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Client Alert

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Public REITs Poised To Capitalize on Robust Non-Traded REIT Market

On February 6, 2009, Pacific Office Properties Trust, Inc. ("Pacific Office") filed a registration statement for the purpose of offering $350,000,000 of Class B Common Shares ("Senior Common"). Pacific Office hopes to capitalize on the robust market for non-traded REIT shares by selling the Senior Common in a best efforts offering. The Senior Common has many of the same characteristics as non-traded REIT shares which have demonstrated remarkable resiliency during this period of very challenging capital markets. According to Robert A. Stanger & Co., Inc., non-traded REITs raised over $9.5 billion during 2008, including over $2 billion during the fourth quarter. Pacific Office hopes to tap into a stable capital source that, because of its modest yield (7%), will be accretive to the holders of its listed common shares. Also because the Senior Common ranks senior to Pacific Office's common shares that are listed on the NYSE Alternext US (the successor to the American Stock Exchange), the offering of the Senior Common will not be the subject of an arduous merit-based blue sky process imposed by many states.

Regulatory Framework

The National Securities Markets Improvement Act of 1996 ("NSMIA") exempted from state blue sky regulations every "covered security." The enactment of NSMIA represented a significant change in the allocation of state and federal regulatory responsibilities over securities regulation. Previously, the system of dual federal and state regulation resulted in a degree of overlap. Congress, in adopting the NSMIA, sought to allocate regulatory responsibility between the federal and state governments based on the nature of the securities offering.

The NSMIA amends Section 18 of the Securities Act of 1933 (the "1933 Act") to provide an exemption from state securities or blue sky laws for securities which are defined as covered securities ("Covered Securities"). There are three aspects to the scope of the exemption. First, it provides that except as otherwise provided in the NSMIA, no rule, law, regulation, or order, or other administrative action of any state or any political subdivision thereof requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions ("Blue Sky Law") shall indirectly or directly apply to a security which is a Covered Security or that will be a Covered Security upon completion of the transaction. Second, it provides that no Blue Sky Law shall directly or indirectly prohibit, limit, or impose conditions upon the use of (1) with respect to any Covered Security, any offering document that is prepared by or on behalf of the issuer; or (2) any proxy statement, report to shareholders, or other disclosure document relating to a Covered Security or the issuer thereof that is required to be and is filed with the SEC or any national securities organization registered under Section 15A of the Securities Exchange Act of 1934 ("1934 Act"), except that it does not apply to the laws, rules, regulations, or orders, or other administrative actions of the state of incorporation of the issuer. Finally, the NSMIA provides that no Blue Sky Law shall directly or indirectly prohibit, limit, or impose conditions, based upon the merits of such offering or issuer, upon the offer or sale of any security that is a Covered Security or that will be a Covered Security upon completion of the transaction. In each case, the prohibition extends to indirect state action, thus precluding the states from exercising indirect authority to circumvent the provisions of the NSMIA that expressly prohibit them from requiring the registration of, or otherwise imposing conditions or limitations upon, offerings of Covered Securities.

There are four categories of Covered Securities: (i) nationally traded securities; (ii) securities issued by investment companies that have filed a registration statement under the Investment Company Act of 1940;

(iii) securities sold to "qualified purchasers," as defined by the SEC; and (iv) securities exempt from registration pursuant to specified sections of the 1933 Act.

The NSMIA creates a category of Covered Security for a security which is listed, or authorized for listing, on the New York Stock Exchange ("NYSE") or the American Stock Exchange ("AMEX"), or listed on the National Market System of the NASDAQ Stock Market ("NMS") (or any successor to such entities) ("Listed Security"). Included in this category of Covered Security is a "senior security" of the same issuer. The term "senior security" means any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payments of dividends. Pursuant to this provision, a broker or dealer registered or licensed in the states in which offers and sales are made may offer and sell a Listed Security (including a REIT security) without having to comply with Blue Sky Laws and without having to make any notice filings or pay any fees. Thus, this provision establishes a uniform federal exemption for Listed Securities (including a REIT security) which embodies the existing practice under the securities laws of most states of not requiring filings and fees for Listed Securities.

