

Tenant in Common Arbitration Cases: Critical Issues for Firms and Broker-Dealers

by Derek C. Anderson, Esq.

I recently had the privilege of successfully defending a registered representative in what I believe to be the first FINRA arbitration proceeding involving the recommendation of a tenant in common ("TIC") interest in real property. In *Branch Avenue Plaza, L.P. v. United Securities Alliance et al.*, FINRA Case No. 08-00532, the Claimant alleged that the broker-dealer and broker involved failed to conduct adequate due diligence prior to recommending a TIC syndication and that the recommendation was unsuitable. The Claimant sought nearly \$4 million in compensatory damages, interest, attorneys' fees, and punitive damages. The case involved a property sponsored by Investment Properties of America and Ed Okun. After hearing testimony and considering the evidence and arguments offered by the parties, the FINRA arbitration panel dismissed the claims of the Claimant with prejudice and ordered that the complaint be expunged from the broker's securities industry record.

I believe that the Panel's award was appropriate, but learned during the litigation just how difficult these cases are to defend. Broker-dealers specializing in TIC offerings expect the number of cases alleging negligence in the due diligence process of such offerings and claims for unsuitability to increase dramatically in the wake of the current economic crisis and its impact on real estate values and tenants' ability to meet their rent obligations. This article reviews the salient issues which will be litigated in these cases over the

next several years.

Suitability

At this point, it is clear that the sale of TIC interests in real property are considered securities transactions and therefore registered representatives must adhere to NASD Rule 2310 regarding the suitability of a securities recommendation. (Although the NASD has been merged into FINRA, the agency has not yet issued a consolidated rule book.)

With respect to suitability allegations, several issues are the key to victory. In the context of an Internal Revenue Code §1031 exchange, diversification may be the first challenge to suitability. Most investors who seek to do a 1031 exchange have already made up their mind to do the exchange. A registered representative in such situations would be well-served to discuss the option of forgoing the exchange and taking the "tax hit." An investor who takes the tax hit can more easily diversify his portfolio and take advantage of asset allocation models. Should the client choose to do the 1031 exchange for the tax benefits, the registered representative should *at the very least* take contemporaneous notes of a conversation regarding diversification, so that he can prove it took place. Many arbitrations come down to a situation of "he said she said." Eliminating the guesswork for the arbitrators greatly increases a registered representative's chances of success. Moreover, broker-dealers should contemplate utilizing a standard disclosure form whereby the client acknowledges that the broker has raised the issue of diversification and that the client has nonetheless chosen to enter into a 1031 exchange because of the tax benefits of the transaction.

The firm's supervisory manuals should also be reviewed to ensure that there are no provisions that unintentionally preclude the 1031 TIC transaction. Many firm's supervisory

manuals have sections which address the sale of direct participation programs (DPP's), including TIC's. Limitations requiring that participation in a DPP not exceed 5% to 25% of the client's net worth are not uncommon. However, in the context of a 1031 TIC transaction, it is not unusual for the percentage of the TIC investment to exceed 25% of an investor's net worth. In some cases, it is closer to 100%. You cannot have conduct that violates your firm's supervisory procedure and expect to easily win an arbitration. Firms with manuals addressing DPP programs should make sure that there is an exception for TIC transactions qualifying for tax deferral under I.R.C. §1031.

Finally, registered representatives must be able to justify the suitability of a particular recommendation or recommendations of a TIC interest in real estate. Under the rules interpreting I.R.C. §1031, an investor can invest in three properties of any fair market value, or seek to take advantage of the 200% rule or 95% rule. Firms and brokers should be prepared for the argument by the investor's lawyer that they failed to adequately diversify the real estate portfolio by utilizing the three property rule. In light of the 45 day window to identify potential exchange replacement properties, the three property rule is often the most practical and most often utilized alternative for the investor. Nevertheless, the investor's lawyer will no doubt question the prudence of implementing the three property rule when the investor could have elected to diversify into, for instance, ten properties. Again, the registered representative should make sure to discuss the investor's options with him and take contemporaneous notes that the investor has elected to pursue the three property rule if that was indeed the case. Such notes will be critical evidence at an arbitration hearing.

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The registered representative must also be able to defend the suitability of each particular recommendation in light of NASD Rule 2310. What are the client's investment objectives, risk tolerance, and investment time horizon are questions that must be answered at a hearing. Is the property a single tenant or multi-tenant property? Are there redundant layers of security like tenant guarantees, sponsor guarantees, and a reserve for re-leasing? Is the investor interested in a higher yield or more safety? All of these questions and more must be asked and the registered representative must be prepared to explain his recommendation(s) on the stand under oath.

Due Diligence

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"), firms were guided only by the vagaries of case law. It is now well settled law that brokers must "know their customers" and "know the product that they recommend to their clients." Courts have held that registered representatives cannot "rely blindly on the issuer of the security for information concerning a company..." *Hanley v. S.E.C.*, 415 F.2d 589, 597 (2nd Cir. 1969). "Securities issued by smaller companies of recent origin obviously require more thorough investigation." *Hanley, supra*. Subsequent U.S. Circuit cases further explain this duty to investigate, and stated that "red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review." *Graham v. S.E.C.*, 222 F.3d 994, 1006 (D.C. Cir. 2000). Securities professionals must "investigate the securities he or she offers to customers," and must further obtain a "reasonable basis" through investigation that "key representations in the statements provided to investors were truthful and complete." *S.E.C. v. GLT Dain Rauscher, Incl. et al.*, 254 F.3d 852, 857 (9th Cir. 2001).

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 (opinions that express an offering "will" or "should qualify" as an exchange under the tax codes is preferred.) 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 in which they could occur.

Thus, 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.

TICA Alert 06-01 also recommends that all loan documents be reviewed prior to closing and preferably at the time the private placement memorandum is finalized and provided. TICA Alert 06-01 further states the appraisals for TIC interest properties be (1) prepared by a licensed MAI appraiser, (2) complete in scope, and (3)

presented in either a summary or self contained format.

TICA Alert 06-01 further suggests private placement memorandums and disclosures should be reviewed to ensure full and fair disclosure. Items in the memorandums should include: risk factors; description of the real estate, lease(s), key tenants, terms of the acquisition, and any financing; summary of key documents (where applicable: TIC agreement, master lease or management agreement, purchase agreement, call agreement and other material agreements); management description; compensation to the sponsor and its affiliates in tabular form; conflicts of interest; tax considerations; sources and uses of proceeds in tabular form; and, who may invest.

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.

Ultimately, both the firm's and the broker's diligence and adherence to recognized securities law principals will determine the likelihood of prevailing in these cases.