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REGULATION OF REAL ESTATE SYNDICATIONS: AN OVERVIEW

The utilization of the real estate syndication as a form of investment has skyrocketed in recent years.¹ On its face the vehicle offers benefits to all concerned: the syndicator can achieve one hundred percent financing and often can receive excellent profits with relatively little personal risk;² the investing public is attracted by the prospect of real estate ownership with its tax shelter, cash flow and capital appreciation benefits.³ Unfortunately, the attraction of syndication for both the syndicator and the investor often results in an investment euphoria which does not provide the proper environment for important investment decisions in an area as complex as modern real estate.⁴ This euphoria can often lead to imprudent purchases of property at prices inflated by tax shelter considerations and artificial demand,⁵ the siphoning of exhorbitant compensation by syndicators⁶ and confusion

¹. In the first five months of 1972, tax shelter plans accounted for over 22% of new security offerings by member firms of the National Ass'n. of Securities Dealers. The Infighting to Reform Tax Shelters, Bus. Week, Jun. 10, 1972, at 62. Oil and gas, cattle and real estate are the predominant tax shelter investments. Forty-nine real estate syndicates offering $401,700,000 worth of real estate limited partnership interests were listed in Nov., 1972, Real Estate Syndication Digest.

². The real estate syndicator normally can get 75-80% financing of the total cost; secondary financing can cover up to 90%. The balance represents the equity portion and is funded by the sale of limited partnership interests. The syndicator as a general partner is personally liable, see note 20 infra; he can insulate this personal liability by using a corporate general partner, see note 19 and accompanying text infra.


⁴. See note 7 infra. See also Hayes & Harlan, Caveat Emptor in Real Estate Equities, 50 Harv. Bus. Rev. 86, 92 (1972).

⁵. See note 34 infra. The ever present admonition for those contemplating investment in real estate limited partnerships is to invest only where there is sound economic justification for the investment. Tax shelter should always be secondary. Speech by E. Bruckner, Marketing Syndications, D. Augustines & R. Lowell, Real Estate Syndications 343-48 (1972).

⁶. One recent syndication plan filed with the SEC called for promoters to keep sixty-seven cents of every dollar raised from investors. Rosenblatt, supra note 3.
on the part of the investor as to exactly what is happening with his money. Too often the aftermath is the collapse of the syndicate and loss of the investment.

The predictable consequence of investor losses and excessive promoter profits stemming from use of an unfamiliar investment mechanism in the real estate investment area has been a clamor for regulation. In response, several states have either enacted or proposed statutes or regulations which will increase substantive regulation of real estate syndications and will buttress the more traditional forms of Blue Sky disclosure regulation. In contrast, the Securities and Exchange Commission has recently completed a study which concludes that real estate syndications should continue to be solely regulated pursuant to the disclosure policies of the Securities Act of 1933, although there

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7. Id. at 1. col. 6. Rosenblatt relates a classic example of a disastrous lack of investor understanding of the real estate syndicate. Investors, including many local doctors and business executives, were approached by promoters with the amazing proposition of achieving tax shelter and income without putting up any money. The investor merely signed a document which arranged an unsecured loan of $15,000 for investment in the syndicate. The investor did not even have to go to the bank or speak to a loan officer. Loans were so easy to secure that "Lawrence Grey, a Hawthorne dentist, obtained his loan while fixing somebody's teeth." The investors acquired an interest in one of many separate syndicates which owned properties such as hotels, apartments, shopping centers, office buildings, and convalescent hospitals. The various investments were allegedly of poor quality: "The prices paid for the properties were grossly in excess of fair market values . . . . Many of the properties were not only not operating profitably at the time of their acquisition, but had never operated profitably. . . ." The income from the various projects and separate syndicates was pooled; bills for all syndicates were paid out of the same account. When cash became short, the promoters merely started up a new syndicate. Finally, the losing properties became too much to carry and foreclosures resulted. There was not enough money to make payments on the investors' bank loans and the bank finally demanded payment from the borrowers. The kicker was that all of the investors were general partners in the syndicates and therefore were personally liable.


9. See generally Berger, supra note 3; Hayes & Harlan, Caveat Emptor in Real Estate Equities, 50 HARV. BUS. REV. 92 (1972); The Infighting to Reform Tax Shelters, BUS. WEEK, Jun. 10, 1972, at 62.

10. See N.Y. GEN. BUS. LAW § 352(e) (McKinney 1968); WASH. AD. CODE § 460-32-010 et seq. (1972); Midwest Securities Commissioner's Association, Statement of Policy Regarding Real Estate Programs. [Current] BLUE SKY L. REP., § 4821 (Adopted Feb. 28, 1973). In addition, the National Association of Securities Dealers has proposed sweeping regulations for tax shelter programs. See NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., TAX SHELTER PROGRAMS, Proposed Rules of Fair Practice, Art. III, § 33. A revised set of Proposed Rules was recently published for public scrutiny and comment by the SEC. (See note 230 infra).
apparently will be radical changes from past disclosure requirements.\textsuperscript{11}

This comment will attempt to make some sense out of the controversy raging around real estate syndications and will attempt to determine what, if anything, should be done to regulate them. First, the mechanism of the real estate syndication and the specific problems it poses for the investor will be briefly examined. Second, the existing legal framework including restrictions imposed on real estate syndications by common law partnership and state and federal securities laws will be examined to determine whether the investor is adequately protected. Third, various proposed regulatory schemes will be examined, including the SEC’s proposals for new disclosure rules, the Washington Rules and Midwest Commissioner’s Guidelines on real estate limited partnerships. A final section examines the need for federal substantive regulations of real estate syndication. This comment concludes that the regulators at federal and state levels have failed to recognize the basic differences between the two major types of real estate syndications—“specific property” versus “blind pool” or unspecified, multiple property syndicates. It is suggested that specific property syndicates can be satisfactorily regulated by disclosure only, as the SEC proposes; blind pool syndicates, on the other hand, appear to require substantive regulation.\textsuperscript{12} Failure to structure regulation to fit these two different types of real estate syndicates will potentially distort the syndication process by further limiting the attractiveness and utility of the specific property syndication.

I. BACKGROUND TO REAL ESTATE SYNDICATIONS: INVESTOR PROBLEMS

Real estate syndication is a highly complex undertaking: it is difficult for the promoter to profitably execute a syndication from begin-


\textsuperscript{12} No readily accepted definition of regulation by “disclosure” or “objective” regulation is available. For the purposes of this comment, regulation by disclosure means that there is no limit on what can be done by a syndicator (within existing legal standards and statutory frameworks, of course) so long as it is fully disclosed beforehand. Substantive regulation places flat prohibitions on certain otherwise legal conduct (limits on syndicator compensation or minimum investment capital requirements) which, of necessity, can interfere with any phase of a real estate syndication. Regulation by disclosure presumes an intelligent investor because mere description is deemed adequate protection; substantive regulation assumes a naive investor and relies on subjective proscriptions of conduct for investor protection.
ning to end;\textsuperscript{13} it is equally difficult, if not more so, for the investor to evaluate the soundness of a given syndication investment. This comment does not attempt to provide a definitive analysis of all facets of the syndication process;\textsuperscript{14} rather, only a few general comments on syndications and real estate investment will be offered before focusing on the specific problems the investor faces when contemplating the purchase of a syndication interest.

The initial problem in understanding real estate syndications is definitional—what is a real estate syndication and how can both the syndicator and investor reap such tremendous benefits? Syndication implies nothing more than a group of people associating to carry out an enterprise. A syndication can take the legal form of a general partnership, a corporation or a trust,\textsuperscript{15} but is predominantly organized as a limited partnership. The combination of a real estate investment and the legal entity of the limited partnership offers the investor many benefits which can include—depending on the specific type of investment—cash flow, tax shelter and ultimately capital appreciation.\textsuperscript{16} Cash flow results from the excess of rental income over expenses (including debt repayments and interest). Tax shelter may be achieved by deductions for depreciation, interest and losses; present tax policy allows some deductions for accelerated depreciation and interest in the early years of the investment.\textsuperscript{17} Capital appreciation may result from the ultimate sale of the syndicate's real property.

\textsuperscript{13} For an analysis of the syndication process and a list of the syndicator's tasks, see S. ROULAC, REAL ESTATE SYNDICATION DIGEST 1972—PRINCIPLES AND APPLICATIONS 10-17 (1972) [hereinafter cited as ROULAC].

\textsuperscript{14} For definitive analyses of the real estate syndicate, see generally ROULAC, supra note 13; Berger, supra note 3; Miller, Real Estate Syndication Under the California Corporate Securities Law of 1968, 16 U.C.L.A. L. REV. 371 (1969) and Hrusoff & Cazares, Formation of the Public Limited Partnership, 22 HASTINGS L.J. 87 (1970).

\textsuperscript{15} Miller, supra note 14.


\textsuperscript{17} INT. REV. CODE OF 1954, §§ 167, 1250. Note the advantages of accelerated depreciation are limited to certain specific types of structures: new commercial structures and new and used rental housing. In addition, section 167 of the Code permits complete depreciation in the case of expenditures to renovate low income housing held for a minimum of five years. Finally, the use of an accelerated depreciation method brings the recapture provisions of section 1250 into play. As a result, accelerated depreciation is advantageous to the limited partner only where he foresees a sharp reduction of his income within the early years of the depreciation period, where the limited partner dies and his estate receives a corresponding stepped up basis, reducing to zero the amount of recapture income and where the limited partner retains the depreciable property beyond the basic holding period required by sections 1250(a)(1)(C) and 1250(a)(2)(B).
The legal entity of the limited partnership allows the investor to realize these cash flow, tax shelter and capital appreciation benefits because of the conduit nature of partnership tax treatment. At the same time the investor enjoys limited liability similar to that of a corporate shareholder. The limited partnership entity also allows the syndicator or general partner to sell his entrepreneurial and management skills to passive investors. Unless a corporate general partner is created, the syndicator becomes personally responsible as general partner for the liabilities of the limited partnership; as compensation for the risk, the syndicator typically is well paid and has absolute control over the business activities of the syndicate.

Traditionally, real estate syndications have been formed to develop one specific piece of property. Development of a “specific property” syndication poses numerous problems, which stem primarily from the short period of time in which the syndicator must establish the syndication and the high organizational costs. During the time period in which investor capital is raised and the necessary securities registration is obtained, the syndicator will seek to control the property by obtaining an option to purchase. Because of the uncertainties involved, including the possible failure to raise sufficient funds, the seller will insist upon a high option price. The syndicator must also underwrite the expenses of locating and researching the property, securing financing for the project.

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18. INT. REV. CODE OF 1954, §§ 701-08.
19. Most states now permit a corporation to be a general partner in a limited partnership, see, e.g., Kitchell Corp. v. Hermansen, 8 Ariz. App. 424, 466 P.2d 934 (1968) and J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP 147 (1968). The Internal Revenue Service, however, has placed some restrictions on liability avoidance by using the device of a corporate general partner. Rev. Proc. 72-13, 1972-1 Cum. Bull. 735. To acquire a revenue ruling, ownership and net worth tests must be met by the corporate general partner. Under the ownership test, the limited partners must not own, directly or indirectly, more than 20% of the stock of the corporate general partner or of any affiliate (as defined in INT. REV. CODE OF 1954 § 1504(a)). The net worth test requires: (1) if the total capital contributions are less than $2,500,000, the net worth of the corporate general partner must at all times be at least 15% of the total contributions or $250,000, whichever is lesser and (2) where the total capital contributions are in excess of $2,500,000, the net worth of the corporate general partner must be at least 10% of the total contribution. The net worth test must be met by using separate assets for a limited partnership in which the corporation is the sole general partner, and the net worth test must be met at all times during the life of the limited partnership.
21. ROULAC, supra note 13, at 10.
and preparing a prospectus to satisfy the registration requirements of both state and federal regulatory bodies. All of these tasks and others must be performed in the normally short period of the option.

A recent development in real estate syndication is the unspecified asset or "blind pool" syndication. Developed to alleviate the timing problems of specific property syndications and to eliminate recurring organizational and marketing functions and expenses, the blind pool syndication achieves savings by first raising investor money and then investing that money pursuant to a stated investment policy. As a result, a blind pool syndication superficially resembles a mutual fund investing in real estate. Because a blind pool syndication relies more heavily on the blind faith of the investor than does the specific property syndication, states have been reluctant to accept blind pool real estate syndication. Although New York has not allowed blind pool syndication since 1961, most states now accept it. Indeed, the popularity of blind pool syndications has grown to the point where they are now a predominant factor in public real estate syndications. Although the specific property and blind pool syndication perform essentially the same functions, the differences between the two should be remembered when analyzing the various problems which confront the syndication investor.

The combination of the complexities inherent in real estate investment and management and the limited partnership form of organizational entity create serious problems for the investor. Under any circumstances, a successful real estate investment depends upon the correct combination of an intricate set of variables. The most important variable is usually the quality of the management. Unfortunately, the limited partnership entity diverts ownership from control: the investor does not have a direct voice in management and normally does not know what is being done with his money or whether he is being fairly treated. These and others problems facing the investor are examined in detail below.

