The Determinants of Organizational Form Changes: Evidence and Implications from Real Estate

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We study changes in the real estate industry among organizational forms with varying degrees of restrictiveness and document the associated changes in profitability free cash flow debt, dividends. and investment policies. All troubled firms in our sample move to a more flexible organizational structure, with subsequent reductions in dividends improvements in performance and increases in asset sales and investments. Healthy firms that move to a tighter structure have larger free cash flows before the change; they increase dividends reduce free cash flows and improve profitability after the change. We document evidence of tax considerations in organizational changes.

Introduction

Real estate firms can choose among a wide variety of organizational forms. At the one extreme, real estate investment trusts (REITs) have mandatory payout requirements and restrictions on investments and asset sales, but offer tax advantages to their investors. In contrast, real estate corporations have 'looser' structures with few constraints on managerial policy, but expose their investors to double taxation and potential agency costs arising from greater management discretion over excess cash flows. In between, there are organizational forms such as master limited partnerships (MLPs) and business trusts, which share some characteristics with both REITs and corporations. This variety gives us a unique opportunity to evaluate the tradeoffs in choosing among organizational forms.

We examine all real estate firms that changed organizational form between January 1966 and December 1989 and categorize organizational form changes as shifts to either a looser (less restrictive) structure or to a tighter (more restrictive) structure. We also categorize these changes according to whether or not the organizational form change is accompanied by a change in the tax status of the entity. We then document the characteristics of firms that make changes from one organizational form to another. In particular, we study changes in performance, asset sales, investment, dividends, free cash flow, and leverage that accompany the change in organizational form. We find that firms in financial trouble are much more likely to change from tighter organizational forms (such as REITs) to looser forms (such as corporations), and to take full advantage of the resulting flexibility gained to restructure their assets and sharply curtail dividends. In contrast firms that change from looser to tighter organizational forms tend to have significant operating cash flows, and increase dividends following the organizational change.

In our sample, organizational form choices seem to be based on the tradeoff between the entity-level tax benefits on the one hand and organizational flexibility with regard to dividend payouts, debt, and investments, on the other. The reasons given by the corporations themselves also highlight tax considerations and dividend, investment, and financing flexibility. However, the previous finance literature has emphasized the structure of contracts and the associated agency problems as important determinants of organizational form choice (see Alchian, 1950; Fama and Jensen, 1983a, b). Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests plus the residual loss incurred because the cost of enforcing contracts exceeds the benefits (see Jensen and MeckIing, 1976).

The paper is organized as follows. In Section 2, we discuss the special features of a real estate investment trust that make it a more restrictive organizational form than a corporation. In Section 3, we describe our sample and methodology and present our findings. Section 4 concludes. An Appendix provides two case studies of organizational form changes.

Institutional Background

Table 1 presents some salient features of the organizational forms examined in this study. These include REITs, MLPs, business trusts, and real estate corporations. As Table 1 shows, there are several key differences among the various organizational forms. The first has to do with taxation. The income produced by REITs and MLPs is taxed only at the investor level. In contrast, corporations and business trusts are taxed at both the entity level (on income) and at the investor level (on dividends). The second key difference concerns investment and dividend policy restrictions. REITs are required by statute to pay out 95% of their earnings as dividends, and are restricted on the kinds of investments and divestitures that they can make. MLPs and business trusts have fewer restrictions on both investment and dividend policy, while corporations, generally speaking, are not restricted on either.

The third key difference concerns managerial discretion over cash flows. The legally mandated requirement to pay out 95% of their earnings as dividends and the restrictions on investment policy associated with the REIT organizational form severely limit managerial discretion over the disposition of the firm's cash flows (see Jensen, 1986). In contrast, managers of corporations have significantly greater power over the cash flows generated by their firms. Since most MLPs specify minimum cash payouts in the partnership agreement (see Moore et al., 1989). they provide for less managerial flexibility than the corporate form but more flexibility than the REIT. Business trusts move further up the continuum towards more managerial flexibility.

Based upon these characteristics, we classify changes in organizational form as shifting to either a looser structure or to a tighter structure. We classify the following changes as shifts to a looser structure: REIT to business trust, business trust to corporation, REIT to corporation, REIT to MLP, and finite REIT (FREIT) to MLP. The other shifts, i.e., corporation to REIT, corporation to MLP, and MLP to REIT, are classified as shifts to a tighter structure.

The trade-off in organizational form is between the greater tax benefits and reduced agency problems associated with organizational forms such as REITs, and the restrictions on investment and dividend policy that come with these benefits. In general, we would expect firms that are losing money and have negative cash flows to value flexibility more than any loss of tar benefits and increased agency problems, and thus be more likely to shift from a tighter organizational form to a looser one. We would expect firms with large earnings and positive cash flows to give much more weight to single-taxation benefits and agency problems than to the value of flexibility, thus making it more likely that they will shift to a tighter structure.

Table 1

Organizational Structure for Real Estate Firms

	REIT	MLP	Business Trusts	Corporation
Management	Centralized direction or trustees are entrusted with protecting the interests of shareholders. Trustees are subject to annual review and reelection. Advisory contract is also	Centralized by an operating company. Difficult to change the general partner (GP) in absence of provable fraud. GP has virtually autocratic powers.	Trustees manage the firm and have a fiduciary responsibility to protect the shareholders.	Centralized directors are entrusted with protecting shareholder interests.

