

▶ INSIDE THIS ISSUE ▶ Inland REIT To List p3 ▶ More Details on State Street Buy p3 ▶ Sun Downgraded p4

INDUSTRY UPDATE

SEC Vs. Edwards: Implications For TICs?

A US Supreme Court decision handed down earlier this winter may have implications for the tenant-in-common industry. Some cite the case as bolstering their

Special Report: Supreme Court Decision

belief that TIC investments should be treated as securities when it comes to their marketing and sale—although others say the case has no real meaning for TICs.

Regardless of one's opinion, one thing is clear: every new industry feels growing pains, and the TIC business is no exception. Whether or not TICs should be treated as securities for securities law purposes—as opposed to being treated as real estate, as they are for purposes of 1031 exchange replacement property—has emerged as the biggest topic of debate and the biggest source of uncertainty for those involved.

The case before the high court, SEC v. Edwards, dealt with a payphone sale-lease-back investment scheme in which 10,000

people invested some \$300 million. Through his company **ETS Payphones Inc.**, Charles Edwards sold payphones via independent distributors to the public and leased them back with a site lease, management agreement, buyback agreement and the promise of a fixed rate of return. Ultimately, the payphones did not generate enough revenue to make the lease payments, and ETS filed for bankruptcy. That was quickly followed by a **Securities and Exchange Commission** civil enforcement action, which alleged various violations of securities law, including registration requirements under the Securities Act of 1933.

The case wound its way through the legal system. A district court held that the payphone scheme was an investment contract and thus subject to federal securities laws. A Court of Appeals reversed that, though, saying it was not an investment contract for two reasons—it said investment contracts exclude schemes offering a fixed rate of return, and that the test of whether the investment's return was "derived solely from the efforts of others," and thus a security, was not satisfied.

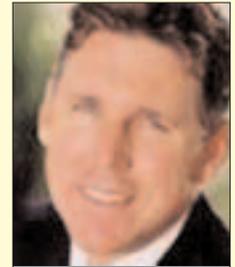
The Supreme Court took up the case in its October 2003 term, and handed down its unanimous opinion, crafted by Justice Sandra Day O'Connor, in January. It reversed the Court of Appeals, stating that the payphone investment scheme did in fact meet the tests to qualify as an investment contract. O'Connor's decision notes that "the test for whether a particular scheme is an investment contract was established in our decision in SEC v. W.J. Howey Co. ... We look to 'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others'. ... We hold that an investment scheme promising a fixed rate of return can be an 'investment contract' and thus a 'security' subject to the federal securities law."

Daniel S. Rosefelt, a Bethesda, MD-based attorney and CPA of counsel to **Selzer Gurvitch Rabin & Obecnay**, thinks the Edwards case may very well have an impact on the TIC business, even though he acknowledges that some TIC deals can be safely structured as real estate. "I think it's a very significant decision," says Rosefelt, who represents both sponsors and individual investors in TIC deals. "It has expanded the reach of securities laws to many other types of investments."

▶▶▶ Continued on page 2

NETLEASE INSIDER

Although he's not practicing law, **Tim Snodgrass**, president and COO of **Argus Realty Investors LP**, a TIC sponsor based in San Juan Capistrano, CA, has a JD. **NET LEASE forum**



Tim Snodgrass

asked Snodgrass, also chairman of the **Tenant-in-Common Association**, to share his thoughts on SEC v. Edwards and the security-real estate debate.

Q: What's this case all about?

A: What they were arguing in this ETS phone case, which dealt with a sale-lease-back and a master lease that people were investing in and making their money from the master lease, was that the profits weren't solely derivative of the efforts of others. That it was really just a contract that was delivering the income, not the guys who were promoting it. But the Supreme Court came back and said, 'Nice argument, but the bottom line is if

▶▶▶ Continued on page 5

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INDUSTRY UPDATE Continued from page 1

"It's all substance over form. You can disguise this thing any way you want, and it can still be a security," Rosefelt adds in interpreting the court's decision. "And if you have a security, you need to register it or you need to qualify for one of the applicable exemptions. And what happens is, if you don't, you have a blown registration, which can be very ugly. It gives an upset investor and their attorney a lot of weapons."

Richard M. Lipton, a partner with **Baker & McKenzie** in Chicago, has a similar take. "On the tenancy-in-common, where there are multiple tenants, meaning more than just two co-owners, I think the Edwards case certainly creates a stronger inference that it is a security for securities law purposes," says Lipton. "We've been advising clients, even before that case, to sell interests in multi-owner deals as securities. Our view has been strengthened by that case."

