



## CLIENT ALERT

### **DELAWARE STATUTORY TRUSTS: WILL DUE DILIGENCE ISSUES EMERGE IN 2016?**

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As 2016 approaches, independent broker-dealer firms have much to be thankful for when it comes to the real estate private placement marketplace. Firms that survived the credit crisis are seeing more products emerge to replace the embattled tenancy in common (TIC) interest and REIT, such as Delaware Statutory Trusts or “DSTs.” With the advent of the newly revised Rule 506(c), firms also have more opportunities for general solicitation. Before ringing in the New Year, however, firms should take a moment to consider FINRA’s enforcement priorities and whether macroeconomic issues will derail these trending products and create another wave in due diligence litigation.

#### **A LOOK BACK AT 2015:**

As the distance between the events of 2008 continues to grow, so do the number of steps regulators are taking to establish a review system designed to prevent a similar liquidity crisis. Whether these steps are capable of preventing another dramatic loss in number of established independent firms remains to be seen.<sup>1</sup> When it comes to real estate private placement offerings, however, what is known is that FINRA will continue to focus on the key issues of disclosure/transparency, liquidity, due diligence and customer suitability.

FINRA’s 2015 Exam Priorities letter reiterated the importance of due diligence and suitability in the sale of private placement investments and REITs.<sup>2</sup> FINRA stated that the sale of certain products that are subject to substantial market, credit, liquidity or operational risks requires firms

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<sup>1</sup> Investment News reported that 43 of 92 BDs that sold TICs sponsored by DBSI (47%) are no longer in business. See Kelly, B. (2014, April 13). A Better TIC? [www.investmentnews.com](http://www.investmentnews.com).

<sup>2</sup> See FINRA – 2015 Exam Priorities Letter, January 6, 2015.

to perform due diligence, make sound suitability decisions and describe product risks in a balanced manner that retail investors can understand.<sup>3</sup> FINRA reminded firms and registered representatives to be attentive to changing circumstances - such as the precipitous fall in oil prices or the rapid fall in some emerging and frontier market indices - that may affect suitability decisions and risk descriptions.<sup>4</sup> FINRA suggested that training registered representatives about product features, pricing and valuation, and providing guidance around suitability are important steps in meeting these challenges.<sup>5</sup>

Private placements were one product that FINRA vowed to focus on in 2015 based on common concerns regarding inadequate due diligence and suitability analysis.<sup>6</sup> A second product, and one popular with independent broker dealers during the last ten years, was the non-traded REIT.<sup>7</sup> FINRA wrote that risks relayed in prior years exam priorities, such as general lack of liquidity, high fees and valuation difficulties remained relevant with respect to customer-specific suitability obligations that firms must perform when recommending non-traded REITs to clients.<sup>8</sup> FINRA also emphasized that firms should perform due diligence on an ongoing basis on REITs they allow their representatives to recommend.<sup>9</sup> Further, “red flags” arising from a REIT’s financial statements or management may cause firms to change the types of clients to whom the firm recommends the product or even to discontinue sale of the product.<sup>10</sup>

These concerns were brought even more to the forefront based on FINRA’s new supervision rules that became effective on December 1, 2014. As of April 2016, firms will also be subject to FINRA’s amended customer-account statement and direct-participation program rules to require firms to give a more accurate per-share estimated value on customer account statements for REITs and DPPs.<sup>11</sup>

A smattering of recent due diligence disciplinary actions serve as reminders that firms must continue to maintain and, of course, continue to improve their due diligence practices.<sup>12</sup> Doing

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<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> See Regulatory Notice 15-02

<sup>12</sup> Cases include: No. 2012-033994701 (Arque Capital censured and fined \$50,000 for failure to review and distribution of offering materials containing false and misleading statements); 2012-032643701 (EDL financial censured and fined \$100,000 for failure to document due diligence efforts); No. 2013-035059001 (Rainmaker

so will protect firms and their customers in the event of another market blow-up or more limited market event. It will also help firms from trouble when FINRA again becomes product specific (i.e. real estate private placements) in its disciplinary focus.

