

# Corporate Finance Alert

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## SEC Staff Issues Rule 144 Guidance Related to REIT Shares Received in Exchange for Operating Partnership Units

The staff of the SEC's Division of Corporation Finance recently issued an interpretive letter concluding that, for purposes of Rule 144 under the Securities Act, the holding period for shares of a publicly traded real estate investment trust (REIT), received in exchange for privately placed units of the REIT's operating partnership (OP units) in an umbrella partnership real estate investment trust (UPREIT) structure, commences upon the acquisition of the OP units.<sup>1</sup>

**Overview.** Rule 144 provides a "safe harbor" from registration under the Securities Act for sales by holders of "restricted securities," which are securities acquired from the issuer or an affiliate of the issuer in a transaction not involving a public offering. This safe harbor requires these securities to be held for at least six months after they have been fully paid for (or for at least one year if the securities are issued by a company that has been public for fewer than 90 days). In limited circumstances, a holder of restricted securities may "tack" (or add on to) the holding period of other parties or related securities to the holding period of newly acquired securities.

In the interpretation letter, we requested that the SEC staff concur with our view that a seller of REIT shares received upon an exchange of OP units in exchange transactions involving securities of UPREITs should be allowed under Rule 144 to tack the holding period of the units to the holding period of the REIT shares, and therefore be able to sell the REIT shares immediately upon receipt if the units had been held for the requisite period. Previously, the staff had not formally addressed the application of the holding period requirement to REIT shares received in exchange for OP units. However, the staff had informally indicated that a new holding period was required for the shares. Under this position, a unit holder's holding period for the REIT shares would not begin upon its acquisition of the units it exchanged for the shares; instead, it would begin upon its exchange of units for shares.

We argued in our submission that in the case of a REIT structured as an UPREIT, the economic risk of the operating partnership units is identical to that of the REIT shares (apart from tax considerations). Under the UPREIT structure, the operating partnership units and the REIT common stock acquired upon redemption represent the same proportionate right to the assets of the operating partnership, so that the exchange does not

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<sup>1</sup> The staff issued the letter on March 14, 2016, in response to a request jointly submitted by Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Incorporated and three law firms, including Skadden. A copy of the letter is available [here](#).

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result in any change to the economic risk of the investment in the underlying assets. A unit holder has the same economic risk as a holder of REIT common stock during the entire period it holds the OP units, and a unit holder retains the same economic risk and the same proportionate share of the underlying real estate assets after exchanging units for shares.

Accordingly, from the date the unit holder pays the full purchase price for the OP units to the date it exchanges the units for REIT common stock, the economic value of an OP unit is the same as the market price of, and therefore the economic value of, a corresponding share of REIT common stock. Because the economic risk is the same after the exchange, we argued the holding periods of the two securities should be combined under the rule. The staff agreed with our position that the holding periods of operating partnership units and REIT shares could be tacked under Rule 144.

**Structure covered.** The SEC staff guidance was based on a specific transaction structure — the UPREIT structure. A summary of some of the key aspects of this structure is set forth below. As is typical when the staff issues interpretative relief, the new guidance is limited to those structures specifically described in the request letter. Whether this new guidance will be helpful in assessing holding periods in other transaction structures and/or whether the staff will be open to providing further guidance in this area remains unclear at this time.

- All of the REIT's real estate assets are owned, directly or indirectly, by its umbrella "operating" partnership, which is typically organized as a limited partnership. The REIT's only material assets are its holdings of units in the operating partnership, of which the general partner is either the REIT or controlled by the REIT.
- Shares of common stock in the REIT are registered under Exchange Act Section 12 and are publicly traded on a national securities exchange.
- OP units are held by other investors that acquired them in nonpublic offerings, typically in exchange for real estate assets such investors contributed to the operating partnership. These

investors acquire their units at the full purchase price.

- There is no public market for the OP units, which are subject to significant transfer restrictions under the agreement governing the formation of the operating partnership.
- One OP unit is the economic equivalent of one REIT share, or of another specified number of REIT shares fixed to ensure economic parity between the REIT shares and the units. The units are substantially identical economically to the REIT shares in that they represent the same right to the same proportionate interest in the same underlying pool of assets.
- After an initial one-year holding period, unit holders may request that the operating partnership redeem their units for cash. The REIT, at its option, may assume the operating partnership's redemption obligation and acquire the units for REIT shares based on the fixed ratio.
- Unit holders are not required to pay any additional consideration for the REIT shares at redemption, and the cash value of each unit at redemption directly corresponds to the REIT share's market value at that time.

**Impact.** The staff guidance is an interpretive position on which any holder of REIT shares received in a covered exchange transaction should be able to rely. As a result, this new guidance should eliminate one of the reasons why REITs need to file registration statements related to these exchange transactions. Because most UPREITs are structured to require that units are held for at least one year, the staff's position will permit most unit holders to sell immediately under Rule 144 any REIT shares they receive in exchange for the units.

Sales by REIT affiliates will remain subject to the volume limitation and other requirements of Rule 144. For tax purposes, a new holding period will commence upon that exchange, so a sale within one year after the exchange would result in short-term capital gain to the extent the shares have appreciated in value since the exchange. The new guidance should also assist lenders when considering whether to accept OP units as collateral for loans.

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