

# Hostile Takeovers of REITs

*Debunking the myth that*

*REITs are takeover-proof.*

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**REAL ESTATE** investment trusts (REITs) have become mainstream investment vehicles. Together with increased liquidity, greater access to capital markets, and the broader investor base that comes with being public—and higher visibility, S&P 500 membership, and growing acceptance in individual and institutional portfolios—REITs now also feel the full pressures of the public markets, and the sharp demands of shareholders for accountability and, often, change. Like all public companies, publicly traded REITs are ultimately controlled by their shareholders and are subject to all the pressures that play out elsewhere on the corporate landscape,

including unsolicited takeovers and proxy fights for control.

But REITs are no more defenseless in the face of hostile advances than other publicly traded companies. The tools and defenses available to directors of all public companies to resist abusive takeover tactics and suboptimal transactions are equally available to REIT trustees and directors. These techniques include shareholder rights plans (also called “poison pills”), and staggered boards of directors, which prevents the entire board of directors being replaced in a single year. In addition, the REIT arsenal may also include further defenses unique to the REIT form, such as “excess share” ownership restrictions and umbrella partnership or “UPREIT” consent rights, which are discussed further below.

With all these tools, however, the bottom-line reality should not be overlooked: REITs are not takeover-proof. On the contrary, while REIT-specific devices may sometimes complicate takeover strategies for a hostile acquirer, REITs are as vulnerable to hostile takeovers as other public companies. Indeed, in some cases they may be more vulnerable than their non-REIT counterparts because of excessive and misguided reliance on REIT-specific, tax-based defenses that—while helpful when properly deployed—are often inadequate as takeover defenses. As shown below, public REITs are subject to the

same economic and shareholder pressures that drive the market for corporate control in other sectors, and the notion that REITs are takeover-proof must therefore be rejected as (dangerous) myth. Accordingly, we emphasize the pre-takeover preparations that REIT trustees and directors can (and should) make to ensure their ability to protect the interests of all shareholders in a complex and changing consolidation environment.

#### THE ERA OF CONSOLIDATION

Public REITs have come of age. The value of assets held by publicly traded U.S. REITs today stands at around \$500 billion, up from \$125 billion in 1996. The industry’s aggregate equity market capitalization exceeds \$290 billion and the daily trading volume of public REITs exceeds \$1.5 billion. On average, a REIT has gone public in the United States once every 40 days over the past ten years, raising more than \$236 billion in initial and secondary offerings. And while REITs in the 1990s were much criticized for their governance, in 2005 the REIT sector earned an Institutional Shareholder Services average score of 65.2, compared to an all-sector average of 51.2.

If the decade 1990-2000 sealed the era of the “corporatization” and securitization of real estate, the driving force behind the

current decade has been REIT consolidation. The last ten years have seen more than eighty multi-million-dollar public REIT merger transactions with a total value in the \$100 billion range. The trend towards fewer, larger REITs with an ever-increasing share of the institutional quality property market is confirmed by increasing M&A activity in the sector. Over the last decade, the average capitalization of REITs has increased nearly six-fold, from \$274 million to \$1.5 billion, and the number of REITs with a capitalization of more than \$1 billion has grown from ten to eighty-two.

The last two years have seen transactions unprecedented in size for the sector, including General Growth's acquisition of Rouse for more than \$12 billion in cash and debt, and ProLogis' \$5 billion acquisition of Catellus to create the world's largest network of distribution facilities. From June to November 2005, there was an average of one major REIT transaction per month including: ING Clarion Partners taking Gables Residential private; Camden's acquisition of Summit; Brandywine's deal to buy Prentiss; Public Storage's hostile (and ultimately successful) bid for Shurgard; DRA Advisors LLC's acquisition of CRT Properties; ProLogis' acquisition of Catellus; General Electric's deal to buy Arden and to sell part of the Arden portfolio to Trizec; Morgan Stanley's acquisition of AMLI Residential;

and the acquisition by Morgan Stanley and Onex of Town and Country. This consolidation has produced more than a dozen REITs with a market capitalization in excess of \$4 billion. The consolidation wave, combined with the costs of Sarbanes-Oxley compliance and other public company burdens, has caused the number of REITs with a market capitalization below \$100 million to dwindle from eighty-five to fourteen. But with close to two hundred publicly traded REITs in the NAREIT Index, and one hundred and sixty REITs currently trading on the New York Stock Exchange, the consolidation wave may still be in its infancy.