	renewable annually.			
Organizational Control	Must have at least 100 shareholders with no more than 50% of shares held by five or fewer individuals.	Limited partners (LP) cannot own 20% or more of the stock of the GP or any of its affiliated companies. GP must have at least 10% of the MLP's total capital contributions. GP must have at all times at least 19% in each materiel item of partnership income, gain loss, deduction, and credit.	No restriction on the number of shareholders who can control 50% or more of the business trust.	No restriction on how many shareholders can control 50% or more corporate Shares.
Voting Rights of Shareholders	Shareholders have the right to vote on certain matters affecting the REIT, including election of directors or trustees.	Shareholders do not have any inherent voting rights or the tight to review partnership's books and records. Full-fledged rights are generally conferred at the GP's discretion. State securities partners. Some as the right to remove GP or assets.	Beneficiaries are not entitled to vote on business matters end have no say in choosing management. Beneficiaries become personally liable for obligations of trust as partners unless they relinquish all control over management. Beneficiaries are not allowed to choose the trustees.	Shareholders are entitled to vote on business matters and have a say in selecting the management.
Continuity	Perpetual life except for FREITS. The rationale for FREITs is that they are more likely to track closely to the fair market value of the underlying real	No continuity of life if subject to state statute corresponding to Uniform Partnership Act. Typically has a life of 100 years. If more than 50% of partners' capital or ownership interests are sold or exchanged	No continuity of life. The trust must have a maximum duration like a partnership.	Unlimited/perpetual life.

	estate.	in a ship is terminated for income tax purposes.		
Transferability/Liquidity	Shares are freely bought and liquidity sold on an exchange.	Theoretically, an MLP cannot have more than 50% of the units change hands each year or it no longer qualities as a partnership. Shares are freely bought and sold on an exchange.	Shares are freely bought and sold on an exchange.	Share are freely bought and sold on an exchange
Stockholder Liability	Limited stockholder liability. Stockholders are not personally liable if the firm is unable to pay its debts to claims against shareholders	Limited liability for limited partners but not for general partners. The general partner of the MLP has unlimited liability.	Limited liability for beneficiaries, but trustees are personally liable for all business debts unless either the declaration of trust specifies that unlimited liability will not .attach to trustees, or the other party to the transaction agrees to look solely to assets of the trust. Beneficiaries become personally liable for debts of trust if they exert any control over trustees.	Limited stockholder liability. Stockholders are not personally liable if the firm is unable to pay its debts. Corporate assets cannot fall to claims against shareholders.
Taxation	Not taxed at firm level if REIT meets certain requirements. Cannot serve as a conduit for losses since operating losses cannot be	Treated as a corporation, Except for MLPs publicly traded on 12/17/87, which are exempt through 1997, and MLPs investing in certain activities, notably real estate	Treated like a corporation for tax purposes.	Subject to double taxation once at firm level and again at shareholder level. Proceeds are treated as portfolio income or loss for tax purposes. Can carry losses back

	passed through to shareholders as capital gains. Proceeds are treated as portfolio income or loss for tax purposes. REITs are only allowed to carry losses forward for eight years.	and oil and gas. For these MLPs, no double taxation exists Proceeds are treated as passive income or loss for tax purposes. Since 1987 income from a MLP can only offset losses from that same MLP. Louts from an MLP may offset only later income from that same MLP. A partner's share of partnership income is taxable whether or not his share of any cash is distributed.		three years and forward five years. Cannot pass through losses to investors.
Dividend Payout Income (Earnings)	Must distribute at least 95% of taxable to shareholders. Distribution of more than 95% is possible because depreciation is en expense. REITs hove the option of distributing capital to investors but a REIT is the gains are not distributed.	High payout ratio is likely, since the partners pay tax whether the income is retained or not. However, there is no requirement that an MLP must distribute a certain proportion of income.	No dividend payout requirement. Management is free to decide the best use of corporate income. Shareholders cannot exert control over management regarding payout.	No requirements. Shareholders have no right to compel the corporation to distribute income to them. Management is free to decide the best use of income.
Restrictions on Business	Must derive 81 least 75% of its gross income from real estate. Income from the sale of securities held less than one year or real estate held less than four years	No restrictions on business operations. Can engage in the real estate trade or business, e.g.. can actively build, buy, and sell properties. No restrictions exist on the management or sale of MLP properties.	No restrictions on business activities except those prohibited in the activitty's declaration of trust.	No restrictions on business exapt by corporate charter.

	must be less than 30% of a REITs income. A REIT cannot operate a business, develop. or trade properties. nor can it sell more than five parcels a year. Prior to the 19X6 TRA, a REIT had properties.			
Reserves	Cannot accumulate reserves to meet special needs because REITs must distribute 95% of their taxable income. REITs need to raise additional money for growth either by secondary stock convertible and fixed-term debt.	Can accumulate reserves to meet special needs. Due to the single taxation structure of an MLP more income is left for reinvestment than if the business were operated as a corporation.	Can accumulate reserves since the trustees have the discretion to distribute earnings.	Can accumulate reserves to meet special needs.
Acquisitions	Cannot enter into tar-free exchanges for properties it washes to acquire.	Can trade its units/shares for real estate with the seller deferring taxes on the trade until he sells the MLP units.	No information could be found.	No information could be found.

Reasons Given by firms for Changes in Organizational Form

Many firms provide reasons when announcing an organizational change. Table 2 summarizes the reported reasons, which we culled from Wall Street Journal and Broadtape announcements. If the firm did not report a reason for the organizational change in either the wall Street Journal or the

Broadtape, we contacted the firm to see if a reason could be obtained. In some cases, the firm refused to give a reason. The total number of firms in each category is also reported in Table 2

Table 2 reveals that the most common reason given for switching to a looser structure is the need for more flexibility in investment and divestiture decisions. Prior to the 1976 Tax Reform Act, the use of tax-loss carryforwards to offset present or future income was also cited as a reason for switching. There are some differences, however, between nondistressed and distressed firms that move to a looser structure. Distressed firms are more likely, relative to nondistressed firms, to cite the wish to engage in enterprises other than real estate such as manufacturing or retailing. Distressed firms are also more likely to say that financing reasons such as restrictions in the debt restructuring agreement, removing restrictions on additional borrowing, and/or avoiding bankruptcy are making the change in organizational form necessary. Nondistressed firms, in contrast to distressed firms moving to a looser structure, are more likely to cite a relaxing of investment restrictions and hence an increase in their investment opportunity set. They are also likely to mention their wish to engage in prohibited real estate investments, such as the development and sale of properties. Thus, the type of flexibility desired differs for distressed and nondistressed firms.