REIT offerings which are not "covered securities" as defined by the National Securities Markets Improvement Act of 1996 ("NSMIA") apply the North American Securities Administrators Association ("NASAA") REIT guidelines. Most of the major management and compensation decisions of a non-"covered securities" REIT are made to satisfy the provisions of the NASAA "Statement of Policy Regarding Real Estate Investment Trusts" ("NASAA Statement"). Most blue sky merit review states have formally adopted the NASAA Statement.

The principal substantive provisions in the NASAA Statement are directed to REIT sponsors. Included are provisions (1) requiring a specific REIT share investment; (2) requiring specified real estate experience for sponsors; (3) limiting sponsors' compensation in amount and form; (4) prohibiting certain sponsor transactions and other dealings that may involve conflicts of interest; (5) requiring shareholders democracy rights; (6) requiring specific reporting to shareholders; and (7) specifying minimum suitability criteria that a potential purchaser must meet before purchasing shares in a REIT.

However, because the Senior Common is a "covered security," Pacific Office will be able to avoid the time and expense associated with having its offering go through a merit review by the state blue sky commissioners. This represents a significant advantage over a typical non-traded publicly offered REIT. Notwithstanding the fact that the Senior Common is exempt from state blue sky regulations, including minimum suitability requirements, Pacific Office voluntarily requires that investors in the Senior Common (including transferees) have either (i) a minimum annual gross income of $70,000 and a minimum net worth (exclusive of the value of the investor's home, home furnishings and automobiles) of $70,000 or (ii) a minimum net worth (exclusive of the value of the investor's home, home furnishings and automobiles) of $250,000.

Terms of the Senior Common

The Senior Common have the following rights, privileges and preferences:

Securities Offered:	Pacific Office is offering $300,000,000 of Senior Common to the public at a price of $10.00 per share ("Primary Offering"), and $50,000,000 of Senior Common to its stockholders pursuant to a Dividend Reinvestment Plan at an initial price of $9.50 per share. Pacific Office reserves the right to reallocate the Senior Common offered between the Primary Offering and the distribution reinvestment plan. The Senior Common is not rated by any rating agency.
Ranking:	The Senior Common will rank senior to the Pacific Office's Class A Common Shares ("Listed Common") and the Common Units and Preferred Units, issued by Pacific Office Properties, L.P. (Pacific Office's operating partnership), with respect to both payment of dividends and distribution of amounts upon liquidation, dissolution, or winding up.
Dividend:	The Senior Common dividend will be a minimum of $0.70 per annum, declared daily and payable monthly. Should the dividend payable on the Listed Common exceed $0.70 per annum, the Senior Common dividend will increase by 10% of that amount by which the Listed Common dividend exceeds $0.70. The Senior Common dividend is cumulative from the date of original issue.
Liquidation Preference:	$10.00 per share of Senior Common, plus an amount equal to accumulated, accrued, and unpaid dividends. The Senior Common will rank senior in liquidation preference to the Listed Common, the Common Units and the Preferred Units.

