

Due Diligence of 1031 Offerings

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Introduction

The offering of tenant-in-common interests in real estate to investors as a means of completing an exchange under Section 1031 of the Internal Revenue Code of 1986, as amended (a "1031 Offering"¹), has grown dramatically over the past few years. Since most, if not all, 1031 Offerings involve the offer and sale of a security,² they are sold through securities broker-dealers and are subject to legal standards applicable to securities offerings, including the liability provisions of the federal and state securities laws.

As discussed below, the National Association of Securities Dealers, Inc. ("NASD") requires that broker-dealers conduct appropriate due diligence of 1031 Offerings. In addition, as is the case with all securities offerings, it is advisable for broker-dealers distributing the securities to perform appropriate due diligence of the offering to limit the potential for liability under federal and state securities laws.

In practice, much of the due diligence of 1031 Offerings is conducted on an outsourced basis by law firms and other providers, and varies widely in a number of respects, including:

- Whether it is being conducted at all;
- The scope of the due diligence review, including whether what is being offered as due diligence actually constitutes due diligence within the meaning of the securities laws;
- The qualifications of the persons conducting due diligence; and
- Whether the persons conducting the due diligence have been retained by the sponsor or the broker-dealer.

In light of this variation, broker-dealers may not be in compliance with NASD requirements or receiving the protections against liability that appropriate due diligence offers, and may unknowingly be exposing themselves to undue risk. Further, NASD has reminded its members of their obligation to conduct their own due diligence of service providers, such as due diligence service providers, to which they outsource certain activities. In order to assist broker-dealers in (i) determining the adequacy of due diligence being conducted in connection with 1031 Offerings in which they are participating, and (ii) performing due diligence on providers of due diligence services, this paper provides information concerning the purpose of due diligence and due diligence standards established by the courts and regulatory authorities, and makes recommendations concerning the appropriate scope of due diligence of a 1031 Offering and the qualifications of due diligence providers.

¹ In addition to offerings of tenant-in-common interests, some 1031 Offerings involve the offer and sale of interests in a Delaware Statutory Trust. Unless the context indicates otherwise, references in this paper to 1031 Offerings include both types of offerings.

² While some sponsors of 1031 Offerings take the position that their offerings are structured as the offer and sale of real estate and not a security, there is limited authority for such a position. While it is beyond the scope of this paper to analyze the issue of whether a 1031 Offering involves a security or real estate, prudent market participants should treat all syndicated 1031 Offerings as involving the offer and sale of a security.

Reasons for Conducting Due Diligence

Federal Securities Laws

The concept of securities offering due diligence was incorporated in the Securities Act of 1933, as amended (the "Securities Act"). Generally, Section 11 of the Securities Act imposes liability on certain persons, including persons who signed the registration statement, directors of the issuer, and underwriters, when a registration statement contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading.³ Persons other than the issuer are not liable with respect to any part of the registration statement, however, if they "had, after reasonable investigation, reasonable ground to believe, and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading[.]"⁴

Similarly, Section 12 of the Securities Act imposes liability on a person who offers or sells a security by means of a prospectus or oral communication, which includes "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading,...and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission[.]"⁵

Thus, as the forgoing quoted language indicates, Section 11 and Section 12 each includes a defense against liability for persons who conducted reasonable due diligence.

Since 1031 Offerings are conducted pursuant to an exemption from the registration provisions of the Securities Act, however, Sections 11 and 12 do not apply.⁶ Therefore, a plaintiff seeking redress under the federal securities laws in connection with a 1031 Offering would likely allege fraud pursuant to Section 10b-5 of the Securities Exchange Act of 1934, as amended. While for a person to be liable under Section 10b-5, the plaintiff must demonstrate that the person must have possessed some degree of "scienter,"⁷ generally, cases have held that the scienter requirement can be satisfied by showing that the defendant acted with recklessness, which has been described as "a mental state apart from negligence and akin to conscious disregard[.]"⁸

³ 15 U.S.C.A. § 77k(a).

⁴ 15 U.S.C.A. §§ 77k(b)(3)(A), 77k(b)(3)(B).

⁵ 15 U.S.C.A. § 77l(a)(2).

⁶ Since Section 11 relates to disclosures in a registration statement, it applies only to registered offerings. In 1995, the Supreme Court in *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995), determined that Section 12 liability is limited to public offerings as private offerings do not involve the use of a "prospectus" as that term is defined in the Securities Act.

⁷ 15 U.S.C.A. §§ 78j(b), 78u-4(b)(2); 17 C.F.R. § 240.10b-5.