But others disagree. Says Louis J. Rogers, a partner who leads the real estate securities practice group of **Hirschler Fleischer** in Richmond, VA: "It's a nothing case. The 11th Circuit did something totally stupid, and the Court slapped them and said, 'You guys are morons!'"

Rogers says he helps clients on both TICs as securities and TICs as real estate. "It's really a function of your channel of distribution. If you're in the real estate world, you're a real estate agent or broker, that's one path. If you're a securities broker, you have more options. The bottom

line is, it's really driven by controls and compensation. The securities sponsors want to control a deal with locked-in management. ... But I just don't see any reason why the local realtor can not take a piece of property and sell it in TICs without becoming a sponsor. As long as they do it the right way; they can't become a sponsor, they can't control the property and they can't be too active."

"It doesn't spell it out perfectly clear to me. I think the jury is still out," Michael Hogue, principal of Minneapolis-based net-lease brokerage **Upland Real Estate Group**, says of the Edwards decision. "We've been advised it potentially could be ruled a security, but we think, and our attorneys think, it's real estate." His company sells TIC investments as real estate (see separate story in this issue about *Safe Harbor Exchange LLC*), though Hogue says he is looking into a possible broker-dealer relationship. (For a TIC sponsor's perspective, see the Q&A with *Tim Snodgrass*, president and COO of *Argus Realty Investors LP*, also in this issue.)

So what's likely to settle this issue? "I doubt anybody is going to be able to get a no-action letter [from the SEC] that it's not a security," Lipton says of TICs. "You might see some no-action letters, assuming they're sold as securities, on who else can share in their fees. I think the other potential possibility—which may be years down the road—is that one of these deals eventually

▶▶▶ Continued on page 3

RECENT TRANSACTIONS

▶ **Wells Real Estate Funds** got its second non-listed REIT, **Wells Real Estate Investment Trust II Inc.**, off to a start with its purchase of the 260,000-sf Houston office building known as **Weatherford Center**. **Weatherford International Inc.** has its headquarters there under a triple-net lease that expires in 2012.

▶ **TSG Real Estate LLC**, a subsidiary of **Tax Strategies Group**, purchased **Prime Center** at Briargate in Colorado Springs for 32 tenants-in-common. The 283,708-sf office complex carried a price tag of \$53.2 million. The seller was **ORIX Real Estate Equities**.

▶ **Specialty Laboratories Inc.** expects to close the sale-leaseback of its future headquarters and laboratory facility in Valencia, CA, by the end of the quarter. The purchaser in the \$47-million deal is **Lexington Corporate Properties Trust**. Specialty will occupy the property, currently under construction, with a 20-year lease.

▶ As part of a 1031 exchange, **LeBelle League City Properties LP** bought a new 13,013-sf CVS in Galveston County, TX, according to *GlobeSt.com*. Developer/seller **CVS-LEC Ltd.** offered

the property for \$4.3 million. **Colliers International** brokered the sale.

▶ **CRIC Capital LLC** is the buyer in an \$18-million sale-leaseback with **Service Mart USA Inc.**, which does business as **GasMart USA** and is a developer and operator of convenience store/gas station properties. The deal involves five properties totaling 15,842 sf in the Chicago area that are being leased back under 20-year triple-net leases.

▶ A 7,615-sf Thousand Oaks, CA building occupied by **KinderCare Center** under a triple-net lease for the next 14 years was purchased for \$2.4 million. **Sperry Van Ness** represented seller **Paul Quintarelli** while **Elite Property** sat in for the buyer, **Elliott Horwitch**. The sale garnered an almost \$400,000 gain for Quintarelli, who purchased the property in February 2003.

▶ Five bank branches in Texas leased to **Bank of America NA** were purchased by **American Financial Realty Trust** for about \$9.5 million. The seller was **Potomac Realty Ltd.** The properties have remaining lease terms averaging 8.5 years and annual contractual rent is approximately \$1 million.

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INDUSTRY UPDATE Continued from page 2

will blow up. In the real world, if you sell enough real estate, one of them goes bad.

“My guess is eventually one of these days there will be some litigation, which will determine [the issue],” Lipton concludes. “In the meantime, I suspect the most cautious promoters or sponsors are going to treat them as securities. We are advising our clients to do so.”

The next issue of **NET LEASE forum**, will examine what, if any, implications *SEC v. Edwards* may have for the traditional real estate sale-leaseback business.

Inland REIT Board: Seek Listing On NYSE

The board of **Inland Real Estate Corp.**, a non-traded REIT that owns single-tenant retail and community shopping centers, has given the company the go-ahead to seek a listing on the New York Stock Exchange. According to a spokesman, the board has considered this several times in the past, but this is the first time it has decided to seek an advisor and pursue a listing.