In addition to consensual transactions, consolidation pressures have resulted in hostile takeover activity in the REIT sector, including the successful bid by Public Storage for Shurgard; Simon/Westfield's failed bid for Taubman in 2003; Sam Zell's Manufactured Home Communities' unsuccessful bid to derail the Chateau-ROC merger, which was defeated as a result of a restructuring of the Chateau-ROC transaction; Apollo's derailment of a transaction between the Santa Anita paired-share REIT and Colony Capital, which resulted in a fourth-party interloper, MediTrust, ultimately outbidding Apollo (which ironically had in the meantime partnered with Colony) and entering into a transaction with Santa Anita; Patriot American's successful bid to derail a trans-

action between the Bay Meadows-Cal Jockey paired-share REIT and Hudson Bay, which resulted in the Patriot-Bay Meadows merger; Wilshire REIT's hostile bid for Imperial Credit; and Gotham's attempt to oust the First Union board. In addition, the last few years have seen a large number of non-public approaches (in the form of so-called private "bear hug" letters) that continue to simmer under the market's surface.

#### THE HOSTILE THREAT

Public companies, including publicly traded REITs, thus face constant exposure to hostile takeover attempts. There are two basic weapons in the hostile arsenal—the tender offer and the proxy fight—and they can be deployed separately or in tandem.

In a hostile tender offer, the raider offers to purchase the outstanding shares of the target's stock for a premium to market, with the closing of the offer typically contingent on the tender of a minimum percentage of the target's outstanding stock and/or other conditions. While there are a number of possible responses to a hostile tender offer, the core defense is the shareholder rights plan—colloquially known as a "poison pill," or just "the pill"—that results in the issuance of a large number of new

shares to all holders except the raider in the event an acquirer's holdings exceed a pre-set threshold, thereby making the transaction prohibitively dilutive. Significantly, rights plans hold out the threat of drastic and permanent economic loss to the potential acquirer, and thus operate as a powerful deterrent on would-be raiders.

In a proxy contest, the raider nominates a slate of insurgent directors committed to support a change in management, and then seeks sufficiently broad shareholder support to elect its candidates at annual director elections. Bidders whose tender offers are blocked by a poison pill often launch proxy contests, with the promise that their slate of directors will "redeem" the pill—that is, nullify its effect as to the tender offer—in the event they are elected. While there are a number of structural defenses against a potential proxy fight, the core defense is the staggered board; that is, a provision in the corporate charter that directors will be elected in successive annual classes rather than all each year, which provision requires an insurgent to elect slates at two or more successive annual meetings in order to seize control of the company.

These threats are well known, and the basic defenses are battle-tested and highly effective. But the defenses are not impregnable. For example, it is not clear

whether and under what circumstances a board facing a hostile bid may be required to redeem a rights plan to allow a bid to proceed. To be sure, Delaware courts have made clear that a board can “just say no” to an unsolicited threat in a variety of circumstances. (See *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1152 (Del. 1989); *Paramount Communications v. QVC Network, Inc.*, 637 A.2d 34, 43 n.13 (Del. 1994).) But it cannot be ruled out that courts would require a board to redeem a pill under certain circumstances, and so simple reliance on a rights plan is not an adequate response to a hostile offer. Moreover, directors may find themselves under considerable pressure to accede to a hostile offer (irrespective of whether the majority of the board faced a reelection fight), and, under any circumstances, an unconditional, fully funded, all-cash premium bid may be very difficult for a board to resist as a practical matter.

Given the constant threat of a hostile bid, there is no substitute for active and engaged board attention to takeover issues. As elaborated below, directors must be aware of the possibility of hostile activity on an ongoing preventive basis. And in the event a bid emerges, directors must be prepared to respond promptly and with discipline in what will, by definition, be a fast-moving and challenging environment.

## EXCESS SHARE PROVISIONS

Advance preparation is critical to managing a takeover situation for all public companies. This truism holds equally well for publicly traded REITs, notwithstanding the widespread (but erroneous) belief that REITs enjoy special and inherent takeover defenses. We survey below two REIT-specific issues responsible for the myth of REIT impenetrability: the “excess share provision” found in almost all REITs; and the UPREIT form that is often (and mistakenly) thought to provide talismanic protection against hostile activity. As the analysis below shows, public REITs are as exposed to takeover activity as any other public company, and, accordingly, REIT directors must consider the same proactive prophylactic steps as their non-REIT public company counterparts.