⁸ *Comshare Inc. Sec. Litig.*, 183 F.3d 542 (6th Cir. 1999).

Thus, simple negligence on the part of a broker-dealer in connection with a 1031 Offering should not be sufficient to subject it to liability under 10b-5, but recklessness or “conscious disregard” likely would be.⁹ While there is no express “due diligence” defense to liability under 10b-5, it would be difficult for a plaintiff to demonstrate recklessness on the part of a broker-dealer where it conducted an appropriate degree of due diligence before participating in the offering.¹⁰ Conversely, if investors were to experience a loss in a 1031 Offering and offering disclosure was arguably inaccurate or misleading, a plaintiff almost surely would pursue a claim against a broker-dealer that sold the offering with no or inadequate due diligence, arguing that the broker-dealer was reckless in doing so.¹¹

State Securities Laws

Although Section 12 of the Securities Act does not apply to private securities offerings such as 1031 Offerings, states may have similar liability provisions, including a due diligence defense, that do apply. For example, article 581-33(A)(2) of the Texas Securities Act provides, in part:

A person who offers or sells a security (whether or not the security or transaction is exempt under Section 5 or 6 of this Act) by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, is liable to the person buying the security from him, who may sue either at law or in equity for rescission, or for damages if the buyer no longer owns the security. However, a person is not liable if he sustains the burden of proof that either (i) the buyer knew of the untruth or omission, or (ii) he (the offeror or seller) did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

The Court of Appeals of Texas has ruled that this statute applies to private offerings, noting that it does not contain the phrase of limitation “by means of a prospectus or oral communication” present in Section 12 of the Securities Act.¹² Thus, under Texas law, sellers (including broker-dealers) can protect themselves from liability by conducting due diligence to satisfy the “reasonable care” standard for avoiding liability under the statute.

⁹ 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5.

¹⁰ For example, the Federal District Court for the Southern District of California found an underwriter was not reckless where it had performed substantial due diligence. *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 623 (9th Cir. 1994); *In re Software Toolworks, Inc. Sec. Litig.*, 789 F.Supp. 1489, 1497 (N.D.Cal.1992).

¹¹ In an administrative proceeding, the SEC has held that soliciting investors for a private placement without validating information supplied by third-party promoters constituted recklessness. *In the Matter of Stires & Co., Inc. and Sidney H. Stires*, 67 S.E.C. Docket 1716 at 7 (1998).

¹² *Anheuser-Busch Companies, Inc. v. Summit Coffee Co.*, 934 S.W.2d 705 (1996); 15 U.S.C.A. § 771(a)(2).

NASD Requirement

NASD requires that its members conduct due diligence of 1031 Offerings in connection with their reasonable basis suitability analysis. NASD Notice to Members 03-71 (“NTM 03-71”), which pertains to “non-conventional investments” (“NCIs”), reminds members that the sale of NCIs, like more traditional investments, requires them to conduct appropriate due diligence with respect to these products. NTM 03-71 states the following:

A reasonable-basis suitability determination is necessary to ensure that an investment is suitable for some investors (as opposed to a customer-specific suitability determination...which is undertaken on a customer-by-customer basis). Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.

While NTM 03-71 does not specifically identify 1031 Offerings as NCIs, NASD Notice to Members 05-18 (“NTM 05-18”), which is discussed below, does. Thus it is clear, as far as NASD is concerned, that members have an obligation to conduct due diligence of 1031 Offerings.

Due Diligence Standards

The following is a brief summary of highlights of leading due diligence cases generally and an important regulatory pronouncement that specifically addresses due diligence of 1031 Offerings.

Case Law

There is a substantial body of case law on the subject of due diligence, typically in the context of defense of a claim under Section 11 or 12 of the Securities Act. Among other things, these cases stress the need for:

- A high degree of care;
- An independent investigation of facts;
- Identification of all facts material to investors; and
- Non-reliance on management representations.

Under Section 11 of the Securities Act, the standard of care for the due diligence defense is “that required of a prudent man in the management of his own property.”¹³ Under Section 12, the standard is “the exercise of reasonable care.”¹⁴ Accordingly, the standard of care is essentially a negligence standard. Implicit in this standard should be that the persons

¹³ 15 U.S.C.A. § 77k(c).

