

ROBERT G. HUTCHINS - LEGAL ESSAYS

Raising Capital for Private Real Estate Equity Funds - Disclosure Issues

Preliminary Note

This Essay examines the disclosures to investors that should be made in an exempt private placement of securities conducted by a small, real estate equity fund (a “Fund”). The typical Fund will be organized by a local or regional builder/developer or investment company (a “Sponsor”) that will manage the Fund directly, or through an affiliate. The Sponsor may engage investment advisers or brokers to help price and sell the securities, but often relies instead on its own judgment and on a pool of potential investors drawn from its business contacts. This Essay is written with the latter preference in mind.

The Fund may invest unemployed capital in mortgage-backed instruments on a temporary basis, or as a hedging device, but it will not attempt to build a portfolio of real estate securities. Rather, it will invest directly in properties that are identified, improved, operated and ultimately sold by the Sponsor. The Fund will thus compete for investors’ capital as an “opportunity” or “value added” Fund focused on discrete properties and markets with which its Sponsor is familiar. It will omit disclosures appropriate only for very large funds that invest broadly in real estate securities and in both “core” and non-traditional properties in all markets. It will also omit certain technical disclosures required of real estate investment trusts.¹

It must be recognized at the outset that, regardless of its size or the amount of capital to be raised, a Fund could conduct a private placement confined to “accredited investors” without registration and without observing *any* line-item disclosure *format*, so long as the placement complied with Rule 506 of SEC Regulation D. Nevertheless, this Essay assumes the Fund will disclose affirmatively all material facts and risks. Given the availability of Rule 506, it is appropriate to begin by explaining why.

Rule 506 provides a safe harbor exemption from registration at both the federal and state levels for offers and sales of securities made to a limited number of sophisticated investors if there is no “general solicitation” and other conditions are satisfied. The Rule accords a special status to “accredited investors” who are defined in terms of their financial strength or their position as a Fund insider. The Rule assumes such investors do not need the protection that full disclosure would provide. Accordingly, it requires line-item disclosure only for non-accredited investors. Seizing on that, many promoters routinely furnish only cursory disclosure on the ground that *all* their investors are “accredited.”

The problem is that the status of investors can be difficult to verify and there is no exemption from the anti-fraud and civil liability provisions of the securities laws even when all investors are, in fact, accredited. Promoters uniformly require that investors certify they are both accredited and sophisticated by completing detailed questionnaires in which they warrant their financial condition and investment experience. The questionnaires are not foolproof, however, and a promoter that relies solely on investor self-certification does so at its peril.

Furthermore, truly accredited investors have the means, and often the inclination, to turn to the courts when an investment goes wrong. They and their representatives will search for misstatements or omissions in whatever disclosure was actually provided with the aid of 20/20 hindsight. If the disclosure was cursory, or

¹ “Small” is a relative term. A Fund could realize annual revenues as high as \$25 million and still be treated by the SEC as a “small business issuer” entitled to conduct a registered offering using simplified disclosure in accordance with Regulation S-B. The disclosure in its private placements will be comparable. “REITS” are designed to attract institutional investors and they must have at least 100 owners with transferable interests. Most REITS are large public companies whose extended disclosure, most of it related to tax and financial matters, is governed by Regulation S-K.

general in nature, it is highly likely that the issuer and all those who participated in the selling effort will face a credible misrepresentation claim. In my view, full disclosure should always be provided unless the securities are placed in a negotiated transaction with a small group of investors whose sophistication and accredited status are obvious and who are represented throughout by securities counsel.²

Contents

The Advantages of Sponsoring a Fund	2
Certain Disadvantages	3
Drafting Challenges.....	3
Disclosure Format	3
Cover Page and Suitability Standards	4
Summary of the Fund.....	4
Summary Use of Proceeds.....	4
Compensation and Fees to the Sponsor	5
Conflicts of Interest.....	5
Fiduciary Obligations to the Fund and its Investors	6
Risk Factors.....	6
Prior Performance - Narrative Introduction and Tables	7
Management.....	8
Investment Objectives and Policies	9
Description of Real Estate Investments.....	9
Federal Taxes	10
Glossary	10
Summary of the Organizational or Operating Agreement	11
Reports to Fund Owners	11
Description of the Units.....	12
Redemption, Repurchase and Presentment Agreements	12
Plan of Distribution	13
Financial Statements.....	13
Updated and Amended Disclosure	13

The Advantages of Sponsoring a Fund

The real estate development market is fragmented, cyclical, illiquid, and influenced strongly by appraisal decisions that are inherently subjective. A significant real estate project may involve, in addition to the developer, a construction lender, a permanent lender, a lead architectural firm, structural, mechanical and electrical engineering firms, environmental consulting firms, a general contractor, various sub-contractors, accounting firms, law firms and other participants whose schedules must be coordinated and whose input must be assessed. Those characteristics place a premium on the quality of the developer’s due diligence and the administrative skills of its executives. To complicate matters, the window of opportunity for securing desirable real estate is often significantly shorter than the time required to complete adequate due diligence, organize an appropriate construction or re-development project, obtain preliminary permits and arrange financing. A developer that controls a large pool of discretionary capital can initiate and complete multiple projects much more efficiently than one that does not. Perhaps less obviously, even after distributions to investors are taken into account, the fees, “carried interests,” expense reimbursements and participating cash flow allocated by the typical Fund to a successful Sponsor can produce a return on net investment vastly exceeding anything the Sponsor could realize from its own resources.³

² For a full discussion of Regulation D, see this Website/publications “Private Placements, Parts I though IV.”