Exchange Option:	Holders of the Senior Common will have the right, at any time after the seventh anniversary of the issuance of the shares, to exchange any or all of their Senior Common into Listed Common. The Pacific Office's Board of Directors reserves the right to accelerate the holder's exchange option to the beginning of the sixth anniversary of the issuance. The exchange ratio is calculated using a value for Listed Common based on the average of the trailing 30-day closing stock price at the date the shares are submitted for exchange and a value for Senior Common of $11.00. For example, if the 30-day trailing average stock price for Listed Common is $13.75 at the time of conversion, the shareholder will receive 0.80 shares of Listed Common for each share of Senior Common exchanged.
Call Protection:	Pacific Office does not have the option to call or force the redemption of the Senior Common, nor does it have the right to force holders to exchange their Senior Common for Listed Common.
Redemption Program:	Pacific Office will provide a limited share redemption program to provide shareholders with some liquidity. The redemption price will initially be $9.50 per share. Redemptions under the program will be made monthly on a first-come-first-served basis with the following restrictions and limits: 1. Shares must be held a minimum of one year before redemption; 2. Shareholders must present all of their outstanding shares; and 3. Redemptions will be limited to the amount of cash available from the dividend reinvestment plan
Dividend Reinvestment:	Pacific Office will provide a Dividend Reinvestment Plan with its offering through which shareholders may reinvest their dividends into additional Senior Common shares at an initial purchase price of $9.50 per share and in no event higher than 95% of the estimated value of a share of Senior Common. The board of directors may change this price from time to time, but not within the first three years after the commencement of the offering and no more frequently than quarterly thereafter.
Voting Rights:	Holders of the Senior Common will have the right to vote on all matters presented to shareholders as a single class with all other holders of common shares. In any matter in which holders of the Senior Common may vote, including any action by written consent, each Senior Common Share will be entitled to one vote.
Listing:	The Senior Common will not be listed on a national exchange or an over-the-counter market.
Minimum Investment:	Investors must initially invest at least $5,000 except insofar as this minimum is waived by Pacific Office's dealer manager. This initial minimum purchase requirement applies to all potential investors, including tax-exempt entities.

Marketing Challenge

At the time of the filing of its registration statement, Pacific Office had not yet identified a dealer manager to sell the offering. Most non-traded REIT sponsors maintain an affiliated broker-dealer that acts essentially as wholesaler for the offering. These wholesalers typically help secure selected broker-dealers who have significant rosters of retail investors who are attracted to the yields and lack of volatility associated with non-traded REITs. Pacific Office will need to form its own broker-dealer division in order to act as wholesaler for the offering or arrange to have an existing dealer-manager that is knowledgeable about the non-traded REIT market act as lead dealer manager for the offering. Securing this dealer-manager relationship or building it from the ground up will represent a significant challenge for Pacific Office.

Conclusion: What Public REITs Should Consider

This filing could represent a new capital-raising opportunity for all publicly traded REITs but should particularly be on the radar screen of undercapitalized REITs and REITs which may not want to dilute their shareholders with a follow-on offering of their shares at prices which management believes are temporarily depressed. In our view, REIT executives should consider the following:

- For REITs that are undercapitalized or do not want to execute a follow-on offering at current stock prices, offering non-traded senior common or unrated preferred stock to investors may help the REIT solve some balance issues;
- The non-traded, unrated senior common or preferred stock issued in these offerings is made to a stable group of retail investors;

- The non-traded, unrated senior common or preferred stock issued in these offerings often can be accretive to the common stock because of its relatively low yield and otherwise represents an efficient and low cost of capital.

- Unlike the stock issued by non-traded REITs, the non-traded, unrated senior common or preferred stock issued by listed REITs is not subject to an arduous merit review blue sky process;

- The non-traded, unrated senior common or preferred stock issued in this type of offering does not need to include a separate class vote on any REIT corporate or trust actions, and from a democracy standpoint is treated the same as the common stock;

- The non-traded, unrated senior common or preferred stock will be issued a fixed price notwithstanding the trading price of the REIT's common stock at any point in time;

- The non-traded, unrated senior common or preferred stock will not be subject to the trading markets which generally causes stock prices to fluctuate based on factors such as supply (number of sellers) and demand (number of buyers) of shares, reflecting shifting preferences among sectors of the economy; and

- The offering of this non-traded, unrated senior common or preferred stock is not likely to depress the stock price of the REIT's common stock, which is often the case when the REIT announces or goes on the road with a follow-on offering.

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If you have any questions about this unique REIT offering, please contact your Proskauer relationship lawyer or one of the lawyers listed below:

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