¹⁴ 15 U.S.C.A. § 77l(a)(2).

conducting due diligence have the qualifications and experience necessary to do so. A leading due diligence case found the due diligence investigation insufficient because it did not identify material facts and noted the inexperience of the attorney supporting the process.¹⁵

The cases also stress that due diligence be conducted in an independent manner and identify all material facts:

[Dealer-managers] are expected to exercise a high degree of care in investigation and independent verification of the company's representations. Tacit reliance on management assertions is unacceptable; the underwriters must play devil's advocate.¹⁶

The purpose of Section 11 is to protect investors . . . To effectuate the statute's purpose, the phrase 'reasonable investigation' must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of 'date presented' to them by the company . . . In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel.¹⁷

[B]ecause the participation of the underwriter is central to the successful distribution of the securities, the underwriter is peculiarly able to demand access to information . . . The underwriter may not always rely on the truthfulness of information supplied by the issuer.¹⁸

It is noteworthy that the *BarChris* court said that the due diligence investigation was inadequate where the attorney:

- Accepted assurances that missing board minutes related to only routine matters;
- Failed to examine key contracts to discover they hadn't been signed;
- Failed to investigate financial difficulties between company and lender; and
- Generally failed to verify information submitted by the company.

In the context of a 1031 Offering, this calls into question the adequacy of a "due diligence" investigation that merely reviews and summarizes information contained in the offering document.

Although the concept of due diligence initially arose as a defense against liability, the SEC and others have characterized due diligence as not only a defense but an implied requirement of underwriters.

¹⁵ *Escott v. BarChris Construction Corp.*, 283 F.Supp. 643, 696-697 (S.D.N.Y.1968).

¹⁶ *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 581, 582 (E.D.N.Y. 1971).

¹⁷ *BarChris* at 697.

¹⁸ SEC Release No. 33-5275 (July 26, 1972).

By associating himself with a proposed offering, an underwriter impliedly represents that he has made such an investigation in accordance with professional standards . . . The underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public.¹⁹

The small size of [the] offerings did not relieve [the president of a brokerage firm] of his duty to investigate. If, as he contends, he lacked the experience in oil and gas drilling programs to understand [the issuer's] materials, it was necessary . . . for him to acquire that understanding. His choice was clear – either conduct a thorough, independent investigation or refrain from selling these initial limited partnership offerings by a relatively new and unseasoned issuer.²⁰

NASD Guidance on 1031 Offering Due Diligence

NASD NTM 05-18 addresses a number of issues relating to 1031 Offerings, including due diligence. NTM 05-18 states that “NASD staff believes that it is not appropriate for members that recommend a [Tenant in Common] transaction simply to rely on representations made by the sponsor in an offering document.” It also states that “members should make a reasonable investigation to ensure that the offering document does not contain false or misleading information.” According to the notice, such an investigation could include:

- Background checks of the sponsor's principals;
- Review of the agreements (*e.g.*, property management, purchase and sale, lease and loan agreements);
- Property inspection; and
- An understanding of the basis for projections, the degree of likelihood that they will occur and a determination whether projected yields can reasonably be supported by the property operations.

Who Should Conduct Due Diligence

Obviously, persons conducting due diligence should possess the expertise necessary to perform an adequate review, and unqualified persons should not be retained for this purpose. The BarChris case noted the inexperience of the person supporting the due diligence investigation and found the due diligence investigation insufficient because it did not identify material facts. In addition, as discussed below, NASD has advised members that they should investigate whether those to whom they outsource certain activities are capable of performing them.

¹⁹ *In re Richmond Corp.*, 41 S.E.C. Docket 398, 406 (1963).

²⁰ *In re Thomas J. Fittin*, 50 S.E.C. Docket 544, 549 (1991).

NASD Notice to Members 05-48

NASD Notice to Members 05-48 (“NTM 05-48”) addresses the practice of broker-dealers contracting with third-party service providers to perform certain activities and functions on a continuous basis. It states that if a member, as part of its business structure, outsources “covered activities,” which are activities that, if performed directly by the member, would be required to be the subject of a supervisory system and written supervisory procedures pursuant to Rule 3010²¹, its written supervisory procedures must include procedures regarding its outsourcing practices to ensure compliance with applicable securities laws and regulations and NASD rules. The NTM further states that the procedures “should include, without limitation, a due diligence analysis of all of its current or prospective third-party service providers to determine whether they are capable of performing the outsourced activities.”

Accordingly, it is incumbent upon broker-dealer firms to have written supervisory procedures relating to their outsourcing practices, including outsourcing of due diligence, and to conduct due diligence of their service providers, including their due diligence providers.