³ The developer that skimps on due diligence is apt to make fundamental mistakes. It will overbuild, underestimate the time required for permitting, construction and absorption, or overestimate the value lenders will place on a given property or completed project. In a lax credit environment, particularly when interest rates are moderate, a careless

Certain Disadvantages

Even though private placements can be completed much more quickly than registered offerings, and at a fraction of the cost, putting a Fund together properly remains an expensive, time consuming process. To minimize the exposure to misrepresentation claims that attends any securities offering and to aid in the selling effort, a comprehensive disclosure Memorandum should be furnished investors. The work involved resists scale economies because the necessary disclosures do not vary directly with the size of the transaction. Moreover, investors in a real estate equity Fund are betting on the success of projects that are not always identified when the investment is made. They therefore rely almost exclusively on the perceived skills, strategies and track record of the Sponsor. It can be difficult to explain those attributes in a way that complies with legal requirements and is also persuasive. Accordingly, the Memorandum for a Fund is apt to be significantly more complex than a Memorandum for a discrete project.

Drafting Challenges

Although there are recognized indices that report property values on an aggregate basis or that compare investment returns on real estate securities, these are of little help in valuing specific properties. Most properties, therefore, are financed, bought and sold on the basis of appraisal opinions that are inherently subjective. Generally accepted accounting principles (“GAAP”) necessarily allow property values to be recorded on an appraisal basis and they recognize other measurements that are based on the subjective judgments of management. As a result, the financial reporting of real estate entities is not uniform and it can be difficult for an investor to compare results.⁴

Moreover, a Fund’s financial structure may be complex, as well as ambiguously reported, while the Fund’s investors, despite their contrary assurances, may be unsophisticated. In a Fund with a simple financial structure, investors receive priority returns until they have recovered their investment, then subordinated returns until the Sponsor has received its “carried interest,” then participating returns shared ratably thereafter with the Sponsor and the remaining investors. That seems straight forward enough, but there are variations that are not so readily comprehensible. Then there is the problem of how to disclose the Sponsor’s compensation clearly and persuasively. In exchange for their services to the Fund, and in addition to their investment return, Sponsors receive performance, development, management and transaction fees some of which are based on subjective asset values rather than revenue or cash-on-cash returns. As a result, the various financial interests of Fund participants can be difficult to calculate and even more difficult to describe.

Finally, the Funds’ legal structure, contract documents, regulatory environment and tax position must also be fully disclosed and that increases substantially the complexity and length of the Memorandum.

Disclosure Format

The SEC has published a Securities Act Disclosure Guide for “...Registration Statements Relating to Interests in Real Estate Limited Partnerships.” The Guide contains helpful narrative and is cross-referenced to applicable SEC disclosure Regulations. It should be consulted by anyone preparing a private placement Memorandum for a real estate equity Fund even though the Fund will not file a registration statement and may not be organized as a limited partnership.⁵

developer may use too much leverage in a misguided effort to maximize profit. Any of these mistakes can put the developer, its project and its fund in an untenable financial position.

⁴ One respected benchmark is the “Real Estate Investment Fiduciaries (NCREIF) Property Index available at www.ncreif.com/index/data.

⁵ See Guide #5 of the SEC publication “Industry Guides.” The publication is available on the SEC website at <http://www.sec.gov/divisions/corpfin/forms/industry.htm>.

The heart of the disclosure will describe the Sponsor, its financial position, its existing and planned projects, its investment strategy, track record and compensation, the risks associated with an investment in the Fund, the distributions to be made to investors and the rights and limitations of the securities. The Guide contains instructions respecting the manner and order in which these subjects will be discussed.

Cover Page and Suitability Standards

The cover page of the Memorandum must identify the Fund, the securities being offered, the minimum and maximum offering proceeds, the closing date for the offering, the selling commissions and the net proceeds available to the Fund assuming, alternatively, that the minimum and maximum proceeds are raised. The cover page should also contain a brief summary of the most significant risk factors.

Following the cover page there should be a summary of the investor suitability standards used by the Sponsor. As noted previously, the standards are detailed in a questionnaire signed by the investor that sets forth the investor's financial position and investment experience and contains representations that the investor (a) is financially "accredited" (e.g. has a net worth of at least \$1,000,000, or current annual income of at least \$200,000 or current annual income with spouse of at least \$300,000) and (b) is "sophisticated" enough in business and financial matters, alone or with a qualified representative, to evaluate the offering.

Summary of the Fund

The substantive discussion should begin with a summary that identifies, in addition to the Fund and the Sponsor:

- = the Sponsors expected compensation;
- = the Fund's form of organization, duration and investment objectives;
- = the estimated maximum time that investors might wait to receive distributions;
- = the properties, or types of properties to be purchased;
- = the amount of offering proceeds that will *not* be committed to specific properties;
- = the depreciation method the Fund will use;
- = the maximum leverage to be used both overall and, if different, on specific properties and
- = a cross-reference to a Glossary. (Given the arcane jargon associated with real estate finance, a Glossary is both essential for legal purposes and helpful in selling the securities).

