REAL ESTATE PARTNERSHIPS AND THE SECURITIES LAWS: A PRIMER

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INTRODUCTION

The limited partnership is an extremely popular investment vehicle for real estate developers. It avoids the double taxation inherent in the corporate form of organization and, at the same time, affords limited liability for the limited partners. Moreover, limited partnerships can provide investors with important tax advantages. In many instances, an investor in a real estate partnership is able to deduct all or at least a substantial portion of his initial capital investment from his taxable income in the first year of investment.

Generally, the sale of limited partnership interests involves the sale of securities for purposes of the federal and state securities laws. While this fact is well known and not particularly earth-shattering, the manner in which some real estate partnerships attempt compliance with the applicable securities laws is often incomplete and could expose the partnership to serious liability. As most real estate developers are unwilling to bear the expense of registering their offerings with the Securities and Exchange Commission or the appropriate state agencies, or are prohibited from doing so because of time constraints, they must rely upon the var-

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1. A corporation as an entity is subject to a corporate income tax, and its shareholders are subject to taxation upon the receipt of dividends. I.R.C. §§ 12, 61, 63. A partnership, on the other hand, is taxed only on the partner level. I.R.C. § 701. See generally W. McKEE, W. NELSON, & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS § 1.01 (1977).


ious exemptions from registration available on both the federal and state levels. Failure to strictly comply with the requirements of the exemptions relied upon results in potential liability under the securities laws. Thus, the absence of experienced securities counsel needlessly places the success of the entire real estate venture in jeopardy.

This article will identify the securities problems that arise when limited partnership interests in a real estate partnership are offered to investors; it is intended to be a primer for the general practitioner who does not encounter the securities laws on a regular basis. In addition to a discussion of the various federal and state exemptions from registration that may be available, special attention will be directed to preparation of a formal disclosure document that should be distributed to all prospective purchasers of limited partnership interests.

GENERAL ATTRIBUTES OF A REAL ESTATE PARTNERSHIP

The term real estate partnership as used in this article refers to a partnership formed to develop a specific parcel of real estate. Generally, a construction company is the major force behind the proposed real estate project, and usually an affiliate of the construction company will serve as general partner for the limited partnership. The general partner and/or other affiliates of the construction company may also perform real estate brokerage functions on behalf of the partnership and manage the project. Thus, the developer-construction company receives substantial compensation for constructing the improvements on the subject real estate, and its affiliates receive compensation in connection with operating or selling the improvements. As will be discussed later in this article, these contractual arrangements between the

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5. For a discussion of available exemptions, see notes 31-87 and accompanying text infra.
6. See generally 3 H. Bloomenthal, supra note 3, at §§ 8.01-.29; Exemptions, supra note 4, at 977-78.
7. Other forms of real estate syndications such as nonspecified property programs (less than 75% of the proceeds of an offering of real estate program interests is to be used for the purchase and development of specified properties) and real estate investment trusts are beyond the scope of this article. For a general discussion of such, see Hrusoff & Cazares, Formation of the Public Limited Partnership, 22 Hast. L.J. 87, 96-100 (1970).
8. The term "affiliate" as used herein means "a person [individual or entity] that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." Rule 405, 17 C.F.R. § 210.1-02 (1978).
9. Special considerations are involved if a partnership has a sole corporate general partner. See 1 W. McKee, W. Nelson & R. Whitmire, supra note 1, at ¶ 3.07.
partnership and its principals give rise to potential conflicts of interests and must be fully disclosed to the limited partners before they purchase their limited partnership interests.\(^\text{10}\)

The limited partners are generally outside, passive investors who contribute the initial capital of the real estate partnership by purchasing limited partnership interests. Investment in a limited partnership offers many attractive features to a limited partner. It allows an investor to own income-producing property and simultaneously purchase professional management, while limiting his actual investment.

The primary attractiveness of a limited partnership usually lies with the tax advantages inherent in its basic structure. The partnership, as an entity, is not subject to taxation.\(^\text{11}\) Instead, it is a conduit through which tax deductions and taxable income are passed to the general and limited partners. Partnership gain or loss is allocated directly to such partners pursuant to the terms of the limited partnership agreement. If the partnership were an association taxable as a corporation, on the other hand, the partnership itself would be entitled to the deductions for the costs incurred in developing the real estate and would be taxed on the income; the partners would receive no direct deductions and would be taxed on distributions from the partnership as dividends to the extent of current or accumulated earnings and profits of the partnership.

Deductions for limited partners in real estate partnerships can be as high as their initial capital investment in the very year their interests are purchased.\(^\text{12}\) Deductions can be enhanced, for example, by using part of the proceeds of the limited partnership interests offering to prepay mortgage interest; to pay a commitment fee incurred in obtaining the financing needed to purchase partnership property; to pay the legal and accounting fees incurred by the partnership in connection with the offering; and to pay the deductible portion of the management fees. The partnership may also adopt an accelerated method of depreciation.

Limited partnerships are attractive even if their objectives do not include the sheltering of an investor's income from outside sources, and there is a substantial cash flow produced by the part-

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\(^{10}\) See notes 141-142 and accompanying text infra. See also Sperling & Lokken, supra note 2, at 1-9.

\(^{11}\) For an excellent discussion of partnership tax law, see generally W. McKee, W. Nelson & R. Whitmire, supra note 1.

\(^{12}\) Real estate was specifically excluded from the "at risk" provisions of the Tax Reform Act of 1978. I.R.C. § 465(c)(3)(D). See also W. McKee, W. Nelson & R. Whitmire, supra note 1, at ¶ 2.02(4)[a].
nership. In such a partnership, none or only a small portion of the investor's capital contribution is deductible. While the cash flow generated is generally subject to income taxes, such taxable income is reduced by partnership tax deductions. In many respects, a cash flow partnership resembles a real estate investment trust ("REIT"), but it is not subject to the restrictive provisions contained in the REIT legislation.13

A limited partnership can also be used to raise funds for the purpose of purchasing raw real estate and holding it for resale. No development or improvements are even contemplated by such partnerships. They merely intend to profit from the anticipated appreciation in the real estate purchased with the funds raised by selling limited partnership interests.

The many rights and obligations of general partners and limited partners are dictated by the limited partnership agreement. Obviously it is extremely important that the limited partnership agreement be drafted with extreme care. If the agreement does not effect the intended tax consequences or cash flow distributions, the benefits of the partnership form of organization can be adversely affected.