22. Id.
23. See note 31 and accompanying text infra.
A. Evaluating the Underlying Real Estate Investment

A potential investor faces an almost insurmountable task in evaluating the quality of the underlying real estate. Yet, such an evaluation must be attempted because it is the specific piece of realty and the existing or envisioned improvements that most accurately reflect the value of the syndication investment. Accurate evaluation of the underlying economics of the investment is increasingly important where real estate prices have been driven up by increased demand. With any given real estate investment, overpricing of the property, inadequate market support for the project or fallacious assumptions behind projections can spell disaster and the loss of equity investment.26

The typical prospectus of a specific property real estate syndication is not of much help to the investor. Numerous generalizations and encouraging signs are intertwined with often confusing real estate terminology.27 Seldom does a prospectus present the objective facts necessary to make a good investment decision; factors of risk concerning the value of the property are likewise normally missing. Even the opinion of an “independent appraiser” is meaningless without a complete statement of the factors upon which the appraisal is based.28 Generally, the individual investor in a real estate syndicate is presented with far less information than is an institutional lender;29 yet if

26. See note 7 supra.
27. See, e.g., Prospectus of Grouse Mountain at Vail, Ltd., Description of Property Section at 15, 1 ROULAC, NOTABLE SYNDICATIONS 333-47 (1972).
28. People unfamiliar with real estate appraisal often make the fallacious assumption that the determination of value by an appraiser is precise and accurate and is determined by “scientific” methods. This is simply not so. S. KAHN, F. CASE & A. SCHIMMEL, REAL ESTATE APPRAISAL AND INVESTMENT 12 (1963) describes the appraisal process as follows:

An appraisal assignment does not permit the weighing of many known factors and the arrival at a precise and accurate statement; rather, it involves an estimation of the influence on value of economic, sociological, political, and geographic factors. These are social sciences and, therefore, cannot be precise, because not enough is known about persons and groups of persons, who are the central concern of the social sciences.

29. It is interesting to compare the information required by an institutional lender considering a mortgage loan to a syndicate with the information available to the individual investor in a prospectus. The syndicator’s burden of convincing the lender to loan money is much greater than the burden of disclosure imposed by securities regulations which normally seek to inform the investor of the value of the investment. The syndicator must absolutely convince the lender of the viability of his project. See W. STOEUCK, CASES AND MATERIALS ON PRIVATE LAND DEVELOPMENT VII-1 (1972). Independent appraisals funded by the syndicator, economic feasibility studies, traffic and marketing surveys, analysis of present and potential competition and other expert opinions
the investor is to make a reasonably prudent investment, he must somehow get information similar to that which the institutional lender demands.\textsuperscript{30}

The problems which the investor faces in evaluating the underlying real estate investment are exacerbated when an unspecified property or blind pool syndication is involved. Typically, the property or properties are not even identified until after the investor money has been raised.\textsuperscript{31} Obviously much more trust must be placed in the individual syndicator or general partner in a blind pool syndication. Trust, however, is no substitute for an adequate definition of the syndication's investment policy and does not assure the investor of a reasonably safe and profitable investment.

\textbf{B. Financial Analysis of the Total Investment}

Beyond an evaluation of real estate underlying the syndication, the investor would ideally like to understand what the total real estate syndication investment will mean financially. Yet where there is no past business history for the syndication, as is generally the case, and


\textsuperscript{31} See note 24 \textit{supra}. The National Association of Securities Dealers' proposed \textit{TAX SHELTER PROGRAMS} regulations (see note 10 \textit{supra}) expressed reluctance to even permit its members to market blind pool programs "since they are marketed to the public without any then contemplated use of the proceeds." The NASD was opposed to giving the syndicator complete discretion in investing the syndication's funds, but seems to have accepted the blind pool syndicate.
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projections are forbidden or discouraged, the investor is left to his own devices to determine from a myriad of statements concerning the risk present in the investment just what his return and tax shelter benefits might be. This problem is, of course, very similar to the problems faced in evaluating the underlying real estate.

C. Tax Shelter Considerations and Loss of Investor Perspective

The appeal to the high-bracket taxpayer of the well documented benefits of tax shelter in real estate limited partnerships has the unfortunate effect of making it easier to obscure the basic economics of the investment and to justify unreasonably high prices. Tax benefits cannot turn unproductive property into a good investment, even

32. ROULAC, supra note 13, at 140, discusses the general problem which confronts the potential investor as follows:

Because there is no institutional research base as exists for many investment alternatives, the analysis of real estate syndication investments is a subject of extreme importance. Limited investor knowledge and limited general information on the field present certain challenges in the investment decision-making process. Many of those active in the field do not understand the economic viability, tax aspects, and legal implications of the syndications in which they are involved. Despite the uniqueness of the concept and the complexity of the investment, there is very little analysis of the investment merits of real estate syndications on the part of those who offer such investments to the public and by those who ultimately invest in the syndications.

33. When taxed as a partnership, the tax shelter benefits of real estate investment to the individual limited partner include the deduction of interest, depreciation and losses of the limited partnership. Deductions can generally be allocated directly to the limited partners. But see Orrisch v. Commissioner, 55 T.C. 395 (1970).

Generally, a real estate limited partnership can avoid corporate taxation by not having a majority of corporate characteristics under 26 C.F.R. § 301.7701-2(a)(1)(1973). With a limited partnership the crucial corporate characteristics are: (1) continuity of life, (2) centralization of management, (3) liability for corporate debts limited to corporate property and (4) free transferability of interests. See generally Morrissey et al. v. Commissioner, 296 U.S. 344 (1935) and B. BITTKER & J. EUSTICE, THE TAXATION OF CORPORATIONS AND SHAREHOLDERS II-4-8 (1972).

One major appeal of a real estate syndication investment is that if it qualifies for partnership tax treatment, it can be a so-called "soft dollar" investment. This means that for each dollar invested there is a dollar tax deduction in the year of investment or shortly thereafter. These initial deductions are obtained by utilizing construction losses, accelerated depreciation and prepaid interest. For an analysis of the tax issues involved in real estate limited partnerships, see ROULAC, supra note 13, at 110-39 and Shapiro, Tax Planning for Equity Financing by Real Estate Developers, 50 TAXES 530 (1972).

34. See Hayes & Harlan, Caveat Emptor in Real Estate Equities, 50 HARV. BUS. REV. 86 (1972). BRUCKNER, MARKETING SYNDICATIONS, in REAL ESTATE SYNDICATIONS 343, 350-51 (D. Augustine & R. Lowell ed. 1972) alludes to the "soft dollar" prepaid interest problem and the general issue of tax factors distorting all other considerations by saying:

A widespread feature in California is the area I call "prepaid interest trap." CPA's
though good tax planning can enhance return from sound property.\textsuperscript{35} The problem for the investor is to keep tax shelter in its proper perspective.

The distortion caused by overemphasis on tax factors can be pervasive. Where the typical corporate businessman would strive for minimum costs and expenses to maximize profits, a real estate syndicator is not so motivated. High interest rates, high purchase prices, high construction costs and high operating expenses can lure investors seeking a tax shelter. Even if the syndicator does not actively seek these adverse economic factors in order to create "soft dollar" investments and high profits for himself, he at least is willing to accept them. The problem of tax distortion becomes more acute when property prices are driven up by demand, because the margin of profit becomes narrower and narrower. Syndications which could once offer attractive "soft dollar" investments and provide high profits for both the syndicator and investor while still generating enough positive cash flow to service debts and escape insolvency can no longer achieve this utopia quite so readily. An investment which initially offers maximum tax shelter benefits may eventually result only in a long term capital loss.

D. Lack of Transferability and Liquidity

For a number of reasons, limited partnership interests are usually not transferable. Qualification for limited partnership tax treatment requires that the limited partnership interest not be freely transferable.\textsuperscript{36}

\textsuperscript{35} See note 33 supra.

\textsuperscript{36} Id. Some state partnership statutes have tried to alleviate this problem by specifically making limited partnership interests assignable, see, e.g., WASH. REV. CODE § 25.08.190 (Supp. 1972), but this does not solve the taxation issue.
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hence most limited partnership certificates include restrictions on alienation.\textsuperscript{37} Additionally, a new purchaser normally cannot become a substituted limited partner without the general partner's consent and the filing of an amended partnership certificate.\textsuperscript{38} In some states, notably California, the new investor must meet suitability standards and the transfer must have the prior consent of the commissioner.\textsuperscript{39}

The unfortunate consequence of these restraints on transferability is a lack of liquidity and a total absence of secondary markets for interests in real estate limited partnerships. This lack of liquidity presents obvious problems for the investor. A long term investment in a real estate syndicate is one thing; a complete lack of transferability requiring retention of the investment until termination or insolvency is quite another.

E. Lack of Investor Control

By definition, the limited partnership form of organization leaves the investor (limited partner) with little control over the general partner. Typically the limited partner has the power to examine the books and to compel dissolution and an accounting;\textsuperscript{40} if greater control is exercised, the limited partner may be exposed to unlimited liability.\textsuperscript{41} Moreover, the common syndicator practice of contracting with an affiliate to manage the property can further remove the inves-

\textsuperscript{37} Berger, \textit{supra} note 3, at 739-40, lists the typical restraints on transfer as: (1) "the transfer must be to a member of a recognized class;" (2) "the transferee must be approved by the syndicate manager;" (3) "the non-selling interests reserve the right of first refusal."


\textsuperscript{39} Efforts have been made to alleviate the liquidity problem. Some syndicates have redemption provisions to allow investors to liquidate their limited partnership interests, but these provisions are normally conditioned by some formula to prevent liquidation of the syndicate's investments. Another effort to increase liquidity is the utilization of a two-layered equity arrangement whereby the original limited partnership sells the entire limited partnership interest to a single individual who in turn issues units of participation in his holding to the public. \textit{Id.} at 13. Although this is an ingenious attempt to circumvent tax motivated restraints on alienability, the individual takes the position of an underwriter and thereby assumes greater risk. \textit{Id.} at 14. Continued partnership tax treatment for the holders of the participation units will also be in doubt. \textit{Roulac, supra} note 13, at 91. These and other ingenious efforts have not produced the degree of liquidity necessary to create secondary markets in real estate limited partnership interests.

\textsuperscript{40} \textit{ULPA} § 10; \textit{WASH. REV. CODE} § 25.08.100 (1963).

\textsuperscript{41} \textit{ULPA} § 7; \textit{WASH. REV. CODE} § 25.08.070 (Supp. 1972).
tor from management control. While some investors purposefully seek a "passive" investment, few investors seek the total lack of control over major decisions which accompanies investment in a limited partnership. The practical effect of this lack of investor control is to give the syndicator exclusive power to make all major investment decisions.\textsuperscript{12} Short of seeking dissolution or damages, the limited partner is powerless.

\textbf{F. Syndicator Compensation}

The complex nature of the syndication process provides endless opportunities for an unscrupulous syndicator to garner exhorbitant profits. Of course, to maintain a proper perspective in considering syndicator compensation, it must be remembered that in undertaking a syndication the typical syndicator will perform an enormous amount of work involving significant expenditures and substantial personal risk. Syndicators quite rightly feel they should be highly compensated.\textsuperscript{13} Unfortunately, some syndicators go beyond reasonable compensation and charge all that the market will bear. Where the syndicator does extract excessive fees, investors' profits are diluted and the viability of the entire enterprise is threatened.\textsuperscript{14}

There are three basic types of syndicator compensation. They include: (1) the "front end load" derived from fees, commissions and promotional interests taken during the organization of the syndica-

\begin{itemize}
\item \textsuperscript{42} Berger, \textit{supra} note 3, at 742 lists major policy decisions over which the limited partner has no say:
These decisions include the making of management or rental arrangements, borrowing, refinancing, the amount and timing of distributions, the appointment of accountants and of counsel, selection of the controlling group, reformating the organizational mode and the acquisition or sale of property.
\item \textsuperscript{43} See \textit{RoulaC}, \textit{supra} note 13, at 10-17. The author distinguishes the fee justifications for a corporation, Wall Street underwriter, and a syndicate promoter. The author sees the following factors as justifying higher fees for syndicate packagers:
1. Real estate syndicates are smaller in size relative to mutual funds and corporations. The proportionate registration and organization costs are therefore greater.
2. Syndicates have relatively much higher costs in identifying, evaluating and selecting investments.
3. Many properties must be evaluated to find the "right" one.
4. Since there is less information available for the investor, the packager must educate the investor as well as sell interests.
44. The investors return is dependent on the cash flow of the syndicate. Where the syndicator imposes numerous expenses, whether or not entirely justified, more money goes to the syndicator and the cash flow is correspondingly diminished. High expenses thus have the effect of raising the syndicate's break-even point.
\end{itemize}
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tion; (2) on-going compensation in the form of management fees and indirect benefits and (3) profits derived from promotional interests on sale or refinancing of the property.\(^{45}\)

The front end load, which usually represents the major portion of the syndicator’s compensation, is the most controversial form of compensation because it can consume a substantial proportion of the total investor contribution to the syndicate.\(^{46}\) The front end load can take numerous forms and variations. Typically, a syndicator arranges the sale of property to a syndicate and thus collects a real estate brokerage fee, or perhaps property previously owned by the syndicator is sold to the syndicate at a profit.\(^{47}\) An affiliate of the syndicator may serve as the underwriter for the offering and be paid a high underwriting commission. The syndicator may seek direct reimbursement for expenses in lieu of other fees and commissions or in addition to them.\(^{48}\) These various charges can represent a large portion of the proceeds raised from investors and can place the syndicate in an early liquidity squeeze, substantially increasing the risk of the investment.\(^{49}\)

Although heavy front end charges may be unavoidable, their magnitude and relative impact on risk and investor return can at least be disclosed to potential investors.

A more serious problem arises for the investor when the syndicator is also allotted a promotional interest.\(^{50}\) The promotional interest may take the form of a straight equity interest in the partnership or a contractually reserved right to a certain percentage of cash distributions and liquidation value. The economic impact of the promotional interest is difficult to discern because there are several ways of formu-
lating the interest;\textsuperscript{51} subtle changes in wording can have dramatic ef-
fects on the relative participation positions of the investors and the
syndicator.\textsuperscript{52} Thus, in analyzing the front end load the investor often
has a very difficult time appreciating just how much the syndicator
will profit from the syndication.

