annual vote, and McGurn

said that ISS will be recommending annual votes to its clients. "If you're not having an annual vote on say on pay, you're just delaying the inevitable," said Weller. "It's going to be a part of the governance landscape."

While admitting she was playing devil's advocate, Joanne Landau asked whether REITs wouldn't be better served by a professional class of directors.

REIT boards have adopted the addition of an independent board of directors in which the CEO is the only insider. Roundtable participants agreed that independent directors are an important asset to a board, but expressed concern about those who are so independent as to be completely disconnected from the REIT world. "REITs are not like companies that make widgets, in that they are transaction-driven," said Lawrence Jones. "You wonder if the second and third generation can be as successful doing those kinds of entrepreneurial transactions, if the art of the deal can be learned. REIT directors need to be conversant with the dynamics of the transaction world."

Joanne Landau

Blake Hornick

John Napoli of Seyfarth Shaw said that independent directors, especially those not "bred in the industry," bring more of an interest in strategic, crisis and succession planning. Playing devil's advocate, he said, "Every company—and this isn't just unique to REITs—but all companies have their own circumstances that are unique to them. Boards could be better served by having one or two 'inside directors' who are familiar with that particular company to bring some crisis management to the table, as opposed to having all their information funneled through the CEO. It's when a crisis really hits, when key decisions must be made that will impact the life of a company… that's when that lack of other voices in the boardroom, I think, shortchanges shareholders in the long-run."

With both public and private REIT representatives at the Roundtable, the oft-debated topic of which business structure is more beneficial to REITs arose. "From a return perspective, check with me every year and I'll have a different answer," said Kenneth F. Bernstein.

One of the main reasons cited for going public was leverage and liquidity. "Public REITs have access to unlimited liquidity, it's always there, and if you don't like the prices, it's always there as liquidity," explained Douglas Crocker II. "In the private sector, it opens and it shuts."

Lee S. Wielansky hypothesized that the recent economic crisis would change how REITs invest. "I don't believe if we were to go back to the way we were that you'd see that high leverage. The carnage was so much greater than anybody anticipated, it'll be a long time before we see anything close to what we saw before," he said.

REITs are stigmatized, said Hermann Buerger, "because they lack sufficient power to internally generate capital, owing to the fact that prevailing tax laws mandate the distribution of the bulk of attained profits in the form of dividends. However, I continue to feel that REITs are an excellent vehicle by which to own real estate."

The REIT business model nears its 50th anniversary, there was a consensus that the structure would continue to evolve for years to come. "I think it's kind of humorous that on one hand the REIT world is celebrating its 50th anniversary and yet when we really think of REITs, they feel more like teenagers," said Bernstein. D

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