**TYPES OF SECURITIES**

Besides the obvious security, the limited partnership interest, real estate partnerships may inadvertently sell other interests or investments that are subject to the securities acts. General partnership interests, for example, can be classified as securities in certain instances.14 As a general partnership interest is not a conventional security in the sense of a share of corporate stock, whether a general partnership interest constitutes a security must be analyzed under the classic definition set forth by the United States Supreme Court in SEC v. W. J. Howey Co.: "[a]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is lead to expect profits solely from the efforts of the promoter or a third party. . . ."15 If a general partner

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does not have the right to participate in the management affairs of the partnership, it has been held that his general partnership interest constitutes a security, provided all the other elements of an investment contract are present.\textsuperscript{16}

The partnership agreement may provide, for example, that certain general partners have no voice in partnership matters. While in theory general partners have equal rights to participate in management of the partnership, a provision in a partnership agreement which lodges all control in designated partners creates a situation where passive general partners are relying on others to generate profits.

Some courts have elected to analyze the question of whether general partnership interests constitute securities by asking whether the partnership involved is a "bona fide partnership."\textsuperscript{17} The effect of the test is that if a partnership is bona fide, a general partnership interest in that entity cannot be a security. The chief criterion of a bona fide partnership is that there is the right of \textit{delectus personarum}, the right to determine membership.\textsuperscript{18} In other words, a bona fide partnership is based upon a personal relationship and is a select, closed group. By definition, interests in bona fide partnerships are never indiscriminately offered to the public at large and thus never constitute securities.

The bona fide partnership analysis is lacking because it ignores the crucial question: Is there an investment in a common venture in which the investor expects to profit from the efforts of


\textsuperscript{18.} \textit{Erwin, Partnership Interests as Securities: An Alice in Wonderland Tour, 9 CREIGHTON L. REV. 310, 324-25 (1975); Long, Partnership, Limited Partnership, and Joint Venture Interests as Securities, 37 Mo. L. REV. 581, 606 (1972).}
others? A limited partner in a bona fide partnership, for example, has not by definition purchased a security. The better test involves an analysis employing the principles enunciated in Howey.

In summation, the best test for determining whether a general partnership interest constitutes a security is whether the general partner has the right to actively participate in the management decisions of the partnership. This is not to say that general partners having a voice in partnership matters cannot delegate managerial responsibility to one or a small group of general partners. The important consideration is that the general partner delegating such managerial responsibilities has the right, if he desires, to participate in managerial decisions.

The concept that real estate itself could be considered a security was also an important contribution of the Howey decision. In that case, the United States Supreme Court held that an ownership interest in an orange grove that was to be operated by the developer for the benefit of all purchasers of such interests was a security. The determinative consideration is whether there is an investment contract. Professor Loss has further analyzed this concept:

[N]o 'investment contract' is involved when a person invests in real estate, with the hope perhaps of earning a profit as the result of a general increase in values concurrent with the development of the neighborhood, as long as he does not do so as part of an enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others.

Several cases have considered the issue of whether the sale of real estate constitutes the sale of a security. The determinative fac-

tors gleaned from these cases are as follows: (1) whether the purchaser bought the real estate as an investment, rather than as a residence;23 (2) whether the seller emphasized the investment nature of the real estate or its use for residential purposes;24 (3) whether the seller impliedly or expressly promised to develop and improve the real estate;25 (4) whether the seller was contractually obligated (expressly or impliedly) to perform management services with respect to the real estate;26 (5) whether there exists a "common enterprise" between the parties;27 and (6) whether the purchasers had any control over or participation in the improvement of the real estate development.28

Therefore, a real estate partnership could conceivably sell securities on different levels. First, the sale of limited partnership interests involves the sale of securities in most instances. Second, general partnership interests, in the absence of the right to participate in managerial decisions, can be investment contracts. Third, if the partnership develops real estate and sells residential lots or other interests in the real estate, or provides management services, this sale may constitute the sale of securities.

EXEMPTIONS FROM REGISTRATION UNDER FEDERAL AND STATE SECURITIES ACTS

OBTAINING INFORMATION FROM THE ISSUER

When confronted with a possible offering of limited partnership interests in a real estate partnership, the most difficult task for counsel is to obtain and marshal the material facts concerning

the proposed offering. This is especially true if counsel has had no dealings with the issuer or its principals prior to the proposed offering. The best way to initiate the information gathering process is to distribute questionnaires to the issuer and the principals that will be involved in the offering. One questionnaire should seek information specifically concerning the issuer and the proposed offering. The other questionnaire should ask personal questions regarding the experience and general backgrounds of the principals.

The issuer questionnaire should seek all general information concerning the real estate partnership, such as its name, address and telephone number, and date and location of filing of the certificate of limited partnership. It must inquire as to the name, residence address, and telephone number of each general partner and of each original limited partner. If the certificate of limited partnership and the limited partnership agreement have not been executed, the issuer questionnaire should also include questions concerning the information that is required in the certificate of limited partnership under the Uniform Limited Partnership Act.

In the questionnaire distributed to the issuer, a section should specifically pertain to the details of the proposed offering of limited partnership interests. Generally, the following information should be sought: (1) the maximum number of limited partnership interests to be offered; (2) the price per unit; (3) the terms of the purchase price (wholly in cash or in installments); (4) terms of the escrow arrangement; (5) refund provisions if a specified number of limited partnership interests are not sold by a specified date; (6) whether there will be different classes of limited partnership interests and the distinguishing characteristics of each class; (7) description of how the proceeds of the offering will be used; (8) the names and addresses of the parties selling or promoting the proposed offering; (9) whether the promoters are registered with the SEC or any state securities agency; (10) the states in which the proposed offering will be made; (11) whether the general partners or their affiliates will be allowed to purchase limited partnership interests if some remain unsold by a specified date, and if so allowed, whether they are required to purchase them; (12) whether any units purchased by general partners or their affiliates are to be included in satisfying any minimum offering requirements; and (13) whether the general partners or their affiliates contemplate reselling any units purchased.

A physical description of the properties to be developed by the partnership should be requested in the issuer questionnaire. The
issuer should include a legal description of the real estate, the address where such real estate is located, and pertinent facts regarding the surrounding community that relate to the potential success of the project, such as the availability of public transportation, access by highway, the proximity of schools, and the availability of various utilities. The issuer questionnaire should also contain questions pertaining to the manner in which the real estate will be or has been acquired, whether such real estate has been appraised and the name of the appraiser, and a construction timetable for the project.

There should also be included specific questions relating to risks or burdens particularly associated with the proposed real estate development (competitive factors, environmental regulations, rent control regulations, and fuel or energy requirements and regulations), whether there will be a government subsidy program used in connection with the development of the project, the amount and the terms of any debt to be incurred by the partnership, and whether any bank or other financial institution will work closely with the partnership in connection with the development of the project. Inquiries should also be made concerning any conflicts of interest which may arise between the general partners and/or their affiliates and the partnership. Disclosure of such conflicts of interest must be made in the formal disclosure document prepared in connection with the offering.