Recommended Scope of 1031 Program Due Diligence

The following is a recommended scope of 1031 Program due diligence. This recommendation is based upon the concept that a principal purpose of due diligence is to ensure that offering disclosure is accurate and complete. Accordingly, an appropriate due diligence review should cover those items necessary for making such a determination. While Section 11 of the Securities Act is not applicable to private 1031 Offerings, the Section 11 due diligence standards, including an investigation that a prudent person would undertake in the management of his or her own property, provide excellent guidance as to what constitutes a reasonable due diligence investigation. The review should also be based upon the guidance issued by NASD in NTM 05-18. Of course, the appropriateness of the scope of any due diligence review depends upon the particular facts and circumstances of the offering and the sponsor.

²¹ Neither NTM 05-48 nor Rule 3010 provides a comprehensive list of activities that are covered activities. We contacted the NASD attorney listed as the contact person for NTM 05-48, and were advised that NASD staff is not providing specific guidance on what constitutes a covered activity. Rather, the guidance is that if the activity – in this case due diligence – would be required to be the subject of a supervisory system and written supervisory procedures if performed directly by the member, it would be considered a covered activity.

The following appear to be some of the items that a prudent person would investigate in connection with a review of a specific 1031 Offering:

- Offering documents: Private Placement Memorandum (“PPM”) and appendices;
- Operative agreements: Tenant in Common (“TIC”) purchase agreement and escrow instructions; TIC agreement; management agreement; master lease;
- Loan documents: mortgage, note, guaranty, environmental indemnity;
- Tenants: current rent roll, leases, tenant financial statements, SEC filings for public company tenants, other tenant credit information;
- Tax: tax opinion, representation letter, PPM disclosure;
- Third-party reports: appraisal, environmental, property condition;
- Property: site visit;
- Market: sales and rent comparables, area analysis;
- Title: title commitment, Schedule B exception documents, survey; and
- Projections: sponsor projections in PPM, sponsor Excel or Argus file.

These items should be obtained, reviewed, and analyzed, all with a goal of ensuring the adequacy of offering disclosure and of identifying business terms or issues that may have a bearing on the broker-dealer’s decision whether to offer the program to its customers.

In addition to specific property-level due diligence investigations, it is advisable periodically to conduct a sponsor-level review. An appropriate sponsor review will identify issues relating to the sponsor that may warrant disclosure in offering documents, and will provide the broker-dealer with information to consider in determining whether it wants to participate in the sponsor’s 1031 Offerings. The following appear to be some of the items that a prudent person would investigate in connection with a review of a 1031 Offering sponsor:

- Organizational structure and control;
- Material contracts;
- Litigation;
- Regulatory compliance;
- On-site management interviews;
- Background investigations;
- Reference checks;
- Management and staff capability analysis;
- Review of policies and procedures;
- Financial statement review;
- Prior performance review;
- Prior performance disclosure;
- Overall performance;
- Identification of problem properties; and
- Analysis of internal controls and procedures.

As these items indicate, a due diligence review is substantially more than a summary of information presented in the sponsor’s offering documents. Unfortunately, program and

sponsor due diligence reviews of this or a similar scope are not always compatible with the desire of some sponsors and broker-dealers involved in 1031 Offerings. Reasons might include the unwillingness of a sponsor to subject itself or its program to the scrutiny due diligence involves, an unwillingness of the sponsor to reimburse the cost of a due diligence review, and the desire on the part of the broker-dealer, for business reasons, to sell the offering regardless of the adequacy of due diligence.

Recommended Qualifications and Independence of Due Diligence Providers

As indicated above, case law establishes that due diligence be conducted with a high degree of care by persons who are qualified and are independent of the issuer.

Substantive Qualifications

There is no case law or other published authority specifically relating to the qualifications of persons conducting due diligence of a 1031 Offering. Accordingly, the assessment of such a person's qualifications must be done in light of the objectives of the due diligence review and the components of a 1031 Offering. The following is a summary of these items and related qualifications and experience that may be appropriate:

Objective	Qualification/Experience
Assessment of adequacy of offering disclosure	Experience and/or training in securities law, including drafting and/or reviewing securities offering documents
Review of operative agreements	Experience and/or training in general corporate law, including contract drafting, review and negotiation
Loan documents	Experience and/or training in finance law
Tenants	Experience and/or training in real estate law (for lease review); experience and/or training in business or finance (for conducting credit research and analysis)
Review of third-party reports (environmental, appraisal, property condition) on real estate	Legal, financial and/or other substantive experience in commercial real estate transactions
Review of title documentation	Training and/or experience in real estate law
Review and analysis of financial projections	Experience and/or training in finance and accounting, including undergraduate or graduate degrees in finance or accounting
Identification and evaluation of real estate investment risks	Experience and/or training in commercial real estate transactions
Review of tax opinion, tax risks, and tax disclosure	Experience and/or training in tax law
Property site visit	Legal, financial and/or other substantive experience in commercial real estate activities

While there is no clear guidance on the appropriate levels of qualifications and experience, the following should be considered:

- As 1031 Offerings are complex and involve myriad legal and financial issues, qualifications and experience levels should be substantial;
- Since a principal objective of due diligence is to assess the adequacy of offering disclosure, substantial experience in securities law is critical; and
- As many of the issues that should be addressed in 1031 Offering due diligence are of a legal nature, performance of due diligence by a non-attorney raises the questions whether the scope of the review is adequate and whether the due diligence provider is practicing law without a license.