The summary creates a critical first impression. It is the most difficult section of the Memorandum to draft effectively and it should not be attempted until the remaining sections are substantially complete.

Summary Use of Proceeds

The uses to which investors' money will be put should be disclosed in a tabular summary. When the money will be used to finance a discrete project, this disclosure is relatively simple because the financial requirements of the project are known or are can be estimated with reasonable certainty. These include prepaid items such as accounting, architectural, consulting, engineering, legal and permitting fees, fees contingent on closing such as real estate brokerage fees (including fees paid nominally by the seller that increase the purchase price), mortgage brokerage fees and financing fees, cash down payments, required and discretionary reserves and miscellaneous transaction fees. The remaining disclosures identify the organizational and selling expenses for the offering, the net amount committed to known projects, and the estimated compensation to be paid the project manager. When multiple projects will be financed and some are not identified, the investment objectives of the Fund will be stated broadly. Under those circumstances, the complexity of the use of proceeds disclosure can increase exponentially.

The Guide includes an appendix that contains a suggested tabular format for the use of proceeds section.

The table segregates, by line item, each component of the prepaid property acquisition and financing fees, offering expenses and working capital reserves that will reduce the amount of investor's capital that can be invested directly in real estate. Though the sample does not show this, the table should also segregate amounts to be invested in identified projects from discretionary amounts to be held for future investment.

The table is followed by a narrative statement disclosing the real estate commissions to be received by the Sponsor, the commissions to be paid by the Fund to third parties and the fact that, because commissions paid nominally by a seller are added to the price of the real estate, they are effectively borne by the Fund.

Compensation and Fees to the Sponsor

The Sponsor will manage most if not all aspects of the Fund's business and will be compensated for each discrete responsibility. Some compensation, e.g. fees for selling the securities and property acquisition fees, will be paid regardless of the outcome of a given project or the ultimate return realized by investors. Other forms of compensation, such as lease fees and "carried interests," are contingent on success. The Guide requires a tabular presentation by category of all forms of compensation, expense reimbursements, profit or cash flow allocations and other benefits that can be realized, directly or indirectly by the Sponsor or its affiliates. The table must identify separately the compensation attributable to each phase of the Fund's business, including property acquisition, development, operations and liquidation. Compensation based on a formula or percentage must be explained and illustrated. If the Sponsor is protected against losses, that fact must be disclosed with a cross-reference to the later discussion of the relevant charter document or operating agreement. If the Sponsor or one or more affiliates will receive interests in the Fund that are disproportionate relative to their tangible contributions, that fact must also be disclosed using a separate dilution table. This table compares the contributions to the net tangible book value of the Fund made by the Sponsor with those made by outside investors and shows the resulting dilution from the offering price that investors will absorb in the book value of their securities.

Conflicts of Interest

A Sponsor experienced enough to promote a Fund credibly will be involved in multiple projects with multiple participants. Some projects will be financed exclusively through third parties who are neither affiliated nor associated informally with the Sponsor or the Fund. Other projects may be financed jointly by the Fund and by outside investors. Accordingly, the Sponsor may limit the Fund's initial purchase in a given project to a specified percentage of the available equity interests, reserving for outside investors a time-limited option to purchase the rest. In addition, as the Fund matures, it will experience a steady turnover in its ownership as early investors tender their securities for redemption. Succeeding owners may have different priorities. To prepare for this, the investment objectives of the Fund may be stated broadly. That creates obvious risk, which must be disclosed, arising from the wide discretion vested in the Sponsor.

Of necessity, the Sponsor will also retain express authority to devote the resources of the Fund to properties in which the Sponsor already has, or will acquire, an interest. Thus, the Sponsor may sell properties to, or purchase them from the Fund, may own properties adjacent to Fund properties, or may serve through an affiliate as a real estate or mortgage broker in Fund transactions. Less obvious conflicts arise when the Sponsor, on a priority basis, promotes, builds, finances or sells projects in which the Sponsor, but not the Fund, is interested.

The Fund documents will require that the investors waive any conflict facing the Sponsor, but the waiver will not be effective in the absence of full disclosure. The SEC Guide requires that investors be furnished "...a summary of each type of transaction which may result in a conflict between the interests of the...investors and those of the (Sponsor) and its affiliates, and of the proposed method of dealing with such conflict." There follows an illustrative list of conflict situations. If appraisals are used to support transactions between the Sponsor and the Fund, a common practice, the Memorandum should disclose the

fact that appraisals are only estimates of value. If specific appraised values are stated, the appraiser should be named as an expert whose consent to being named should be attached to the Memorandum.⁶

The disclosure must be meaningful. It is not sufficient, for example, to state that the Fund may purchase property from the Sponsor without also stating, if this is the case, that the transaction is already planned. The Guide contains an ominous warning that if the Memorandum discloses the possibility of such a purchase without describing specific property, and property in which the Sponsor has an interest is thereafter purchased by the Fund, the Sponsor will have the “heavy burden” of demonstrating that it did not intend to consummate such purchase when the Memorandum was delivered to investors. In short, this is an area so often abused that full disclosure is imperative.

