APPENDIX 23

AGENCY COSTS AND CONFLICTS OF INTEREST IN REITs

Any large firm involves various interest groups or **stakeholders**, such as stockholders, bondholders, other creditors, managers, employees, and customers. While all of these groups share common interests in the firm, inevitably **conflicts of interest** arise. The structure and governance of the firm, as well as its operating procedures, generally attempt to minimize the conflicts and promote the common interests and synergy. But no complex human organization is perfect, and remaining conflicts of interest can potentially reduce the value of the firm as measured by its equity share price, the stockholders' interest. The general economic term for such reduction in firm value is **agency cost**, referring to the potential conflict of interest between the principal party, the stockholders (that is, the owners of the firm), and their agent, the firm's professional management.[1] REITs are not immune to the general types of conflict of interest and agency cost that can plague any firm. But REITs also have some unique issues in this regard.

In the old days of the REIT industry, that is, prior to the 1990s, REITs were always very small firms (by stock market standards), usually very passive in their investment styles, and virtually always run by external managers. In fact, until 1986, REITs were required to hire external advisors to manage their assets. The external manager did not have any ownership share in the REIT. In this structure, the REIT owners (that is, the stockholders as represented by the REIT board of directors) could only hire or fire the advisor. They could not hire or fire the individual employees who actually ran the REIT but worked directly for the advisor, not for the REIT. This blunted the line of authority from ownership to management and made active, vertically integrated management almost impossible. It also allowed a number of unique conflicts of interest to occur. For example, the external advisor who actually ran the REIT operations was often paid a fee that was determined solely by the value of the assets under management. As a result, there was a built-in conflict of interest regarding property acquisitions and dispositions. It would rarely ever be in the advisor's interest to sell properties, even if such sales were highly profitable. With REITs being so small and comprising such a small share of the stock market, very few Wall Street stock analysts specialized in REITs, and most major institutional investors could not invest in most REITs because of the five-or-fewer rule described in section 23.1.1. As a result, there was little effective scrutiny and oversight of REITs in the marketplace, and REITs developed a reputation for having major agency cost problems.

The so-called "modern REIT" is a very different animal. Internally managed like most industrial and service corporations in other sectors of the stock market, it is typically a large- to medium-size firm tracked by a number of Wall Street analysts that specialize in REITs. It has a number of large, institutional investors, as well as substantial stock ownership on the part of top managers. Its governing board of directors includes both external members and top management.

Operations in modern REITs typically encompass the provision of specialized, vertically integrated commercial real estate services at both the portfolio and property levels, and potentially range from raw land acquisition through development, ownership, management,

[1]Other types of conflict of interest resulting in agency cost are also possible. For example, we noted in Chapter 15 the possibility of conflict of interest between different classes of investors, such as stockholders and bondholders. (See section 15.2.3.)

and leasing. This new structure has mitigated many of the old conflicts and agency costs, but some unique problems remain, and some additional problems have arisen in the new system. Here we will note only a few of the most commonly mentioned, to give you an idea of the types of conflicts of interest that can cause suboptimal performance in REITs.[2]

1. **Transaction bias in UPREITs.** As noted previously, most of the modern REITs that went public since 1992 have been organized as umbrella partnership REITs, meaning they do not own real estate directly. Instead, they own units in an **umbrella partnership**, also known as an **operating partnership (OP)**, which directly owns and operates the REIT's properties. This structure enables the REIT to acquire properties from taxable individuals while allowing those individuals to defer realizing a capital gains taxable event. But the resulting structure is very complex, and sets up some potential conflicts of interest. One of the most noteworthy is the fact that the REIT may share with outside OP unit holders the control of the timing of sales of properties from the OP. These outside unit holders will typically have a greater capital gains tax liability than the REIT shareholders will have in the event of a sale of property. A tax-based conflict of interest is thereby set up between the REIT shareholders and the outside OP unit holders regarding the timing or desirability of the sale of certain properties; OP unit holders may be reluctant to sell properties with a low book value or depreciated basis, even though it may be in the best interest of shareholders in terms of maximizing shareholder equity. How important is this to REIT shareholders? A recent working paper by Wu and Yavas (2004), sponsored by the Real Estate Research Institute (RERI), presents empirical results that suggest this bias is relatively small because agency costs are capitalized into the property acquisition prices in a tax-deferred exchange.
2. **Real estate interests outside the REIT.** It is not uncommon for a REIT to be originally sponsored by, and to remain effectively controlled by, an individual or group of individuals who are successful private real estate entrepreneurs and managers. Of course, this in itself makes eminent sense. However, for a variety of reasons, the sponsoring individual or group may not place all of their real estate interests within the REIT.[3] For example, some properties may remain outside the REIT, or a property management or leasing business may remain outside the REIT, yet still be owned by the group that effectively controls the REIT. This can cause a potential for two types of conflicts of interest as identified by Sagalyn (1996), **resource allocation**, and **competitive affiliates**. The former refers to the fact that the top managers of the REIT may have other demands on their time and interest besides the REIT and may therefore neglect some duties at the REIT in order to serve their interests outside the REIT. The competitive affiliates' conflict of interest refers to the fact that the REIT managers may have outside interests that actually compete with the REIT. For example, a REIT manager may own properties that compete with the REIT's properties or may operate a leasing brokerage business that would benefit from leasing space to buildings that compete with the REIT's buildings.[4]
3. **Potential for self-dealing.** Another type of conflict of interest that may be set up when REIT managers or sponsoring shareholders have outside interests is what Sagalyn termed **self-dealing**. This refers to the REIT dealing with affiliated entities in less-than-arm's-length transactions. For example, the REIT might hire a firm that is affiliated with its managers or sponsoring shareholders to provide property management or

[2]For a more detailed and comprehensive, yet quite readable, summary of conflicts of interest in the modern REIT, see Sagalyn (1996). Much of the remainder of this section is based on Sagalyn's article.

[3]Some of these reasons could make good management sense. For example, it may be desirable to focus the REIT on only one aspect of the sponsoring group's real estate interests, so as to enable the REIT to benefit from specialized management expertise.

[4]An important feature of agency cost is the fact that this type of cost may be incurred by shareholders (in the form of diminished share value) even if the conflict of interest has not yet actually materialized, in the sense that no behavior actually contrary to the interest of the REIT shareholders has actually yet occurred. The mere presence of the conflict of interest, the setting up of some positive probability that management behavior contrary to shareholder interest might occur, can cause a diminution in shareholder value.

leasing services. If the arrangement involves so-called "sweetheart" terms, providing the outside entity with a better than normal arrangement, then this obviously harms the REIT's other shareholders.

In spite of potential problems such as these, it seems likely that the governance structure and highly competitive stock market environment in which REITs trade are generally able to combine to keep agency costs down to a level that is not much worse in the modern REIT industry than it is in other sectors of the stock market. It is nevertheless important for investors and analysts to be aware of the potential dangers.

KEY TERMS

agency cost
competitive affiliates
conflicts of interest
franchise value
operating partnership (OP)
resource allocation
self-dealing
stakeholders
umbrella partnership