### A LOOK FORWARD – DUE DILIGENCE AND THE DST:

One product that resulted in the downfall of many independent firms is the Tenant-In-Common interest (or “TIC”). TICs clearly did not work out as many investors and firms had hoped. A new product appears, however, to be replacing the TIC – the Delaware Statutory Trust (or “DST”).<sup>13</sup> A DST is a separate legal entity created as a trust under Delaware law.<sup>14</sup> The law permits a very flexible approach to the design and operations of the entity.<sup>15</sup> The DST owns 100% of the fee interest in the real estate.<sup>16</sup> Unlike a TIC, the Lender only needs to make one loan to one borrower.<sup>17</sup> The DST is bankruptcy remote.<sup>18</sup> That is, it contains provisions which prevent the bankruptcy creditors of the beneficiaries from reaching the DST’s property and gives the lender greater security that it can foreclose on its first mortgage of the real estate should the need arise.<sup>19</sup> The beneficiaries’ only right with respect to the trust is to receive distributions.<sup>20</sup> They have no vote or say in operations of the property.<sup>21</sup> The signatory trustee of the DST will generally be the sponsor of the private placement offering or one of its affiliates.<sup>22</sup> Unlike a TIC deal, there is no one year time limit on the trusteeship or the term of the property manager.<sup>23</sup> The Trust Agreement contains provisions requiring the trustee to comply with all of the terms of the loan documents and states that they are for the benefit of the lender.<sup>24</sup> The Lender does not need

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Securities censured and fined \$125,000 for failure to enforce WSPs relating to due diligence for unregistered private offerings; Case No. 2011025785602 (TNP Securities and Anthony Thompson expelled); Complaint filed in June 2015 against Carolina Financial Securities for failure to conduct reasonable due diligence despite numerous red flags and reliance solely on information from entity and, specifically, failure to follow guidance of Regulatory Notice 10-22.

<sup>13</sup> DSTs were 89% of deals in 2013. See Kelly, B. (2014, April 13). A Better TIC? [www.investmentnews.com](http://www.investmentnews.com).

<sup>14</sup> See Harrison, A. (2005, July 28). A Delaware Statutory Trust as an Alternative Borrower for Tenant in Common Programs. [www.apps.americanbar.org/HarrisonDSTsasalternativesforTICs.DOC](http://www.apps.americanbar.org/HarrisonDSTsasalternativesforTICs.DOC).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

to qualify any of the investors because they are totally isolated from the property.<sup>25</sup> The enabling IRS revenue ruling which forms the basis for a DST transaction in a Section 1031 exchange program has prohibitions on the powers of the trustee, which are built into the Trust Agreement and have become known as the “seven deadly sins”.<sup>26</sup>

Because of these restrictions, the only types of a real estate ownership transactions that will work in a DST are: (1) a Master Lease transaction whereby the Master Tenant takes on all of the operating responsibilities or, (2) a triple net long-term lease to an “A” Credit tenant.<sup>27</sup> DSTs continue to allow investors who are selling commercial real estate to reinvest profits and defer capital gains from the sale.<sup>28</sup> DSTs also have lower upfront fees, lower maintenance, portfolio offerings and added options when it comes to use of leverage.<sup>29</sup>

DST’s, however, by their very nature are interest rate sensitive. Economists overwhelmingly expect the Fed to raise interest rates in 2016.<sup>30</sup> Should an interest rate rise affect performance of DST’s, it is not a stretch to imagine another wave of litigation like the industry saw post 2008 with TIC sales.

Given the potential rise in interest rates and corresponding effects on the real estate loans, firms should take extra care to adhere to the aspects of Regulatory Notice 10-22 that are particularly

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<sup>25</sup> *Id.*

<sup>26</sup> *Id.* The seven deadly sins are :

1. Once the offering is closed, there can be no future contributions to the DST by either current or new beneficiaries;
2. The Trustee cannot renegotiate the terms of the existing loans nor can it borrow any new funds from any party unless a loan default exists as a result of a tenant bankruptcy or insolvency;
3. The Trustee cannot reinvest the proceeds from the sale of its real estate;
4. The Trustee is limited to making capital expenditures with respect to the property to those for (a) normal repair and maintenance, (b) minor non-structural capital improvements and (c) those required by law;
5. Any reserves or cash held between distribution dates can only be invested in short term debt obligations;
6. All cash, other than necessary reserves, must be distributed on a current basis; and,  
The Trustee cannot enter into new leases or renegotiate the current leases, unless there is a tenant bankruptcy or insolvency. *See Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *See* Kelly, B. (2014, April 13). A Better TIC? [www.investmentnews.com](http://www.investmentnews.com).

