

REGULATORY AFFAIRS

DEFENDING—AND WINNING—TENANT IN COMMON DUE DILIGENCE ARBITRATION CASES

by
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In the wake of the collapse of the real estate markets, and the effect the economy has had on tenants generally, broker-dealers selling securitized real estate offerings have seen a significant increase in arbitrations alleging inadequate due diligence. I recently had the privilege of successfully defending a registered representative in the first FINRA arbitration proceeding involving the recommendation of a tenant in common (“TIC”) interest in real property. Defending the due diligence done in that case was paramount.

Due diligence regarding investment products is a nebulous concept, which has evolved over time. Prior to NASD Notice to Members 05-18 (“NTM 05-18”), industry firms were guided only by case law. Court cases held that brokers had a duty to know their customers and the products that they recommended to clients. The courts also established that a registered representative was not entitled to rely blindly on the issuer of a security for information concerning that company. Red flags and suggestions of irregularities required appropriate inquiry, as well as adequate follow-up and review.

NTM 05-18—which was published in 2005—offered additional guidance to NASD members when offering TIC investments to investors. NTM 05-18 requires member firms to obtain a tax opinion stating the likelihood of whether or not the TIC’s offering structure will qualify as a 1031 exchange under the tax code. NTM 05-18 acknowledges that due diligence of specific properties will vary. It instructs member firms to undertake a *reasonable* investigation to ensure that the offering document does not contain false or misleading information. Such an investigation *may* include background checks of the sponsor’s principals, review of the agreements (property management, purchase and sale, lease and loan agreements) and property inspection. Additionally, if any offering documents contain projections, members should understand the basis of the projections and the likelihood they will occur.

The timing of a particular recommendation will dictate whether NTM 05-18 is applicable or not. *Subsequent* to NASD’s issuance of NTM 05-18, the Tenant in Common Association (“TICA”), a leading industry group, issued a Guide to Certain TIC Best Practices in its TICA Alert 06-01. TICA Alert 06-01 recommends that broker-dealers obtain and review several documents in addition to the private placement memorandum. These documents include: the executive summary of the offering and property; appraisal; property condition assessment; environmental report; rent roll and, if available, abstracts of material leases; copy of any purchase agreement; existing survey; title commitment; two years’ historical financials for the property; and, loan application or commitment letter.

The due diligence and best practices suggested by NTM 05-18 and TICA Alert 06-01 provide a framework for broker-dealers and registered representatives to follow *today* when selling a TIC interest to investors. Although they may not have been applicable when many of the recommendations which will be litigated over the next few years were made, whether a firm or its broker adhered to the standards stated above will determine whether the due diligence undertaken survives the scrutiny of arbitration. Plaintiffs’ lawyers will undoubtedly call an expert to testify that these standards were applicable at the time of the recommendation even if they were not yet memorialized. Defending a



claim on the basis that the firm or the broker was not yet required to adhere to these principals would significantly complicate the defense and increase exposure. Additionally, expert testimony will almost always be necessary, both to explain the evolution of industry standards and also to refute allegations that red-flags were missed.

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