Excess share provisions (sometimes called “ownership limitations”) generally restrict the number of shares that any REIT shareholder can own to 9.9 percent (or some lesser percentage) of the shares outstanding. These provisions are included in the articles of incorporation of most REITs and serve the central purpose of ensuring compliance with the so-called “5/50 rule” of the Internal Revenue Code, which prohibits five or fewer individuals from owning in excess of 50 percent of the shares of a REIT during the last half of the REIT’s taxable year. Under a standard

excess share provision, any shares acquired by a shareholder in excess of the ownership threshold are stripped of excess voting rights or any right to receive dividends until the excess shares are transferred to a holder who can own them without violating the ownership restriction. A purported acquirer who exceeds the percentage cannot vote, receive dividends on, or otherwise enjoy any benefits of ownership of the “excess share.” Any such shares are thereafter disposed of by an “excess shares trustee”; when the trustee sells the excess shares, the acquirer receives the price it paid or the sale proceeds, whichever is less. The purported acquirer loses the entire economic benefit, (but not the risk of loss) of share ownership, as well as the ability to vote the shares.

The typical excess share provision grants the REIT’s board the discretion to waive (or increase to a stated higher limit) the limitation with respect to particular acquirers, so long as the board, usually after consulting with outside legal counsel, is satisfied that the acquirer is not an individual for purposes of Section 542(a)(2) of the Code—that is, that the acquirer is a corporation, partnership, estate, trust or any other non-“individual” to whom the 5/50 rule’s “look-through” provision would apply and the board obtains sufficient assurances that no individual’s beneficial ownership of stock through the acquirer will violate the ownership limit.

The REIT as a whole is thus protected from the adverse tax consequences that would flow from any violation of the 5/50 rule, but the board retains the power to waive the excess share provision in an appropriate circumstance. Many REITs set the ownership limitation at 9.9 percent, which is the highest threshold that mathematically ensures compliance with the 5/50 rule assuming no substantial ownership blocks in excess of 10 percent already exist. The bar can, however, and when one or more holders own more than 10 percent *must* be set lower in order to achieve the basic purpose of ensuring the tax benefits of REIT status.

If properly drafted and implemented, an excess share provision can and probably will serve as a form of takeover defense. Indeed, some state statutes specifically validate such charter ownership provisions, including for purposes beyond the preservation of tax benefits, and some REITs have specifically disclosed that their excess share provision may be used for anti-takeover purposes. Excess share provisions thus have a role to play as part of a REIT’s overall takeover defense strategy.

But the fact that REITs have excess share provisions does not mean that they are immune from hostile attack and have no need for a rights plan and other structural defenses. On the contrary, excess share provisions are largely untested as anti-takeover devices and may be inherent-

ly vulnerable because of their grounding in the tax code. While the case law and statutes of Maryland (where most REITs are incorporated) provide some support for the use of an excess share provision to deter a coercive bid, courts have yet to determine whether such provisions may be used to block a transaction that does not threaten a REIT's target status. And it goes without saying that a fast-moving, high-stakes control contest is not the time to find out whether one's core defense is legally secure. The poison pill, on the other hand, has been judicially validated in a variety of contexts in major commercial jurisdictions across the country.

Moreover, excess share provisions typically act simply as a temporary bar to voting and dividend rights until the excess shares are transferred to purchasers who do not exceed the ownership limit, whereas poison pills threaten permanent and punitive dilution to the acquirer. Accordingly, excess share provisions do not have the same deterrent effect as a shareholder rights plan; this lesser risk and punishment has a smaller deterrent effect and, in the right (or wrong) circumstances, may entice a bold acquirer to "blow through" the limit. Another relative weakness in excess share provisions lies in the REIT board's flexibility to waive the excess share provision after it has been violated. Properly drafted rights plans cannot be redeemed after they have been triggered, which

increases their deterrent effect and avoids placing the board under intolerable pressure in the heat of a contest for control. Finally, the excess share provision confers no additional protection against the real-world pressure on a board to consider waiving protection in the face of a premium hostile bid, as a board can under certain circumstances dismantle either device—the pill and the ownership limitation—at its discretion, and unsolicited suitors can be expected to attempt to force the board to do so. Ownership limitation provisions, even when specifically authorized by statute or designed for anti-takeover purposes, are thus unlikely to be as powerful as other common takeover defenses such as a rights plan, and in many circumstances may prove far less robust.