Fiduciary Obligations to the Fund and its Investors

The Sponsor will occupy a fiduciary relationship to the Fund and those who invest in it. Accordingly, the Sponsor must exercise “good faith and integrity” when overseeing the Fund’s business affairs. The Guide contains legends which stress that obligation and add that “This is a rapidly developing and changing area of the law and (investors) who have questions concerning the duties of the (Sponsor) should consult with their counsel.” As it happens, the fundamental attributes of a fiduciary relationship have been settled for centuries and, legend or no, the Fund documents will always admonish investors to consult with counsel. The legends, however, pave the way for related disclosure respecting contractual provisions for exculpation and indemnification of the Sponsor against civil liability to third parties. Here the Guide notes that “To the extent ...the (provisions) purport to include indemnification for liabilities arising under the Securities Act of 1933, in the opinion of the Securities and Exchange Commission, such indemnification is contrary to ... public policy and therefore unenforceable.” The courts have not been unanimous in endorsing that pronouncement, but the better practice is to include it.

Risk Factors

The Guide introduces the subject of risk disclosure with the following instruction: “This section should include a carefully organized series of short, concise subcaptioned paragraphs, with cross-references to fuller discussion where appropriate, summarizing the principal risk factors applicable to the offering and to the (Fund’s) particular plan of operations. The risk factors section should be brief.”

In fact, the disclosure of risk in private offerings varies widely both quantitatively and qualitatively. In mega offerings by industry superstars, investors may be lucky to receive a three page term sheet containing only cursory risk disclosure. By contrast, some small issuers discuss every conceivable catastrophe that could affect their business, which renders their disclosure meaningless. A well done Memorandum will stress the risks that apply with particular force to the Sponsor, its strategies, its properties, the Fund structure and the Fund securities.

Obvious business risks include, if applicable, the Sponsor’s lack of relevant experience, its short operating history and its poor results from past projects. Financial risks arise if the Sponsor has wide discretion to select projects or use “leverage,” if the offering proceeds are not sufficient to support the Fund’s strategic plan or if the Sponsor or a key affiliate is inadequately capitalized. Structural risks arise if the form of organization of the Fund is not compatible with lender requirements. Structural risks are particularly acute in conduit financings where the Fund’s mortgage debt will be securitized and sold in secondary markets. Legal risks may arise from, among other things, pending or threatened litigation, deposits of hazardous substances, restrictive zoning laws or permitting requirements, the imposition by project lenders of unlimited owner guarantees or onerous default provisions, high voting requirements for removal of the manager, exculpation and indemnification provisions favoring the manager and restrictions on resale of the Fund securities.

⁶ In a registered, public offering the consent is attached to the registration statement, not the prospectus.

In light of the widely publicized abuses arising from “aggressive tax shelters” and “tax advantaged” offerings, the Guide requires prominent disclosure of the risk that investors will be denied the tax benefits touted for Fund ownership. That occurs most often when the Fund is treated as an association taxable as a corporation. If the Sponsor has not obtained a favorable IRS ruling confirming the status of Fund as a pass-through tax entity, the resulting risk must be stated along with the related risk that an audit of the tax return of the Fund may trigger audits of the returns of its owners.

There are other significant tax risks. Owners may not deduct Fund losses in excess of their tax basis in the Fund’s equity securities. Accelerated depreciation taken by the Fund may be recaptured. Excessive deductions for prepaid interest and other expenses may be disallowed. At some point, the Fund’s non-deductible amortization payments on mortgage debt may exceed its depreciation resulting in unanticipated taxable income to its owners. Taxes levied on a sale by the Fund of its property, or a sale by owners of their Fund securities, may exceed distributions. All material tax risks must be separately disclosed and cross-referenced to a full discussion of tax matters.

Any Fund will also face generic risks attributable to real estate investments such as adverse local market conditions, chronic illiquidity, uninsured catastrophic losses and adverse changes in the regulatory environment. The Guide requires that these risks be discussed briefly following the discussion of risks specific to the Fund.

Above all, the Sponsor should recognize that most investors are acutely aware of risk, expect it to be disclosed fully and will decline an offering if presented with a laundry list of meaningless generalities. Risk disclosure should be as specific as possible and the Sponsor should be careful to identify the means by which it proposes to mitigate risk and protect investors. Preparing the risk factors section is daunting, certainly, but a thoughtful disclosure of risks and risk management policies can inspire investor confidence.

Prior Performance - Narrative Introduction and Tables

The financial performance of the Sponsor’s completed projects, called its “track record,” will be of major importance to investors. The Memorandum should contain a narrative summary of past projects written from an investment perspective. The summary should disclose the use made of the offering proceeds, the compensation paid to the Sponsor, acquisitions and sales of properties and distributions to owners. If the Sponsor has organized at least 5 funds, the disclosure should be limited to those with similar investment objectives. If not, the performance of all prior funds must be disclosed. If the Sponsor has not previously sponsored a Fund, the disclosure should be derived from accounting measurements for relevant Sponsor-financed projects supported by the Sponsor’s GAAP based financial statements. These measures would include profits, losses, return on assets and return on equity. All material subjective judgments used for the statements should be disclosed by attaching or quoting the notes to such statements.

The Guide requires that an itemized summary of the track record be presented in six Tables, each containing appropriate cross-references to the narrative. Table I quantifies the Sponsor’s performance in raising and investing capital. It compares, for each program that closed within the most recent three years, the gross amounts offered with the amounts actually raised, in both dollars and on a percentage basis. It subtracts offering and selling expenses, reserves, acquisition costs and leverage by line item to identify the net proceeds available for investment. It then compares the length of the offering with the time required to invest 90% of the net proceeds.