Firms switching to a tighter structure usually cite tax reasons. To a more limited extent, such firms also cite agency and cash flow reasons. The Appendix documents two case studies of organizational form changes to provide some perspective on the process by which real estate firms make organizational changes and the rationale advanced at the time of the change.

Sample Description, Methodology and Results

Our sample includes all real estate companies that voluntarily converted from one organizational form to another during the period January 1966 to December 1989. We examined all REITs listed in various issues of the REIT Facebook for a change in organizational structure with both the dates of board of trustee/directors approval and shareholder approval obtained from either the Wall Sweet Journal, 10Ks, SEC proxy statements, and/or the Dow Jones Broadtape. Information on organizational restructurings was also obtained from issues of Audit Realty Stock Review and Moody's Bank and Finance Manual (vol. 2). The latter sources also reported cases in which the change in organizational form did not involve a REIT, e.g., from a corporation to an MLP and vice versa. Each company in the sample traded on either the New York, American, or OTC exchanges between 1966 and 1989 and has information available for the period on the Center for Research in Security Prices (CRSP) daily returns database and the COMPUSTAT quarterly database. There are 128 organizational changes during the period that fulfill these criteria and hence are included in our sample. There are 28 firms that made two organizational changes during the period, first from a REIT to a business trust and then from a business trust to a corporation.

We classify the total sample according to several criteria. First, we examine the Wall Street Journal Index for the five-year period preceding a change in the firm's organizational structure. We classify a firm as distressed if it experienced a net loss for each of the three years prior to the reorganization and one or more of the following events occurred during that three-year period: (a) the firm filed for protection under either Chapter 10 or 11 of the Federal Bankruptcy Act; (b) the firm missed two or more interest payments on classes of debt; (c) the firm asked banks and/or public debtholders to swap properties in forgiveness of debt; (d) one or more of a firm's creditor banks refused to sign a revised credit agreement that the company stated was vital for continued solvency; (e) the board of directors decided to omit divider& or (f) the auditor gave a qualified opinion on the firm's financial condition.

Since all firms classified as distressed had negative earnings per share for at least three years, and 87% of the firms were in actual or technical default on bond payments, these firms were in serious financial distress. Thus, the firms that are classified as nondistressednon-distressed cover the spectrum from substantial to marginal health, a point to which we will return when we examine differences among nondistressed firms.

Second, we define the organizational changes as shifts to a looser or a tighter structure, as described in Section 2.1. Table 2 provides the details of this classification as well as some interesting findings about the sample. For example, of the total sample of 128 organizational changes, 112 were to a looser structure and only 16 to a tighter structure. Moreover, the overall sample has more nondistressed firms (70) making organizational changes than distressed ones (58). Finally, about 25% of the nondistressed firms move to t tighter structure and the rest to a looser structure. In contrast, all of the distressed firms moved to a looser structure.

Motivated by the change in the tax law in 1976 that allowed REITs to carry net operating losses forward, we create a third classification based on whether or not the organizational change occurred prior to 1976. Prior to 1976, taking advantage of accumulated net operating losses provided an additional incentive to switch to a corporate form. The importance of this reason for organizational changes can be examined by contrasting the pre- and post-1976 samples.

The final classification consists of two subsamples, based on whether the organizational change results in a change in tax status from single to double taxation. A shift from a REIT to a corporation changes the tax status from single to double taxation; a change from a business trust to a corporation does not change the tax status since business trusts are also double-taxed.

Table 2
Reasons given for a change in organizational form

The sample includes 128 organizational changes divided into nondistressed (ND) and distressed firms (D) based upon characteristics at the time of the organizational change, and then further classified on the basis of whether the shift is to a looser structure (L) or a tighter one (T) based on organizational constraints on investment and financing policy. Types of organizational changes to a looser structure include REIT to business trust, business trust to corporation, REIT to corporation, REIT to MLP, and FREIT to REIT. Corporation to REIT, corporation to MLP, and MLP to REIT are considered changes to a tighter structure. A firm may give more than one reason as to why it is changing its organizational form. The first column (#) of each category gives the number of firms citing a particular reason, while the second column (%) of each category reports the percentage of firms relative to the total number of firms in the sample. Every effort was made to contact each firm that did not report a reason in the *Wall Street Journal* or *Broadtape*.

	ND-L		D-L		ND-T	
	#	%	#	%	#	%
Total number of firms in the sample	54	42.2	58	45.3	16	12.5
Investment flexibility						
Greater flexibility in managing assets and making investment decisions	25	46.3	27	46.4	0	0.0
To engage in prohibited REIT activities involving real estate	11	20.4	7	12.0	0	0.0
For a corporation to acquire a major stake in the company	0	0.0	1	1.7	0	0.0
To transfer the trust's assets, properties, or business to a subsidiary	1	1.9	0	0.0	0	0.0
Dividend and financing flexibility						
Eliminate mandatory dividends	2	3.7	6	10.3	0	0.0
To remove limits/restrictions on additional trust borrowing	0	0.0	4	6.9	0	0.0
To raise capital less expensively to obtain more effective leverage	1	1.9	0	0.0	0	0.0
To avoid financial distress; firm stated that it might have to seek bankruptcy protection	0	0.0	2	3.4	0	0.0
Taxation reasons e.g.,						
To reduce taxes; avoid double taxation	0	0.0	0	0.0	13	81.3
Change in tax laws and/or tax accounting affecting MLPs	0	0.0	0	0.0	4	25.1
Use tax-loss carryforwards to offset present or future income (pre-1976)	7	13.0	11	19.0	0	0.0
Liquidate the firm to realize its true market value while minimizing taxes	0	0.0	0	0.0	2	12.5
Managerial discretion over cash flows						
To give trustees discretionary authority not to qualify as a REIT or to convert to corporate status	8	6.3	9	15.5	0	0.0
To increase dividend payout to shareholders	0	0.0	0	0.0	2	12.5
To protect shareholders by disclosure of business activities and/or lessening conflicts of interest	0	0.0	0	0.0	2	12.5
No reason given/Company declined to comment	8	6.3	15	25.9	1	6.3