Finally, the issuer questionnaire must request specific information in regard to affiliated corporations, partnerships, or other business entities owned or operated by the general partners and their affiliates. The track record for each entity affiliated with the general partners and promoters must be obtained. Besides the general questions concerning these affiliated entities, specific information must be received concerning any issuance of securities by them, particularly any real estate partnerships. For each real estate partnership, the partnership’s accountant should be requested to fill out Table II contained in SEC Guide No. 60.

29. The United States government administers several loan programs to promote the construction of housing for lower income people and the elderly. See, e.g., 42 U.S.C. §§ 1404a-40, 1485, 1490a (1976). If such a subsidy program is utilized, counsel must become familiar with the applicable program even if he does not represent the partnership in connection with the government loan application because such program is an essential part of the proposed real estate project.

A second questionnaire should be distributed to all principals involved in the proposed offering of limited partnership interests. The principal questionnaire should contain the following information: (1) name, residence address and residence telephone number, and business address and business telephone number; (2) date and place of birth; (3) relationship to issuer; (4) compensation received from issuer or affiliates; (5) total income; (6) the amount of time that will be devoted to the business of the issuer; (7) details concerning occupation for the last ten years, including the date of initial employment, the date the employment terminated, the name and address of the employer, the nature of the position, and the reason for leaving the employment; (8) details of formal education and specialized training; (9) whether or not a member of any organizations relating to the occupation or the business of the issuer; (10) other positions held that would be of interest to a prospective investor (governmental, civic, or charitable positions); (11) details concerning ownership of common stock or other equity interests of the issuer or its affiliates; (12) whether involved in any pending litigation; (13) whether is or has ever been a licensed dealer or salesman of securities; (14) whether is or has ever been a registered dealer in securities under a securities exchange or SEC registration and details relating thereto; (15) nature and amount of judgments existing against subject of the questionnaire or spouse; (16) current and past affiliations as an officer, director, trustee, or member of any corporation, syndicate, association, or partnership and details relating thereto; (17) whether ever personally bankrupt or whether affiliated with any business concern that became insolvent or suffered involuntary bankruptcy; (18) whether salary paid by issuer is to be paid from proceeds of the sale of the proposed offering; (19) details concerning any charges of misrepresentation or fraudulent acts of any kind or character; (20) details concerning any arrests other than traffic violations; (21) social security number; (22) details concerning any refusal by a surety company to issue surety or fidelity bond coverage or any payments made by a surety company relating to coverage under a surety or fidelity bond; (23) details concerning any material interest in or any material transaction with the issuer or its affiliates (other than equity interests in issuer or its affiliates); (24) details concerning any possible securities violations or charges of securities violations (including any suspensions or expulsions from membership in any securities associations or securities exchanges); (25) details concerning involvement with any registra-
tion statements filed with the SEC within the last five years; (26) details concerning involvement with any unregistered offerings of securities within the previous five years; and (27) confirmation regarding lack of involvement with any current offering or contemplated offering of any securities in addition to the proposed offering of limited partnership interests.

Obviously, no completed questionnaire can contain all necessary information, but the answers to the foregoing questions should provide counsel with enough information to ask more penetrating questions if needed. With respect to both questionnaires, it is imperative that counsel secure complete answers. Counsel should impress on the issuer and its principals that his legal work cannot be commenced until the questionnaires are completed in full.

**Federal Exemptions**

In general, counsel may rely upon three different exemptions from registration under the Securities Act of 1933: the private offering exemption, the intrastate exemption, and the small offering exemption.

**The Small Offering Exemption**

The relatively new small offering exemption is available as long as the provisions of Rule 240 are strictly satisfied. Generally,

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34. Unlike the private offering and intrastate exemptions, the small offering exemption did not exist before the adoption of Rule 240 by the SEC, which was effective March 15, 1975.

35. 17 C.F.R. § 230.240 (1978). Interestingly, as originally proposed, Rule 240 did not apply to the sale of limited partnership interests. [1973-74 Transfer Binder]
to secure an exemption pursuant to Rule 240, the following conditions must be met:

(1) the aggregate sales price of the unregistered securities of the issuer sold during any consecutive twelve-month period cannot exceed $100,000;36

(2) immediately before and immediately after an offering is made in reliance on Rule 240, the issuer must have reasonable grounds to believe, and in fact believe, that its securities are beneficially owned by 100 or fewer persons;37

(3) there cannot be resale of the securities issued pursuant to Rule 240 without registration under the Securities Act of 1933 or exemption therefrom; the issuer must exercise reasonable care to assure that the purchasers are not buying with the intent to resell the securities.38 The exercise of reasonable care includes making reasonable inquiry as to the purchaser's investment intent; informing the purchaser of the restrictions on resale; and placing a legend on the certificate evidencing the limited partnership interests that sets forth specific restrictions on transferability;39

(4) within ten days after the close of the first month in which a sale in reliance on Rule 240 is made, the issuer must file, with the regional office of the SEC for the region in which the issuer's principal business operations are conducted, three copies of a notice on Form 240, signed by a duly authorized person on behalf of the issuer.40

The major drawback to Rule 240 is the $100,000 aggregate sales price ceiling. Another serious drawback is that a purchaser generally has to hold the securities indefinitely because of the limitations upon resale.

Intrastate Exemption

An intrastate offering of securities is exempted from federal registration under section 3(a)(11) of the Securities Act of 1933.41 Rule 14742 is an administrative pronouncement promulgated by the SEC relating to the intrastate exemption and it represents a safe harbor if all of its conditions are met. It is conceivable that a sec-

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37. Id. § 230.240(f).
38. Id. § 230.240(g).
39. Id. §§ 230.240(g)(1)-(3).
40. Id. § 230.240(h)(1).
42. 17 C.F.R. § 230.147 (1978).
tion 3(a)(11) exemption is available outside of Rule 147, but it is prudent to comply with the Rule where possible as it represents the Commission’s administrative interpretation of the intrastate offering exemption. As with all exemptions, the issuer has the burden of showing that it has complied with the Rule and that the offering should not be integrated with other offerings of the issuer.43

In order to comply with the exemption afforded by Rule 147, all of the following conditions must be met:

1) The partnership must be a resident, and doing business in the state in which the offers and sales of the limited partnership interests are made—the subject state.44 The partnership will be deemed to be doing business in the subject state provided that at least 80% of its assets are located in such state, it intends to use and substantially uses at least 80% of the net proceeds from the offering in such state, and its principal office is located in the subject state.45 Additionally, the partnership is a resident provided it was organized under the law of the subject state.46

2) All offerees and purchasers must have their principal residence in the subject state.47

3) A legend must appear on the face of the certificates evidencing the limited partnership interests stating that the certificates have not been registered with the SEC and setting forth the limitations on resale of these limited partnership interests.48