Management fees and indirect benefits serve as compensation for
the syndicator's ongoing efforts during the term of the syndication.
Again the combination of direct management fees and indirect bene-
fits makes it difficult to determine how much is being raked off the top
by the syndicator. The management fee typically ranges from three to
six percent of gross rent revenue.\textsuperscript{53} Indirect benefits can include
charges for managing syndicate affairs, as distinguished from man-
aging syndicate property.\textsuperscript{54} Affiliates of the syndicator also typically
provide numerous management services whose charges are treated as
expenses over and above the basic management fee. Other indirect
benefits include insurance fees, fees for acting as the general con-
tractor and fees for acting as the holder of secondary financing in the
form of a wrap-around mortgage.\textsuperscript{55}

Finally, the syndication may provide for "incentive compensation"
to management which typically takes the form of a promotional in-
terest in gains realized on sale or refinancing.\textsuperscript{56} This nebulous provi-
sion further clouds the issue of determining exactly how much the
promoter is being compensated.

G. Conflicts of Interest and Self Dealing

A real estate limited partnership is fertile ground for conflicts of
interest and self dealing. Only a few will be mentioned. All the indi-
rect services which may be furnished to the partnership by the syndi-
cator's affiliates present serious self dealing problems.\textsuperscript{57} When the

\begin{itemize}
  \item \textsuperscript{51} \textit{Id.}
  \item \textsuperscript{52} \textit{Id.} at 35-49. The promotional interest will be determined by the definition of
terms such as "return," "investment" and "proceeds from sale." If the general partner's
promotional interest is subordinated until the limited partners receive certain returns, it
is often important whether the promotional interest is cumulative, what priority it has
and whether its calculations are based on net or gross income.
  \item \textsuperscript{53} \textit{Id.} at 29.
  \item \textsuperscript{54} \textit{Id.} at 30.
  \item \textsuperscript{55} \textit{Id.} at 31.
  \item \textsuperscript{56} \textit{Id.} at 30.
  \item \textsuperscript{57} See Trans-West Companies' brochure which describes three affiliated companies
\end{itemize}
syndicator is compensated by a real estate brokerage commission he is motivated to pay a high price in order to maximize his commission, which runs contrary to the syndicator’s duty to the partnership. Other potential conflicts include selling property to the partnership at a profit, leasing property from the syndicate at low rates and transacting business between various syndicator owned partnerships.

As the foregoing discussion illustrates, the problems facing an investor who either attempts to evaluate a real estate syndication’s potential or who has already invested in a syndicate are numerous. These problems are not of recent origin, and an investor in a real estate syndication can look to several bodies of law for protection. Whether the existing syndicate investor protections are adequate in view of the increased complexity and popularity of real estate syndication is open to question.

II. EXISTING SYNDICATE INVESTOR PROTECTIONS

Investors in real estate limited partnership interests can look to three basic bodies of law for protection against the many potential abuses of the real estate syndication—the common law (including the law of limited partnerships as codified by the uniform partnership acts) federal securities laws and finally state securities laws. Each provides potentially important protections for the investor.

A. Common Law

The common law and the common law of limited partnerships as codified by the Uniform Limited Partnership Act (ULPA) and the Uniform Partnership Act (UPA) form the basis of the relationship which perform property management and marketing, land research and acquisition and underwriting, respectively. See also Rosenblatt, supra note 3, which describes a typical affiliate problem like this: "One of several subsidiary firms would run the property: there was a hotel management firm, a bar management firm, and even a company to run a food service at two student residence halls." See note 7 supra for the context of the author’s comments.

58. The limited partner and the relation between the limited partner and the general partner is governed by the ULPA. See note 20 supra. As of 1972, the ULPA had been adopted in some form by 48 states. 6 Uniform Laws Annotated 559, as amended, (Supp. 1972). See, e.g., Wash. Rev. Code ch. 25.08 (1963).

59. Uniform Partnership Act, 6 Uniform Laws Annotated 3 (1969) [hereinafter cited as UPA].
between the syndicator and the investor in a limited partnership syndication by defining the duties and responsibilities of each. Unfortunately, there is a dearth of case law dealing specifically with the limited partnership entity. Thus, while some aspects of the relationship between the general and limited partners are clear from the governing statutes, other aspects of the relationship must be determined by reference to analogous relationships in general partnership, corporation, trust and creditor-debtor law. These bodies of law make it possible to characterize the relationships and corresponding duties of the parties to a real estate syndication with some precision despite the paucity of specific case law.

Many of the problems surrounding investment in real estate syndications arise in the solicitation stage of the syndication. The investor often can be misled by a promoter's sales talk, a circular or a prospectus which contains misrepresentations or material nondisclosures. Most investors who have been duped at this stage of the process will turn to the state and/or federal securities law remedies which will be discussed later. Although generally viewed as less effective than securities law remedies, the common law remedies can be utilized in some jurisdictions more effectively than corresponding securities law remedies.

Common law remedies can be especially effective in situations where the relationship between the parties to a transaction justifies the imposition of special duties. Such a relationship exists in the context of the real estate syndication. The syndicator is under a duty to the investor to exercise reasonable care to disclose pertinent information concerning the investment. This duty arises from two separate sources: (1) the business relation between the syndicator and the

60. The ULPA governs most aspects of limited partnership relations. ULPA § 9(1) incorporates UPA provisions concerning the general partner.

61. Recently courts have been willing to look to these analogous bodies of law for answers to limited partnership issues. See, e.g., Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965). The court in holding that limited partners have the right to sue derivatively analogized the limited partner to a creditor, trust beneficiary and shareholder. The case is noted in Comment, Standing of Limited Partners to Sue Derivatively, 65 Colum. L. Rev. 1463 (1965).

62. See text accompanying notes 93-148 infra. The securities law remedies serve as a codification and in some cases an extension of the common law remedies of rescission and deceit. See Shulman, Civil Liberty and the Securities Act, 43 Yale L.J. 227, 228-29 (1933) [hereinafter cited as Shulman].

63. See generally L. Loss, Securities Regulation 1430-44, 1624-31 (2d ed. 1961).

investor and (2) the fiduciary duties owed by a general partner to a prospective limited partner upon the formation of the partnership. Where this duty exists, courts are willing to impose liability without rigid adherence to the traditional elements of deceit, thereby avoiding some of the more troublesome elements of proof.

Where the business relationship forms the basis for the action, the action will sound in tort and damages will be owed by the syndicator to the investor for misrepresentation or nondisclosure. These damages will normally be measured by the difference between the actual value of the limited partnership interest received and the value of the interest.

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65. Boonstra v. Stevens-Norton, Inc., 64 Wn. 2d 621, 393 P.2d 287 (1964), which quoted the Restatement of Torts § 551(2)(a) (1938) in applying the rule that a "... party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated ... such matters as the other is entitled to know because of ... a relation of trust and confidence between them," to a mortgage banker who successfully solicited an investment without stating all the material facts. The court held the mortgage banker liable and equated nondisclosure of a material fact with a false representation. See also Sigman v. Stevens-Norton, Inc., 70 Wn. 2d 915, 425 P.2d 891 (1967).

66. The ULPA § 9 incorporates UPA § 21(1) which imposes fiduciary duties on the general partner. See note 83 and accompanying text infra. Unfortunately, it is not clear when this fiduciary duty of the general partner to the limited partner begins. See R. Rowley, Partnership 523 (2d ed. 1960). Upon analyzing the relationship of a general partner who is privy to all information and a prospective limited partner who is not, it seems clear that the fiduciary duties should be established early. Moreover, there is an apt analogy to corporations law which imposes fiduciary duties on the promoter. See W. Cary, Corporations 1042 (4th ed. 1969); Old Dominion Copper Mining and Smelting Co. v. Bigelow, 203 Mass. 159, 89 N.E. 193 (1909). The court in Klebanow v. New York Produce Exch., 344 F.2d 294 (2d Cir. 1965), was willing to freely analogize to corporate relationships. See note 61 supra.

67. See, e.g., Sigman v. Stevens-Norton, Inc., 70 Wn. 2d 915, 920, 425 P.2d 891, 895 (1967) which lists nine elements for establishing fraud:

(1) A representation of an existing fact; (2) its materiality; (3) its falsity; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) his intent that it should be acted upon by the person to whom it is made; (6) ignorance of its falsity on the part of the person to whom it is made; (7) the latter's reliance on the truth of the representation; (8) his right to rely on it; (9) his consequent damage.

The Washington court uses the term fraud instead of deceit, but the elements of proof are identical.

68. Thus, nondisclosure has been held to be the equivalent of an affirmative false representation of fact. Sigman v. Stevens-Norton, Inc., 70 Wn. 2d 915, 425 P.2d 891 (1967); Boonstra v. Stephens-Norton, Inc., 64 Wn. 2d 621, 393 P.2d 287 (1964). Several jurisdictions are apparently willing to accept innocent misrepresentation of fact as a basis for liability where the misrepresentation was made to induce a business transaction and there was detrimental reliance by the buyer. See W. Prosser, Law of Torts § 107 at 711 (4th ed. 1971). See also Pratt v. Thompson, 133 Wash. 218, 233 P. 637 (1925). But see Brown v. Underwriters at Lloyds, 53 Wn. 2d 142, 332 P.2d 228 (1958), where the court indicates that negligence is required to make misrepresentation actionable as fraud.
Where the partnership fiduciary relation forms the basis for the action, the general partner is accountable to the partnership for any benefit or profits achieved. Where the partnership fiduciary relation forms the basis for the action, the general partner is accountable to the partnership for any benefit or profits achieved.

Once the limited partnership is formed, the duties and responsibilities of parties become subject to the provisions of the ULPA and the terms of the partnership agreement. The ULPA defines the relationship between the various parties and establishes certain basic rights and privileges which cannot be compromised in the partnership agreement. While this offers the typical investor numerous benefits and many significant protections, the ULPA also places severe restrictions on the limited partner. It is therefore necessary to examine how the ULPA affects the relationship between the investor and syndicator.

One major attraction of the limited partnership organization entity is that the limited partner, like a corporate shareholder, will not be held personally liable to the creditors of the partnership. This aspect of the real estate syndication is of critical importance and in order to retain this insulation from liability, the typical investor will religiously seek adherence to the provisions of the ULPA which condition this limited liability. Unfortunately, to adhere to these conditions, the investor must give up the ability to retain control over his investment. This relinquishment of control contrasts with the corporate context where the corporate shareholder potentially has much greater control through the exercise of his voting power.

The critical condition to limited liability is the ULPA’s proscription against limited partners taking part “in the control of the business.” Unfortunately, neither “the Act nor the decisions under it are very helpful on the critical question of how much review, advisory management selection, or veto power a limited partner may have without being regarded as taking part in control.” The prudent limited partner will restrict his conduct to avoid any possible imposition of

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70. J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP 389-97 (1966) [hereinafter cited as CRANE & BROMBERG].
73. CRANE & BROMBERG, supra note 70, at 147.
liability; the syndicator will welcome this insulation from investor control and scrutiny.

Some jurisdictions have extended the limited partners' ability to take actions which do not constitute "control" by permitting limited partners to vote on the election or removal of general partners, termination of the partnership, amendments to the partnership agreement and sale of all or substantially all of the partnership's assets. But these provisions are permissive only; if they are not included in the partnership agreement, they cannot be of help to the limited partner. Absent these special powers, the limited partner can only inspect the partnership books and judicially force a dissolution and accounting. In sum, the limited partner's position is clearly tenuous: his capital contribution is subordinate to creditors' claims on dissolution or insolvency and he normally has no ability to control management.

Since the limited partner is precluded from active participation in the business of the partnership, he must rely on the general partner to operate within prescribed fiduciary patterns. Although the ULPA does not specifically mention fiduciary duties, section 9(1) of the ULPA incorporates all of the UPA provisions concerning the general partner, including the imposition of fiduciary duties. Included is the duty to:

1. account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

74. See CAL. CORP. CODE ANN. § 15507 (West 1970); WASH. REV. CODE § 25.08.070 (Supp. 1972).
75. ULPA § 10(1); WASH. REV. CODE § 25.08.100 (1963).
76. ULPA § 23; WASH. REV. CODE § 25.08.230 (1963). The general partner's claims, however, are subordinate to the limited partner.
77. See note 75 supra.
78. One classic characterization of the fiduciary duties of the general partner is found in Latta v. Kilbourn, 150 U.S. 524, 541 (1893). It is:

well settled that one partner cannot, directly or indirectly, use partnership assets for his own benefit; that he cannot, in conducting the business of a partnership, take any profit clandestinely for himself; that he cannot carry on the business of the partnership for his private advantage; that he cannot carry on another business in competition or rivalry with that of the firm, thereby depriving it of the benefit of his time, skill, and fidelity, without being accountable to his copartners for any profit that may accrue to him therefrom; that he cannot be permitted to secure for himself that which it is his duty to obtain, if at all, for the firm of which he is a member; nor can he avail himself of knowledge or information which may be properly regarded as the property of the partnership, in the sense that it is available or useful to the firm for any purpose within the scope of the partnership business.
The general partner's fiduciary duties go beyond this basic charge to include both a duty of care and a duty of loyalty. 80

Because of a lack of case law, the requisite standard of care for the general partner in a limited partnership is not clear. The general partner in a general partnership need only satisfy a good faith/gross negligence test. 81 As long as he performs his duties to the best of his ability and in good faith, courts seem willing to excuse negligence. 82 This standard appears to be too lenient for the limited partnership context where the limited partner is precluded from participating in partnership business. It seems much more logical to analogize to a corporate director-shareholder relation, where liability is imposed for simple negligence, and to impose this same standard of care on the general partner in a limited partnership. 83

The general partner's duty of loyalty in the limited partnership context is similarly unclear. Here, however, it seems reasonable to analogize to the general partnership context where a very high standard of loyalty is imposed on the "managing partner" 84 and to impose this same standard of loyalty on a general partner who exercises complete control over a limited partnership's affairs. 85 Accordingly, the general partner should be required to disclose to the limited partners all matters material to partnership affairs. Further, this high duty of loyalty should prohibit the general partner from taking advantage of partnership opportunities for personal benefit. 86 Unfortunately, judicially recognized exceptions to the partnership opportunity doctrine have developed in the general partnership context and may be applied to limited partnerships as well. These exceptions include good faith action by the general partner where the partnership has insufficient funds or where the general partner is not acting within the scope of the partnership business. 87


81. Id.

82. Id.

83. The general partner resembles in many ways the corporate director who is liable for ordinary negligence. See, e.g., Hun v. Cary, 82 N.Y. 65 (1880); Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966).