Effects of Organizational Change on Financial and Investment Policies

In Section 2, we argue that a primary motivation for switching to a looser structure could be to gain contractual flexibility in financial investment and payout policies. Such flexible would be particularly valuable for a troubled firm coping with financial distress. On the other hand, the mandatory payout requirements and other constraints on investment policy could reduce agency costs for nondistressed firms with high free cash flows. Table 3 shows the changes in asset structure, financial leverage, and dividend policy that accompany a change in organizational form,. We report the cross-sectional averages for the pre- and post-change periods.

There are no statistically significant changes in the average debt/equity ratios for the overall sample, which decrease from 3.00i n the pre-change period to 1.95 in the post-change period. Nondistressed firms moving to a looser structure maintain existing debt ratios, whereas those moving to a tighter structure decrease debt. Troubled firms also reduce debt after changing organizational form. These differences are not statistically significant, however.

On average, after organizational changes, the dividend yields decline for the overall sample from an average of 8.15% to an average of 2.16%; this drop is significant at the 1% level. Nondistressed firms that move to a looser structure cut dividends significantly, with the average dividend yield decreasing from 4.31% to 1.27%. More than 70% of these firms stop paying dividends after the switch to a looser structure. Firms that move to a tighter structure increase dividends, with the average yield increasing from 2.61% to 10%. When firms are classified by health, nondistressed firms do not change dividend yields significantly around organizational changes, on average. On the other hand troubled firms cut dividends dramatically, with the average yield dropping from 12.68% to 0.07%. All but two of the troubled firms stopped paying dividends after the switch to a looser structure.

Fig 1 summarizes dividends and operating income for firms switching to tighter and looser structures. Firms switching to a tighter structure have cash flows that are significantly higher than dividends before the switch, and greater Rarity between these two numbers afterward. The equalization is due to a drop in operating income and a significant increase in dividends. Firms switching to a looser structure have much smaller cash flows available for distribution. They pay dividends that are roughly equal to cash flows before the switch, and have much lower dividends after the switch. These results reemphasize our findings that there are gradations of health even among nondistressed firms. The healthier a firm, if health is defined in terms of cash flows available to meet financial obligations, the more likely it is to shift to a tighter structure. The less healthy a firm, the more likely it is to shift to a looser structure.

Table 3

Policy measures around organizational changes

The year in which the organization change is made is year 0. The policy measures are for the two years before (pre-change) and the two years after (post-change) the organization change. The firms are classified on the basis of structural change (looser vs. tighter structures) and firm health (nondistressed vs. distressed firms). The cross-sectional standard errors are reported in brackets below the cross-sectional averages. A change is classified as a shift to a looser (tighter) structure if it leads to a structure with fewer (more) constraints on capital structure, dividend policy and asset sales. The classification of firms at the time of the organizational change into nondistressed and distressed firms is based upon observables at the time of the change. The t-statistic tests the hypothesis that the means of the two groups are equal. The z-statistic is a nonparametric median test, based upon the number of points above the median.

	Nondistressed to		Looser vs. tighter		Firm status		Nondistr vs Distressed		All Firms
Year	Looser	Tighter	t-stat	z-stat	Nondistr	Distressed	t-stat	z-stat	
# Reports	44	13			57	38			
1. D/E									
Pre-change	1.46	1.49			1.47	4.59			3.00
	(0.45)	(1.09)			(0.36)	(1.15)			(0.61)
Post-change	1.50	0.69			1.30	2.75			1.95
	(0.28)	(0.42)			(0.23)	(0.53)			(0.28)
Difference	0.04	− 1.03	0.42	1.64	− 0.24	− 1.88	1.52	0.35	− 1.01
	(0.40)	(0.83)			(0.34)	(1.07)			(0.74)
2. Div Yield									
Pre-change	4.31%	2.61%			3.90%	12.68%			8.15%
	(1.35%)	(1.10%)			(1.21%)	(3.24%)			(1.74%)
Post-Change	1.27%	10.00%			3.82%	0.07%			2.16%
	(0.60%)	(1.38%)			(0.87%)	(0.05%)			(0.52%)
Difference	− 3.11%	7.70%[a]	2.26[a]	5.02[a]	− 0.07%	− 12.37%[a]	3.09[a]	2.77[a]	− 5.65%[a]
	(1.95%)	(1.79%)			(1.75%)	(3.84%)			(2.09%)

3. Investment									
a. AS/TA									
Pre-change	0.08%	0.83%			0.12%	0.33%			0.23%
	(0.06%)	(0.69%)			(0.11%)	(0.21%)			(0.12%)
Post-change	0.70%	0.19%			0.47%	3.80%			1.66%
	(0.30%)	(0.18%)			(0.27%)	(1.15%)			(0.57%)
Difference	0.62%	− 0.64%	2.70[a]	2.15[a]	0.57%	3.41%[a]	2.11[a]	1.73	1.97%[a]
	(0.35%)	(0.50%)			(0.34%)	(1.32%)			(0.69%)
b. CEX/TA									
Pre-change	0.60%	5.26%			1.26%	0.95%			1.11%
	(0.72%)	(2.54%)			(0.65%)	(0.39%)			(0.38%)
Post-change	3.06%	2.05%			2.32%	3.50%			2.84%
	(0.90%)	(1.32%)			(0.79%)	(1.25%)			(0.71%)
Difference	2.55%	− 2.82%[a]	2.26[a]	2.08[a]	1.31%	2.90%[a]	1.01	0.64	2.04%[a]
	(0.90%)	(0.69%)			(0.81%)	(1.42%)			(0.79%)

