Credit market turmoil and sponsor due diligence: How does your due diligence stack up?

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Credit markets have recently been roiled by the substantial illiquidity brought on by uncertainties in pricing risk. Financing costs to acquire a property have threatened acquisitions and complicated syndications. Simultaneously, loan spreads have greatly expanded and base interest rate benchmarks have increased. Spreads of 200 basis points have been experienced.

Many believe increased spreads reflect creditor uncertainty in pricing credit and market risk. Some report this increase stems from hedge funds and other buyers of "B piece" paper exiting the market.

This illiquidity impedes financing acquisitions and has restricted the number of offerings that will meet market demand for return on investment. Transactions are more difficult and expensive to complete for sponsors. Sponsors are bearing the brunt of the increased cost. The overall result has been a dampening of the volume of transactions being brought to market.

In this perfect financial storm, some sponsors may feel pressure to depart from their routine pacing schedule when bringing a syndication to market in favor of accelerating the marketing process to close their loans before credit costs widen or increase further.

This sense of urgency can adversely impact the quality of the disclosures contained in the private placement memorandum. Participants in the selling channels should not be ambivalent about the quality of the disclosure they require in a private placement memorandum (PPM). Disclosure is the responsibility of the sponsor and inadequate disclosure in the PPM can lead to immeasurable problems down the road for the sponsor and other participants in the syndication, including those marketing the securities. If, for example, a tenant-in-common syndication becomes financially troubled, a sponsor with inadequate documents along with the securities reps that sold the transaction may become named as a defendant in a securities fraud action.

Some sponsors erroneously believe that they are immune from such liability if they are marketing to an "accredited investor." This is incorrect. While it is true that the "accredited investor" assumes various risks, under Federal Law, fraud is not one of them. Fraud in the offering is actionable.

Be confident that a tenant-in-common investor will not necessarily shrug his shoulders in the failed syndication context. Disgruntled investors become securities plaintiffs. Securities plaintiffs will typically seek to round up the broadest array of possible defendants who have the financial ability to pay million dollar judgments or settlements. Defendants will typically include not only the primary offerers, but also the so-called "secondary actors," which includes those who wrote the offering memorandum, those who sold and placed the offering, the registered representatives, and the lawyers and accountants.

What are those circumstances where a secondary actor can be held to be part of a scheme to defraud?

Look first to the Securities and Exchange Act of 1934. It is a violation of Section 10(b) to use or

employ, in any way, "any manipulative or deceptive device or contrivance in contravention" of SEC regulations. Judicial case law, among other things, has sought to put meaning into that rule. In the mid-1990s, the U.S. Supreme Court seemed to provide great protection to secondary actors when it decided Central Bank of Denver, N.A. vs. First Interstate Bank of Denver, N.A. There, the court generally said that to be liable under Section 10(b), a person needed to be a primary participant. In Central Bank, the court concluded that a defendant needed to do more than merely do business with an issuer. However, in the aftermath of Enron, much of this insulation has eroded. One cannot easily predict how the Federal Circuits will interpret the Securities and Exchange Act.

What is clear, however, is that participants in the selling channels should not be ambivalent about the quality of the disclosure they require in a private placement memorandum. The PPM functions as both a defensive document and a marketing instrument. The PPM promotes the benefits of the project while simultaneously identifying transaction risks so TIC investors receive the basic protection of full and fair disclosure required by state and federal law.

The PPM drafting process does not have to be tedious and expensive. The PPM should be drafted in a manner that makes it easy for TIC investors to not only read the document but, fully comprehend it. It is helpful to avoid the unnecessary use of legal and business jargon. Care should also be taken to avoid burying disclosure deep in the document as that can lead to a determination that the TIC investor did not receive the basic protection of full and fair disclosure.

When contrasted with the cost of litigation, which can easily exceed a defendant's resources-not to mention the broker-dealers that will also likely be targets for lawsuits-it is more efficient and effective to put the money and time in up front and prepare a quality PPM that reflects the sponsor's commitment to syndication.

Investor Due Diligence

Efficiencies-The Extra-net

Syndications are document intensive transactions. There are many parties that participate including the sponsor, property seller, lender, various consultants, third party due diligence reviewers and tenant in common purchasers, to name a few. Indeed, closing a typical TIC investor-level investment is akin to simultaneously closing 15 or so mini-real estate transactions (based on the number of tenants in common in a given syndication). Due diligence review and closings mean substantial document administration. Economy and simplification of the document review and signing process is paramount to preparation of the PPM in an efficient manner and, for the closing, good TIC investor relations.

We make available to our clients the benefits of an electronic interface which allows them (and the TIC investor and their registered representative) to determine the due diligence status of every aspect of the transaction and their investment documentation process-including obtaining signatures. Our extra-net creates a virtual document due diligence repository and closing room. This extra-net repository contains discrete virtual rooms which can be entered by a TIC investor with a unique password. Once in their own "document room" a TIC investor or his or her representative, can see and access, from the convenience of their home or office, on a real time basis, all relevant due diligence, real estate and financing documentation, including separate "file boxes" of documents and instruments pre-arranged for the TIC investor or his or her representative, to download, printout and sign. TIC investors, registered representative and broker-dealers can access transaction documentation. This capability saves time and money.

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