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Gene Phillips

Real-Estate Magnate Gene Phillips Draws Investor Ire for Dealings

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DALLAS -- At Transcontinental Realty Investors Inc.'s annual meeting, three men sat before a room whose audience consisted of several dozen empty chairs.

It was time to vote on a slate of directors "Please raise your hands," said Karl L. Blaha, the company's president, asking if anyone wanted a ballot. He looked around the room. "Obviously, there's no one to do that."

Indeed, no outside shareholders showed up at that meeting last October. Nor did any directors. Maybe that's because the real power behind Transcontinental has an office down the hall. His name is Gene E. Phillips.

The 63-year-old Mr. Phillips has long been one of the most controversial figures in publicly traded real estate -- which, in that famously eccentric industry, is saying something. Best remembered as the head of Southmark Corp., the Dallas real-estate conglomerate that collapsed in 1989 in a swirl of lawsuits, Mr. Phillips now presides over a $2 billion empire of garden apartments, warehouses and office buildings belonging to Transcontinental and two other public companies.

For nearly 12 years, a group of Transcontinental shareholders has been trying to wrest power from him, arguing in a San Francisco lawsuit that he has abused his position to milk the company's assets for his private use. He's also under siege from prosecutors: In June, a federal grand jury in New York charged Mr. Phillips and a top aide with racketeering and wire fraud as part of an alleged scheme to pay kickbacks to corrupt pension-fund officials in exchange for investing with one of the companies he controlled.

Mr. Phillips's attorneys say he hasn't broken any laws and has done right by shareholders. Mr. Phillips declines to comment. He and an affiliate, Basic Capital Management Inc., have filed separate libel lawsuits against Dow Jones & Co., publisher of this newspaper, over two earlier stories. Last month Basic Capital sought a temporary restraining order to prevent the reporter of this article and two former directors from disclosing allegedly confidential information. "You're not supposed to be talking to me," Mr. Phillips angrily told the reporter outside Basic Capital's offices. "You're going to get buried."

Battling with enemies, real and imagined, is one of the things Mr. Phillips does best, and it has helped make him one of real estate's most resilient survivors. But the real secret of his staying power may well lie in the Byzantine nature of his empire, in which the public companies farm out their management tasks and some board members have been overwhelmed by the complex deal making.

An Elusive Target

For all the commotion surrounding him, Mr. Phillips doesn't even hold a title at the public companies -- making him an elusive target in any shareholder lawsuit. Instead, his official involvement is limited to serving as a "representative" of a trust benefiting his children, which in turn owns Basic Capital. Basic Capital sits at the center of the corporate web, holding controlling stakes, directly and indirectly, in the companies -- Transcontinental, Income Opportunity Realty Investors Inc. and American Realty Investors Inc. -- and, through a

nd partnerships, gathering up enormous fees.

All told, the public companies in Mr. Phillips's orbit paid $60.6 million to Basic Capital and its affiliates in 1999, the latest year for which financial information is available, while paying just $7.6 million in dividends.

For the real-estate-securities industry, which is trying to buff the image of its offerings as mainstream investments, the Phillips companies are a reminder of the sorts of problems that continue to dog it: perceived conflicts of interest, weak corporate governance and, occasionally, scandal.

So-called real-estate investment trusts, or REITs, have struggled to put such criticism behind them. A creation of the federal tax code, REITs are publicly traded companies formed to hold income-producing properties. They don't pay corporate income taxes and must distribute 95% of their taxable income to shareholders. The first REITs were required by law to hire outside managers, known as advisers. But because the advisers were paid for the size of the assets under management and the number of transactions they carried off -- rather than the profitability of the REIT -- their interests often diverged from those of shareholders. Throw in weak board oversight, and it is easy to see why REITs languished on Wall Street.