Additionally, if an excess share provision is to provide even minimal protection, it must be properly conceived and implemented. In fact, many provisions contain unclear and counterproductive features. Some ownership limitation provisions affirmatively require a board to exempt an acquirer who so requests unless the board makes a determination that the exemption would jeopardize REIT qualification under the tax law. Another common drafting shortcoming is lack of clarity about whether the ownership restrictions operate on a "look-through" or entity-level basis. Entity-level excess share limitations are obviously more effective than "look-

through” provisions (which explicitly or, rather more frequently, implicitly appear designed only to guard against violations of the 5/50 rule). A further source of confusion is the drafting practice of cross-referencing REIT charter provisions to the tax code. In many cases, the scope of the cross-reference is ambiguous, and the ambiguity can be exploited by a hostile acquirer seeking to attack the provision in the course of a control contest with the argument that the excess share provision should be understood to reference the 5/50 rule. Such ambiguity can be costly: when Manufactured Home Communities attempted to break up the merger between Chateau and ROC Communities, it argued in court that Chateau’s ownership limitation was a pure look-through provision that did not prevent its acquisition of Chateau’s stock. Although the case was settled before the court decided it, the ambiguity in Chateau’s excess share provision gave Manufactured Home an additional argument that careful drafting might have eliminated.

#### UPREIT STRUCTURES

In an UPREIT structure, the real estate holdings of the REIT are owned through a partnership in which the real estate’s former owners (often called “sponsors”) are limited partners and the REIT is the gen-

eral partner and also holds a limited partnership interest. The UPREIT structure is an effective tax deferral mechanism for REIT sponsors or others who own low-basis real estate that has been contributed to the REIT. While contribution of real estate directly to a REIT in exchange for stock is generally a taxable transaction, contribution of the real estate to a REIT’s operating partnership in exchange for limited partner units (called OP Units) is tax-free and defers recognition of the built-in gain. Of course, the deferred gain will be recognized when the sponsors sell or convert their OP Units (including in connection with a cash takeover) and in various other circumstances. OP Units are generally convertible by the unit-holder at any time, into stock of the REIT or cash, at the election of the REIT.

Despite common beliefs to the contrary, the UPREIT form provides no special protection against an unwanted suitor. To be sure, some UPREITS—like some public companies—have founding or sponsoring unit-holders whose economic position is sufficiently large that they have the mathematical or practical ability to block any transaction (including, of course, a change-in-control transaction) that requires a shareholder vote. This was the case in the 2003 contest between Simon Properties and Taubman, where Simon offered what was then an above-market price for Taubman shares



that the Taubman board (correctly, as hindsight has confirmed) resisted as inadequate. The Taubman family owned some 30 percent of the REIT's outstanding voting power (and a corresponding economic interest), and the transaction proposed by Simon required 67 percent of the vote. Thus, as a practical matter, the Taubmans exercised an effective veto over the proposed transaction. Such governance structures—in which the voting rights of each of the UPREIT's classes of equity (stock and units) are directly proportional to their relative economic value and are exercised at a single level to elect the REIT's board—are inherently fair and appropriate. There can be no question that the exercise of voting power by a sponsoring, founding or otherwise substantial unit-holder in such circumstances is reasonable. Such unit-holders plainly have an important stake in the affairs of the UPREITs they own, and any notion that the tax deferral such unit-holders enjoy requires their disenfranchisement would have as little basis in logic or fairness as would the suggestion that Bill Gates or Warren Buffett should have no voting rights in Microsoft or Berkshire Hathaway simply because their shares have a low basis.

In other UPREITs, sponsoring unit-holders have taken care to protect their interests by providing contractually for disproportionate voting rights or selective

consent rights with respect to certain exceptional transactions. Such arrangements reflect bargained-for economic benefits for the sponsoring unit-holder; they should be respected by courts, and unit-holders should be able to rely upon them as a legal and practical matter.