84. For illustrations of the high standard required in a general partnership context see Fiduciary Duties, supra note 80, at 907 and Meinhard v. Salmon, 249 N.Y.458. 164 N.E. 545 (1928).

85. Fiduciary Duties, supra note 80, at 907.

86. Id. at 908.

87. Id. at 910.
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Despite the uncertainty surrounding the general partner's duties of care and loyalty, several recent cases breathe life into the protections afforded limited partners through the fiduciary duty concept. In Lichtgyer v. Franchard Corporation,88 the New York Court of Appeals permitted a limited partner class action suit to obtain compensatory and punitive damages from general partners who had breached their fiduciary duties by negotiating new lease and mortgage terms which significantly reduced the limited partners' investment return. The court held that nothing in partnership law precluded a class action against the general partners, reasoning that a limited partner is in a position analogous to that of a corporate shareholder.89 The court saw no reason not to give the limited partner the rights of a corporate shareholder in a similar situation.90

[T]he principle is the same—those in control of the business must deal fairly with the interests of the other investors and this is so regardless of whether the business is in corporate or partnership form . . . . A breach of this fiduciary duty adversely affects in the same way the interests of every investor who has no voice in the operations of the business and, being a wrong done to all, it should be susceptible of correction by legal action taken for the benefit of all. To permit stockholders to bring a representative suit but to deny the same privilege to limited partners would be highly unreasonable.

If courts are willing to equate a limited partner to a corporate shareholder in other situations, limited partners will have a significant new tool for dealing with real estate syndicators.

Limited partners have also been allowed to sue derivatively in situations where the general partner cannot or will not act for the benefit of the limited partnership.91 Derivative suits by the limited partners have not been held to be precluded by ULPA § 26, which provides that a limited partner is not a proper party in actions by or against the partnership. This section has been construed only to prohibit the limit-

89. Both a corporate shareholder and a limited partner have limited liability and neither has a significant voice in the operation of the enterprise. Lichtgyer, supra note 88, 223 N.E.2d at 873, 277 N.Y.S.2d at 383.
90. Id. at 873-74.
ed partner from interfering with the right of the general partner to carry on the business of the partnership. If the general partner wrongfully refuses to carry out the business of the partnership, however, then the limited partners can sue derivatively.92

Thus, the investor in a real estate syndication has significant common law rights vis-à-vis the syndicator or general partner. The potential impact of these rights on common syndication abuses such as conflict of interest, self dealing, unreasonable compensation and disclosure is apparent. In practice, however, these common law remedies have not proved to be beneficial for a number of reasons. The legal structure of the limited partnership fosters secrecy on the part of the general partner which results in a lack of timely information and prevents effective utilization of these remedies. Without information, breaches of these common law duties will not be discovered and actions will not be brought. Even when breaches are discovered, without adequate and timely information liability may be difficult to establish or the general partners may have become insolvent or disappeared. Where there is little chance of recovery, the cost of litigation deters action.

B. Federal Securities Regulation

The federal securities laws were conceived to compensate for the shortcomings of the common law remedies by compelling complete and accurate disclosure of all relevant information to enable the investor to make an intelligent decision on the efficacy of an individual investment.93 To buttress the disclosure requirements, the securities laws incorporate both civil and criminal liabilities for misrepresentation.94 Because of their emphasis on disclosure, the federal

93. SEC, DISCLOSURE TO INVESTORS, THE WHEAT REPORT, § II B I at 49 (CCH 3d ed. Oct. 1969) [hereinafter cited as WHEAT REPORT] summarizes the policy of disclosure as follows:
The fundamental aim of the prospectus requirement was to provide information, and not to shield the public from ventures deemed to be of dubious merit. 'The purpose of these sections,' said the House Committee, 'is to secure potential buyers the means of understanding the intricacies of the transaction into which they are invited.' (footnotes omitted)
94. Shulman, supra note 62, at 227.
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securities laws are best viewed as preventive regulation, whereas the common law remedies have a primarily repressive impact.\(^95\)

There is no question that limited partnership interests are securities and thus covered by the Securities Act of 1933.\(^96\) Rather, the threshold issue in the regulation of real estate syndicates is whether the syndicate offering comes within one of the exemptions to the 1933 Act.\(^97\) It should be noted that SEC Proposed Rule 146 may significantly expand present concepts of the nonpublic offering exemption by allowing sales to 35 or fewer persons to be exempt.\(^98\) If there is no exemption, the syndicate must register its securities and conform to the 1933 Act's stringent requirements of disclosure;\(^99\) if exempt, the offering is left to the regulation of applicable state securities laws. Even though the securities are initially registered with the SEC, state

\(^95\) Id.


Under the Federal Securities Laws, an offering of limited partnership interests and interests in joint or profit sharing real estate ventures generally constitutes an offering of a 'profit sharing agreement' or an 'investment contract' which is a 'security' within the meaning of section 2(1) of the Securities Act of 1933. The Supreme Court has said that an 'investment contract' is a contract, transaction or scheme whereby a person invests money in a common enterprise and is led to expect profits from the efforts of the promoter or a third party (SEC v. W.J. Howey Co., 328 U.S. 293, 298, 299 (1946)). In other words, the investor provides the capital and shares in the risk and the profits; the promoter or third party manages, operates and controls the enterprise, usually without active participation on the part of the investor. See also Sire Plan Portfolio, Inc. v. Carpenter, 8 Ill. App. 2d 354, 132 N.E.2d 78 (1956); Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635 (9th Cir. 1969) (construing the definition of "security" contained in Washington's security legislation (WASH. REV. CODE § 21.20.005(12) (Supp. 1972)) to be identical to the definition of that term in the Federal Securities Act of 1933).


\(^99\) Failure to register a real estate syndicate as required gives the purchaser the right to rescind and recover the price paid plus interest. 15 U.S.C. § 77l(1970).
regulation can be a second hurdle for syndicate offerings. The Securities Act of 1933 provides that states have the power to impose additional regulation on securities sold within their jurisdictions.\textsuperscript{100}

1. Regulation by Disclosure: Problems with Form S-11

The disclosure required for registration constitutes the heart of present SEC regulation of real estate syndicates. Most blind pool syndicates and many large specific property syndicates want national exposure for their offering and therefore have to conform to these disclosure requirements. Form S-11 promulgates the primary guidelines for the form and content of the prospectus and registration statement for real estate related offerings.\textsuperscript{101} Since the purpose of Form S-11 is to disclose information essential to an investor's understanding of the risks involved in a real estate investment, the efficacy of the form can best be analyzed by examining its disclosure requirements in light of specific investor problems which might be alleviated by full disclosure in the prospectus.

Perhaps the most important part of the prospectus to the investor is the introductory statement which is required to summarize the "principal factors which make the offering speculative."\textsuperscript{102} Form S-11 instructions specifically require that the following factors be discussed where appropriate for a clear understanding by investors: (1) a percentage comparison of the securities being offered to the public and those issued to persons affiliated with the promoter; (2) potential liability of security holders for the acts or obligations of the registrant; (3) allocation of cash distributions between investors and affiliated persons and (4) remuneration and other benefits to be received by affiliated persons.\textsuperscript{103} In addition, the cover of the prospectus must speci-


\textsuperscript{101} See SEC Form S-11, For Registration Under the Securities Act of 1933 of Securities of Certain Real Estate Companies, 1 CCH FED. SEC. L. REP. ¶ 7231 (1973) [hereinafter cited as Form S-11], Section A of the General Instructions states: This form shall be used for registration under the Securities Act of 1933 of (i) securities issued by real estate investment trust, as defined in Section 856 of the Internal Revenue Code, or (ii) securities issued by other issuers whose business is primarily that of acquiring and holding for investment real estate or interests in real estate or interests in other issuers whose business is primarily that of acquiring and holding real estate or interest in real estate for investment.

\textsuperscript{102} Form S-11, supra note 101, General Instructions D(c).

\textsuperscript{103} Id.
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cifically disclose both the limitations on the transferability of securities and the absence of a secondary market. If there are high risk factors not included in the specific introductory risk statements, the "risk factor" section of the introductory statement may be expanded to disclose these supplemental considerations. The SEC may also tailor the Form S-11 to fit a particular offering. Presumably this introductory "risk factor" section will make the investor apprehensive of a highly speculative investment.

After reviewing the specific high risk factors, the investor theoretically should be able to extract from the body of the prospectus enough information to undertake the first step in an inquiry into the efficacy of a particular real estate investment—the evaluation of the underlying real estate. Of utmost importance then, are the factors relevant to valuation of the project disclosed in the prospectus. Because of the risks and assumptions inherent in any estimation of value, the determination and disclosure of the value of a proposed real estate project is one of the most difficult aspects of disclosure mechanics.

On its face the Form S-11 disclosure requirements appear to require sufficient disclosure concerning the particular property involved. However, in practice these disclosure requirements are apparently of little help. The Form requires the registrant to give the location and to describe the general character of major properties held or to be ac-

104. Id. at D(d).
105. See, e.g., Prospectus of Pacific Properties Ltd., ROULAC, supra note 13, at 356, 360-61 where the following factors were discussed in the introductory "risk factor" section: (1) Use of proceeds undetermined; (2) no assurance that proceeds raised will reach minimum; (3) no cash distributions from general partner run syndications; (4) possible conflicts of interest; (5) management fee of 5% of cost of syndicate properties; (6) lack of transferability; (7) might be taxed on income even though no cash distribution; (8) investments of syndicate leveraged; (9) no guarantee that tax treatment will not be changed; (10) changes in general and local economic conditions and in rates of interest may adversely affect the operations of the partnership; (11) Phase Two effects; (12) no participation in management for limited partners; (13) general partners will not devote full time to syndicate business.
106. Although the standard S-1 Form does not require an introductory statement, similar statements have been required on that form for high risk offerings. For real estate connected registrants, the S-11 introduction may require special introductory disclosures relating to the property and the promoter. Special property disclosures may require paragraphs concerning competition, lack of tenants, age or unsuitability of the building or other factors contributing to high risk. Special promoter disclosures include possible adverse factors such as lack of experience, prior bankruptcies or prior securities act violations. See Rikkind & Borton, SEC Registration of Real Estate Interests: An Overview, 27 BUS. LAW 649, 663 (1972). See also SEC Form S-1, Information Required In Prospectus, 1 CCH Fed. SEC. L. REP. ¶ 7123 (1973).
quired by the syndicate, to describe the use or proposed use of the properties and to evaluate the properties' suitability and adequacy for that use. The syndicator is required to outline any proposed program for renovation, improvement or development of the property and to describe the general competitive conditions for the property. The information garnered from these requirements can be, and usually is, general and inconclusive, if not actually misleading, concerning the "value" of the project. One can only conclude that the SEC intends that the investor rely upon other parties in the transaction—such as the syndicator, underwriter or primary lender—for an evaluation of future value. Perhaps the Commission believes that the typical investor is not capable of assessing the value of a project. Yet these basic considerations concerning the value of the real estate are the underpinnings of the syndicate and represent a very large part of the limited partner's risk.

The Form S-1 disclosure requirements for the financial aspects of the syndication are much more thorough, perhaps even too thorough. The poor organization of the financial data forces the investor to synthesize the maze of information located in different parts of the prospectus to determine what the economic future of the project is and how the mortgages, front end load, promotional interests, management fees and collateral expenses will affect his risk. While the effect of each of these factors on the investor's risk is adequately disclosed, an evaluation of the cumulative effect of all the factors, which is most important to the investor, is missing. However, if the security being registered is a new issue for an existing syndicate, the Form provides sufficient information because one section must provide past financial information. However, for a new issue, the poor organization of the financial data forces the investor to synthesize the maze of information located in different parts of the prospectus to determine what the economic future of the project is and how the mortgages, front end load, promotional interests, management fees and collateral expenses will affect his risk. While the effect of each of these factors on the investor's risk is adequately disclosed, an evaluation of the cumulative effect of all the factors, which is most important to the investor, is missing. However, if the security being registered is a new issue for an existing syndicate, the Form provides sufficient information because one section must provide past financial information.