[a]Significant at 0.05 level.
[b]Significant at 0.10 level.
CEX: Capital expenditures and acquisitions
TA: Total assets
AS: Asset sales and divestitures
D/E: Debt/equity

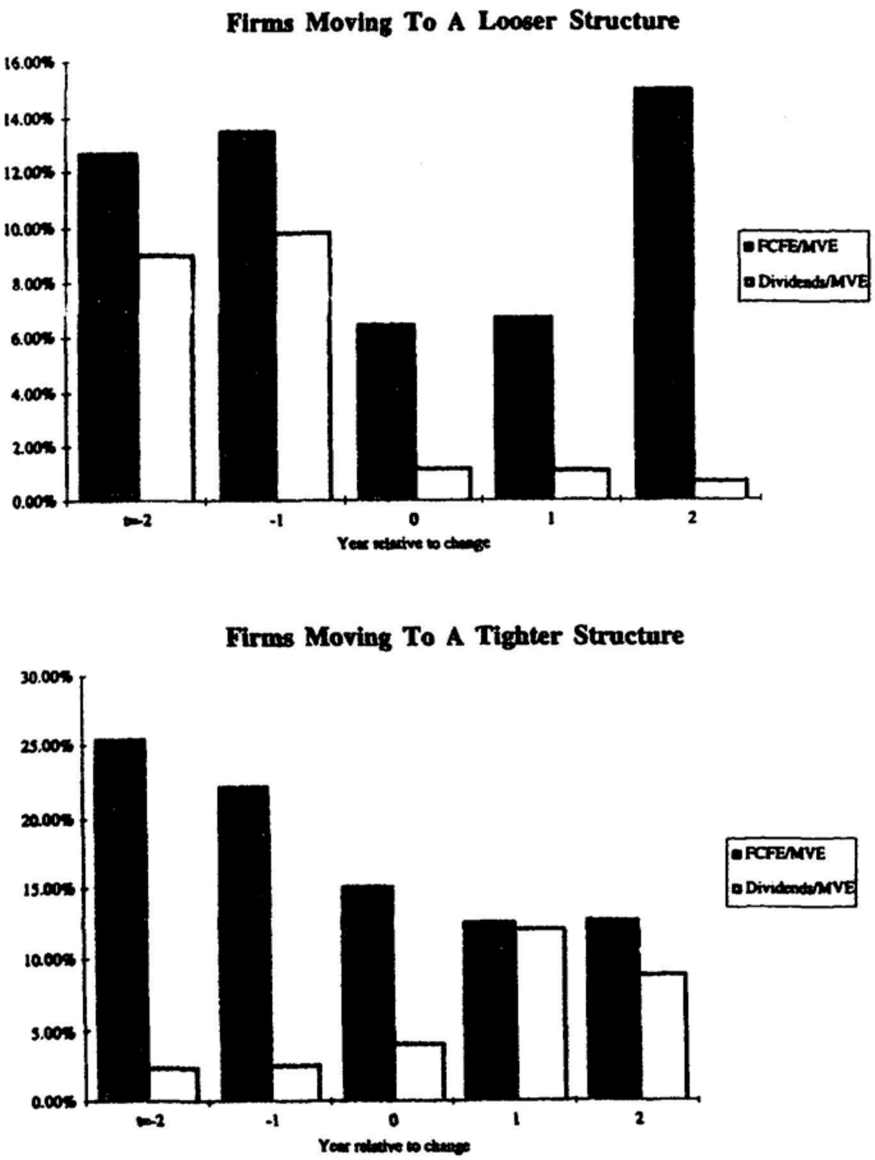

Fig. 1. Free cash flow versus dividends.

The free cash flow to equity (FCFE) measure the cash flows left over after meeting capital expenditures and debt financing needs. The market value of equity (MVE) is the market value of equity at the beginning of the period. (a) Firms moving to a looser structure and (b) Firms moving to a tighter structure.

In the last part of this analysis, we evaluate the investment and divestiture decisions of firms around organizational changes. Table 3 reports that asset divestitures(as a percentage of total assets)increase after organizational changes for the overall sample from 0.23% of the value of total assets before the organizational change to 1.66% afterward. Nondistressed firms switching to a looser structure report an increase in asset sales after the change, with divestitures increasing from 0.08% of total assets to 0.7%. Firms switching to a tighter structure report a drop in divestitures, but the change is small and not statistically significant. When firms are classified on the basis of health, both nondistressed and troubled firms increase asset sales, on average, after changing their organizational form. The increase is much larger for troubled firms switching to a looser structure.(from 0.33% to 3.8% of the market value of equity) than for nondistressed firms (0.12% to 0.47%). Thus, troubled firms are much more likely to use their newly acquired freedom to restructure assets.

If the divestitures reported here had not been accompanied by new investments, these firms would have become smaller. However, there is evidence that these divestitures were offset by acquisitions and capital expenditures. On average, firms report an increase in new investments after organizational changes, with capital expenditures and acquisitions increasing from 1.11% of the market value of equity to 2.84%. Nondistressed firms switching to a looser structure increase investments from 0.6% of the market value of equity to 3.06% a change that mirrors the divestitures reported above. Firms switching to a tighter structure report a decrease in new investments from 5.26% :o 2.05% of the market value of equity. Both nondistressed and distressed firms report increases in new investments after organizational changes, but again, the change is more dramatic for troubled firms. In summary, troubled firms switching to a looser structure seem to take advantage of their new flexibility by divesting themselves of a portion of their old assets and acquiring new assets. Nondistressed firms switching to a looser structure divest fewer assets, but also embark on major investments and acquisitions after the change.