It is thus true that some UPREITs include large and powerful unit-holders who may have either a sufficiently large economic and voting position in the UPREIT to block any unwanted takeover, or specific contractual consent rights over extraordinary transactions, or both. While this point is true as a matter of historical generality, it would be error to conclude that UPREITs (still less REITs generally) are thereby immunized against hostile activity. Indeed, in the context of a widely held UPREIT (where the sponsor no longer has a blocking economic position or other veto right), the entity will be as vulnerable to hostile attack as any other public company. Moreover, even where an UPREIT sponsor maintains a sufficiently large economic stake to block any unsolicited bid, or retains a contractual veto over extraordinary transactions, the sponsor may be subject to tremendous pressure to consent to a transaction that enjoys wide support among public holders, and particularly so where the economic ownership stake is small, regardless of the contractual entitlements. Thus, the same forces that would bear down on the eco-

nomically dominant holder in any public company whose interests, economic and otherwise, may not be perfectly congruent with the public at large—think again of Bill Gates and Warren Buffet—are equally at work in the UPREIT context. Put simply, there is no magic in the UPREIT form that wards off unwanted suitors.

#### TAKEOVER PREPAREDNESS

Although REITs have a number of defenses at their disposal, there is nothing inherent in the REIT structure that makes REITs any less vulnerable to unsolicited offers than other public companies. The key for REITs, as with other companies, is to deploy the tools at hand effectively; there is no substitute for advance preparation to achieve this goal. When an unsolicited takeover approach is received, directors of REITs and other target corporations have a central role in evaluating any proposed transaction and the alternatives available to the corporation. The board must respond actively to any threat, however, and must take account of the realities today facing public companies—including REITs—in the takeover context. These include the current attitudes of the large institutional shareholders and the willingness of shareholders to act aggressively with respect to boards of directors, at and between annual meetings. Absent special

circumstances, inside ownership or show-stopper defenses, a board facing a bona fide transaction proposed by a determined suitor and desired by shareholders will come under intense pressure from the market.

Like all public companies, REITs should make advance preparations to respond to a hostile bid. The well-prepared REIT will have a team in place to deal with unsolicited initiatives; will have developed clear instructions for directors and employees in the face of a bid; and will undertake a periodic review of structural defenses. In many cases, a structural defense will be possible only if there has been careful advance preparation by the REIT and its legal and financial advisors. The most fundamental structural decision will often be whether to implement a rights plan, which, as elaborated above, provides a potential target with substantial and judicially tested protection from unsolicited bids. These structural issues should be examined with care by REIT directors, in concert with their financial and legal advisors, before any threat of takeover activity emerges.

Excess share provisions should also be considered in a REIT's advance takeover preparedness review. For the reasons set forth above, an excess share provision can never substitute for a shareholder rights plan, but such provisions can serve as a useful defensive supplement. Significantly, excess share provisions can apply at lower

ownership levels than rights plans, which rarely have triggers below 10 percent or more of a company's stock, and often have triggers of 15 percent or 20 percent; they can therefore deter accumulations at lower levels. To achieve these supplemental protective benefits, however, an excess share provision should be drafted and implemented with care: it should appear in the articles of incorporation rather than the bylaws, and should be drafted to make crystal clear that the ownership restrictions operate on an entity-level (not look-through) basis. Drafters should take care when employing the common practice of cross-referencing excess share provisions to the tax code, as the scope of such cross-references may prove ambiguous in a subsequent court test.

REIT boards should also take care to publicly disclose the anti-takeover purpose and effect of the excess share provision. Appropriate disclosure to shareholders at time of adoption and periodically thereafter will fortify the argument that the provision has a role to play in the context of a control contest and will help defeat the argument, sure to be advanced by unsolicited suitors, that the excess share provision should be limited to transactions that threaten the REIT's tax status. Finally, excess share provisions should be drafted to clarify that the power to grant exemptions and waivers is discretionary with the board. This drafting precaution will weak-

en any potential argument that the board is required to grant an exemption in favor of a hostile bidder if its ultimate judgment is that such an exemption would be imprudent. By attending to these precautions in advance, a REIT maximizes the likelihood that its excess share provision will prove useful in the event a hostile bid materializes.

