TENANT-IN-COMMON

Legal News Alert℠

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Managing the Risk for Real Estate Securities Sponsors and Broker-Dealers

Warren E. Buffet has offered perhaps the pithiest description of what happens in a down segment of the economic cycle: When the tide goes out, we see who has been swimming naked. Certainly, in the current economic circumstances, tenant-in-common (TIC) sponsors and the broker-dealers who sell their offerings have been confronted with problems, including extreme financial pressure on their businesses and potential liability to investors unhappy with the returns on their investments. In most cases, the sponsors and the broker-dealers have done nothing wrong. Nevertheless, their businesses and their business models are under unprecedented attack.

Part of avoiding liability in down cycles of course depends on such business basics as adequate capitalization, offering quality assets in quality markets, conservative use of leverage, and aggressive asset management. This article does not address those business basics. However, even if the business basics are sound, things can still go wrong. This article provides some practical tips, based in part on real life examples that have surfaced in the recent past, on what sponsors and broker-dealers can do to manage their risk.

Sponsors

TIC sponsors are in the business of issuing securities through private placements, a business that in even the best of times is not for the faint of heart. However, following a few basic guidelines can help reduce risk. Here are some examples:

1. **Sell to accredited investors**. There is a recurring temptation to broaden the base of potential investors to include non-accredited investors. While it is true that some non-accredited investors are just as able to weigh risk and make informed decisions as accredited investors, an investor who the sponsor knew was not accredited has a significant head start in making a claim based upon lack of suitability. In most cases, selling to unaccredited investors simply presents an unacceptably high risk of liability for sponsors.
2. **Pay attention to corporate structure**. Although the concept of control-person liability in a securities-offering context lessens the traditional shelter of a corporate structure, there are still significant benefits in careful planning. Entities need to be properly formed and maintained in jurisdictions that are generally business-friendly. Each offering should be "siloed" — any entity having responsibilities or liabilities as to a particular offering should not be used for other purposes, including other offerings. There should be no parent-level guaranties or guaranties across transactions, explicit or implicit. Investors in a particular offering should be told in some detail that if anything goes wrong, they can look only to these offering-specific entities, and not to the parent or other affiliates. There also should be very careful disclosure of the limited capitalization of the offering-specific entities and of the risk that limited capitalization poses for investors.
3. **Utilize third parties**. While some larger TIC sponsors have their own "captive" broker-dealers, and others do not sell through broker-dealers at all but rather simply act as principals of the issuer (either for reasons of "control" or reduced offering costs), by far the safest course is to sell through independent broker-dealers. Experience has shown that in problem situations, the absence of an independent broker-dealer raises questions about the adequacy of due diligence, the depth of disclosure, and in general the presence of conflicts of interest in the sales process.

   In addition to an independent broker-dealer, sponsors should always ensure that current and complete sponsor and project due diligence reports as well as in-depth appraisals by experienced independent appraisers are available to the broker-dealers. While these materials add time and costs to offerings, they are cheap when measured against the risk of proceeding without them.
4. **Exercise control over the selling group**. Even if a sponsor utilizes a managing broker-dealer, a sponsor must control what broker-dealers are in its selling group, make sure that it has suitable selling agreements with them, and exercise some control over sales activities. While theoretically the broker-dealers are a sponsor’s first line of defense based upon suitability or lack of due diligence claims, the reality is that it is generally the sponsor and not the broker-dealer that gets sued. Keeping questionable broker-dealers out of the selling group and maintaining tight controls over those in the selling group substantially reduces sponsor risk.
5. **Maintain relationships and build in buffers**. A sponsor who waits until a problem is serious before informing investors and broker-dealers is asking for trouble. There have been far too many instances of sponsors cutting distributions to investors with little or no warning. This creates the impression that the sponsor has either been misleading investors or simply did not understand what was happening at the property level, neither of which is good. Sponsors most likely to avoid claims even with problem assets are those that have carefully maintained contact with investors, anticipated problems, and made an effort to help investors take any actions required to fix the problem at an early stage.

In addition, building in buffers is critical, whether in the form of reserves; tenant improvement and leasing commission lines of credit; adequate insurance; low, fixed-rate, consistently amortizing leverage; or other forms of financial cushions. There are few things more difficult for a sponsor than trying to solve immediate cash needs by arranging a capital call among 35 TIC investors.

Broker-Dealers

The day-to-day business activities of broker-dealers, whether captive or independent, are much more regulated than those of sponsors. All broker-dealers should have experienced compliance and due diligence people who are reasonably separated from the sales process. They also should have trustworthy securities compliance legal advisers, ideally both internal and external.

FINRA, the primary supervisory authority over broker-dealers, issued very useful guidance for its broker-dealer members selling TIC offerings in FINRA Notice to Members 05-18. FINRA has provided related guidance in Notice to Members 03-71 (Non-Conventional Investments) and Regulatory Notice 09-09 (Unlisted REITs and DPPs). In turn, FINRA's guidance was supplemented by the Tenant-in-Common Association (TICA) in its Alert 05-02 and Alert 08-01. These materials cover such crucial issues as avoiding general solicitation, establishing a substantive pre-existing relationship with the investor, doing proper due diligence, ensuring suitability, payment of referral fees, and internal controls and recordkeeping.

These materials should be on the desk of every broker-dealer control and compliance person, not just because they provide useful guidance, but also because of their mere existence. If the broker-dealer's regulator and industry trade group have dealt specifically with certain standards, the broker-dealer is more likely to be exposed to claims if it does not comply with those specific standards. Careful and regular training of those who will be involved in any part of the program will prevent many problems and act as a sound defense if the broker-dealer's actions are ever questioned.