Hiring that advisor will be the next step for Inland, which has a portfolio of 12 million square feet in 138 properties. “If the board does approve filing the application [with the Securities and Exchange Commission],” says the spokesman, “then we expect the listing process to take several months to complete.”

Inland, the first of three publicly registered, non-traded REITs under the Oak

Brook, IL-based **Inland Real Estate Group of Cos.** umbrella, was formed in May 1994. As of its latest financial statement, dated Sept. 30, 2003, it had sold more than 51.6 million shares of common stock at prices ranging from \$10 to \$11 through four offerings. It had sold an additional 12.3 million shares through a distribution reinvestment plan at prices ranging from \$9.05 to \$10.45, and had repurchased 4.8 million shares through its share repurchase program at prices ranging between \$9.05 and \$9.75. Proceeds totaled almost \$683.2 million as of Sept. 30, 2003.

According to the company, a listing has been a part of its strategy all along. Indeed, non-traded REITs such as Inland typically include in their prospectuses an exit strategy that usually involves, by a certain year, either liquidating the portfolio or seeking a public exchange listing.

“There really isn’t any one specific event or action that precipitated this,” says the Inland spokesman about the timing of the decision. “Now that we’ve built up our assets ... the market can recognize the value of the company’s efforts.”

Earlier this month, Inland wrote to its shareholders suggesting that they not sell into a mini-tender offer made by Overland Park, KS-based **Madison Liquidity Investors LLC**, which buys illiquid financial assets. According to Inland, Madison offered \$10 per share less any distributions made on or after Feb. 2 and a fee of \$50 per transfer. “We believe the price offered

by Madison is inadequate and recommend that you not tender your shares,” stated a letter signed by chairman, president and CEO Robert D. Parks.

Followup: AFRT Closes Buy, Restructures State Street Lease

American Financial Realty Trust closed on its \$705.4-million acquisition of State Street Financial Center, secured \$520 million of debt from **Lehman Brothers Holdings Inc.** to help finance the purchase and signed an amended lease for the 1.05-million-sf tower with sole occupant **State Street Corp.** The Jenkintown, PA-based REIT and the financial services firm also agreed to terms for a new lease of the 900-space parking garage at the property, in Boston’s Financial District.

“In signing a contract to acquire this property, we had really just begun our work,” AFRT president and CEO Nicholas S. Schorsch said during a conference call following the closing on Feb. 17. During the 15 days between contract and closing, his company worked with the tenant and the lender “to make a good acquisition much better,” he added.

The new office building agreement, which expires in September 2023, changes the rent structure to flatten State Street’s rent payments over the years, according to Schorsch. It also requires State Street to pay all operating expenses above an annual

▶▶▶ Continued on page 6

Dear Reader:

This issue marks the one-year anniversary of **NET LEASE forum**. When we launched the newsletter, we knew it would be the only resource of its kind devoted to the net lease and 1031 exchange marketplace. The goal was to fill a void, and it seems we were right on target—as evidenced by new subscribers every week.

We are confident **NET LEASE forum** will keep providing a competitive edge to our readers as sale-leaseback activity picks up, the tenant-in-common industry continues to bloom and the net-lease acquisition environment continues to be characterized by more investor demand than property supply.

We want to thank our subscribers, advertisers and advisory board members for their support. Your participation is valued, so please provide input, ideas and news by e-mailing editor Michelle Napoli at mnapoli@remediainc.com.

Thank you.

Jonathan A. Schein
President and CEO
Real Estate Media Inc.

RATINGS UPDATE

▶ The senior unsecured debt of **Sun Microsystems Inc.** was downgraded to BBB- from BBB and the outlook changed to stable from negative by **Fitch Ratings**. The agency cites "Sun's on-going operating losses and Fitch's belief that the company's financial and operating performance in the near term will be more volatile than historical patterns due to an increasingly competitive marketplace."

▶ The senior unsecured rating of **Lucent Technologies**, meanwhile, was upgraded to B- from CCC+ by Fitch. 'The ratings reflect Lucent's improved cost structure and return to profitability, strengthened balance sheet as a result of the company's debt retirement efforts and manageable

near-term debt obligations," according to Fitch. The outlook is stable.

▶ **Standard & Poor's Ratings Services** lowered the senior unsecured debt of **Schering-Plough Corp.** to A- from A. The downgrade results from S&P's belief that the pharmaceuticals manufacturer's earnings prospects "remain highly uncertain, that the operational turnaround being implemented by the company's new management will take several years and that the company's financials will significantly deteriorate." The outlook is negative.