In the past decade, a new generation of REITs has made strides in overcoming such problems by structuring themselves like traditional companies. Now 158 of the nation's estimated 189 REITs have internal management -- a chief executive, chief financial officer, and other employees who perform basic administrative tasks -- representing 96% of the sector's market capitalization.

But not the three Phillips real-estate companies, which pay fees for services normally done in-house. For instance, when Transcontinental bought a 138-unit apartment complex in Tulsa, Okla., in 1999 for $3.2 million, it paid a $107,000 commission to Regis Realty Inc., a Dallas company owned by another company, Syntek West Inc., which Mr. Phillips owns. Transcontinental also paid a $32,000 "acquisition fee" to Basic Capital.

Basic Capital's president, Mr. Blaha -- who also serves as president of Transcontinental, American Realty and Income Opportunity, among other posts -- said in a letter responding to questions from The Wall Street Journal that Basic Capital has created "substantial value" for shareholders. He said all the public companies' transactions must be approved by the boards, which have a majority of independent members. "Accordingly, neither Basic Capital nor Mr. Phillips can cause any of the companies to engage in any transaction," Mr. Blaha wrote.

Mr. Phillips has long been described as a domineering presence in the boardroom. A bankruptcy examiner looking into the collapse of Southmark wrote in a 1990 report that the three outside directors were "basically yes-men" who didn't understand the company. Mr. Phillips and his former partner, New York attorney William

Friedman, built the once-sleepy REIT into a real-estate syndication machine boasting $9 billion in assets.

The examiner, R. Neal Batson, acting under the authority of a Dallas federal bankruptcy judge, concluded that Southmark created "illusory" sales and "phantom" profits by buying massive real-estate portfolios and selling them to limited partnerships in deals Southmark financed. Many partnerships defaulted, helping drive Southmark into bankruptcy.

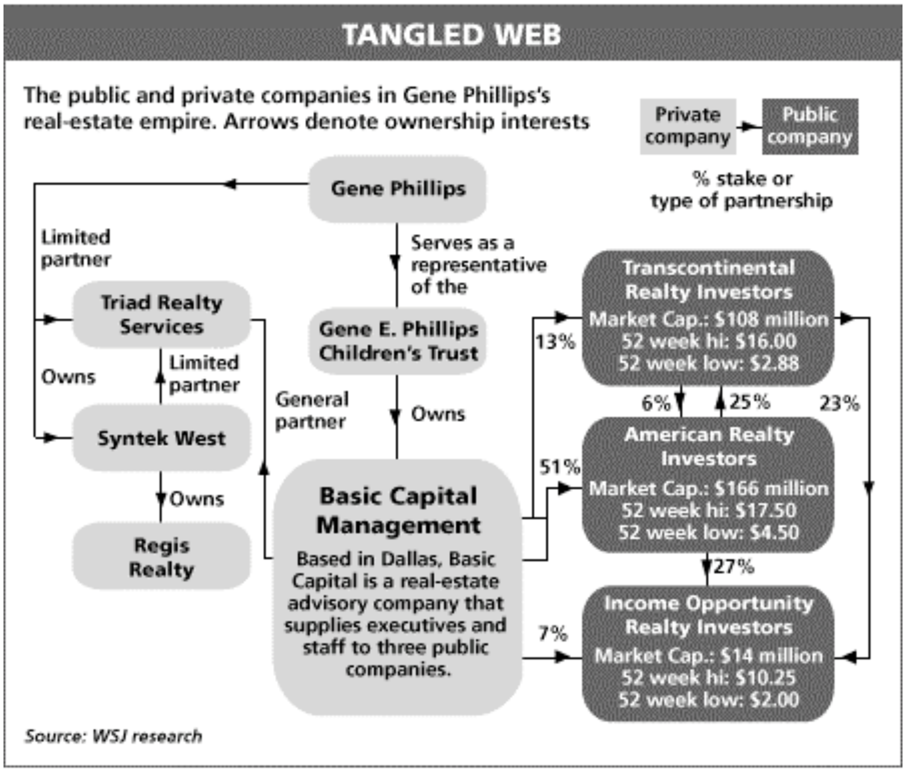
The report said the chairman, Mr. Phillips, and the vice chairman, Mr. Friedman, were chiefly responsible for the collapse and reaped "substantial benefits" at Southmark's expense. These included general-partnership fees from affiliates, Southmark advances to "insider partnerships" and personal loans.