Table II discloses, in a separate column for each relevant Fund, all compensation paid to the Sponsor or its affiliates for each of the most recent 3 years. If the Sponsor has organized at least 5 funds, the disclosure need cover only prior funds with similar investment objectives. Otherwise, the disclosure must be provided for all prior funds, which must be grouped by year according to their investment objectives and accompanied by notes explaining those objectives. The line items begin with the offering proceeds actually raised, set forth fees and commissions, then identify cash flow from operations, property sales and refinancings before and after payments to the Sponsor. The line items cover every recognized form of

compensation, plus a catch-all item for “other” compensation, which must be identified and quantified.

Table III discloses the cash-on-cash operating results of prior funds that closed within the most recent five years, presented separately for each year. Again, Sponsors that have organized at least 5 funds need cover only those with similar investment objectives, otherwise all prior funds must be covered, grouped by year according to their investment objectives and accompanied by notes explaining those objectives. GAAP based presentation is required unless the Sponsor’s financial reports are prepared on a tax basis. In the latter case, the table may be presented on a tax basis, but any “significant” differences in operating results that would appear from a comparison of the two methods must be identified and explained.

Table IV shows the financial results before and after tax of funds that have completed operations within the most recent 5 years and no longer hold properties (though they may hold installment purchase contracts or notes). The disclosure is categorized depending on whether the Sponsor has organized more than 5 funds in the manner required for Tables II and III. In an effort to ensure conformity, tax and distribution data are to be presented by property on a “per \$1,000 investment” basis. Cash distributions are to be categorized by source on a GAAP basis.

Table V discloses sales or disposals of all properties that have been closed by funds with similar investment objectives with the most recent 3 years, regardless of the number of funds organized by the Sponsor. The presentation should be GAAP based “where feasible without undue effort or expense.” The properties, their dates of acquisition and sale, their aggregate cost and net selling price, and all mortgage pay-downs at the time of sale must be disclosed.

Table VI discloses acquisitions of properties by funds with similar investment objectives if the transaction closed with the most recent three years. The properties are identified by name, location, type, gross footage and net leasable space or number of units, the date of purchase and, of course, the selling price, cash down payment, expensed and capitalized expenses and total acquisition cost.⁷

As noted, a Sponsor organizing its first Fund will be unable to present its prior performance in the format required by the Tables, but it would be well advised to present line-item results from its self-financed projects in a comparable format. The presentation would show the returns that would have been received by outside investors on each project had they contributed the equity component of the financing.

Management

The identity of the managing entity and the backgrounds and accomplishments of its senior executives will always be disclosed, if for no other reason that to tout their abilities and experience. The Guide assumes as much and focuses instead on four related subjects:

First, the Sponsor must disclose the identity and background of all individuals who will determine how to invest any material net offering proceeds not committed to specific properties. The disclosure must include legal proceedings in which these individuals have been involved within the prior five years “that are material to an evaluation of (their) ability or integrity.” Thus, bankruptcy proceedings initiated by or against the individuals or any entities for which they acted as Chief Executive Officer must be disclosed together with any criminal convictions (other than traffic violations and similar minor offenses) and any civil proceeding as a result of which the individuals were permanently or temporarily barred from engaging in the securities or commodities business or found to have violated any securities or commodities law.

Second, if the Sponsor relies on or materially compensates a non-affiliate for management activities, the relevant prior experience of the recipient must be disclosed. The amount and purpose of the compensation is presented in a table captioned “Fees and Compensation Arrangements with Non-affiliates.”

⁷ In a registered, public offering Table VI is attached to the registration statement, not the prospectus.

Third any contractual provision covering a change in the management of the Fund must be disclosed with attention to the manner in which such change could be accomplished.

Finally, the amount and basis for any contingent liability of the Sponsor or its affiliates with regard to prior funds must be disclosed, though it may be incorporated by reference to the extent already disclosed in financial statements.

Investment Objectives and Policies

The Guide's introductory instruction for disclosure of the Fund's investment objectives and policies is brief and deceptively simple: "Disclosure should be made of the nature of the property intended to be purchased (e.g., commercial, residential) and the criteria (e.g., method of depreciation, location) to be utilized in evaluating proposed investments." The Guide adds that disclosure should also be made of any contractual provisions allowing the Sponsor to change the Fund's objectives and cautions that it is "not appropriate" to state a rate of return on investment if the offering proceeds will be invested in properties that are not identified or do not have a "significant" operating history.

The disclosures should distinguish clearly between the Fund's investment objectives and its investment policies. There should be a description of the Fund's risk/return and financial analyses, its preferred transaction structure; its risk controls, its asset allocation strategy and its return strategy. Some Funds "buy and hold" properties, others "develop and sell" them. A conservative Fund might invest primarily in substantially rented, well maintained properties within the four basic property types (office, industrial, retail and multifamily housing). Qualified properties would have orderly lease expiration schedules, would not require excessive capital reinvestment and would carry no more than a specified percentage of debt. Other Funds may limit their investment in any one property or property class and diversify by investing across sectors. Still others might pursue a mix of conservative and "enhanced" strategies, the latter characterized by investments in non-core, special use properties, such as medical complexes, that offer the potential for high returns. In most cases, the strategies actually employed are shaped primarily by the experience of Sponsor, less so by current research.