REITs should also consider additional takeover preparedness options under state takeover laws. In the important case of Maryland REITs, for example, the state's control share and fair price statutes and the constituency provisions in the Maryland Unsolicited Takeover Act permit directors confronted with a potential acquisition of control of the corporation to consider the interests of the corporation's shareholders, employees, customers, creditors, suppliers and communities in which the corporation is located or does business. Under the constituency provision, directors may reject an offer because of the effect that the acquisition would have on non-stockholder stakeholders or may accept a lower priced offer that the directors believe is more favorable to all of the company's constituencies. These are potentially powerful tools in a takeover contest, and REITs should therefore consider thoroughly and in advance the various interests and stakeholders that they serve.

An important additional part of takeover preparedness is an advance strat-

egy for monitoring and responding to the first signs of potential bidder activity, including market accumulations by potential raiders and casual, non-public expressions of interest. The appropriate monitoring activity and preparatory steps will vary in every case, and REITs will generally benefit by working with their advisors to develop an anticipatory takeover response plan.

In the event that a hostile bid materializes, directors generally retain the ability to “just say no” that is, to conclude, after careful and fully informed deliberation, that the proposed transaction is not in the best interests of the entity and its shareholders and that the company is simply not for sale. The “just say no” response to a hostile bid was approved in the Time Warner case and reaffirmed in subsequent decisions. It continues to be good strategy and good law. But while the “just say no” defense may be available as a legal matter, it may not always be a practical option as a control contest unfolds in the market. Accordingly, any REIT under a hostile attack should, in addition to relying on structural defenses, consider actions that decrease its attractiveness as a takeover target, including making acquisitions (for example, to create antitrust problems for a hostile bidder or to increase the size of the potential transaction for the bidder); conducting asset sales or spin-offs of assets that may be desirable to the acquirer; initiating

share repurchases or self-tenders; liquidating; issuing targeted stock; or effecting a recapitalization. Here again, these options should be preliminarily developed in advance, in cooperation with legal and financial advisors, to ensure their maximum efficacy.

Whatever measures are taken to protect against unwanted bids, careful board process and regular communication between the company’s offers and the board is critical. The CEO should be the sole spokesperson for the company on independence, merger and takeover matters. The company’s response to any particular approach must be specially structured and a team of officers and outside advisors should confer to decide on a proper response. In all cases, the board must deliberate with care and ultimately act in good faith and on an informed, reasonable basis. There is no one-size-fits-all prescription for complying with a board’s open-ended fiduciary obligations in the context of a control contest, but boards may generally consider the following factors in analyzing an offer: the adequacy—or inadequacy—of the bid; the nature and timing of the offer; questions of illegality; duties to unit-holders; the impact on constituents other than shareholders (provided that consideration of such other constituents is permissible under local law); the risk of non-consummation; the qualities of the

securities being offered (if bid is not all cash); and the basic shareholder interests at stake. Ultimately, a diligent, well-informed board—one that takes careful account of these considerations and all others that present themselves in the unique circumstances of an actual control contest, in an appropriately deliberate manner and with the advice of experienced counselors—will be credited with due exercise of good judgment in the event its conduct is later challenged.

#### CONCLUSION

Healthy fundamentals and strong private market valuations of underlying real estate assets mean that the REIT industry remains ripe for takeover activity. In this environment, REIT directors would be well-advised to re-examine strategic plans and review their takeover response preparations. Contrary to the conventional wisdom, excess share ownership limitations are not a silver bullet against unwanted takeover activity and, indeed, are generally less effective than a rights plan because of (among other things) their grounding in the tax laws and their relatively unthreatening punitive effect.

Properly deployed, the takeover preparedness guidelines set forth above will help protect a REIT against abusive takeover tactics, increase the REIT's ability

to control its own destiny, and, in appropriate circumstances, allow directors to negotiate the best possible deal for the REIT and all of its shareholders and unit-holders. In reviewing and implementing these recommendations, it should be kept in mind that not all of these guidelines are appropriate for every REIT. Takeover defense is an art, not a science. It is essential to adopt and keep current effective defenses in advance of any danger, to be able to adopt new defenses quickly and to be flexible in responding to changing takeover tactics. There is simply no substitute for advance preparation.

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The views expressed herein are not necessarily the views of Wachtell, Lipton, Rosen & Katz.