Independence

As indicated above, case law emphasizes that those conducting due diligence must be independent of the issuer. Accordingly, it would be prudent for broker-dealers to require that those conducting due diligence on their behalf possess the requisite independence.

If due diligence is being conducted by an attorney or a law firm that represents the broker-dealer and does not also represent the issuer, independence would be clearly established. For example, the Maryland Lawyers' Rules of Professional Conduct require that an attorney, when acting as an advisor, "provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications."²² As an advocate, "a lawyer zealously asserts the client's position under the rules of the adversary system."²³ As a negotiator, "a lawyer seeks a result advantageous to the client but consistent with the requirements of honest dealing with others."²⁴ In addition, under the rules, a lawyer has an obligation to be competent, prompt and diligent, which requires "the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."²⁵

One question that arises in due diligence of 1031 Offerings has to do with the fact that in many cases the sponsor pays or reimburses the fees of the due diligence provider. When properly structured, such a payment mechanism is permissible for attorneys, and the attorney rules of professional conduct require that under those circumstances the attorney continue to represent the interests of the broker-dealer client. For example, under the Maryland rules, a lawyer may be paid from a source other than the client so long as the client is informed of the fact, consents to the arrangement and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client.²⁶ The comments to the rules state that "(l)awyers are frequently asked to represent a client under circumstances in which a third person will compensate the lawyer, in whole or part Because third-party payers frequently have interests that differ from those of the client,

²² Preamble to Maryland Lawyer's Rules of Professional Conduct.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*; Maryland Lawyer's Rules of Professional Conduct § 1.1.

²⁶ Maryland Lawyer's Rules of Professional Conduct § 1.8(f); Maryland Lawyer's Rules of Professional Conduct § 1.7, comment 13.

including interests in minimizing the amount spent on the representation and in learning how the representation is progressing, lawyers are prohibited from accepting or continuing such representations unless the lawyer determines that there will be no interference with the lawyer's independent professional judgment and there is informed consent from the client."²⁷ Thus, a law firm representing a broker-dealer in connection with due diligence has an obligation to maintain its independence, regardless of the ultimate source of the funding for its fees.

Other arrangements raise troublesome independence issues. Clearly, if the due diligence provider is retained by the sponsor and not the broker-dealer, there is no semblance of independence present. Similarly, if the provider represents both the sponsor and the broker-dealer, the provider's loyalty may be ambiguous and its independence questionable. Likewise, even if the provider purports to represent the broker-dealer, if it provides other services to the sponsor, its independence is questionable. Finally, even if the provider is an attorney or law firm, its attorney-client relationship with the broker-dealer, as opposed to the sponsor, should be clear and unambiguous.

In light of the importance of independence, broker-dealers should consider including independence inquiries as part of their investigation of due diligence providers.

Conclusion

Due diligence is an important component of the securities offering process. When properly conducted, it serves to mitigate offering risk for broker-dealers selling the securities, and NASD has notified its members that it is required for 1031 Offerings.

1031 Offerings are complex, involving a range of legal and financial issues. In order for a due diligence investigation to protect broker-dealers, its scope must be appropriate and it must be conducted by persons qualified to do so who are independent of the sponsor.

When outsourcing due diligence, broker-dealers should consider the following questions in determining whether a due diligence investigation of a 1031 Offering is sufficient:

- What is the scope of the review? Is it sufficient to ensure that offering disclosure is accurate and complete? Will it address all items covered by NTM 05-18?
- What are the qualifications of my firm's due diligence provider? Does it possess all skills necessary to conduct a competent due diligence investigation of an appropriate scope? Has my firm investigated the due diligence provider's qualifications as called for by NTM 05-48? and
- Does my firm's due diligence provider represent my firm's interests? Is it independent of the sponsor? Does it lack conflicts of interest?

If each of these questions is answered affirmatively, the broker-dealer can have confidence that it is obtaining due diligence services that protect its interests and that satisfy applicable NASD requirements.

²⁷ Maryland Lawyer's Rules of Professional Conduct § 1.8, comment 11.