Description of Real Estate Investments

The Guide begins with the proposition that competitive, market, regulatory and other risks specific to properties owned or to be acquired by the Fund must expressly be noted. If a property to be acquired by the Fund is subject to rent controls, for example, it is not sufficient to rely on a generic disclosure in the Risk Factors section that the Fund may have to comply with rent control regulations.

The principal objective of the Guide is to force timely disclosure of risks attaching to properties that have been targeted by the Fund, but not yet acquired. If, when the Memorandum is prepared, there is a "reasonable probability" that the Fund will acquire a material property, the property and all associated risks must be described. Furthermore, if such a property is newly targeted during the selling period, it must be described in a sticker amendment that supplements the Memorandum. The Guide notes that the burden of making timely disclosure is on the Fund. It then adds the following pointed admonition:

"It has come to the staff's attention that on a number of occasions issuers have identified properties to be purchased and have delayed proceeding with the purchase in order to avoid the necessary disclosure. In the staff's opinion, such practice is not consistent with the obligation of the issuer to disclose material facts relating to the offering."

The issue of timeliness will invariably arise in a context in which the Fund has begun due diligence on a property prior to closing its private placement, but no purchase has been consummated. The question becomes whether the documentation supports the Fund's contention that it had not yet determined to purchase the property or, alternatively, that the purchase was subject to conditions beyond the control of the Fund that might not be satisfied. In the first case, it may well be that no disclosure should be made since a premature statement that a property may be purchased can prove to be false and misleading. In the second

case, disclosure is clearly required because the Fund's purchase decision has been made, but the conditions should be explained and investors should be cautioned that the property may not be acquired.

Federal Taxes

The Fund will be organized as a pass through entity for federal income tax purposes. Since aggressive tax shelters are not for the faint hearted, the usual objective is merely to avoid double taxation on Fund profits, permit owners to offset Fund losses against outside income to the extent of their net investment and ensure generally that the tax attributes of the Fund and its properties will be attributable to the owners without substantial change. That objective seems modest enough, but its achievement depends on whether the Fund can satisfy certain Treasury Regulations that implement the Internal Revenue Code and govern the taxation of partnerships. These regulations start ambiguously and soon reach a level of incoherence that is remarkable even for a tax discussion. As a result, the tax disclosure in securities offerings consumes several pages of impenetrable text replete with numerous and overlapping citations to the Code and Regulations. The material will be read grudgingly, if at all, and will rarely be comprehended.

The Guide, undaunted, requires disclosure of "all material Federal tax aspects" associated with an investment in the Fund, plus a summary of filing requirements and tax provisions that might be imposed on investors by states other than their state of domicile or by foreign countries. In a public offering, an opinion of counsel respecting all material tax issues should be filed with the registration statement and the prospectus should "summarize or restate the tax information contained in the opinion." If counsel cannot express an opinion because of legal uncertainties, the consequences to investors of an adverse determination on the relevant issue must be disclosed. It does not follow automatically from this that a formal tax opinion should be attached to the Memorandum in a private placement, but if no opinion has been obtained that fact should be disclosed as a risk factor. In any case, the tax discussion in a private placement should always be prepared or approved in writing by a qualified expert.

The Guide divides the disclosure into categories. The Fund must begin by disclosing whether an IRS ruling confirming its status as a partnership for tax purposes has been requested, obtained or denied. All consequences arising from the treatment of the Fund as an "association" taxable as a corporation must be explained, together with the fact that, if partnership status is allowed, the income, gain, loss, deductions and credits of the Fund will be passed through to the owners even if there are no distributions.

Any special tax allocations provided by contract must be identified. The fact that Fund losses may only be deducted to the extent of the investors' adjusted basis in their securities must be stressed. The method of depreciation employed by the Fund, and the risk that depreciation will be recaptured must be explained together with the possibility that deductions of prepaid and other expenses may be disallowed.

The Fund must also expand on its Risk Factor disclosure that an investor's tax liability may at some time exceed distributions from the Fund. The tax consequences of resales by the Fund or the owners must be explained after repeating the earlier Risk Factor disclosure that there may be no market for either the properties or the securities. There must be full disclosure of the tax consequences of a liquidation of the Fund, an explanation of required tax returns and a summary of the tax information and reports that the Fund will provide to investors. Investors should be cautioned again that an audit of the tax return filed by the Fund may trigger audits of the returns filed by owners. Correspondingly, adjustments at the Fund level will trigger adjustments of the owners' returns.

Finally, miscellaneous tax aspects such as the minimum tax on "tax preference" income must be disclosed together with any special tax issues not identified in the Guide but attributable to the Fund or its properties.

Glossary

The North American Securities Administrators Association ("NASAA") has adopted a Statement of Policy Regarding Real Estate Programs." The Statement contains definitions of arcane financial terms that are subject to more than one interpretation, such as "book value," "cash flow" and "cash available for

distribution.” The Guide lists a series of all such terms “that are technical in nature or are susceptible to varying methods of computation.” It requires that the terms be defined in a Glossary with reference to the NASAA Statement. Any departures from the Statement should be noted.