'Danged Complicated'

In a 1991 SEC filing, Messrs. Phillips and Friedman "emphatically" denied the allegations in the Batson report, which they said contained "material factual errors," "unsubstantiated allegations" and "misleading innuendoes."

Arthur Crowe, a Marietta, Ga., lawyer who once served as a Southmark director, acknowledges that the company "was just so danged complicated we couldn't understand any of it." Mr. Crowe said he once asked that a vote be put off on a stack of planned deals to allow more time to investigate them. After an argument, Mr. Crowe says an angry Mr. Phillips told him: "I want you to resign from the board. You're not a team player."

Messrs. Phillips and Friedman themselves eventually resigned from Southmark -- but only after a three-day meeting in a Dallas hotel in which board members agreed to transfer the right to advise Transcontinental and six other companies from a Southmark unit to a closely held company controlled by Messrs. Phillips and Friedman. The bankruptcy examiner would later conclude that the hotel-room negotiations had yielded Messrs. Phillips and Friedman an "enormous windfall."



The settlement certainly created an enormous headache for Marilyn H. Patel, a U.S. district court judge in San Francisco. More recently known for her work on the music industry's lawsuit against Napster Inc., Judge Patel in December 1989 drew a case called *Olive et al. v. Phillips et al.* , after Jack Olive, a Marin County shareholder. In it, several shareholders of Transcontinental and three other REITs alleged that Messrs. Phillips and Friedman, the advisory company -- now known as Basic Capital -- and various board members, among others, wasted corporate assets and engaged in self-dealing. The defendants denied all allegations.

The lawsuit has since filled 30 court folders and tens of thousands of pages of documents. For 12 years, the same San Francisco plaintiffs lawyers, George Donaldson and Daniel Harris, have argued against a rotating team of defense lawyers, which have included a former San Francisco mayor and now includes a former San Francisco U.S. attorney.

The original complaint asked, among other things, that the judge remove the REITs' directors and order the companies to pay more dividends. A 1990 settlement -- the first of three -- required the REITs to pay combined dividends of $29.5 million and appoint three independent directors to the shared board. It also mandated the formation of board committees to monitor deals between the REITs and entities controlled by Messrs. Phillips and Friedman and to keep tabs on the voluminous litigation against the two men.

But within a year, plaintiffs complained the board committees weren't doing their jobs, leading to more legal maneuvering and another agreement in 1994. That "modification of stipulation of settlement" called, among other things, for even more independent directors to join the boards and required unanimous board approval for related-party transactions.

"The whole case is a torture," Judge Patel said at one point.

Screenwriter in the Boardroom

The independent board members haven't always been dynamos. Bennett B. Sims, a New York screenwriter, says he was offered a directorship on Transcontinental and two other REITs because his girlfriend was a close friend of Mr. Friedman's wife. A self-described "aging Beatnik," he acknowledges he knew little about real estate and says he accepted the assignment because he enjoyed the monthly trips to Dallas and needed the yearly stipends, which eventually reached $45,000.

Mr. Friedman, who split with Mr. Phillips in 1992, declined interview requests.

Nor did the board's efforts to assert independence always prosper. At a January 1995 meeting, for instance, Geoffrey C. Etnire, a Palo Alto, Calif., real-estate lawyer, pushed a measure to buy directors' and officers' insurance, arguing that this protection against lawsuits and other matters was needed to attract and retain capable directors. Mr. Phillips opposed the plan, arguing it would waste corporate assets, according to people who were present.