4) The limited partnership interests cannot be reoffered or resold for a period of nine months from the date of the last sale of a limited partnership interest which was a part of the same offering, unless the resale is made to a person who is a permanent resident of the subject state.49 Any limited partnership interests transferred in this nine-month period to a permanent resident of the subject state must also contain the same restrictive legend regarding the limitations on transferability.50

5) The partnership (or its transfer agent) must make notation in the appropriate records regarding the restric-
tive nature of the limited partnership interests.\textsuperscript{51}

6) The partnership must disclose in writing to all offerees and purchasers the limitations on transferability.\textsuperscript{52}

7) The partnership must obtain a written representation from each purchaser that he is a permanent resident of the subject state.\textsuperscript{53}

Notwithstanding its adoption of Rule 147, the SEC does not favor this exemption.\textsuperscript{54} There are no disclosure requirements as a condition precedent to its availability nor is there a ceiling on the dollar amount of the securities that can be sold pursuant to the exemption. Thus, the SEC takes the position that the intrastate exemption affords an opportunity for large scale abuse.\textsuperscript{55}

While there is no absolute disclosure requirement contained in Rule 147, an issuing partnership would be extremely foolish in not preparing a formal disclosure document even though it is relying upon such rule. First, the antifraud provisions of the federal and state securities acts are easily violated in the absence of formal disclosure.\textsuperscript{56} Second, a formal disclosure document provides evidence of what disclosures were actually made. If an issuer informally discloses all material facts concerning the limited partnership, he will have a more difficult time establishing exactly what disclosures were made. Finally, preparation of a formal disclosure document by experienced securities counsel forces the issuer to thoroughly think through all aspects of the proposed real estate development. Crucial shortcomings with respect to the proposed development or the proposed organization of the limited partnership are often discovered during the preparation of the formal disclosure document, thus providing the issuer with an opportunity to cure the problems before it sells the limited partnership interests to outside investors.

If the limited partnership interests are offered to nonresidents of the subject state, even if sold exclusively to residents of the subject state, the intrastate exemption is not available.\textsuperscript{57} The SEC has never deviated from its position that a single offer or a single sale to a nonresident destroys the availability of the intrastate exemp-

\textsuperscript{51} Id. § 230.147(f)(1)(ii).
\textsuperscript{52} Id. § 230.147(f)(3).
\textsuperscript{53} Id. § 230.147(f)(1)(iii).
\textsuperscript{55} See 3 H. Bloomenthal, \textit{supra} note 3, at § 4.04[6].
\textsuperscript{57} 3 H. Bloomenthal, \textit{supra} note 3, at § 4.04[3].
tion for the entire offering. Furthermore, where the issuer offers and sells solely to residents of the subject state, the exemption could still be lost if one of the purchasers resells to an unqualified person. Therefore, it is imperative that an issuer relying on the intrastate exemption take appropriate steps to police the offering.

While Rule 147(f) sets forth certain requirements in regard to policing the offering, more comprehensive precautions should be taken. All advertising and sales literature, for example, should include an appropriate legend to the effect that the offering is open only to permanent residents of the subject state. The subscription agreement executed at the time a limited partnership interest is purchased should therefore include a statement concerning the purchaser's permanent residence address. It should also provide that the subscription agreement is not binding on the parties until the issuer reviews all subscription agreements and takes appropriate steps to assure that the purchasers are permanent residents of the subject state.

Of course, the federal securities laws have not preempted the field, but coexist with the various state blue sky laws. In fact, one of the underlying assumptions of the intrastate exemption is that state regulation is adequate. State exemptions from registration can be more limiting in their nature than the federal exemptions.

The Private Offering Exemption

Section 4(2) of the Securities Act of 1933 provides that the registration provisions of the Act are not applicable to "transactions by an issuer not involving any public offering. As in the case with Rule 147, the SEC has an administrative pronouncement governing the private offering exemption—Rule 146. Rule 146, like Rule 147, is not exclusive but merely represents a safe harbor, and issuers can also rely on other administrative and judicial interpretations in establishing a basis for the private offering exemption. Rule 146, however, is based primarily upon the past experience of the SEC and the courts. Therefore, where an issuer intends to rely upon Rule 146, it is important to carefully consider the many

58. Id.
60. See 3 H. BLOOMENTHAL, supra note 3, at § 4.04[8].
62. See notes 80-89 and accompanying text infra.
64. 17 C.F.R. § 230.146 (1978).
court decisions and administrative interpretations which preceded its adoption.

Rule 146 provides an exemption from registration for a real estate partnership issuing limited partnership interests if all of its conditions are satisfied. The following sets forth and provides a brief discussion of such conditions:

1) No general solicitation or advertising can be utilized in connection with the offering of limited partnership interests. 66

2) No offer can be made to a person unless the issuer actually believes or has reasonable grounds to believe that the offeree has sufficient knowledge and experience in financial and business matters to make him capable of evaluating the merits and risks of the prospective investment, or in the alternative, that the offeree is able to bear the economic risks of the investment. 67 To prevent an inadvertent offer to unqualified persons, any letters, circulars, notices, or other written communications should be made only to persons with the requisite financial sophistication or wealth.

3) While an offer can be made to a person who is sufficiently wealthy to bear the economic risks of the investment, but who is not necessarily financially sophisticated, no sale can be made to such a person unless the issuer actually believes and has reasonable grounds to believe, after making inquiry, that such a purchaser has the requisite financial sophistication, or in the alternative, that such a person together with an offeree representative have such knowledge and experience in financial matters. 68 It must be emphasized, however, that an offeree representative can only be used to fulfill the financial sophistication requirement before sale if the otherwise financially unsophisticated purchaser is able to bear the economic risks of the investment.

4) Each offeree must have either access to, or be supplied with, specified information concerning the issuer and the particular offering. 69 In general, this information is the same type of information that would be required in a registration statement. Access can only exist by reason of the offeree's position with respect to

67. Id. § 230.146(d)(1).
68. Id. § 230.146(d)(2).
69. Id. § 230.146(e).
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the issuer.\textsuperscript{70} Position in this context refers to an employment or family relationship or an economic bargaining power which enables the offeree to obtain information from the issuer in order to evaluate the merits of the prospective investment.\textsuperscript{71} The fact that the issuer informs all prospective purchasers that they may examine all information the issuer has in its possession is not sufficient to satisfy this access requirement.\textsuperscript{72} Thus, preparation of a formal disclosure document which contains all information of a material nature is necessary to fulfill the access requirement, unless all offerees are in a unique position with respect to the issuer. When limited partnership interests are offered to outside, passive investors, such prospective purchasers simply do not have this position with respect to the issuer.

5) Generally, sales must be limited to 35 purchasers.\textsuperscript{73} This limitation on the number of purchasers is further limited by restrictions on the number of purchasers contained in any applicable state exemptions.