The Glossary should describe any terms whose meaning might not be apparent to investors, whether or not the terms are listed in the Guide. For example, what exactly is a “stabilized” property and how does the Fund measure stabilization when making an investment decision? All of us tend to assume that others are familiar with the jargon we use every day when often that is not the case. Even though a Glossary may be disregarded by investors, its presence in a disclosure Memorandum will reduce substantially the risk of a misrepresentation claim based on a failure adequately to disclose technical data.

Summary of the Organizational or Operating Agreement

The rights and obligations of investors respecting their purchase of the Fund’s securities and their subsequent participation in its affairs will be set forth in subscription agreements (which incorporate the investment questionnaires) and organizational or operating agreements. Those agreements will be delivered for signature with the Memorandum and their major provisions will be discussed separately in the Memorandum under appropriate captions, e.g. “Compensation and Fees to the Sponsor.” Under the circumstances, the Guide’s instruction respecting contract disclosure reads, in its entirety, as follows: “A brief summary of the material provisions of the (relevant agreements) should be included.”

However, there are many provisions in these agreements that could be considered “material” and a lucid “summary” of them is rarely brief. To understand why, assume an investor has been adequately informed that the Fund may block a resale of its securities if no exemption from registration is available for the resale transaction. Nevertheless, the investor has asserted a misrepresentation claim on the ground that the Memorandum did not stress the Fund’s related right to block a resale that threatened its tax status. The Guide does not contain a specific instruction covering the latter right. If the right is buried in a 40 page contract and given only passing reference in the Memorandum, a court may conclude that the investor could not reasonably have been expected to be aware of it. For that reason, the right should be summarized in the contracts section, along with the other rights of the Fund’s manager and the summary should be cross referenced to the sections on “Risk Factors,” “Federal Taxes” and “Description of the Securities.”

There are other contractual provisions of critical importance to investors that are not covered by the Guide’s specific disclosure requirements. Examples include definitions of potentially ambiguous financial terms such as “Net Cash Flow” and “Percentage Interest” and provisions governing the circumstances, if any, under which the Fund’s securities are assessable. All such provisions should be summarized in the contracts section and cross referenced to other sections relevant to their subject matter..

On the other hand, the Sponsor is entitled to assume that straightforward contractual provisions speak for themselves and need not be discussed at length in the Memorandum. The Sponsor can strike a safe balance between adequate disclosure and needless redundancy by concentrating on provisions that affect the management of the Fund, its financial reporting and the return on an investment in its securities.

Reports to Fund Owners

The Guide’s instructions respecting reports to owners are focused exclusively on financial matters. They require that the Memorandum disclose the accounting basis used by the Fund (e.g. accrual or tax), confirm that annual financial statements will be prepared in accordance with GAAP and furnished to owners within 90 days after the close of each fiscal year, disclose whether the statements will be audited by independent certified accountants and confirm that the statements will be accompanied by an itemization of all transactions conducted during the year between the Fund and the Sponsor or its affiliates. The itemization should include all compensation paid to those entities. If the Fund has applied for but has not received an IRS ruling respecting its tax status, it must inform owners promptly upon its receipt of a response whether favorable or unfavorable.

The Guide requires that publicly held Funds make available to “security holders” (i.e., its owners) the information contained in current, quarterly and annual reports filed under the Exchange Act. A private Fund makes no such filings, but would be well advised to update its reports to owners at least on a quarterly basis, more frequently if necessary to provide prompt disclosure of material events.

Description of the Units

The Memorandum must describe any dividend, voting or preemption rights that apply to common or preferred equity (e.g. LLC membership units), plus any earnings or liquidation preferences, conversion rights or sinking fund provisions that apply specifically to preferred equity. Charter or bylaw provisions that can delay or prevent a change in the management or control of the Fund must also be described. Redemption rights are discussed separately. See, “Redemption, Repurchase and Presentment Agreements.”

If the Fund issues debt securities, the Memorandum should describe the maturity date, interest rate, conversion rights and sinking fund requirements that apply, plus any other provisions that affect the rights of debt holders, such as subordination clauses, minimum financial ratios, or restrictions on the issuance of additional debt or on the payment of dividends.

Particular care should be taken to disclose restrictions on the transfer of Fund securities arising from the tax laws or imposed by contract, charter documents or federal or state securities laws.

Redemption, Repurchase and Presentment Agreements

Real estate is inherently illiquid and resale of Fund’s unregistered securities will be restricted by law and agreement. To attract investors, the Fund may provide a limited degree of liquidity through charter or contractual provisions giving the Sponsor or its affiliates both the right and a conditional duty to redeem or repurchase the securities. When describing these provisions, it will be important to distinguish between redemption rights, which are subject to capital surplus requirements and may not be assigned, and repurchase rights, which may be assigned to a designated third party that may consummate the purchase without regard to the Fund’s capital.

The formula used to determine the redemption or repurchase price must, of course be explained, together with all conditions to closing. Since the formula will depend on appraisals, the fact that appraisals are mere estimates, already mentioned in the Risk Factors section, should be emphasized.

There should also be disclosure of the source and amount of funds available to fund the reacquisition of securities tendered for redemption or repurchase. The formula for allocating available funds among holders if tenders cannot be honored in full should be explained, together with the circumstances under which a tender may be rejected, the minimum holding period that must elapse before a tender may be made, the length of time a tender might be pending and the order in which tenders will be processed. The mechanical procedures that must be followed to submit a valid tender must be explained in detail.⁸

Although the Guide does not address this specifically, it is worth noting that redemption and repurchase agreements have far reaching consequences that are not limited to procedural matters. The redemption by the Fund of the securities of a given owner alters the relationships between the Fund, the redeemed owner and the remaining owners. The transaction can raise complex questions respecting the determination of an appraisal -based redemption price, the payment structure, the legal rights of the redeemed owner prior to payment in full and the tax position after the redemption of the Fund and its remaining owners.