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107. Form S-11, supra note 101, Item 10(a).
108. Id. at 10(d) & (e).
109. See, e.g., Prospectus of Pacific Properties Ltd., ROULAC, supra note 13, at 356, 373-74. The prospectus states that the subject property was valued at $10,000,000 by an appraisal which used a 96% occupancy factor, which is quite high. The prospectus goes on to say that "the report [of the appraiser] did not take into account all expenses which will be incurred in the operation of the property." There was no indication of what the "expenses" alluded to might be or how significant they were. The prospectus goes on to mention several encouraging factors, such as the soon to be completed "BART" service, but does not specifically disclose competition or other risk factors. Compare Prospectus for Tucker Land Co., in REAL ESTATE SYNDICATIONS 406, 413-20 (D. Augustine & R. Lowell ed. 1972), which provides a thorough description of the general area, the property, utilities, description of adjacent properties, zoning, plan of development and property taxes and includes topographical maps.
110. See note 30 supra.
financial data, if any.\textsuperscript{111} Unfortunately, the vast majority of registrations are the initial offerings of syndicates for which detailed financial histories are not available.

Disclosure of blind pool investment policies also is inadequate under the Form S-11. Blind pool syndicators are required to indicate the geographic areas in which real estate will be acquired, the specific types of real estate, \textit{e.g.}, office buildings, apartment buildings or other, and the proposed method of operating and financing.\textsuperscript{112} The registrant must also indicate whether his policy is to invest primarily for income or for capital gain and must state any limits on the percentage of assets to be invested in any one property.\textsuperscript{113} Again, these are general statements which are of questionable value to the investor.\textsuperscript{114} Absent much more detailed disclosure requirements for the blind pool’s future investment policies, perhaps the most useful information the potential investor could receive relates to the syndicator’s background and experience, especially when the blind pool has no operating history. Unfortunately, the Form S-11 does not specifically require detailed background information; the Form requires only the names, positions and principal occupations for the past five years of the syndicate’s general partners and officers.

The relative value of tax shelter and its importance to the investor are also not adequately disclosed when the S-11 requirements are followed. The issue here is not the risk of losing favorable tax treatment, but rather the allocation of too high a “value” to the tax shelter as-

\textsuperscript{111} See Form S-11, \textit{supra} note 101, Item 6, which requires a thorough summary of financial data for the registrants’ last fiscal year.

\textsuperscript{112} Form S-11, \textit{supra} note 101, Item 9.

\textsuperscript{113} \textit{Id.}

\textsuperscript{114} See, \textit{e.g.}, Prospectus for Pacific American Real Estate Fund 1971B, 2 \textsc{Roulac}, \textsc{Notable Syndications} 739-46 (1972), where the investment objectives state:

\begin{itemize}
  \item capital will be invested in improved real estate of the following types only: apartment buildings; hotel, motels, and related facilities; shopping centers; warehouses; mobile home parks; manufacturing plants; health and medical care buildings; and office buildings.
\end{itemize}

(Obviously the syndicator did not want to tie his hands.) The prospectus goes on to describe several restrictive but nonexclusive conditions on investment and concludes with the final condition that

\begin{itemize}
  \item \[I\]n the opinion of the General Partner’s Investment Committee, the property will generate, during the period of at least two years following the purchase, cash flow after debt service of no less than 8 per cent per annum of the partnership’s cash investment in the property.
\end{itemize}

pects of the syndication. The Form requires only a brief description of the "material aspects of the tax treatment of the registrant" and is apparently concerned only with the investor understanding the risks of not receiving the tax treatment that is represented. Yet the importance of the tax shelter aspects of a syndication can only be kept in perspective if discussed in connection with the other financial aspects of the syndication. When the tax aspects of the investment are isolated in the prospectus, the investor may not obtain the proper tax shelter perspective and may form erroneous assumptions concerning the normally adverse factors of negative cash flow and high expenses, which can appear to be an "asset" from the tax shelter point of view.

Registrant and affiliate "remuneration" are emphasized throughout the Form S-11, but the overall impact of insider remuneration is not apparent when the Form is followed. An important deficiency is that the syndicator's promotional interest in profits and proceeds of sales to the syndicate is not specifically disclosed along with other more direct forms of compensation, with the result that the total compensation to the syndicator and his affiliates may not be apparent. An additional problem is that the registrant need disclose only basic property management arrangements; the same section of the prospectus need not disclose that sub-management services may be performed by affiliates at substantial cost.

In summary, there are two basic problems with the Form S-11 when used in connection with the registration of real estate syndications. First, the information required is so unorganized that it can often be more confusing than helpful for the investor. Second, it appears that the Form was not devised specifically for real estate limited

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115. Form S-11, supra note 101, Item 12.
116. Isolating the tax shelter aspects of a prospectus from the other financial factors can be misleading to the unsophisticated investor. It is not hard to envision the investor hungry for tax shelter reading the following paragraph in the introductory "risk factor" section and then looking for the possibility of "soft dollars" throughout the prospectus.

Investment in the Units is only considered suitable for those whose taxable income places them in the higher federal income tax brackets since it is expected that each holder of a Unit will be entitled to substantial tax deductions at least in the earlier years, and, therefore, the risks of such investment will be significantly reduced for such persons.

117. Form S-11, supra note 101, Item 20. The risk factor section must also disclose syndicator equity participation. Id., Item 4.
118. Form S-11, supra note 101, Item 22.
partnerships and the peculiar problems that they present to the investor;\(^{119}\) the Form seems primarily designed for ongoing businesses with historical data which are making a non-initial offering. Unfortunately, real estate syndicates normally make only one initial offering. Since for these syndicates the Form does not require adequate information to replace the missing historical data, it is of little use to the investor. The Form can and should be changed to accommodate the peculiar problems of the real estate limited partnership and should require that the information be organized and collated to enable the investor to understand what various aspects of the syndication mean to him.

Of course, a more basic problem also exists. Even if the prospectus format is improved to provide full and accurate disclosure of all necessary information for the typical investor, it is questionable how much impact the disclosures would have. Factors such as high expenses and negative cash flow with their tax shelter implications are so divorced from these considerations involved in the corporate offering that the federal securities law policy of regulation solely by disclosure without substantive rules becomes suspect.

2. Remedies for Violation of Federal Securities Law

The general disclosure policy of the 1933 Act is supplemented by restrictions on marketing practices,\(^{120}\) the threat of civil and criminal remedies,\(^{121}\) and the SEC's rigorous supervision of registration statements.\(^{122}\) All of these factors theoretically promote precision in the prospectus and other promotional material used by the syndicator.

The civil liability remedies of the 1933 and 1934 Acts are especially important to the syndicate investor because they provide a prime source for legal redress against unscrupulous syndicators. These

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\(^{119}\) The form was designed for real estate investment trusts and corporations and is used collaterally for real estate limited partnerships. See note 101 supra.


\(^{121}\) The criminal remedies have not been effective as a supplement to the disclosure policy because the criminal penalty provisions of the 1933 Act have not been enforced due to fiscal and manpower restraints within the SEC. HOUSE SUBCOMMITTEE ON COMMERCE AND FINANCE, SECURITIES INDUSTRY STUDY REPORT, CCH FED. SEC. L. REPORTS, Special Report 438 (Aug. 25, 1972).

\(^{122}\) The SEC's supervisory powers are backed by the use of stop orders, which can have disastrous effects on the marketing of limited partnership interests.
provisions broaden some aspects of common law investor remedies and, in addition, broaden the group of persons potentially liable to the investor. The 1933 Act has three specific civil liability provisions. Section 11 subjects the issuer of registered securities and other participants in the offering to liability for damages when the registration statement is materially misleading or deceptive. Section 12(1) imposes liability for rescission or damages upon anyone who offers or sells a security in violation of the registration or prospectus provisions of the Act while using an instrumentality of interstate commerce. Section 12(2) imposes liability for rescission or damages upon anyone who offers or sells a security by means of a prospectus or oral communication that contains a material omission or misstatement, whether or not the security is registered or exempt from registration. Although the civil liability provisions of the 1933 Act may promote accurate disclosure by serving as a deterrent, they have not been utilized to a high degree by investors in the past and will probably continue to play a small role in the future due to the emergence of Section 10b of the 1934 Act and Rule 10b-5. The existence of a private remedy under Rule 10b-5 seems well established, the major issue being the scope of coverage under the Rule. When literally read, liability is established under Rule 10b-5 in connection with the purchase or sale of a security when it is proved that there exists (1) fraud, material misstatement or silence when there was a duty to speak and (2) use of some instrumentality of interstate commerce. Judicial interpretations of the Rule, however, have added requirements of reliance, causation and scienter. Most courts

123. The Securities Act of 1933 provides that all persons who sign the registration statement or who participate in the preparation or certify part of the registration statement and all underwriters are potentially liable for misrepresentations or material omissions in the registration statements. 15 U.S.C. § 77k (1970).
124. Id.
129. Loss, supra note 127, at 3869-73.
130. Id. at 1764-65.
131. Id. at 3876-80.
132. Id.
133. Id.
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will accept negligent as well as intentional misstatements or material nondisclosures as a basis for liability.\textsuperscript{134} The implementation of Rule 10b-5 by the federal courts has essentially created a new source of substantive law which has developed from the common law concepts of fraud and deceit. As a result, Rule 10b-5 can be extremely useful to the investor.

C. State Securities Regulation

The state blue sky laws inject another crucial element into the present group of investor protections. State blue sky registration standards can affect all public real estate syndications because the federal statute gives states the right to regulate all offers and sales of securities within their jurisdiction.\textsuperscript{135} More importantly, real estate syndications frequently will seek an exemption from federal registration and register only at the state level because of the time, trouble and expense involved at the federal level.\textsuperscript{136}

Even a brief look at state blue sky laws reveals a wide variety of statutory regulation. Lack of uniformity is predominant, despite the fact that 27 states have enacted versions of the Uniform Securities Act. This lack of uniformity is even more pronounced in the rigor of administrative implementation of the blue sky laws. For simplicity's sake, this comment will present only the general regulatory pattern of Washington whose securities laws are derived from the Uniform Act.

Blue sky laws in general present the syndicator with a different set of problems than the federal securities laws.\textsuperscript{137} Where the federal policy regulates by requiring full and accurate disclosure, the states typically take a more paternalistic approach and require both disclosure and an administrative evaluation of the offering to determine the worthiness of an issue.\textsuperscript{138} The typical regulatory pattern has three facets: (1) registration of securities offered and sold in the state; (2) pro-

\textsuperscript{134} See, e.g., SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 854-55 (2d Cir. 1968).
\textsuperscript{136} These syndications will take advantage of the intrastate exemption. See 15 U.S.C. § 77a(11) (1970).
\textsuperscript{138} Rooks, supra note 137, at 187.
hibitions of fraud and (3) registration of persons engaged in the selling of securities. Registration provisions require all offers or sales of securities to be registered unless specifically exempted. Failure to register can invoke civil and criminal liabilities. Once a registration statement has been filed and 15 days have elapsed, the securities may be offered and sold unless the administrator issues a stop order denying registration or revoking the prior registration. The stop order must be based upon a finding that the offering is adverse to the public interest. The statute provides nine standards for assessing the public interest. The most important condition permits denial of a registration if “the offering has worked or is intended to work a fraud upon purchasers or would so operate.” Fraud presumably will be interpreted broadly. Additionally, the registration can be denied if there are unreasonable amounts of underwriter and seller discounts, commissions, compensation, promoter profit or participation or unreasonable amounts or kinds of options. Although these criteria require administrative inquiry into specific aspects of the worthiness of a proposed offering from an investor’s point of view, they should not be confused with the much broader “fair, just, and equitable” standard which justifies inquiry into the financial or economic soundness of the business itself. The typical state securities statute also provides fraud protections similar to Rule 10b-5 and allows for rescission or damages. The broker-dealer registration requirement provides little additional protection for the investor.

The basic problem with blue sky regulation is that it provides flexible standards which are only as effective as the state administrator’s investigation and scrutiny of each registration statement. Unfortunate-

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140. There are two major exceptions. First, the isolated transaction and/or non-public offering. Second, transactions which limit offer or sale of securities to not more than 20 persons in any 12-month period. Wash. Rev. Code § 21.20.320(1) & (9) (1963).
141. See Rooks, supra note 137, at 196.
144. Rooks, supra note 137, at 206.
147. Rooks, supra note 137, at 206.
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ly, the universal characteristic of blue sky commissions is lack of funds and staff. Because these fiscal restraints preclude the state administrator from effectively administering present standards, state blue sky administrators faced with specific problem areas such as real estate syndications quite naturally turn to sets of substantive regulations in the form of rules or guidelines issued under the administrator's rulemaking power. These substantive regulations substantially ease the investigatory burden of the administrator for it is much easier to require conformity with a set of substantive standards than to make a vague "public interest" determination under the existing regulatory structure in each individual case. The adequacy of these substantive standards with regard to real estate syndications will be discussed in detail later in this comment.

III. PROPOSED CHANGES IN REGULATION

A. SEC Proposals: More and Better Disclosure

After a thorough study of real estate securities problems by a specially appointed Real Estate Advisory Committee, the SEC has recently made the policy determination that protection for the real estate syndicate investor can be best achieved through full and uniform economic disclosure in real estate offerings. Although this stance by the SEC generally perpetuates past disclosure policy, to compensate for past deficiencies there apparently will be significant changes in the mode of disclosure. The goal of the SEC policy is to establish a permanent market for real estate securities within the existing capital market system. The SEC apparently views fragmented federal and state regulation as a threat to this objective and seeks "consistency" of regulation at the state and federal levels. Whether such consistency is possible in view of the SEC's exclusive reliance on regulation by disclosure is open to question.


