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Arbitration of Limited Partnership Cases

By Douglas J. Schulz*

Securities attorneys are being called upon more often than ever to evaluate limited partnerships, a task which can be extremely arduous given the volume of paperwork involved and the complexity of the investment itself. Most limited partnership investments were made in the 1980's, and it has taken investors a number of years to realize they were not as lucrative as first promised. Estimates are that if all investors liquidated their limited partnerships today, only 25% would realize a return of their original equity. Limited partnerships were risk laden, loaded with up-front management fees, poorly structured, and riddled with conflicts of interest. It is important for both claimant and defense attorneys to understand the risks of limited partnerships and, in suitability cases, how these risks meshed with the goals, needs and desires of the client.

Since 1980, over \$100 billion of limited partnerships have been sold, with over one half of that amount constituting sales of real estate limited partnerships. 1987 was the most productive year, with sales declining ever since due to changes in the tax laws and investor disenchantment.

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Battling Time

The Statute of Limitations in Securities Arbitration: How to Extend Limitations Periods and Circumvent the Shortened Periods Under the Federal Securities Acts

By Seth E. Lipner and Herbert M. Deutsch*

It is not uncommon for attorneys representing broker-dealers in securities arbitrations to raise issues of expiration of the statute of limitations as part of their defense. The likelihood that such issues will arise was increased recently as a result of Lampf v. Gilbertson, 501 U.S. ___ (1991), where it was held that the statute of limitations for suitability claims under the federal securities acts was one year from discovery, but never more than three years from the fraud. This short limitations period, which would appear to allow of

no exceptions or equitable tolls, has been decried as seriously undermining the aggrieved investor's ability to obtain relief.

The purpose of this article is to demonstrate that the Lampf case is not
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The driving force behind the sale of so many partnerships by brokerage firms was the high level of commissions and fees, making limited partnerships a significant profit center. Likewise, the 8% gross sales commission generated by the broker is about the highest percentage the broker can earn on any one product. The broker's percentage payout is also among the highest attainable on any product. The average limited partnership investment was larger than most investments made by clients; therefore, sales could be the highest commission generators for brokers.

Of course, such fees are not out of line with commission charges on mutual funds or public offerings of stock, which also concern initial (or continuing) distributions of an investment. Moreover, limited partnerships are longer-term vehicles for investment, so the money, once invested, remains tied up for some time. Their structure dictates a long-term outlook, plus frequent limitations on transferability and the lack of a ready secondary market. Indeed, this long-term character was a factor in the impression many investors and brokers alike assumed that the partnerships involved only conservative risks. As a result, in the worst instances, there were promises of safety, impeccable management, and forecasts of exceptional returns that did not materialize.

For defense attorneys, a limited partnership case may be more difficult to defend than most, where the brokerage firm bears much culpability for the way limited partnerships were both organized and marketed to brokers. In many cases, brokers merely repeated to their clients what they were told about the limited partnerships by the brokerage firms. A great majority of limited partnership claims involve unsuitability allegations. It is no wonder, since the point-of-sale situation often presented the explosive mixture of an income-seeking, rather conservative investor, high commissions, and a broker who did not fully comprehend the risks inherent in a complex product.

A typical real estate limited partnership is replete with risks, which are the subjects of disclosure in the Prospectus. For example, many are formed under a "blind pool;" at the time of the investment, properties have not yet been purchased. Therefore, even an experienced investor cannot evaluate what he is purchasing. Another risk is that there is not an established secondary market for most limited partnerships; this illiquidity disallows for a bail-out should the investment go bad. That is why, in many arbitration Awards concerning limited partnership disputes, the Award grants rescission, compelling the brokerage firm to return the adjusted purchase price in exchange for a tender of the Claimant's limited partnership interests.

Additionally, leveraged investments mean higher risks. Not only are the limited partnerships oftentimes leveraged; the Prospectus sometimes allows leverage as high as 100%. One of the advantages of limited partnerships is supposed to be limited liability; yet, some investors have been exposed to liability, through recourse notes and otherwise, that have caused them liability in excess of their initial cash investment. Beyond the risks of the specific partnership, there are the general risks of real estate investments. Some prospectuses are thorough enough to list these general risks; many that I have read do not.

Commissions and fees add to the risk of a particular investment, too, because the investment cannot realize a profit or a return of capital until these costs are overcome by the investment. Front-end fees on a real estate limited partnership can run 18-20%. The investor, in such a situation, has an uphill battle from the beginning, with only 80% of his investment in the ground. In addition to the front-end fees, there can be hefty administrative expenses and management fees, assessed by the general partner and its affiliates.

Tax consequences can be one of the greatest risks a client can assume in purchasing a limited partnership. For

many investors, promised tax advantages are a large factor in the investment decision. If an investor is not careful, he may subject all of his income to calculation under alternative minimum tax computation, which could force him into a higher tax bracket overall. It is also possible for an investor to have tax liability which exceeds his yearly distribution. In addition to these yearly shortfalls, some investors have been hit with a single tax bill in an amount which exceeded their initial investment for income they never received. Other tax risks include depreciation recapture, partnership status changes, reallocation of losses and auditing.

The final area of risk is the conflicts of interest which the general partner has. A general partner has incentive to transact on behalf of the limited partnership because he receives commissions and fees for each transaction. Conflicts may arise when the general partner takes actions which may not be in the best interest of the limited partnership in order to generate fees and commissions. In addition, the general partner may have an incentive not to liquidate these partnerships even if they are performing poorly, since the transaction fees, commissions, and management fees are a major source of his income. General partners also manage their own real estate investments, in addition to other real estate limited partnerships. Interrelated transactions do occur and are permitted by federal and state regulators, assuming adequate disclosure in the Prospectus. Such potential conflicts become relevant to brokerage arbitrations, where the brokerage firm, as sponsor or selling agent, failed to assure adequate due diligence, disclosure, or oversight regarding an errant general partner's activities.

For both defense and claimants' attorneys, understanding the role of an expert witness in limited partnership cases can be crucial to the outcome. An expert witness needs to explain to the arbitration panel the risks of this com-

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plicated investment vehicle and how these risks were suitable or not for the investor. For defense attorneys, an expert witness can be used to offset the negative press limited partnerships have received recently and to counteract the claimant's expert witness. An expert witness will also assist in formulating and defending against discovery requests.

For claimant's cases, the expert should carefully scrutinize what investments can be made by the limited partnership. Investors may be shocked to learn that their limited partnership was investing in other limited partnerships, not direct investments in real estate. An investor may have thus taken on additional risk and conflicts with no opportunity to assess same.

For both sides, the expert will also testify to the economics of the limited partnership; for example, he will calculate yield to date, current yield, as well as the current value and status of the limited partnership. Such testimony will be of benefit to the arbitration panel in reaching any conclusions on appropriate damages.