Overall, there is evidence that organizational changes are accompanied by changes in payout, investment, free cash flow, leverage, and asset divestitures that reflect the change in restrictiveness of the organizational form. Firms that switch to a looser structure pay smaller dividends and restructure their assets. These changes are most pronounced for troubled firms with partial liquidations of many such firms followed by a redeployment of the assets. Firms that switch to a tighter structure pay larger dividends and reinvest less of their cash flow in new projects.

Organizational Changes and Tax Factors

There are two tax-related issues that arise in the context of the organizational form changes studied here. The first is the shift from purely personal taxation (under the REIT structure, in which income flows to the investors and is taxed at personal tax rates, i.e., single taxation) to a mixture of entity and personal taxation (under the corporation structure, in which income is taxed at the entity level and dividends are again taxed at the personal level, i.e., double taxation). The tax advantage of personal taxation (i.e., single taxation) over a mixture of entity and personal taxation clearly depends on the personal and corporate tax rates involved and the payout policy of the double-taxed entity. The second issue is the prohibition on carrying net operating losses forward that governed REITs prior to 1976,[1] providing an incentive for at least some REITS with substantial net operating losses to shift to a corporate status in that period.

We examine both issues by regressing the changes in financial policy against two dummy variables, one that measures whether the organizational change occurred prior to the tax law changes in 1976 and another that measures whether the change in organizational form resulted in a shift in tax status from single to double taxation, with the following results (t-statistics in parentheses):

$$\begin{array}{rllll} \text{DDY} = & -0.0072 & -\ 0.4010\ \text{PER} & +\ 0.0136\ \text{TXTYPE} \\ & (0.45) & (13.44^{a}) & (0.57) \\ \text{DINV} = & -0.0010 & -\ 0.2548\ \text{PER} & +\ 0.0159\ \text{TXTYPE} \\ & (0.05) & (9.91^{a}) & (0.79) \\ \text{DAS} = & 0.0001 & -\ 0.1342\ \text{PER} & +\ 0.0111\ \text{TXTYPE} \\ & (0.01) & (8.25^{a}) & (0.87) \end{array}$$

where

PER= zero if the organizational change happened after 1976, one if before 1976

TXTYPE = zero if tax status remains the same, one if tax status shifts from single to double taxation

DDY = Change in dividend yield ($DY_{post} - DY_{pre}$)

DAS = Change in asset sales/total assets ($AS_{post} - AS_{pre}$)

DINV = Change in investments/total assets ($INV_{post} - INV_{pre}$)

In terms of firm behavior after organizational changes, there are significant differences between changes in the pre-1976 period relative to the post-1976 period. Firms that changed organizational form prior to 1976 reduce dividends much more dramatically than firms that changed their organizational form after 1976, but make significantly smaller changes in asset structure, investing less in new assets and selling fewer existing assets. Thus, they took no advantage of the financial flexibility that the corporate form offered in terms of capital investments or divestitures, and concentrated instead on reducing dividends. The firms that made organizational changes prior to 1976 also take advantage of net

[1] Prior to the 1976 Tax Reform Act a REIT was not permitted a net operating loss Furthermore. a REIT was not allowed to reduce its capital gains by ordinary losses If a firm intentionally de-REITed, the firm could carry that loss forward to a year in which it had to pay corporate taxes. After passage of the Tax Reform Act, REITs were allowed to carry losses forward or reducer net capital gains. A net operating loss could be carried forward for eight years, but not backwards Prior to 1976, REITs were allowed to change to a corporate form in one year and change back the next year. Under the Tax Reform Act a firm cannot make a new election for five taxable years.

operating loss carry forwards. These facts seem to suggest that tax reasons dominated in the pre-1976 time period.

Firm Performance Before and After Organizational Change

To evaluate firm performance before and after organizational changes, we examine three measures: net income/total assets, return on assets (defined as EBIT/total assets), and the cumulative abnormal return for the two years before the change and the two years after the change. (We scale the operating income by total assets because the dollar values are skewed by a few larger REITs.) For firms making organizational changes, Table 4 reports the cross-sectional means and standard errors of each of these measures for the pre- and post-change periods. There are two classifications, one on the basis of whether the shift is to a looser or a tighter structure and the other on the basis of financial health at the time of the change. The difference between the pre- and post-change measures is reported, with a r-statistic testing for differences in means.

There is a significant increase in profitability for the overall sample, with the average net income increasing from - S7.45 million in the pre-change period to - $0.24 million after the change, though the return on assets is unchanged. The difference is most dramatic for troubled firms many of which have large losses but are profitable afterwards. The improvement is significant both in dollars and in return on assets. For nondistressed firms, the increase is much larger for firms that go to a tighter structure than for those that move to a looser structure, though the improvement is not significant on the return on assets measure.

We also perform the same analysis but correcting for overall changes in profitability for all REITs during each year, to adjust for any changes that might affect all REITs. For instance, if REITs are more likely to shift to a looser structure just before economic recoveries, there will be an improvement in profitability after the change, not because of the change per se but because of the economic upturn. This correction should also significantly reduce any autocorrelation that might exist in the annual data for individual firms. The results are similar.

At the time of the change, nondistressed firms that switch to a tighter structure have significantly higher operating income as a percentage of total assets than firms that switch to a looser structure. The mandatory payout requirements of the tighter organizational structure force the firms disgorge some of this cash flow after the organizational change and consequently reduce agency costs. They may also benefit from avoiding double taxation on these cash flows. For obvious reasons, troubled firms have much smaller operating incomes than nondistressed firms. We find that nondistressed firms moving to a looser structure have much lower returns on assets than nondistressed firms those that move to a tighter structure, suggesting that the former may be relatively less healthy at the time of the change.