151. See note 149 supra. See also, REAC Report, supra note 149, Recommendation 9 (recommending abatement of state imposed regulations on compensation until uniform regulation by disclosure has had a chance to be evaluated).
The substance of the SEC's regulation will be a new "uniform prospectus" to be used for all nationally distributed real estate securities.\(^{152}\) The uniform prospectus does not exist as of this writing, but it may be assumed that the recommendations of the SEC's Real Estate Advisory Committee will serve as the basis for the disclosure requirements of the new prospectus. The new uniform prospectus should require a "numerical economic analysis" of the potential consequences of participation in a particular real estate program based upon "standard assumptions" to aid the investor in evaluating a syndicate.\(^{153}\) This approach will probably necessitate specific projections of the cash flow and tax shelter aspects of the real estate investment. In general, the use of projections which allow the investor to see exactly what an investment should bring would be a pronounced improvement over the present Form S-11,\(^{154}\) at least insofar as specific property syndications are concerned.

The recommendations further provide that the new prospectus should require investor-oriented disclosure in other real estate problem areas. There should be "a clear exposition of the real and potential conflicts of interest that may be involved in the sale of the securities, the use of the proceeds, and the arrangement of the properties purchased."\(^{155}\) The registrant should be required to include a "summary of each type of transaction in which an affiliate may engage with the registrant, and the manner of resolving conflicts."\(^{156}\) Syndicator compensation should be regulated by "appropriate disclosure which will assume that the reasonableness of the fees will be self-policed by competitive market forces."\(^{157}\) The prospectus should require "a summary disclosure in one section of all direct and indirect compensation payable by the partnership to promoters, general partners, underwriters and their affiliates."\(^{158}\)

The Advisory Committee recommendations include several assorted disclosure requirements designed specifically for "speculative" real estate syndicates. The requirements include: a statement in the prospectus that the investment is intended for investors in or above a

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152. See REAC REPORT, supra note 149. Recommendation 13.
154. See text accompanying notes 107-19 supra.
155. See REAC REPORT, supra note 149. Recommendation 7.
156. Id., Recommendation 3.
158. Id., Recommendation 10.
certain tax bracket;\textsuperscript{159} a summary in the prospectus of the experience of the general partner or promoter in previous public limited partnerships, including an indication of "the investment by promoters and others and the return on such investment and compensation received . . . ."\textsuperscript{160} and approval of all sales literature by the SEC prior to use.\textsuperscript{161} While recognition of the need for special requirements for "speculative" real estate syndicates is a step in the right direction, it is questionable whether these few special disclosure requirements would adequately protect the investor.

The general recommendations of the Real Estate Advisory Committee must be implemented before it will be possible to evaluate fully the effectiveness of the proposals. If the Committee's recommendations are followed, however, it is apparent that many of the confusing and deficient disclosure practices present in the Form S-11 will be eliminated. As discussed later, even considering these proposed improvements in the disclosure requirements, the SEC is subject to serious criticism for perpetuating its policy of regulation solely by disclosure for all types of real estate syndications.

B. State Proposals: More Substantive Regulation

As a reaction to the problems posed by real estate syndications, several state securities administrators have recently promulgated or are in the process of promulgating rules or policy statements concerning real estate limited partnerships.\textsuperscript{162} The Washington Rules on

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\item \textsuperscript{159} Id., Recommendation 18.
\item \textsuperscript{160} Id., Recommendation 21. Additional requirements for speculative syndicates include: (1) full disclosure of the economic and tax benefits of participation in the program and the risk inherent in such programs; (2) a balance sheet of promoters and general partners; (3) disclosure of business failures, bankruptcy or insolvency involving the general partner or promoter in the past ten years plus disclosure of violations of state and federal securities laws and (4) disclosure of all accounting practices to be used.
\item \textsuperscript{161} Id., Section 2. "[A] ll literature not filed or approved will be prohibited."
\item \textsuperscript{162} The new California Real Estate Syndication Rules, filed on April 10, 1973, and effective 30 days thereafter, adopt extensive substantive regulation. Included are provisions governing the experience and net worth of the general partner, investor suitability standards, limits on syndicator compensation, prohibitions on conflicts of interest, requirements guaranteeing increased control for limited partners and new disclosure requirements. See 10 CAL. AD. CODE § 260.140.110 et seq. (1973). The California Rules were adopted after lengthy discussion with the Midwest Securities Commissioner's Association, the NASD and the SEC's Real Estate Advisory Committee. The background and basic structure of the new California Rules are discussed in an article by the California Commissioner of Corporations, Van Camp, Living With Tax Shelters in California: A Discussion of the New California Real Estate Syndication Rules, 7 U.S.F. L. REV. 403 (1973).
Limited Partnerships\textsuperscript{163} and the recently adopted Guidelines of the Midwest Securities Commissioners Association\textsuperscript{164} will differ significantly from basic blue sky regulation by imposing both strict disclosure requirements and substantive restrictions on real estate syndications.\textsuperscript{165} Although the substantive regulations are designed to protect the investor, and many will be flexibly applied as the circumstances dictate, some rules will be rigidly enforced and may have substantial impact on the future of real estate syndications. It is therefore necessary to closely examine these substantive restrictions.

1. \textit{Syndicator Compensation}

A major area of substantive regulation of real estate limited partnerships is syndicator compensation. The Midwest Guidelines start with the general admonition that except for subordinated promotional interests, compensation may only be paid by the partnership for "reasonable and necessary" goods, property or services.\textsuperscript{166} More specifically, the Midwest Guidelines would limit syndication front end load to some degree. The "acquisition fee" normally taken in the form of a

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\item \textsuperscript{163} \textit{WASH. AD. CODE} § 460-32-010 \textit{et seq.} (1972); \textit{[Current] BLUE SKY L. REP.--WASH.} ¶ 50. 611 \textit{et seq.} [hereinafter cited as Washington Rules].
\item There is some doubt whether the Washington Rules are a valid exercise of the State Securities Administrator's rule making power. The preamble, § 460-32-010, states that offering circulars "shall contain" certain specified provisions. Since the provisions will require many substantive requirements, it can be argued that the administrator has exceeded his authority. Cases like Marble v. Clein, 55 Wn. 2d 315, 317-18, 347 P.2d 830, 831 (1959), state that the Securities Act must be strictly construed and not be "extended beyond its plain terms." \textit{But see} Barry & Barry, Inc. v. Dept. of Motor Vehicles, 81 Wn. 2d 155, 500 P.2d 540 (1972).
\item \textsuperscript{164} Midwest Securities Commissioner's Association, Statement of Policy Regarding Real Estate Programs, \textit{[Current] BLUE SKY L. REP.} ¶ 4821 (adopted Feb. 28. 1973) [hereinafter cited as Midwest Guidelines]. The Midwest Guidelines represent the consensus of opinion of the administrators of the states who comprise the membership of the Midwest Securities Commissioner's Association and are a policy statement only. They are not binding on an individual member state unless expressly adopted by the state. Washington is a member of the Association. (California has adopted rules which substantially conform to the Midwest Guidelines. \textit{See} note 162 \textit{supra}).
\item \textsuperscript{165} Generally states have followed the pattern of regulation set out in the above description of Blue Sky regulation. \textit{See} text accompanying notes 162-64 \textit{supra}.
\item New York has had special statutory coverage of real estate syndications since 1961. \textit{See N.Y. Gen. Bus. Law} § 352(e) (McKinney 1968) and Real Estate Syndication Offerings regulations \textit{[Current] BLUE SKY L. REP.--N.Y.} ¶ 35.611 \textit{et seq.}. The first to deal specifically with real estate syndications, this legislation regulates syndication offerings with strict disclosure requirements. The most significant aspect of the statute is that it gives the New York Attorney General the power to disapprove blind pool syndication offerings. Since 1961 most such offerings in New York have not been approved.
\item \textsuperscript{166} Midwest Guidelines, \textit{supra} note 164, IV A 2.
\end{itemize}
real estate commission is permitted only for services actually rendered and is limited to the lesser of comparable fees charged in similar transactions or eighteen percent of the gross proceeds of the offering. Moreover, the sum of the purchase price of the property plus the acquisition fee cannot exceed the fair market value of the property as established by an independent appraisal.167 Organization and offering expenses are allowed to the extent that they are reasonable and comply with state restrictions.168 Washington would permit a standard real estate commission paid to the promoters when property is purchased by the partnership,169 and does not mention organizational expenses.

Management fees are limited by the Midwest Guidelines to one quarter of one percent of the cost of the unimproved land and to two percent of the original cost of the land for improved property.170 All other management fees are prohibited. Washington would "presume to be reasonable" management fees of one percent of cost for unimproved land and three to seven percent of gross proceeds per year for improved property.171 No management fee limitation is meaningful, however, without a limitation on fees paid to affiliates for management and operation of the property. Washington imposes a flat prohibition on payment to any affiliate in which the general partner has a five percent or greater interest "unless fully disclosed to the investor."172 The Midwest Guidelines require the syndicator or affiliate to have related business experience and limit charges to "competitive" rates; moreover, all other services rendered by the syndicator or affiliate must be embodied in the contract which can be modified only by a majority vote of the limited partners and can be terminated without penalty on 60 days notice.173

167. Id., IV C 4.

168. Id., IV C 4.

169. Washington Rules, supra note 163, § 460-32-100(2).

170. Midwest Guidelines, supra note 164, IV D. The use of the project cost as the basis for determining management fees does not seem rational since the cost is not necessarily related to management efforts or the income from which the management fee should be paid.


172. Id.

173. Midwest Guidelines, supra note 164, V E 3. Whether such a vote by the limited
Promotional interests of syndicators are also severely restricted. The Midwest Guidelines are the most stringent, allowing promotional interests only to the extent that they are "reasonable." The promotional interest is presumed to be reasonable if it is equal to: (1) twenty-five percent of undistributed amounts remaining after all capital contributions have been paid to each investor, (2) ten percent of distributions from cash available for distribution or (3) fifteen percent of the distributions to investors after payment of an amount equal to one hundred percent of capital contributions plus an amount equal to six percent of capital contributions per annum cumulative less the sum of prior distributions to investors. Washington simply subordinates the syndicator's promotional interest for purposes of distributions of capital for the duration of the partnership and presumes that a promotional interest in excess of twenty percent of the net profits is unreasonable. Although both provisions seem fair to the investor, the Midwest Guidelines can be construed with greater certainty.

Both the Midwest Guidelines and the Washington Rules further limit syndicator profit by proscribing various potential conflicts of interest. The Midwest Guidelines prohibit the following: (1) sales or leases to the syndicator except for a total, guaranteed leaseback; (2) loans to the syndicator; (3) dealings with related syndicates; (4) exclusive listing agreements; (5) commissions on reinvestment of proceeds of resale, exchange or refinancing; (6) insurance brokerage fees by the syndicator and (7) investments in other syndicates. The Midwest Guidelines also prohibit the sale or lease to the partnership of property in which the syndicator has an interest except at formation of the syndicate. Even at this time the sale price cannot

174. The Washington Rules define a promotional interest as one that is acquired by the syndicator for other than cash and/or property. Washington Rules, supra note 163, § 460-32-060.
175. Midwest Guidelines, supra note 164, IV E.
176. Id., IV E 1-2.
179. Id., V C & V D.
180. Id., V E 1.
181. Id., V I.
182. Id., V A 1.
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exceed fair market value as established by an independent appraisal.\textsuperscript{183} Washington allows the sale of property to the syndicate in which the syndicator has an interest if the syndicator has owned or has been obligated to purchase the property for six months prior to the filing of the registration and has paid consideration (other than an option or earnest money) toward the principal.\textsuperscript{184} The price cannot exceed fair market value as established by an appraisal, and if the sale price exceeds ninety percent of the appraised value, the syndicator can be compensated only by a promotional interest in the partnership in the amount of the excess.\textsuperscript{185}

Neither set of regulations questions the propriety of real estate commissions for syndicators. Yet the conflict of interest inherent in these commissions (the higher the cost of the property, the higher the commission) should not be ignored. It would make more sense to require that front end syndicator compensation be measured by the amount of money raised, rather than the cost of the property purchased by the syndicate. In sum, both the Midwest Guidelines and the Washington Rules take significant steps towards limiting syndicator compensation by substantive regulation.

2. Investor Control

Both the Midwest Guidelines and the Washington Rules increase the participation of investors in the control of limited partnerships. The Midwest Guidelines permit ten percent of the limited partners to call general meetings by initiative. To the extent consistent with state law, the limited partners by a majority vote can amend the partnership agreement, dissolve the limited partnership, remove the general partner or approve or disapprove the sale of all or substantially all of the assets of the partnership.\textsuperscript{186} On the other hand, the Washington

\textsuperscript{183} Id. Moreover, any increase in the sales price above the actual cost to the syndication is deemed unfair unless there has been some "material change," such as the passage of two or more years or the syndicator taking the risk of getting the property rezoned. Id., V A I c.

\textsuperscript{184} Washington Rules, supra note 163, § 460-32-100.

\textsuperscript{185} Id. There is nothing sacred about appraisals. Different appraisers can arrive at different appraisals of the same property. See, e.g., Northwest Chemurgy Securities Co. v. Chelan County, 38 Wn. 2d 87, 228 P.2d 129 (1951) (In a dispute over an assessed valuation of $110,800 for tax purposes, three appraisers used as expert witnesses made value estimates of $30,000, $40,000 and $86,240 on the same piece of property.)

\textsuperscript{186} Midwest Guidelines, supra note 164, VII B.
Rules require thirty percent of the limited partnership interests to call a general meeting.\textsuperscript{187} Limited partners can vote to dissolve the syndicate by removing the general partner,\textsuperscript{188} to readjust management fees (if so provided in the partnership agreement)\textsuperscript{189} or to accept or reject proposed buyers of a corporate general partner's interest,\textsuperscript{190} but all such votes require a sixty-six percent majority.\textsuperscript{191} The Washington Rules permit voting by proxy.