At about 11:30 that night, as he was falling asleep in his hotel room, Mr. Etnire says he got a call from A. Cal Rossi, a onetime amateur boxer and hotel developer close to Mr. Phillips. For the next 45 minutes, Mr. Rossi berated him, calling him "obnoxious" and "aggressive," according to voluminous notes Mr. Etnire kept.

During a two-day meeting in June 1995, Mr. Etnire says Mr. Rossi followed him around Basic Capital's offices as he tried to talk privately to another director about the initiative. When Mr. Etnire objected, "Rossi bodied me, our chests and stomachs touching and him continually moving forward," Mr. Etnire wrote in his notes.

Mr. Rossi, who didn't return telephone calls, declined comment through a Basic Capital spokesman.

The board initially voted 4-3 to buy the insurance. But in a bizarre twist, Mr. Etnire says an ashen-faced Mr. Sims called him to his hotel room at 8 the next morning and told him he had gotten two threatening phone calls in the night. According to Mr. Etnire and court documents outlining his version, Mr. Sims said the callers had told him that they knew he was "vulnerable" to the Internal Revenue Service and that "it would be in his best interests to change his vote." The next day, Mr. Sims and at least one other director changed their vote. The initiative died.

In an interview last October, Mr. Sims acknowledged that he failed to file income taxes for more than 15 years and said he was working out a settlement with the IRS. He also acknowledged that Mr. Etnire's account of their conversation that morning in 1995 is roughly accurate. But Mr. Sims denied that anyone actually called him that night or improperly pressured him -- a position supported by Mr. Phillips, Basic Capital and a sworn affidavit Mr. Sims submitted to the court. He said he made up the story because he believed Mr. Etnire wouldn't accept anything but a sinister explanation. "I wanted to get him out of the room," said Mr. Sims, who said the real reason he changed his vote was because he was concerned that a close vote might be used against the REITs by plaintiffs in the shareholder suit.

An Awkward Silence

Ultimately, Mr. Etnire argued that Mr. Phillips's very presence at board meetings inhibited directors. With Mr. Phillips absent at the August 1995 meeting, Mr. Etnire proposed that the board limit attendance to directors plus the REIT executives, according to notes he kept which were introduced into the San Francisco court proceedings. The resolution passed 4-1 with one abstention. Just then, Mr. Phillips -- unaware of the resolution -- walked in. After an awkward silence, Mr. Etnire said he asked for a recess and disclosed the resolution to Mr. Phillips, who promptly re-entered the meeting and asked for an "open invitation" to all board meetings, Mr. Etnire said. The board granted it 5-1.

Mr. Sims resigned in 1996, as did an exhausted Mr. Etnire. "The overriding problem is the subservience of the boards and [Basic Capital] to Mr. Phillips," Mr. Etnire wrote in his resignation letter. "Mr. Phillips is the de facto board."

Mr. Blaha, in his Dec. 29 letter, said Mr. Etnire was a "disgruntled" former director whose claims had been investigated by other independent directors, who found "no corroboration whatsoever."

Mr. Blaha also said the public companies advised by Basic Capital have prospered and that their average stock price has grown over nine times since 1990. "In addition, the companies have paid $135 million in dividends to shareholders since 1990, or nearly five times their investment if you were an investor in 1990," he wrote.

On the other hand, a shareholder who invested $100 in Transcontinental's predecessor company in March 1988, when Mr. Phillips first got involved through Southmark, would have about $50 today. That assumes a shareholder reinvested dividends, which have shriveled over the past dozen years. The same amount invested in the average REIT, by contrast, would now be about $338, according to the National Association of Real Estate Investment Trusts.

"I was counting on those dividends," says Dorothy Campbell, a retired San Diego vice principal. One of a dwindling number of Transcontinental outside shareholders, mostly small investors, who have hung onto their stock, she adds: "I don't ever go to a department store and pay full price for anything." Transcontinental in 1999 reported assets of $714 million, including 140 properties: apartments, office buildings, industrial warehouses and hotels.