6) The issuer must place an appropriate restrictive legend on the certificate evidencing the limited partnership interests.\textsuperscript{74}

7) The partnership must issue stop transfer instructions to its transfer agent, or, if the issuer transfers its own securities, make an appropriate notation in its record which restricts transfer.\textsuperscript{75}

8) The issuer must make a reasonable inquiry as to whether the purchaser is buying the securities for investment purposes and obtain a signed agreement from the purchaser that he will not sell the securities unless they are registered under the applicable securities laws, or otherwise exempted.\textsuperscript{76} Generally, purchasers of securities issued pursuant to the private offering exemption must hold the securities indefinitely.

9) Notice of sale must be filed with the appropriate regional office of the SEC on Form 146.\textsuperscript{77}

\textbf{Failure to comply with the conditions of Rule 146 or the section...}

\textsuperscript{72} 3 \textit{H. Bloomenthal, supra} note 3, at § 4.05[1][f].
\textsuperscript{73} 17 \textit{C.F.R.} § 230.146(g) (1978).
\textsuperscript{74} Id. § 230.146(h)2).
\textsuperscript{75} Id. § 230.146(h)(3).
\textsuperscript{76} Id. § 230.146(h)(1), (4).
\textsuperscript{77} Id. § 230.146(i).
4(2) exemption in general could result in a rescission of the transaction by the purchasers, imposition of criminal sanctions, or an injunction against the issuer. Furthermore, as is the case with all exemptions from registration on both the federal and state level, the private offering exemption does not provide an exemption from the civil or criminal penalties contained in the antifraud provisions of the federal and state securities laws. Accordingly, a purchaser who believes that he did not receive all material information in connection with the sale of the limited partnership interests could initiate an action against the issuer and the persons selling those limited partnership interests. Such potential liability affords an additional reason for distributing a formal disclosure document to all prospective purchasers, because, while such a document does not provide immunity from liability, it does evidence the information that was, in fact, provided to all offerees.

**STATE EXEMPTIONS FROM REGISTRATION**

Meeting the conditions of one or more of the exemptions from registration afforded on the federal level does not necessarily assure that a corresponding state exemption from registration will be available. The Uniform Securities Act, adopted in varying degrees by more than thirty states, provides for an exemption from registration for offerings made to a limited number of investors without regard to their sophistication or knowledge, provided all purchases are for investment and no commissions are paid. Section 402(b)(9) of the Uniform Securities Act provides an exemption for any transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in paragraph (8)) in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this state, if (A) the seller reasonably believes that all the buyers in this state other than those designated in paragraph (8) are purchasing for investment, and (B) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state (other than those designated in paragraph (8)); but the [Administrator] may by rule or order as to any security or trans-

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78. See generally 3 H. Bloomenthal, supra note 3, at §§ 38.01-03.
79. Id. §§ 8.05-07, 25.
81. Uniform Securities Act § 402(b)(9).
82. Id. § 402(b)(8) (footnote added).
action or any type of security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in Clauses (A) and (B) with or without the substitution of a limitation on remuneration.\(^\text{83}\)

The states which have adopted versions of this exemption differ considerably with respect to the permissible number of offerees or purchasers. Furthermore, the limited offering exemption’s importance is decreasing as there is a definite movement to adopt a Rule 146 equivalent at the state level.\(^\text{84}\)

In the questionnaire that is recommended to be distributed to all real estate partnerships at the inception of a proposed offering of limited partnership interests, there should be a question relating to the states in which offers will be made.\(^\text{85}\) After receiving such information, counsel should prepare a blue sky survey which outlines the conditions of the applicable exemptions in each state.

The blue sky survey is especially crucial with respect to offerings of limited partnership interests that utilize the services of an investment banker in connection with the selling of the interests. Some states have an absolute prohibition against the payment of commissions or other remuneration for soliciting prospective purchasers,\(^\text{86}\) or require an issuer to obtain a special waiver of such prohibition before the offering is made.\(^\text{87}\) Iowa, for example, provides for an automatic waiver of the commission prohibition requirement upon application if, among other things, a copy of the disclosure document used in connection with the offering is submitted to the appropriate state agency for review before any offers are made in that state.\(^\text{88}\) This requirement proves extremely significant if an offering must be completed by a specific date, and

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83. Id. § 402(b)(9).
84. Iowa has adopted the 35 purchaser limit of Rule 146. IOWA CODE § 502.203(9)(a) (1977). The Nebraska Department of Banking and Finance, Bureau of Securities has announced that it requested the Chairman of the Banking, Commerce, and Insurance Committee of the Nebraska Unicameral to have the Committee or an individual member to introduce legislation that would amend the Securities Act of Nebraska and add a private offering exemption under certain circumstances. The Department of Banking and Finance, Bureau of Securities also contemplates adopting a Rule 146 equivalent to supplement the proposed private offering exemption. Letter from Barry K. Lohe, Assistant Director and Legal Counsel of the Nebraska Department of Banking and Finance, to Larry Ruth of the Nebraska State Bar Association (Oct. 18, 1978).
85. See text at notes 28-30 supra.
86. See, e.g., [1978] 1 BLUE SKY L. REP. (CCH) ¶ 6655.
88. Iowa Insurance Department, Securities Division Rule 510-50.17(502), [1976] 1A BLUE SKY L. REP. (CCH) ¶ 18,617.
counsel must include the period of review in his planning of the timetable for the offering.

In preparing the blue sky survey, counsel should be aware that the Uniform Securities Act places a limit on the number of offers, not the number of sales or the number of purchasers. Many states have adopted a version of the Uniform Securities Act limited offering exemption, but place the limit on the number of purchasers or sales.89

REGISTRATION AND REGULATION OF BROKERS AND DEALERS

A common misconception is that a person who falls within the definition of broker and dealer, but engages solely in transactions which are exempt from the registration requirements of the Securities Act of 1933, is also exempt from the broker-dealer registration requirements of the Securities Exchange Act of 1934.90 The SEC has expressly stated that brokers or dealers who engage exclusively in private placements are not exempt from the broker-dealer registration requirements for that reason alone.91 In fact, the only true exemption from registration available to broker-dealers selling limited partnership interests in real estate partnerships is the exemption afforded by section 15(a)(1) of the Securities Exchange Act of 1934,92 which exempts brokers or dealers whose business is “exclusively intrastate.”93

Section 15(a) of the Securities Exchange Act of 1934 applies only to those who fall within the definition of a broker or a dealer. In general, a broker is one who effects transactions for the account of others, and a dealer, on the other hand, is one who is engaged in the business of buying and selling securities for his own account. A real estate partnership, as it is an issuer,94 is not a dealer within the meaning of section 3(a)(5) provided it does not buy and sell its own security.95 The term broker, on the other hand, does not require the purchasing of securities, and whether a real estate partnership, its general partner, and any salesmen offering such

95. Id. § 78c(a)(5).
partnership's securities must register as brokers is a question of fact in each particular case.\textsuperscript{96}