Provision for increased limited partner control over the general partner is a step forward. To make this power meaningful, however, the limited partner must be kept up to date with complete and accurate information. Yet Washington requires only that the general partner provide each limited partner with an annual certified audit and a copy of the syndicate’s federal income tax return.\textsuperscript{192} The Midwest Guidelines have somewhat more stringent informational requirements. Beyond requiring that all partnerships supply limited partners with an annual report plus the federal tax returns,\textsuperscript{193} a report is required after the first six months of partnership operation,\textsuperscript{194} and all partnerships registered under Section 12(g) of the Securities Exchange Act of 1934 are required to submit detailed quarterly reports.\textsuperscript{195} The Midwest Guidelines require quarterly reports by blind pool syndicates until all funds are invested.\textsuperscript{196} Of special importance, the Midwest Guidelines require that whenever the general partner receives fees for services, including acquisition fees, then a report detailing the services rendered and the amount of fees received must be sent to all limited partners within 60 days after the end of the quarter during which the fees were paid.\textsuperscript{197} Such timely information regarding an area with enormous potential for abuse should make the limited partners' voting power even more meaningful.

\begin{itemize}
\item \textsuperscript{187} Washington Rules, \textit{supra} note 163, § 460-32-050.
\item \textsuperscript{188} Id., § 460-32-050.
\item \textsuperscript{189} Id., § 460-32-090(1)-(2).
\item \textsuperscript{190} Id., § 460-32-050.
\item \textsuperscript{191} Id.
\item \textsuperscript{192} Id., § 460-32-180.
\item \textsuperscript{193} Midwest Guidelines, VII C 3-4.
\item \textsuperscript{194} Id., VII C 2.
\item \textsuperscript{195} Id., VII C 1.
\item \textsuperscript{196} Id., VI E.
\item \textsuperscript{197} Id., VI E 6.
\end{itemize}
3. **Investor Suitability Standards**

The Midwest Guidelines impose a variety of investor suitability standards. The syndicator is given some discretion in determining the suitability standards for the real estate syndication. Where the syndicate is designed to maximize tax advantages, the investor must be in a high tax bracket and have a high net worth. A duty is imposed on the syndicating entity to investigate investors and to maintain records on the investors. The minimum investment for a "low risk" syndicate is $2500; $5000 is required for high risk syndicates. Washington does not require suitability standards.

4. **Disclosure Requirements.**

Strict disclosure provisions dominate both the Washington Rules and the Midwest Guidelines. Specific requirements are too numerous to list in detail. The Midwest Guidelines permit, but do not require, projections of future results. Since these projections are designed to help the investor see what the syndicate will mean to him, they "shall be realistic in their predictions and shall clearly identify the assumptions made with respect to all material features of the presentation." Since the projection must be made for ten years into the future or to the planned termination date of the syndicate, whichever is shorter, the early year tax benefits should not be overemphasized. More general projections, such as disclosure of the occupancy rate required to break even, also must be included. Although the Midwest Guidelines prohibit projections for unimproved land, the Washington Rules have no such restrictions.

5. **Special Treatment of Blind Pools**

Unlike the Washington Rules which do not differentiate between
specific property and blind pool syndications, the Midwest Guidelines isolate blind pool syndications for special treatment. Beyond the requirement that blind pools make quarterly reports to the limited partners until all funds are invested,\textsuperscript{207} the Midwest Guidelines contain a number of specific requirements. The blind pool limited partnership must have a minimum of $1,000,000 of paid-in capital after all marketing and organizational expenses,\textsuperscript{208} the offering period is limited to one year, and all proceeds not invested within two years of the date of effectiveness must be returned to the investors.\textsuperscript{209} Blind pool syndicators must have a higher level of experience than specific property syndicators; moreover, the size and scope of projects undertaken by such syndicators cannot exceed their experience.\textsuperscript{210}

Unfortunately, the Midwest Guidelines do not differentiate between blind pool and specific property syndicates in the area of syndicator compensation. It is arguable that the various economies inherent in a blind pool syndication\textsuperscript{211} justify tighter restrictions on compensation. By lumping both types of syndication under one regulatory scheme, the Midwest Guidelines may unnecessarily deter specific property syndications (because the greater risks may not be adequately compensated) and may correspondingly encourage blind pool syndications.

Taken together, the Midwest Guidelines and the Washington Rules markedly increase the substantive regulation of real estate syndications. These new regulations should benefit the investor by limiting syndicator power and profit. Unfortunately, the Midwest Guidelines and the Washington Rules often seek to accomplish the same goals by widely different means, resulting in inconsistent and often irreconcilable restrictions. For example, the Midwest Guidelines require only a majority vote to dissolve a limited partnership while Washington requires a two-thirds vote.\textsuperscript{212} Such inconsistent restrictions may prohibit syndi-

\textsuperscript{207} See text accompanying note 196 supra.
\textsuperscript{208} Midwest Guidelines, supra note 164, VI A.
\textsuperscript{209} Id., VI D.
\textsuperscript{210} Id., VI B. The Midwest Guidelines require "not less than four years relevant experience" for real estate syndicators in general (Id., II A), but "not less than five years experience in the real estate business in an executive capacity and two years experience in the management acquisition of the type of property to be acquired..." for blind pool syndicates (unless the syndicator can convince the state securities administrator that he has sufficient experience otherwise). Id., VI B.
\textsuperscript{211} See note 22 and accompanying text supra.
\textsuperscript{212} See text accompanying notes 186 & 191 supra.
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cates from registering in a large number of states and may hinder the
development of a national real estate syndicate market. Nonetheless, the various proposals for substantive regulation reflect a recognition of the pressing need for increased protection of investors in real estate limited partnerships.

IV. THE NEED FOR FEDERAL SUBSTANTIVE REGULATION

A. Can Regulation Solely by Disclosure Be Justified?

As discussed above, the states are moving in the direction of more substantive regulation of real estate syndications. Given the SEC's recent policy decision to continue to regulate real estate syndications by disclosure only, the much sought-after goal of "consistency" of state and federal regulation seems less and less attainable. The divergent paths of state and federal regulation may yet meet, however, for the SEC has recognized that substantive regulation of real estate syndications may be unavoidable.

While the SEC's Advisory Committee specifically asserted that the real estate limited partnership should continue to be exempted from the Investment Company Act of 1940 (which contains provisions for substantive regulation), both the Committee's report and the statements of (then) SEC Chairman Casey make it clear that if uniform disclosure does not adequately protect the investor, investment company-type regulation will be imposed. This recognition by the SEC that substantive regulation may be necessary invites a comparison of the problems which precipitated investment company substantive reg-


214. See REAC REPORT, supra note 149, Recommendations 11-12. The Investment Company Act of 1940, 15 U.S.C. § 80a (1970), places numerous substantive restrictions on the operation of investment companies. (For a list of the abuses which necessitated the Act see notes 216-21 infra) For example, conflicts of interest and self-dealing are tightly restricted (id., § 80a—10), and investor control over management is bolstered (id., 80a—8(b)(1)). In addition, when the SEC published the revised NASD proposals for public commentary (see note 230 infra), the Commission specifically requested comment on the following question:

3. Should the regulation of issues of these programs be achieved through a comprehensive federal regulatory program rather than NASD rulemaking?

215. See REAC REPORT, supra note 149.
ulation and, more recently, proposals for the substantive regulation of oil and gas limited partnerships with the problems of real estate syndications. Justification for the SEC's differing approach to regulation of investment companies and oil and gas limited partnerships by substantive regulation and regulation of real estate syndications by disclosure alone should be based upon significant distinctions between the problems presented by each type of investment. Yet, upon examination, it is apparent that no such significant distinctions exist.

1. A Comparison with Past and Present Abuses

The abuses which precipitated enactment of the Investment Company Act of 1940 are markedly similar to the abuses rampant in real estate syndication today.216 First, there was little or no control over management once an investor had made his investment. The problem stemmed not from the centralized management of funds, which is inherent in the investment company concept, but rather from the fact that control was not exercised for the benefit of the fund and the investors.217 Real estate limited partnerships face the same problem of divorce of the investor's interest from control.218 Second, conflicts of interest were rampant in the investment company industry. For example, the organizers who controlled the investment companies were frequently large brokerage houses which used the investment company to their own advantage.219 Real estate syndications are similarly plagued with conflicts of interest and self-dealing. Third, investment companies were charged excessive management fees and other hidden fees.220 Real estate syndicates are subject to the same abuses. Finally, congressional awareness of pyramiding and excessive financial power gave further impetus for regulation of investment companies,221 a factor currently not present with real estate syndications.

In summary, three of the four abuses which led to the enactment of the Investment Company Act of 1940 are present in modern real es-

216. See Tolins, The Investment Company Act of 1940, 26 CORNELL L. REV. 77, 84 (1940) [hereinafter cited as Tolins].
217. Id. at 85.
218. Tolins supra note 216, at 86.
219. Id. at 89-90.
220. Id. at 87-89.
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tate syndications. Far from justifying a policy of regulation solely by
disclosure, this similarity in problems leads to the conclusion that sub-
stantive regulation might also be appropriate for real estate syndica-
tions.222

The SEC's recently proposed legislation for the regulation of oil
and gas programs223 raises further questions relating to the lack of
substantive regulation of real estate syndications. Oil and gas pro-
grams and real estate syndications are both used as tax shelter invest-
ments and both normally take the form of a limited partnership.
Again, the problems necessitating regulation of oil and gas limited
partnerships are strikingly similar to the problems which presently
plague real estate syndications. These problems include: (1) the invest-
ment is offered as a tax-sheltered speculation to investors without re-
gard to the investor's suitability; (2) arrangements for management of
oil companies almost always involve elements of self-dealing and
other conflicts of interest; (3) "The multiplicity of complex methods of
compensating managers of oil programs make it practically impossible
for investors to make meaningful comparisons and, in some cases,
such methods appear to provide for high compensation to managers in
relation to the risk they, as opposed to public investors, assume"224 and
(4) "by use of 'redemption' or repurchase features, installment
plans, and increasingly lower minimum investments, many of the pro-
grams have some characteristics of traditional mutual funds."225 The
SEC's proposed statute increases investor protections by providing
specific controls to prevent conflicts of interest and unfair transactions
between oil programs and their managers, and by insuring that pro-
gram managers are financially responsible.226

222. Perhaps the SEC's reluctance to impose investment company-type regulations
on real estate limited partnerships is due in part to the unsuccessful attempts by several
states to use this type of regulation on real estate investment trusts in the early 1960's.
This regulation proved to be unworkable for two reasons: (1) the severe restrictions
removed the incentive to use real estate investment trusts, and (2) different state
standards made blue sky qualification extremely burdensome, if not impossible. See
generally Sobieski, State Securities Regulation of Real Estate Investment Trusts—the
Midwest Position, 48 VA. L. REV. 1069 (1962); Armstrong, An Attorney's Viewpoint,

223. SEC PROPOSED LEGISLATION, REGULATION OF OIL AND GAS PROGRAMS, CCH
FED. SEC. L. REP., Special Report 428 (Jan. 19, 1972) [hereinafter cited as SEC
PROPOSED LEGISLATION].

224. See SEC ANALYSIS OF LEGISLATIVE PROPOSAL FOR OIL AND GAS INVESTMENT
See also SEC PROPOSED LEGISLATION, supra note 223, § 1.

225. Id.

226. Id., § 18.
The proposed bill also provides for greater investor participation. Changes in fundamental policy must be approved by the holders of program participations\textsuperscript{227} and the program manager must function under a written contract which must be approved by program participants.\textsuperscript{228} Significantly, the bill gives the National Association of Securities Dealers (NASD) specific regulatory authority over sales literature, sales charges and suitability and classification of management compensation. The proposed statute does not provide for SEC or NASD regulation of management compensation other than through full and accurate disclosure.\textsuperscript{229}

2. \textit{The NASD Begins Substantive Regulation}

In the background of both the newly announced SEC policy concerning real estate limited partnerships and the SEC's proposed Regulation of Oil and Gas Programs is the NASD’s revised proposed Regulations for Tax Sheltered Programs.\textsuperscript{230} These proposed tax shelter program regulations are to become part of the NASD’s Rules of Fair Practice and are designed to prohibit NASD members from underwriting or participating in the distribution of any tax sheltered program which does not meet prescribed standards of reasonableness and fairness.\textsuperscript{231} Because the marketing, and perhaps even the underwriting, of a national syndicate offering requires utilization of NASD members,\textsuperscript{232} the proposed rules will have a substantial impact on real

\textsuperscript{227} \textit{Id.}, § 10.
\textsuperscript{228} \textit{Id.}, § 13.
\textsuperscript{229} \textit{Id.}, § 19a.
\textsuperscript{231} NASD Proposed Rules, supra note 230.
\textsuperscript{232} Besides registration of brokers and dealers pursuant to the Securities Exchange Act of 1934, 15 U.S.C. § 780 (1970), primary SEC control of over-the-counter brokers and dealers is through the National Association of Securities Dealers (NASD). The NASD is an association of over-the-counter brokers and dealers authorized under the Maloney Act, 15 U.S.C. § 780, designed to regulate members on an ethical level, "to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element of the industry," and "to cope with those methods of doing business which while technically outside the area of illegality, are nonetheless unfair to
estate syndication to the extent that they become binding on NASD members.