⁸ In its ill-fated initial attempt to regulate the hedge fund industry, the SEC distinguished between a hedge fund and a private equity fund in terms of the length of the minimum required holding period for fund securities. If the period was at least two years, the fund was a private equity fund whose adviser could avoid registration. Given the SEC’s persistence, would-be Sponsors of real estate equity Funds should bear that original distinction in mind.

Plan of Distribution

If the Sponsor will engage brokers or finders to help sell the securities, the terms of the arrangement must be disclosed with attention to the compensation provisions. Since this will be a private placement, the brokers will undertake to sell the securities only on a “best efforts” basis with no guaranty that the proceeds necessary for the Fund to realize its objectives will actually be raised. That possibility will have been disclosed in the Risk Factors section, but it should be repeated here.

If the securities are offered on an “all or none,” “minimum/maximum” or other contingency basis and securities purchased by the Sponsor or its affiliates will be counted to determine whether the contingency has been satisfied, the Memorandum must disclose the details, with attention to how the purchasing entity will pay for its securities and whether it will resell them after the closing. As the closing date for a private placement approaches, the pressure to ensure that all contingencies are satisfied increases dramatically. Occasionally a Sponsor, its affiliate or another entity with a financial interest in the success of the placement will purport to satisfy a contingency by purchasing or financing the purchase of securities in a sham transaction. Securities that are purchased at closing and resold for a price paid from the closing proceeds and purchase money “loans” that are repaid from such proceeds are examples of this. Such transactions defraud investors by reducing the amount of proceeds actually applied in accordance with the Use of Proceeds section. The SEC has brought a number of well publicized enforcement actions to curb these abuses and those responsible for them have been held liable to investors in civil litigation. A well advised Sponsor will follow the disclosure mentioned above with cautionary language, e.g.:

“We (the Sponsor), one of our affiliates or another person with a financial interest in the success of this placement may purchase securities in common with other investors. All such securities will be counted in determining whether the minimum number of securities has been sold. You should not assume from the closing of this placement that all securities have been sold to disinterested persons exercising independent investment discretion.”

Financial Statements

The Guide incorporates the financial statements required of public funds under the Exchange Act. These are specified in the Forms for periodic reporting, e.g. Form 10K. Rule 502 of Regulation D, which applies to private placements, requires merely that non-accredited investors be furnished with the financial statements that would accompany a registration statement filed on the Form the Fund would use under the Securities Act. The financial statements for a Fund that qualifies as a “small business issuer” are identified in Forms S-B 1 and S-B 2 and described in Item 310 of Regulation S-B. They include an audited balance sheet as of the later of the end of the Fund’s most recent fiscal year, or a date within the preceding 135 days, plus audited statements of income, cash flows and changes in owners’ equity for each of the two fiscal years preceding the balance sheet date (or any shorter period that the Fund has been in business.) Similar financial statements for each affiliate whose financial condition is material to the Fund (e.g. because the affiliate guarantees Fund indebtedness) must also be furnished. All financial statements must be prepared in accordance with GAAP.

For a qualified Sponsor, the financial reporting requirements should not be unreasonably burdensome. In the normal course of its business, the Sponsor will have furnished lenders with GAAP-based financial statements that are at least reviewed by independent certified public accountants. The accountants can audit the reviewed statements for the necessary time periods without starting from scratch.

Updated and Amended Disclosure

The Sponsor has an affirmative duty to disclose promptly all previously undisclosed material events or changes that occur prior to the closing. Usually, this can be accomplished by distributing a short supplement to the Memorandum known as a “sticker amendment.” The changes that should be disclosed are not necessarily adverse. The purchase of a property not already identified and the receipt of an IRS ruling respecting the tax status of the Fund are changes that may not be regarded by the Sponsor as adverse, but must nevertheless be disclosed because they affect the investment analysis. The property may

not uniformly be regarded as suitable for the Fund and the ruling may be subject to conditions or factual assumptions that investors feel are not warranted.

Occasionally, adverse changes so diminish the merits or increase the risks of the investment that the Memorandum must be substantially rewritten and resubmitted. These changes may also make it necessary to offer to rescind all subscription agreements and return all proceeds unless the subscribers affirmatively ratify their investment after full disclosure of the changes and their effect. Material adverse changes in the financial position of the Sponsor or a key affiliate, material litigation affecting those entities, the discovery of hazardous substances on a property of the Fund, unanticipated permitting delays or regulatory changes affecting such property, material increases in interest rates and the unanticipated withdrawal of a key lender can fall into this category.

Legal Essays and Bulletins are published periodically by the Law Offices of Robert G. Hutchins, PS on subjects potentially of interest to clients and others with whom the firm maintains business or professional relationships. These publications do not address a specific situation, are necessarily general in scope and should not be construed as legal advice. For more information, please contact Robert G. Hutchins at 1201 Pacific Avenue, Suite 1702, Tacoma, WA 98402-4322, 253-272-5480, rghutchins@msn.com.