▶ The ratings of **El Paso Corp.** and subsidiaries were placed under review for a possible downgrade by **Moody's**

Investors Service. The move followed El Paso's announcement that "it is revising down its proven reserve volumes," according to Moody's. "This revision is material and raises concerns about the direction of future production, which has been in decline for some time, and the degree of asset and cash flow coverage that those reserves provide to EP's creditors." S&P, meanwhile, lowered El Paso's corporate credit rating to B- from B.

▶ Moody's upgraded **PepsiCo Inc.**'s ratings, including its senior unsecured debt, to Aa3 from A1. The change "reflects steadily improving debt protection measures at the company and for the PepsiCo system overall," says Moody's. The outlook is stable.



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NETLEASE INSIDER Continued from page 1

you're inducing people to invest money, it [can be] a security.' So what it means for everyone—not just tenancy-in-common—is if I'm the guy who's going to put it together, provide the program and say you're going to get some kind of return, that under federal law very well may be a security.

Q: Why should folks doing TICs care?

A: Just as we see in any industry, as more money flows into it, the scrutiny gets higher at every level. I don't want to pick up the *Journal* at some point and see 'tenancy-in-common and Elliott Spitzer' and now we're the next target. We're an industry; we're relying on ourselves to defend ourselves and protect our economic interests. I'm trying to protect the way I make a living, and I want other people who are involved to understand that we are all inextricably tied, and that the good deeds and bad deeds of others will affect us.

EXECUTIVE MOVES

James M. Seneff Jr. has handed **Commercial Net Lease Realty Inc.**'s CEO reins to **Craig Macnab**. Seneff remains chairman of the Orlando-based REIT, recently added to the S&P SmallCap 600 Index.. Macnab was most recently CEO of **JDN Realty Corp.** of Atlanta, which merged with **Developers Diversified Realty Corp.** last year, and has held executive positions in real estate and investment banking.

Q: Why do you sell TICs as securities?

A: I tried to figure out how to sell it as a non-security, because if I could do it I'd be all for it. I wouldn't have to do the private-placement memorandum, the risk disclosures and have the remedies available under securities law that are not available to real estate. In securities law it's disclosure, as opposed to caveat emptor in real estate. But I couldn't get there on a federal level or a state level, so I chose to sell it as a security. So does [SEC v. Edwards] affect me? No. And that's the case with say 85% of the people who are doing what I do. But it's the 15% that we know of, and the other ones that we don't know of, that are not in the loop. Those are the people we're trying to bring into the Association.

Q: How does SEC v. Edwards affect broker-dealers placing investors in TICs?

A: I think it helps them, because they now have some ammunition to show investors. Broker-deals will be able to say, 'We're doing it the right way as we believe it is the right way. We've got the Supreme Court telling us it is the right way.' If you are buying one of these investments you need to understand the risks, not only from a real estate standpoint but from a security standpoint, why we are bound to disclose everything. And if we do not disclose, voluntarily or involuntarily, i.e., a material omission, and you invest, there are remedies that apply to you. The right of rescission

and restitution is huge.

Q: How about folks who are not securities brokers? Is there any regulation?

A: One of the members of the TICA's legislative subcommittee has an employee who had worked with one of the NASD districts. They discussed tenancy-in-common, and are now asking all the districts to report what type of business is being done in their district. What that means is that it will come onto the radar. First they'll look at the people doing the business—how they're selling it, how they're structuring it. But from there, it will go to who are the people who are selling it.

Q: What does the whole security v. real estate issue boil down to?

A: It's all about how it's sold. If I buy a building and I go and find investors, I just list it and provide the financials, but it's on you to do due diligence. I'm not promising you any returns, I'm not going to manage the thing afterward, I'm going to simply sell you the property. That's real estate. But if I put a bunch of investors together, I'm going to manage it through my property management company, I think the returns should be in the 7% to 8% range, I'm going to send you distribution checks through my company, and I'm going to ask you when you think we might sell and I'll advise you on that—that's where it's completely different. If you induce someone to invest in something on returns, it's an investment contract.

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INDUSTRY UPDATE Continued from page 3

\$16.4 million cap. "We're getting considerably more in the early years of the lease," than would have been the case with the previous rental agreement, AFRT CFO James T. Ratner said during the call.

The new lease for the parking garage will give State Street total control over the facility in exchange for rental payments that start at \$2.5 million for 2004 and ramp up over the lease term. Together, the building and garage leases will still deliver to the REIT more than \$1 billion of net rent.