Beyond these regulatory and industry guidelines, recent experience has suggested a few other useful techniques for reducing risks to broker-dealers in the TIC industry:

1. **Due diligence**. As FINRA and TICA have pointed out, broker-dealers have a due diligence obligation that goes beyond simply obtaining and reviewing the private placement memorandum (PPM). The first and best assurance that this obligation is met is by requiring an independent third-party sponsor and project due diligence report on any offering sold by the broker-dealer. This does not relieve the broker-dealer of its obligation to perform its own due diligence, but having an analysis prepared by an independent third party can be a critical protection against claims by investors that the due diligence performed by the broker-dealer was inadequate due to internal pressure to maximize commissions.

   One caution about third-party due diligence reports — if they are prepared, they must be read and not simply filed. If concerns about the sponsor or the offering are expressed, there should be a record in the broker-dealer's file that the concerns were brought to the sponsor's attention and a reasonable response was provided. We have seen many instances of third-party due diligence reports in broker-dealers' files with significant critical comments, with no record that these critical comments were addressed to the sponsor for a response or disclosed to the investor.
2. **Know the sponsors**. Broker-dealers should go through a careful, documented, deliberative process before signing a selling agreement with a sponsor they have not sold for before. If the sponsor is new to the broker-dealer, but not to the TIC industry, check the sponsor's track record and talk to references, both those provided by the sponsor and those the broker-dealer finds for itself. Also, find out who else is in the selling group. If the group includes other established, careful broker-dealers, it provides a measure of comfort.
3. **Understand the products**. Even the simplest TIC offerings involve complex structures. Sponsors take those innately complex structures and make them even more complex in an effort to push the edges of Rev Proc. 2002-22. If a broker-dealer is going to sell the offering, the broker-dealer must understand how the offering deals with a number of key questions such as will the investor be exposed to liability to the lender or the other tenants in common, how are decisions made, if there is a master lease, how is the master lessee capitalized, how are disputes resolved, and so forth. For further guidance on this subject, review Foley's separate article "Ten Simple Rules for Reading a PPM."
4. **Maintain records**. The importance of maintaining complete and organized records on all investor relationships, from the substantive, pre-existing relationship stage to the current time, is critical. This includes all investor emails and memos of investor phone calls. Every broker-dealer should have an explicit set of employee guidelines on maintenance, security, and ultimate retention or destruction of client files as well as a regular internal review to make sure those guidelines are followed.
5. **Suitability.** At the time of an investment, investors are asked to sign very explicit acknowledgements and waivers, not only as to their financial condition, but also as to their sophistication and capacity to make informed decisions. Broker-dealers should always probe on these issues and not simply rely on such acknowledgements and waivers. This will require judgment calls, as TIC investors are almost by definition (because they are prior owners of real estate) knowledgeable about real estate ownership. However, ownership and capacity to make investment decisions are two different things. In addition, many TIC investors come in to TIC transactions already exposed to large, illiquid real estate allocations on their balance sheets, and in their determination to defer taxes, are not concerned about maintaining those large, illiquid positions. There are many techniques to lessen this risk, including purchasing smaller amounts of several diverse offerings and not exchanging but retaining and paying taxes on some of the exchange money to establish liquidity. At a minimum, the broker-dealer should maintain a record of discussing the specific issues

of diversification and liquidity with the investors.

6. **Supervision.** A fundamental part of the regulation of broker-dealers is the requirement that they have a supervisory system, including written supervisory procedures reasonably designed to ensure that the firm and its employees comply with the federal securities laws and the rules of the self-regulatory organizations. This entails a program to monitor the activities of registered representatives to ensure that they are complying with applicable rules. At a minimum, a supervisory system should specify who is responsible for supervision, what the supervisor should do, how often those steps should be taken, and how those steps will be documented. For example, a supervisory system for ensuring that investments are suitable for particular investors would specify that an identifiable supervisory principal shall review the documentation for each investor as to suitability. The procedures should provide guidance on how that determination will be made and what to do if an investor does not meet the standards. Finally, the procedures should specify how the supervisor will document that he has completed his review.

All of these suggestions for sponsors and broker-dealers are merely that: suggestions. However, these suggestions have been tested in the fire of recent distressed transactions, where sponsors and broker-dealers have been exposed to liability that could have been better managed. Now is the time to plan a detailed risk management strategy — before the next uptick. If these suggestions are taken to heart, perhaps when the tide next recedes, more sponsors and broker-dealers will be seen to be fully clothed.

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If you have any questions about this alert or would like to discuss the topic further, please contact your Foley attorney or the following individuals:

Stephen I. Burr, Author
Boston, Massachusetts
617.342.4038
sburr@foley.com

Richard G. Wallace, Author
Washington, D.C.
202.295.4049
rwallace@foley.com

Craig P. Wood
Los Angeles, California
213.972.4555
cwood@foley.com

Kenneth R. Appleby
Boston, Massachusetts
617.342.4091
kappleby@foley.com

Douglas S. Buck
Madison, Wisconsin
608.258.4282
dbuck@foley.com

Terry D. Nelson
Madison, Wisconsin
608.258.4215
tnelson@foley.com

James A. Manzi, Jr.
Boston, Massachusetts
617.342.4014
jmanzi@foley.com

Peter J. Elias
San Diego, California
619.685.4613
pelias@foley.com

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