Table 4

Performance measures around organizational changes

The year in which the organization change is made is year 0. The performance measures are for the two years before (pre-change) and the two years after (post-change) the organization change. The firms are classified on the basis of structural change (looser vs. tighter structures) and firm health (nondistressed vs. distressed firms). The cross-sectional standard errors are reported in brackets below the cross-sectional averages. The return on assets is the earnings before interest and taxes divided by the total assets. The cumulative abnormal returns are estimated for day − 520 to day − 21 for the pre-change period and day + 21 to day + 520 for the post-change period. The betas are estimated over the 250 trading days preceding each period. A change is classified as a shift to a looser (tighter) structure if it leads to a structure with fewer (more) constraints on capital structure, dividend policy and asset sales. The classification of firms at the time of the organizational change into nondistressed and distressed firms is based upon characteristics at the time of the change. The t-statistic tests the hypothesis that the means of the two groups are equal. The z-statistic is a nonparametric median test, based upon the number of points above the median.

	Nondistressed firms to		Looser vs. tighter		Firm status		Nondistr vs. distressed		All firms
Year	Looser	Tighter	t-stat	z-stat	Nondistr	Distressed	t-stat	z-stat	
# Reports	44	13			57	38			95
1. Net Income									
Pre-change	− 0.85	− 0.43			− 0.73	− 14.44			− 7.45
	(1.81)	(0.42)			(1.70)	(4.67)			(2.53)
Post-change	− 0.66	9.83			1.38	− 2.42			− 0.29
	(1.24)	(3.71)			(1.29)	(2.08)			(1.17)
Difference	0.20	9.36[a]	1.90[b]	1.88[b]	2.78	12.02[a]	1.80	1.53	7.03[a]
	(1.56)	(4.10)			(1.49)	(5.30)			(2.60)
2. ROA									
Pre-change	4.01%	10.15%			6.81%	1.74%			4.37%
	(1.25%)	(2.63%)			(1.09%)	(1.19%)			(0.84%)
Post-change	4.46%	11.68%			7.07%	4.39%			4.42%
	(1.01%)	(3.19%)			(0.85%)	(1.46%)			(0.80%)
Difference	0.40%	0.14%	0.44	1.38	0.26%	2.66%[b]	2.01[a]	2.46[a]	0.05%
	(1.00%)	(2.50%)			(1.34%)	(1.36%)			(1.32%)
3. CAR									
Pre-change	− 25.55%	− 6.65%			− 22.07%	− 58.19%			− 36.05%
	(9.76%)	(11.05%)			(9.64%)	(23.15%)			(10.9%)
Post-change	4.01%	1.06%			3.60%	4.10%			3.73%
	(9.07%)	(7.16%)			(8.91%)	(15.29%)			(7.91%)
Difference	28.33%	7.71%	1.86[b]	1.95[b]	25.56%	58.80%	1.09	1.17	37.96%
	(14.15%)	(7.34%)			(13.80%)	(21.96%)			(14.7%)

[a] Significant at 0.05 level.
[b] Significant at 0.10 level.

We measure cumulative abnormal returns, which are measured for the two years prior to and after each change, based on betas from the 250 trading days prior to the pre-change and post-change periods. The pre-change period starts 521 days prior to the organizational change and ends 21 days before the change; the post-change period starts 21 days after the organizational change and continues until 521 days after the change. All firms that make organizational changes to a looser structure, whether nondistressed or troubled at the time of the change, have significant negative abnormal returns in the two years prior to the change and mildly positive abnormal returns in the two years after the change. Again, the change is most dramatic for troubled firms that shift to looser organizational structures, a finding that is consistent with those on net income and operating income.

In summary, nondistressed firms that move to a tighter structure and distressed firms that move to a looser structure become more profitable and increase the value of their equity. Nondistressed firms moving to a looser structure do not do as well in terms of improving net income or return on assets, but they do increase the value of their equity in the aftermath of the change. The differences between distressed and nondistressed firms are neither dramatic nor statistically significant. Furthermore, nondistressed firms with high levels of operating income are much more likely to switch to a tighter structure to obtain the lower agency costs of free cash flow and the tax advantages associated with these organizational forms.

Discussion of Results

The evidence presented here is consistent with the hypothesis that firms do indeed trade the benefits of a tighter structure (tax benefits and reduced agency costs) against the restrictive constraints on investment and dividend policy that go with these structures. Thus, distressed firms that incur losses and have negative cash flows shift from tighter to looser structures, since the benefits of the flexibility gained far exceed the lost tax benefits and the increase in agency costs associated with such a move. The subsequent actions taken by these firms to restructure assets and curtail dividends provide consistent evidence, as does the improvement in stock price and profit performance after the change.

At the other extreme, firms with large free cash flows switch from a looser to a tighter structure. They find the tax benefits and reduction in agency costs large enough to justify the loss of flexibility associated with these changes. Here again, these firms increase dividends and curtail investments after the change.

The one group for which the tradeoff is more ambiguous includes the firms classified as nondistressed that switch from a tighter to a looser structure. The tax benefits lost and agency costs incurred as a consequence of the shift to a looser structure are smaller and are clearly offset by the benefits that come from the switch. This group can be broken up into two subgroups: those that change their organizational form prior to 1976 and those that change after 1976. Of the 44 nondistressed firms that switch to a looser structure, 25% make the switch prior to 1976. They all cite the carryforward of operating losses as the primary reason for the switch (see Table 2). These firms also tend to have much huger net operating losses as a percentage of total assets (10.5%) than the nondistressed firms that switch after 1976 (who average net operating losses amounting to only 3.5% of total assets).The nondistressed firms that switch to a looser structure after 1976 are profitable, on average, but much less so than the nondistressed firms that switch to a tighter structure. It follows that these firms, while increasing their tax exposure by switching to a looser structure, have low profitability and therefore do not pay very much in taxes. Presumably, they believe that their gains from increased flexibility more than offset this tax disadvantage. Again, this is borne out by the reasons given at the time of the change. The managers of the nondistressed firms that switch after 1976 cite the flexibility gained (in being able to invest more broadly in real estate) as the primary factor for the switch.