Lehman Brothers' 20-year secured

loan features a six-month upfront floating rate period (125 basis points over Libor) and then fixed-rate financing at 5.79%. The loan is not fully amortizing, having a \$150-million residual value at the end of its term. A source familiar with the deal says Lehman may securitize its loan in the form of structured lease-backed certificates. The REIT used available cash and \$35.9 million of operating partnership units issued to chairman and CEO Stan Gale and other affiliates of Florham Park, NJ-based **Gale Co.**, to pay for its equity investment in the property.

Upland, Geneva Join For Safe Harbor Exchange

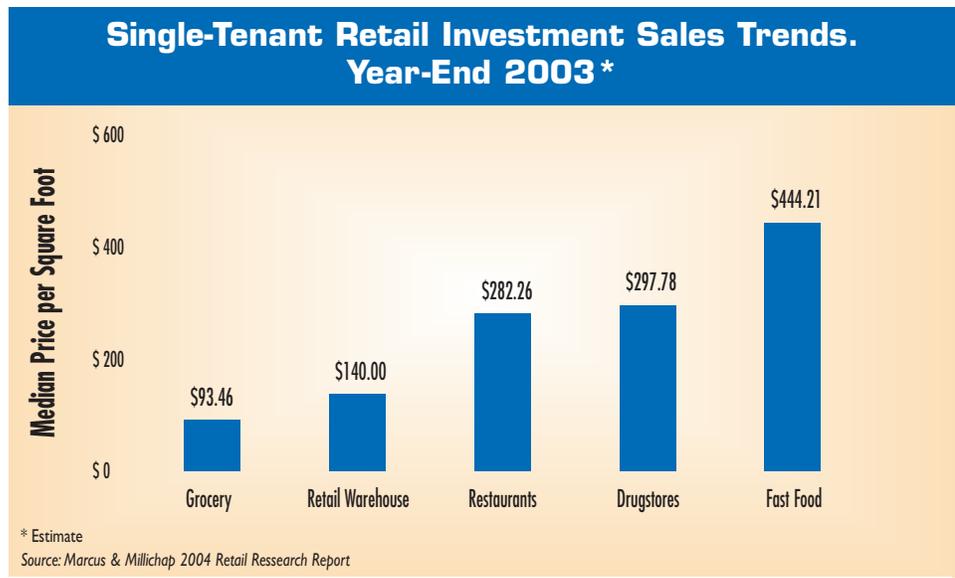
Two Minneapolis companies, net-lease brokerage **Upland Real Estate Group** and real estate wealth management firm **Geneva Organization**, have formed **Safe Harbor Properties Exchange LLC**. The web-based enterprise, intended to market tenant-in-common investment opportunities, has already closed one deal and expected to have a second closed by press time. Another approximately \$125 million of properties are in the pipeline, too, says Upland principal Michael Hogue.

The venture was a result of Upland's desire to find more management-free 1031 exchange investment opportunities for its clients and Geneva's desire to get into the TIC business, according to Hogue. "Frankly, we couldn't source enough deals," he says. "These investors are not only looking for a reasonable yield, they're looking for wealth preservation. And with the TIC structure, it looks and smells like a net lease."

Upland and Geneva, which will maintain ownership interests in all of their TIC deals, are focusing their efforts on properties in upper Midwest locations. They are targeting single- and multi-tenant properties in a variety of asset classes, including office, industrial, retail, multi-family, even seniors housing, says Hogue. The sellers of their properties will also maintain ownership stakes. While Hogue says Safe Harbor expects its TIC investors to be accredited, and puts together paperwork similar to a

private placement offering memorandum, it is treating its TICs as real estate.

Geneva Real Estate Exchange LLC closed on **Geneva Exchange Fund X LLC**, a \$5-million tenant-in-common purchase of a multi-tenant showroom property in Minneapolis suburb Apple Valley. Tenants include **Wal-Mart** and the **Pioneer Press**. A \$13-million retail deal was expected to close last week as well, says Hogue. Safe Harbor expects to close on between \$150 million to \$200 million of properties, with leverage in the 50 percent to 65 percent range, during the year.



Among the most common single-tenant retail properties, fast-food properties garnered by far the highest median per-sf price during 2003.

Revamped 1031Buyer.com Offers Free Exchange Property Listings

1031Buyer Corp. has launched a revamped version of its Web site, www.1031buyer.com, with new resources and features for investors and their brokers and advisers alike.

Chief among these is a database of properties available for sale that may be ideal for 1031 exchanges. Site visitors can list their for-sale properties for free, and, if they searching for a replacement property but don't see what they need, can list their specific criteria, says Jivonne Gilliam, a company owner.

The Atlanta-based company of real estate professionals has been in business for more than 10 years and works with investors to complete 1031 exchanges.