Sweeping Indictment

In June, Transcontinental stock took a hit after the U.S. attorney in Manhattan announced the indictments of Messrs. Phillips and Rossi and 118 others in a sweeping case alleging organized-crime influence on Wall Street. The indictment alleges that Messrs. Phillips and Rossi attempted to bribe union pension-fund officials to buy securities of a predecessor to American Realty. The alleged planned transactions never took place.

Both Messrs. Phillips and Rossi, who are scheduled for trial in September, have pleaded not guilty.

"They did absolutely nothing wrong," says Mr. Phillips's lawyer, Abbe Lowell, of Manatt, Phelps & Phillips, Washington, D.C. "Not only are we looking forward to the trial, we wish it were tomorrow."

Mr. Rossi's lawyer, H. Jay Ethington, of Dallas, said the allegations against his client are "unfounded" and based on taped conversations that will actually exonerate both Messrs. Phillips and Rossi.

Messrs. Phillips and Rossi and Basic Capital filed lawsuits in October against Dow Jones, publisher of The Wall Street Journal, for libel in connection with two brief stories published after the June federal indictment. One of the stories, published June 20, incorrectly said federal authorities alleged in the indictment that bribe and kickback money was laundered through Basic Capital. A correction ran July 12. The Journal has denied it libeled the plaintiffs and is defending the lawsuit. The suits are pending in state court in Austin, Texas, and federal court in Tulsa, Okla.

The Dallas companies' shares plunged in unison on the news of the indictments -- Transcontinental's fell 70% to $3 a share in composite trading on the New York Stock Exchange over the next two days. Basic Capital and American Realty received margin calls on Transcontinental stock totaling $72 million from big Wall Street houses. A New York vulture fund, Gotham Partners LP, and affiliates swooped in and bought a 21% stake in Transcontinental, mostly from Morgan Stanley Dean Witter Inc., one of the margin lenders.

After the indictments, Transcontinental and Income Opportunity announced Messrs. Phillips and Rossi had "stepped down from the operations of Basic Capital."

Shoring Up Control

In July, Judge Patel issued an order barring Messrs. Phillips and Rossi from any "further involvement whatsoever, directly or indirectly" in Transcontinental and Income Opportunity. The following month, plaintiffs requested that the judge appoint a special master to supervise the selection of new boards. Plaintiffs want the judge to direct the new boards to terminate the REITs' contracts with Basic Capital. The motion is pending.

Recent Transcontinental/Income Opportunity board moves have, if anything, shored up Mr. Phillips's control since the indictment. In June, the Transcontinental/Income Opportunity board, acting for Transcontinental, voted to lend $12 million to help Basic Capital and American Realty meet their margin calls. And in October, the same board, acting for Income Opportunity, agreed with American Realty to buy Gotham Partners' stake in Transcontinental for $16.50 a share, roughly three times what Gotham paid for it. That would return the Phillips-related stake to about 59%, roughly the level before the indictment. (American Realty took over the deal alone after shareholders in the San Francisco case objected that Income Opportunity shouldn't be used to bail out Mr. Phillips.) Transcontinental shares closed Thursday at $12.55, up 38 cents.

For shareholders, which numbered about 6,209 as of last March, the roller-coaster ride has continued. In November, Transcontinental announced that it had lost its status as a REIT under the federal tax code and would now be required to pay income taxes. The reason? REITs are meant to be widely held among many investors, but after recent deals, Transcontinental said its "concentration of ownership" had exceeded the tax code's limits. In his letter, Mr. Blaha blamed Gotham for the change. William Ackman, a Gotham principal, says he's mistaken and that Gotham funds, which represent "hundreds of entities," would only spread out Transcontinental's ownership.

And in December, Transcontinental made another announcement: For the fourth quarter, it would stop even the small dividend it had paid as a REIT.

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