There are three basic tests employed by the SEC in determining whether salesmen of securities are merely employees, thus not subject to the registration provisions,\textsuperscript{97} or whether they are independent contractors and, therefore, subject to the broker registration requirements. In general, to be an employee one must be compensated by salary, not by commission; the employer should withhold federal, state, and social security taxes; and the salesmen should be employed by the issuer both before and after the offering.\textsuperscript{98} Furthermore, the SEC has also recommended that it is beneficial if an employee does not have a significant background in the securities business, and that the scope of his employment does consist primarily of the selling of securities.\textsuperscript{99}

In all likelihood, a professional real estate syndicator is required to register as a broker. It has been suggested that a professional real estate syndicator is one that "has been recently involved in more than two syndications as a professional."\textsuperscript{100} The theory is that a professional syndicator usually becomes a general partner in real estate partnerships in order to market limited partnership interests under the so-called issuer exemption. But if he does so on a recurring basis, he is no longer selling securities for his own account and is a broker under the definition set forth in the Securities Exchange Act of 1934.\textsuperscript{101}

If a real estate syndicator is not selling for others, takes an active role in the management of the real estate partnership, and receives no remuneration for selling the units, there is authority

\textsuperscript{96} If a real estate partnership, its general partner, and its salesmen fall within the definition of the term "issuer," they are not exempt from broker-dealer registration, but are simply not broker-dealers. The so-called "issuer exemption" is thus a misnomer and is confusing. The difference between an exemption and an exclusion from the definition of broker-dealer is extremely significant because a broker-dealer exempt from registration is not necessarily exempt from regulation (e.g., net capital requirements. See Augustine & Fass, supra note 93, at 386-92. An issuer who is not a broker-dealer, on the other hand, is not subject to either the registration requirements or regulation. Id. at 370 n.4.

\textsuperscript{97} Employees of an issuer are not subject to registration or regulation as they are within the definition of "issuer." Securities Exchange Act of 1934, § 3(a)(8), 15 U.S.C. § 78c(a)(8) (1976).

\textsuperscript{98} Augustine & Fass, supra note 93, at 371. See 2 L. Loss, Securities Regulation 1298 (2d ed. 1961).

\textsuperscript{99} Augustine & Fass, supra note 93, at 371.

\textsuperscript{100} Id. at 371 n.13.

\textsuperscript{101} See Wertheimer & Mark, Special Problems of Unregistered Real Estate Securities, 22 U.C.L.A. L. Rev. 1219, 1227 (1975).
indicating that he need not register as a broker.\textsuperscript{102} Salesmen who are not employees of the real estate syndicator-general partner should not be utilized, however, because such salesmen would be subject to the broker licensing requirements.

Registration as a broker-dealer may also be required on the state level. The Uniform Securities Act, for example, does not provide an exemption from broker-dealer registration if the securities offered and sold are exempt from registration.\textsuperscript{103} The Uniform Securities Act's definition of broker-dealer does not include, however, one who directs fifteen or fewer offers to sell or buy securities in the state in question.\textsuperscript{104} As is the case with respect to the limited offering exemption of the Uniform Securities Act, the broker-dealer provisions of that Act, as adopted by the states, are far from uniform.\textsuperscript{105} The blue sky survey completed with respect to the various exemptions available from registration of the limited partnership interests should also include analysis of the broker-dealer provisions in the subject states.

Moreover, counsel must be aware that the Uniform Securities Act provides that it is unlawful for any person to transact business in the subject state as a broker-dealer or agent unless he is registered under the broker-dealer registration provisions of the Uniform Securities Act.\textsuperscript{106} Agent is defined as "any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities."\textsuperscript{107} It does not include, however, an individual who represents an issuer in connection with certain exempted securities or exempted transactions, including the limited offering exemption.\textsuperscript{108}

\textbf{FORMATION OF THE LIMITED PARTNERSHIP}

As a limited partnership is a creature of statutory law and was never recognized by the common law,\textsuperscript{109} it is imperative that extreme care be taken with respect to the formation of a real estate

\textsuperscript{102} Augustine & Fass, supra note 93, at 371 (citing [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,415).
\textsuperscript{103} Uniform Securities Act § 402.
\textsuperscript{104} Id. § 401(c).
\textsuperscript{106} Uniform Securities Act § 201(a).
\textsuperscript{107} Id. § 401(b).
\textsuperscript{108} Id.
partnership. Under the Uniform Limited Partnership Act, a limited partnership is formed upon the filing of a certificate of limited partnership with the appropriate county office of the county in which the principal place of business of the limited partnership is located. At the time of formation, a limited partnership must have one or more general partners and one or more limited partners. Since in most instances a real estate partnership will not have investor limited partners until after it is formed, it is necessary to use a non-investor limited partner for purposes of formation. Ordinarily, the status of this original limited partner will terminate upon admission of one or more investor limited partners to the real estate partnership.

Failure to record a certificate of limited partnership which substantially complies with the requirements of the Uniform Limited Partnership Act causes the attempted limited partnership to be treated as a common law general partnership. Thus, all partners in a defectively formed limited partnership would be personally and jointly liable for the debts and obligations of the partnership with respect to third parties dealing with the partnership. Furthermore, the original certificate must be amended upon the admission of additional limited partners.

PREPARATION OF THE FORMAL DISCLOSURE DOCUMENT

In most instances, a formal disclosure document should be prepared and distributed to prospective purchasers of limited partnership interests who are outside, passive investors, irrespective of the exemption from registration relied upon at the federal and state levels. If an offering of limited partnership interests in a real estate partnership is registered pursuant to the Securities Act of 1933, Form S-1116 and Guide No. 6017 provide the format with

110. UNIFORM LIMITED PARTNERSHIP ACT § 2(1)(b).
111. Id. § 1.
113. E.g., Filesi v. United States, 352 F.2d 339, 341 (4th Cir. 1965).
114. UNIFORM LIMITED PARTNERSHIP ACT § 24(2).
respect to the preparation of the registration statement. On the state level, many states have adopted the Midwest Securities Commissioners Association's Statement of Policy Regarding Real Estate Programs ("Midwest Rules"). Even if a particular real estate partnership offering is exempted from registration, counsel should prepare the formal disclosure document to be used in connection with the offering as if the disclosure document were to be filed as a registration statement. Of course, any language relating to a public offering must be altered to reflect the fact that the offering in question is not a public offering; the following discussion makes the appropriate alteration. It is impossible to set forth all of the requirements of the SEC and state commissions which have adopted the Midwest Rules, and thus what follows will be a broad overview of the type of information that should be contained in a formal disclosure document prepared in connection with an offering of real estate limited partnership interests. The specific contents of disclosure documents are not uniform, of course, and vary with each particular offering.