Conclusion

This paper examines changes by real estate firms among four types of organizational forms: REITs, MLPs, business trusts, and corporations. We classify our sample of organizational changes according to whether the change is to a looser or a tighter structure, and whether or not the firm is in financial distress at the time of the change in organizational form. We document the changes in free cash flow, leverage, dividends, asset sales, and capital expenditure that accompany the organizational form changes, both for the overall sample and the subsamples. We also note the accompanying changes in equity value and other performance measures.

We study whether there are systematic differences in value changes and changes in dividend leverage, and investment policies associated with organizational changes. We test to see if these differences are consistent with the increase or decrease in flexibility accomplished by the organizational changes. We find that all organizational changes made by distressed firms are to a looser structure. Firms switching to a looser structure pay substantially smaller dividends after the change and that they restructure their a sets, selling significant portions of their existing assets and acquiring new assets to replace them. These changes are more pronounced for distressed firms than for nondistressed firms. Firms switching to a tighter structure have significantly larger free cash flows before the switch and pay more in dividends after the organizational changes. However, they do significantly less asset restructuring than firms switching to a looser structure.

We also find some evidence of taxes as a factor in organizational form changes. The dividend yield reductions associated with an organizational form change to a looser structure are more severe when the change occurs prior to 1976. In addition, organizational changes are followed by increased equity value and improvement in earnings for nondistressed firms moving to a tighter structure and troubled firms moving to a looser structure, with the increase being more dramatic for the latter group. Nondistressed firms that move to a looser structure lag both of these groups in stock price and earnings performance.

In summary, firms are motivated to change to a looser organizational form to gain advantage of the greater flexibility, and to a tighter structure for the tax benefits. On average, at least, these changes seem to pay off in terms of increased profitability and stock prices.

Appendix: Case Studies of Organizational Form Changes

Tighter to Looser Organizational Form: Centennial Group/Midland Mortgage

The Centennial Group commenced operations on May 5, 1969 as Midland Mortgage Investors Trust, a REIT making construction and other short-term mortgage loans. In order to obtain funds to lend, the REIT borrowed substantial amounts of short-term funds through bank lines and the sale of commercial paper in addition to the sale of subordinated debentures. In September 1974, the trust started to show early signs of financial difficulties, and reported that it had $19 million in nonearning investments which comprised 16% of its invested assets.

By March 1975, Midland was able to negotiate a new revolving credit line with a syndicate of ?3 U.S. banks for $102 million, in return for substantial restrictions on dividend and financing policy. In spite of this, nonearning investments increased to 43% of invested assets by April 1975. On July 25.1975, the board of directors of the trust recommended amendments to the declaration of trust allowing trustees discretionary authority not to qualify as a REIT for tax purposes. The intent was to give the trustees greater flexibility in operating and disposing of foreclosure property and to allow them to take advantage of tax-loss carryforward credits. The board also proposed reductions in interest and principal payments on outstanding debt, and the bondholders approved these proposals on November 11 t+. Three days later, the stockholders affirmed these amendments.

The firm entered into an unsecured revolving credit agreement with its participating banks in July 1976, which allowed Midland to transfer assets to creditor banks in exchange for either canceling or reducing debt and cash. By the end of the year, the accounting firm of Ernst and Ernst gave the firm a qualified opinion due to uncertainties as to whether the firm could maintain this credit agreement and also maintain a minimum of $1 million in shareholders' equity.

On June 15, 1981, the firm announced that it would seek shareholder approval to change from a business trust to a corporation because 'the trust form of doing business is quite cumbersome' (Wall Street Journal, June 198 1, p. 5). As part of this process, the firm also changed its name to the Centennial Group Inc. to reflect a change in emphasis to real estate development (Wall Street Journal, August 12, 1981, p. 38).

In many ways, the path adopted by Midland, which started as a REIT and moved progressively from that status to a business trust to a corporation, is mirrored by other firms that switch to a looser structure in our sample.

Looser to Tighter Structure: Weingarten Realty Investors

Weirgarten Realty Inc. commenced operations in 1948 to own and develop shopping centers and other commercial real estate primarily m the Houston area. On December 28.1984 the company's board of directors approved a reorganization plan which was designed to qualify the company as a REIT (Weingarten Realty Investors, 1987 Annual Report). More specifically, the company created a holding corporation known as WRI Holdings to hold not only assets unsuitable for ownership by a REIT but also $3.5 million in cash and $26832000 in debt securities (Weingarten Realty Investors, Notice of Annual Meeting of Shareholders, May 26, 1988). The firm received $26832ooO in mortgage bonds and voting and nonvoting common stock of WRI Holdings, Inc. in exchange for these net assets. The company also entered into a management contract with the Weingarten Realty Management Company to manage its properties as part of the plan.

The board of directors sought REIT status given their belief that this changeover would reduce taxes and administrative expenses for an annual savings of approximately $575000 (Weingarten Realty Investors, Proxy Statement, February 12, 1988). The company completed its initial public stock offering (IPO) in 1985 and was taxed as a REIT starting in that year. Goldman, Sachs, and Co., the lead underwriter of the IPO reported that 3.75 million common shares of the REIT were sold , at $19.5O each. Of the total 2.6million shares were sold by the company and the rest by the shareholders. The company used its portion of the proceeds from the IPO to reduce short-term debt. The voting and nonvoting common stock that the company received from WRI Holdings was distributed to the company's shareholders in 1985. On March 22, 1988 the shareholders formally approved the conversion of the company from a Texas corporation to a Texas REIT. The company's predecessor entity, Weingarten

Realty, Inc., transferred all remaining assets and liabilities to the new REIT in exchange for shares. The distribution of shares to shareholders was made on the basis of one trust share for each share of common stock. The IRS deemed this transfer to be a nontaxable event to both the firm and its shareholders.

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