The NASD proposed rules impose a number of substantive restrictions. The proposed rules require that the issuer have a minimum level of experience in real estate and that the general partner have a minimum net worth. The syndicate can reinvest distributable cash flow in subsequent programs only after participants are given the option to receive cash. Limited partners (investors) are given the right to remove the sponsor, to amend the partnership agreement, to dissolve the partnership or to approve or disapprove the sale of all or substantially all of the assets of the program.

The proposed rules treat conflicts of interest extensively, dividing them into two groups: those which are permissible subject to regulation and those which are impermissible. Permissible conflicts subject to regulation include sales of property, supplies, services and equipment furnished by the general partner to the syndicate. Property which is owned by the general partner and is sold to the syndicate must, with certain exceptions, be sold at cost or fair market value, whichever is less, regardless of when the general partner purchased the property. Where the general partner furnishes services, supplies, equipment or other property to the syndicate, the fees and prices must be either competitive with similar fees in the area, or contributed at cost (if there is no basis for comparing the fees or prices).

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the customer and the decent competitor." 2 L. Loss, SECURITIES REGULATION 763 (1951) (quoting from legislative history of the Maloney Act). NASD self-regulation is closely supervised by the SEC.

The NASD has a significant degree of power over its members. NASD rules require members to treat nonmember brokers and dealers the same way members of the public are treated. Since members give each other benefits of special discounts in ordinary trading, incentive to obtain and keep membership is quite high. It is virtually impossible for a dealer who is not a member of the NASD to participate in a distribution of any size. Id. at 770.

The NASD rules require elaborate policing provisions and disciplinary procedures.

234. Id., § 2(b).
235. Id., § 2(a).
236. Id., § 2(q).
237. Id., § 3(a) (1-4). However the availability of these rights is conditioned upon the absence of an adverse effect on the participant’s limited liability.
238. Id., § 4.
239. Id., § 4(a)(1) (a-b). The property can be sold to the syndicate at more than cost if the syndicator owned the property for more than one year prior to the formation of the syndicate or there has been a material change of the value of the property since it was acquired.
240. Id.
Impermissible conflicts of interest prohibit the general partner from being the principal or prime tenant of property owned by the syndicate,241 prevent the sale or exchange of any property between syndicates with the same general partner242 and prohibit sales by the general partner of a blind pool syndicate of any services or property unless it is fully disclosed in the prospectus.243 Additionally, the proposed rules require adherence to investor suitability standards.244 Offering, organizational and management expenses for the first year are limited to fifteen percent of the cash receipts of the offering.245 Limited use of projections is permitted,246 but the content of these projections is standardized, requiring a "Distributable Cash Flow Statement," a "Tax Statement" and a "Combined Cash Flow and Tax Statement."247 The proposed rules do not permit illustrations unless reliable data are available.248

Because continued NASD membership is crucial to members, fairly close adherence to the proposed rules can be expected.249 NASD disciplinary proceedings can result from discrepancies discovered in NASD inspections or from general complaints. (An adverse determination by the NASD can mean suspension or revocation of membership.) Of equal importance has been a trend toward imposing civil liability for violation of NASD rules.250

The NASD's proposed rules may be a significant supplement to SEC regulation. Although the SEC has not approved the proposals as of this writing, it regards the NASD regulations as supplements to its own regulations.251 Yet to the extent that the NASD proposed rules substantively affect real estate syndications, they are inconsistent with the SEC's policy of regulation solely by disclosure.

241. Id., § 4(b)(1).
242. Id., § 4(b)(3).
243. Id., § 4(b)(5). The NASD uses the term "unspecified property program" in place of "blind pool." The original NASD definition referred directly to "blind pool."
244. Id., § 5.
245. Id., § 6(a)(2).
246. Id., § 9(e).
247. Id., § 9(e)(1)(c).
248. Id., § 9(e)(1)(d-f).
249. See note 232 supra.
251. See notes 230 & 232 supra.

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It appears that state and private regulators are responding to the problems in real estate syndication by moving in the direction of increased substantive regulation. When confronted with similar problems in the areas of investment company and oil and gas program regulation, the SEC also has responded with substantive regulation. Given the fact that every regulatory agency other than the SEC is increasing the substantive regulation of real estate syndications, the goal of a consistent regulatory policy to guarantee access to the national capital market will be unattainable so long as the SEC adheres to its policy of regulation solely by disclosure.

B. The Prime Candidate for Federal Substantive Regulation: Blind Pool Syndications

The basic differences between specific property and blind pool real estate syndicates are ignored by the SEC's current policy of real estate syndication regulation solely by disclosure. In contrast with specific property syndications for which disclosure alone seems generally adequate, blind pool syndications seem especially amenable to federal substantive regulation.

Blind pools markedly resemble investment companies which are already subject to federal substantive regulation. Both enable a number of investors to pool their funds in order to reap the benefit of intelligent investment in a diversified portfolio of securities or property. Both allow an ordinary investor without the time, finances or expertise to participate in the securities or real estate markets. In general, blind pool syndicates are subject to the same kinds of abuses which necessitated substantive regulation of investment companies.

Regulation of blind pools by disclosure alone seems destined to be inadequate. Because property is not owned when the initial offering is made, the required projections which are the key to SEC disclosure policy for real estate limited partnerships are not possible with a blind pool syndicate. Increased disclosure of the types of investment property can be meaningless. Further, no additional disclosure of prior experience or net worth beyond that required of specific property syndicators is required of blind pool syndicators even though investors are forced to rely more heavily on the syndicator's judgment.

252. See, e.g., note 114 supra.
Because of the problems in their format, blind pools are beginning to receive specialized substantive treatment from existing regulators. The Midwest Guidelines place a number of special restrictions on blind pools including a limited offering period, a minimum amount of initial investment capital after marketing and organizational expenses, a limited investment period after the capital is raised and provisions for quarterly reports to the limited partners during this investment period. The Proposed NASD Rules also contain special provisions for "unspecified property programs." A blind pool syndicator is prohibited from selling any service or any property to the syndicate unless it was previously disclosed in the prospectus;\textsuperscript{253} blind pools can pay management fees only from operating income;\textsuperscript{254} deferred subscription plans\textsuperscript{255} and provisions for levying assessments\textsuperscript{256} are flatly prohibited. The newly adopted California Real Estate Syndication Rules impose special substantive requirements upon blind pool syndicators, such as prior experience standards.\textsuperscript{257} Clearly, the trend is toward recognizing the special characteristics of blind pools.\textsuperscript{258}

Currently most of the real estate syndicates which register with the SEC are blind pools.\textsuperscript{259} Special treatment of blind pools by the SEC would have an immediate national impact. Indeed, to avoid abdicating meaningful regulation of real estate syndications to the patchwork state regulatory schemes, the SEC may find it necessary to reevaluate its policy of regulating blind pool syndications solely by disclosure.

\textsuperscript{253} NASD Proposed Rules, supra note 230, § 4(b)(5).
\textsuperscript{254} Id., § 7(a)(9).
\textsuperscript{255} Id., § 2(h).
\textsuperscript{256} Id., § 2(k).
\textsuperscript{257} 10 CAL. AD. CODE § 260.140.115(2) (1973). See note 162 supra.
\textsuperscript{258} Despite this special treatment, both the proposed NASD Rules and the Midwest Guidelines are subject to criticism for failure to differentiate between blind pool and specific property syndicates in other areas as well. The NASD's 15% limit on organization and offering expenses applies to both kinds of syndicate. (See note 245 and accompanying text supra.) The Midwest Guidelines likewise fail to account for the economies inherent in blind pools when establishing arbitrary limits in syndicator compensation. (See text accompanying note 211 supra.) The previous experience and net worth minimums set by the NASD for syndicators are the same regardless of the type of syndication being offered. (See note 210 and accompanying text supra.)
\textsuperscript{259} See Nov., 1972, REAL ESTATE SYNDICATION DIGEST 3-19 for a listing of recent real estate syndications.
CONCLUSION

The only consensus that can be gathered from this maze of proposals, rules and reports is that there are serious problems with existing methods of regulating real estate syndication. The real estate limited partnership presents substantial problems for the regulator. Reducing the many opportunities for self-dealing and conflicts of interest and forcing a syndicator to offer an investor a prospectus with a balance between tax shelter and economic soundness is not an easy regulatory task. Moreover, the substantial need for such regulation is underscored by two factors which inhibit the ability of the investor to fend for himself—lack of transferability and the lack of investor control inherent in limited partnership interests.

Existing disclosure requirements seem largely ineffectual in combating the problems in real estate syndications. Typically, neither the investor nor the investment adviser can make much sense out of the prospectus. Most if not all syndicate offerings are new offerings with no past business history to rely upon. When projections are not permitted or a business history is not available, the investor is left to consider numerous and confusing "risk" factors, the claimed "quality" and "value" of the project and incomprehensible disclosures concerning syndicator compensation. The high risk factors, especially those relating to the tax aspects of the syndicate, can add to this confusion by being construed to be selling points for the syndicate.

Specific proposals to substantively regulate real estate limited partnerships, though properly motivated, inevitably create some problems. Regulation of syndicator compensation is a very troublesome issue, especially when arbitrary lines are drawn. Nevertheless, some aspects of substantive regulation, including increased control for limited partners and outright proscriptions of certain conflicts of interest, can only be viewed as beneficial.

Perhaps the major problem posed by substantive regulation of real estate limited partnerships is the multiplicity of standards being developed by different regulators. Where the NASD and the several states require compliance with diverse substantive provisions governing the syndicate offering, qualification in all states may become burdensome and expensive, if not impossible.260 In addition, substantive regulation

260. Unlike the normal corporate offering, where most states allow registration by coordination when the corporation has registered with the SEC, real estate syndications
can conflict with the SEC's policy of regulation solely by disclosure. Because the divergent patterns of regulation decrease the chances of achieving nationwide access to the capital market for real estate securities, the SEC's proposal that all parties concerned with the regulation of real estate syndications get together and work out a "consistent" policy of regulation makes eminent sense.261

The SEC's policy decision to regulate real estate syndications exclusively by disclosure must be seriously questioned however. There is a marked inconsistency between this pronounced exclusive disclosure policy and the SEC's support of substantive NASD regulation. Further, the SEC's response to similar problems in the investment company and oil and gas limited partnership areas has been substantive regulation.

It seems particularly inconsistent for the SEC not to substantively regulate blind pool syndicates. Projections are typically meaningless with blind pools because no property is owned when the offering is made and existing disclosure requirements are easily circumvented. Because the eventual success or failure of a blind pool depends upon the background and experience of the general partner, strict disclosure and substantive regulation of experience and net worth seems necessary. In addition, blind pool syndications merit such substantive investor protections as a limited offering period, minimum initial investment capital requirements and a limited investment period with special quarterly reports to the limited partners.

While the Midwest Guidelines accord blind pools special treatment as suggested above, most state blue sky commissions fail to differentiate between blind pool and specific property syndications. Not recognizing these differences can unintentionally promote the use of blind pool syndications, since a syndicator can often make more money within the limits set by the state regulations by utilizing a blind pool syndicate with its low organizational expenses and decreased risks. The specific property syndicator whose compensation is unreasonably restricted and whose organizational costs are extremely high, in part

will probably have to conform to the various substantive requirements of each state's real estate limited partnership rules.

261. A start was apparently made for coordinating efforts to regulate real estate syndications when a meeting of SEC staff, NASD officials and various state securities regulators was held during the last week in December, 1972. See [July-Dec. 1972 Transfer Binder] BNA Sec. Reg. & L. Report No. 179.
because of stringent disclosure requirements, may not be able to com-
pete with the blind pool syndicator.

It is clear that a consistent if not uniform policy of regulation of
real estate limited partnerships would be most advantageous. It is also
clear that the blind pool syndication, although similar in many ways
to the specific property syndication, presents unique problems for the
regulator. Because of these problems, the blind pool syndicate should
be specially regulated by the SEC and the states. Federal substantive
regulation seems appropriate.

The specific property syndication, on the other hand, is more ap-
propriately regulated solely by disclosure with the exception of certain
requirements for some degree of limited partner control over the gen-
eral partner and proscription of flagrant conflict of interest abuses.
The specific property syndication can present adequate descriptions of
the subject property, which is the basis of the value of the syndicate, 262
and can make fairly reliable projections of future earnings. Be-
cause the syndicator must generally present a similar analysis of the
virtues of the development to the primary lender, there appears to be
no reason why he cannot make projections to the investor in an un-
derstandable fashion. These projections should include a comprehen-
sive comparison of tax shelter, cash flow benefits and promoter com-
pensation. The SEC's requirement that projections be based on cer-
tain standard assumptions seems helpful, as does the Midwest Guide-
lines' requirement that the downside potential and consequences be
disclosed in the projection. In short, a combination of the best aspects
of the SEC, NASD and Midwest requirements would result in the dis-
closure of highly useful information to the investor. Regulation solely
by disclosure should allow the specific property syndication to con-
tinue to be an attractive method of financing real estate development.

Recognizing the basis distinctions between the blind pool syndica-
tion and the specific property syndication leads to the most rational
approach to regulation. Unfortunately, the SEC and many state secur-

262. One way of doing this is to require the opinion of an independent appraiser as
to the value of the property including a statement of the appraiser's assumptions and
factors which might lessen the value of the property. The appraiser's estimate of value
might include a final estimate and also a range of values and should state why the final
estimate was chosen. Since bare estimates of value can often be meaningless or mislead-
ing, this additional type of report is necessary, but not burdensome, as the typical ap-
praisal will include a detailed report by the appraiser.
ities administrators treat the blind pool syndicate as the equivalent of the specific property syndicate and regulate both in much the same way. However, the practical differences between these two approaches to syndication, the potential abuses of the blind pool syndicate and the history of regulation of investment companies dictate a contrary conclusion.

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