**Cover Page**

The term cover page is a misnomer in that it is ordinarily impossible to include all of the information required by the SEC and the Midwest Rules on a single page. In most instances, therefore, the so-called cover page of a disclosure document actually consists of two to four pages.

In general, Guide No. requires that the cover page contain the following information unless special circumstances warrant additional disclosure: (1) the name of the issuer; (2) a description and amount of securities to be offered; (3) the legend required by Rule 425, (4) a table showing the per unit and total offering price,

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121. 17 C.F.R. § 230.425 (1978). Rule 425 requires the following legend to be printed on the cover page in bold-face roman type at least as large as 10-point modern type and at least 2 points leaded:

*THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS [DISCLOSURE DOCUMENT]. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.*
the underwriting discounts and commissions, and the proceeds to be received by the issuer; (5) the name of the underwriter(s); (6) the date of the disclosure document; (7) a brief identification of the material risks involved in the purchase of the limited partnership interests with a cross-reference to further discussion contained in the text of the disclosure document; and (8) any material required by the laws of any state in which the limited partnership interests are to be offered. Guide No. 5 (which both Form S-11 and Guide No. 60 incorporate by reference) also emphasizes that boiler plate language does not, by itself, provide meaningful disclosure.

In addition to the basic information required by Guide No. 5, Guide No. 60 requires the termination date of the offering, any minimum required purchase, and any arrangements to place the funds received in an escrow, trust, or similar arrangement be set forth on the cover page. Guide No. 60 also expands on the significant risk factors which should be identified, specifically setting forth examples relating to tax risks, use of proceeds, and conflicts of interests.

In addition to the foregoing, the Midwest Rules require that "the maximum acquisition fee, or development and/or construction fees [and] the estimated amount of organization and offering expenses" must be disclosed on the cover page.

TABLE OF CONTENTS

Form S-11 makes reference to Rule 421(c) which requires a disclosure document to include a reasonably detailed table of contents in the forepart. Form S-11 also refers to the fact that a legend is customarily placed on the table of contents page which indicates that [the disclosure document] does not constitute an offer to sell any of the securities in any state to any person to whom it is unlawful to do so; that no person has been authorized to give any information or make any representations, other than those contained in the [disclosure document]; and that neither the delivery of the [disclosure document] nor any sale thereunder shall create any implication that there has been no change in the affairs of the issuer since the date of the [disclosure document].

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123. Id.
INVESTOR SUITABILITY STANDARDS

Guide No. 60 requires that immediately following the cover page, the standards to be utilized by the issuer in determining the acceptance of subscription agreements (investor suitability standards) should be described. The methods the issuer intends to utilize to assure that persons selling the limited partnership interests will adhere to the suitability standards should be disclosed. The factors pertaining to the need for such investor suitability standards should also be briefly discussed. Such factors include lack of liquidity, the importance of the investor's federal income tax bracket, and the long-term nature of the investment because of the possible adverse tax consequences of premature sale of the limited partnership interests and the lack of a resale market.

If Rule 146 is relied upon for the exemption from federal registration, mention should be made in this section regarding the financial sophistication requirements of that Rule. Reference should also be made to the offeree questionnaire and offeree representative questionnaire attached to the disclosure document. Such questionnaires are recommended because of the issuer's obligation to make reasonable inquiry regarding the offeree's investment experience and ability to fend for himself.

The Midwest Rules require that limited partners be able to bear the economic risk of the investment. For purposes of determining the ability of a prospective limited partner to bear such economic risk, the Midwest Rules set forth the following standards:

Unless the Administrator approves a lower suitability standard, participants shall have a minimum annual gross income of $20,000.00 and a net worth of $20,000.00, or in the alternative, a net worth of $75,000.00. Net worth shall be determined exclusive of home, home furnishings and automobiles. In high risk or principally tax oriented offerings, higher suitability standards may be required. In the case of sales to fiduciary accounts, the suitability standards shall be met by the fiduciary or by the fiduciary account or by a donor who directly or indirectly supplies the funds to purchase the interest in the program.

Reference should be made to any restrictions contained in the subscription agreement to be used in connection with closing the...
sale of the limited partnership interests. The subscription agreement should be attached as an exhibit to the disclosure document.

Summary of the Partnership and Use of Proceeds

Guide No. 60 requires an outline summary relating to the real estate partnership and a tabular summary of the use of the proceeds resulting from the offering to immediately follow the suitability section. The following information relating to the partnership should be disclosed in outline form with appropriate cross-references: (1) name, address and telephone number of the general partner and the names of any persons making investment decisions for the partnership; (2) the intended termination date of the partnership; (3) a statement regarding the fees and profits to be received by the general partner and its affiliates in connection with the offering; (4) a statement concerning whether current distributions are an investment objective, and if so, the estimated date when an investor might reasonably expect to receive the distributions; (5) a brief description of the real estate to be purchased, and appropriate disclosure if a material portion of the net proceeds of the offering of limited partnership interests is not committed to the real estate; (6) reference to the depreciation method to be used; (7) a statement concerning the maximum leverage expected to be used by the partnership; and (8) a cross-reference to a glossary of any technical terms used in the disclosure document.

The use of proceeds tabular summary should include the estimated expenses of the offering (both organizational and sales), the amount available for fulfilling the objectives of the partnership, non-recurring initial investment fees, prepaid items and financing fees, cash down payments, reserves, and any acquisition fees. The estimated amount that will be paid to the general partner and its affiliates should be specifically identified, and both dollar amounts and percentages of the maximum and minimum proceeds of the offering should be included with respect to each individual application of the proceeds. Guide No. 60 provides an example of a table showing the estimated application of the proceeds re-
ceived from an offering of limited partnership interests. 137

COMPENSATION AND FEES TO THE GENERAL PARTNER AND AFFILIATES

This section should include a summary tabular presentation which itemizes by category and specifies, in dollar amounts where possible, all compensation (including reimbursement of out-of-pocket expenses) that the general partner and its affiliates may earn or receive in connection with the offering or the operation of the real estate partnership. 138 If a more detailed explanation is required, reference should be made to an appropriate subsection in the summary of limited partnership agreement section of the disclosure document and any other parts of the disclosure document discussing the compensation received by the general partner and its affiliates. The tabular presentation should identify the person and his affiliation with the general partner receiving the compensation and the services to be performed by that person. It should reflect whether the compensation relates to the offering and organizational stage, the developmental or acquisition stage, the operational stage, or the termination and liquidation stage of the real estate partnership. 139

TERMS OF THE OFFERING

The offering price and the payment terms should be explained to the prospective purchasers of limited partnership interests. If the purchase of the limited partnership interests may be made pursuant to a deferred payment schedule, the consequences of default by a limited partner should be discussed. 140