<sup>29</sup> *Id.*

<sup>30</sup> “About 92% of the business and academic economists polled by The Wall Street Journal in recent days said they expected the Fed to raise its benchmark federal-funds rate at its Dec. 15-16 policy meeting; some 5% said the Fed would stay on hold until March and 3% predicted the Fed would keep rates at near-zero even longer.” *See* Leubsdorf, B. (2015, Nov. 12). Economists Overwhelmingly Expect Fed to Raise Interest Rates in December. [www.wsj.com](http://www.wsj.com).

applicable to real estate private placement investments such as DST's. FINRA Regulatory Notice 10-22 has established itself as the current benchmark by which reasonable due diligence for Regulation D offerings is measured. It provides detailed guidance on the minimum steps a reasonable investigation should include, factors that broker dealers should consider in determining the appropriate scope of an investigation in a particular offering and practices that are consistent with an adequate due diligence investigation. Regulatory Notice 10-22 also reminds firms of suitability requirements, including both reasonable basis suitability and customer specific suitability. Relative to DST's, FINRA suggests reasonable due diligence would include:

Conducting an on-site inspection;

Reviewing the issuer's contracts, leases, mortgages, financing arrangements, contractual arrangements between the issuer and its management, employment agreements and stock option plans; and

Inquiring about the forms and amount of management compensation, who determines the compensation and the extent to which the forms of compensation could present serious conflicts of interest. A BD might make similar inquiries concerning the qualifications and integrity of any board of directors or similar body of the issuer.<sup>31</sup>

Firms should also recognize the characteristics of a DST that differentiate it from a TIC and keep in mind the "seven deadly sins." These should be integrated into a firm's due diligence analysis with respect to DST's. Particularly relevant guidance from Regulatory Notice 10-22 is that reasonable due diligence should include:

Examining historical financial statements of the issuer and its affiliates, with particular focus, if available, on financial statements that have been audited by an independent certified public accountant and auditor letters to management (of course in the real world, this most likely will be available at the sponsor level only and would be of no value at the program level);<sup>32</sup>

Looking for any trends indicated by the financial statements;

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<sup>31</sup> See Regulatory Notice 10-22 at Section III(A) – Reasonable Investigation Practices, Issuer and Management.

<sup>32</sup> DST PPM's almost always state that an investor has the right to request an audited financial statement but it will not be provided automatically because the cost will eat into investment returns.

Obtaining a property condition report and an environmental site assessment;

Inquiring about the industry in which the issuer conducts its business, the prospects for that industry, any existing or potential regulatory restrictions on that business and the competitive position of the issuer;

Requesting any business plan, business model or other description of the business intentions of the issuer and its management and their expectations for the business, and analyzing management's assumptions upon which any business forecast is based. A BD might test models with information from representative assets to validate projected returns, break-even points and similar information provided to investors;

Requesting financial models used to generate projections or targeted returns;

Analyzing past programs and assumptions made and comparing those assumptions and performance to the current program; and,

Maintaining in the BD's files a summary of the analysis that was performed on financial models provided by the issuer that detail the results of any stress tests performed on the issuer's assumptions and projections.<sup>33</sup>

Moreover, particularly with DST's, firm's should scrutinize a customer's leverage on the relinquished property as compared to the leverage on the replacement program. Some DST programs involve higher levels of leverage than is typically seen on TIC properties. Increasing a customer's exposure to leverage could ultimately form the basis for claims down the road. Additionally, firms should also be wary of conflicts of interest. Oftentimes, the DST program is spun out of a REIT looking to create a liquidity event. In such cases, firms should make every effort to ensure that there is a solid outside appraisal or fairness letter provided by the sponsor. Finally, careful consideration should be given to the program's financing; whether a loan is interest only and the length of the term. In today's interest rate climate, this issue in particular could be a ticking time bomb.

#### LESSONS TO LEARN:

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<sup>33</sup> See Regulatory Notice 10-22 at Section III(A) – Reasonable Investigation Practices, Issuer and Management and III(B) Reasonable Investigation Practices, Issuer's Business prospects.

The risks associated with DST investments are certainly within the framework of FINRA's latest priorities.<sup>34</sup> Indeed, FINRA specifically reminded firms to "be attentive to changing circumstances as that may affect suitability and risk descriptions."<sup>35</sup> FINRA specifically mentioned that its 2015 surveillance and examination activities that include product-related risk reviews will focus on due diligence, suitability, disclosure, supervision and training.<sup>36</sup> Based on 2015 priorities, there is every reason to believe that 2016 will include regulatory focus on products that are replacing TIC's and REITs and other failed real estate private placement investments and that DSTs may be among the products selected for increased attention.

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<sup>34</sup> See FINRA – 2015 Exam Priorities Letter, January 6, 2015.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*