CONFLICTS OF INTEREST

Each type of transaction and any aspect of the business to be engaged in by the real estate partnership which may result in a conflict between the interests of the limited partners and those of the general partner and its affiliates should be disclosed and discussed. Potential conflicts of interest may include: (1) whether the general partner is a general partner or an affiliate of the general partner in other real estate partnerships; (2) whether real estate or other properties in which the general partner or its affiliates have

137. Id.
138. Id.
139. Id. See also SEC Form S-11, 17 C.F.R. § 239.18, 29 Fed. Reg. 12,689 (item 20) (1964).
an interest will be purchased by the real estate partnership, and whether any appraisals have been made in connection with the transactions; (3) whether the general partner has the authority to invest the funds of the partnership in other projects in which the general partner or its affiliates have an interest; (4) whether the general partner or its affiliates have an interest in the real estate adjacent to the real estate proposed to be purchased and developed by the partnership; (5) whether the general partner or its affiliates propose to lend money to the partnership or otherwise act as a finance broker for the partnership; and (6) whether a compensation arrangement with the general partner or its affiliates may create a conflict between the interests of the general partner or its affiliates and those of the partnership.\textsuperscript{141}

If legal counsel to the partnership and the partnership's accountant have rendered services to the general partner, that should be disclosed. Additional conflicts of interest can arise as result of the complete authority of the general partner to manage the partnership.\textsuperscript{142} The general partner is ordinarily free to contract with affiliates, for example, and thus the terms of such transactions may not be the result of arms-length negotiations. In addition, limited partnership agreements often limit the liability of a general partner to the partnership or limited partners that may result from acts or omissions by the general partner. Those provisions should be referred to in the conflicts of interest section, along with any indemnity provisions which may also exist in the limited partnership agreement.

**Risk and Special Factors**

This section consists of a series of short, concise, individually captioned paragraphs which summarize the principal risk factors associated with the offering and the partnership's plan of operations.\textsuperscript{143} This section should contain a summary of the material tax risks with appropriate cross-references to fuller discussions in the section of the disclosure document relating to income tax consequences. Such tax risks may include the absence of an Internal Revenue Service ruling as to partnership tax status and that there is a risk that the Internal Revenue Service on audit may determine, for tax purposes, that the partnership is an association, taxable as a corporation; the risk that after some years of partnership operations a limited partner's tax liabilities may exceed his cash

\textsuperscript{142} See also [1976] 1 Blue Sky L. Rep. (CCH) ¶ 4821.
distributions in corresponding years; the risk that upon a sale or other disposition of a limited partnership interest, or upon a sale or other disposition of partnership property, it is possible that a limited partner's tax liabilities may exceed the cash he receives upon the disposition; and the risk that an audit of the partnership's information return may result in an audit of a limited partner's individual tax return.  

Other risk factors that need to be disclosed in this section include any lack of relevant experience on the part of management, the fact that the proceeds of the offering may be insufficient to meet the requirements of the partnership's objectives, and a discussion concerning any additional sources of capital the partnership may utilize. Further factors requiring discussion are any high risk investment objectives the partnership may have, the fact that no public market exists for the limited partnership interests, and any environmental or other government regulations that may pertain to the partnership. In addition, disclosures should be made concerning the fact that the success of the partnership depends in part upon the financial stability of the general partner, the risks of leverage, any possible adverse competitive factors relating to the partnership's objectives, and the fact that certain assumptions concerning any projections used in connection with the offering depend upon facts and events over which the partnership will have no control.

DESCRIPTION OF PROJECT

A detailed physical description of the proposed real estate project should be given to prospective purchasers of limited partnership interests. Short biographies about the architect and general contractor of the project may also be included in this section.

GENERAL PARTNER AND AFFILIATES

A biographical sketch of the general partner and its principal officers, if it is a corporate general partner, and other managers of the real estate development should be included in the disclosure document. The information disclosed should include their business experience for the past ten years, and if there is a lack of ex-

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experience in regard to the project proposed by the real estate partnership, this fact should be prominently displayed in the disclosure document.  

Cross-reference should be made to the table showing all compensation (indirect and direct) to be paid to the general partner and its affiliates located in the forepart of the disclosure documents.

The track record of the general partner and its affiliates with respect to real estate developments during the past five years which involve either a public offering of securities or a private or limited offering of securities should be disclosed in the disclosure document.  

The Midwest Rules specifically list information which should be included.

FIDUCIARY DUTY OF GENERAL PARTNER

Prospective purchasers of limited partnership interests should know the limits of the fiduciary responsibility owed to the partnership by the general partner. Any exculpation or indemnity clauses contained in the limited partnership agreement should be referred to in this section. In addition, limited partners should be informed that they have the right to recover damages for a breach of any fiduciary duties owed the partnership by the general partner.

INCOME TAX CONSEQUENCES

A section should be included in the disclosure document that summarizes all material income tax aspects of the offering. The purpose of this section is to inform prospective purchasers of limited partnership interests of the tax consequences they can reasonably expect as a result of investing in the partnership. An opinion of tax counsel as to all material aspects of the offering should be filed as an exhibit to the disclosure document, and the income tax consequences section of the disclosure document should summarize or restate the tax information contained in the opinion. A caveat should be included that all discussion regarding the tax aspects contained in the disclosure document is based upon the Internal Revenue Code of 1954, as presently amended.

148. [1975] 1 BLUE SKY L. REP. (CCH) ¶ 4821.
150. [1975] 1 BLUE SKY L. REP. (CCH) ¶ 4821.
152. [1975] 1 BLUE SKY L. REP. (CCH) ¶ 4821.
existing laws, judicial decisions, administrative regulations, and rulings, all of which are subject to change and which changes could be retroactive in their application to the partnership and/or its properties. The tax risks associated with an investment in the partnership should be noted and discussed. If a partnership contemplates taking deductions that may be challenged by the Internal Revenue Service, the tax effect of disallowance by the Internal Revenue Service should be explained. This section should also contain discussion concerning the partnership's tax status as a partnership; general rules regarding taxation of limited partners; general discussion concerning a limited partner's basis; the method or methods of depreciation to be used by the partnership; deductibility of prepaid interest and other expenses; potential tax liabilities in future years; the type of tax information that will be supplied to limited partners; any relevant state, local or foreign tax considerations; the possible impact of section 183 of the Internal Revenue Code of 1954; and the tax consequences upon sale or other disposition of a partnership interest or partnership property.

SUMMARY OF LIMITED PARTNERSHIP AGREEMENT

A brief summary of the material provisions of the limited partnership agreement should be included in the body of the disclosure document. It must be emphasized that the statements contained in the summary and elsewhere in the disclosure document do not purport to be complete, and in the event of a conflict between the summary of the limited partnership agreement provisions and the limited partnership agreement, the limited partnership agreement will control.

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Other sections in the disclosure document should disclose rel-
relevant details concerning the partnership's accountant and legal counsel. In addition, if any of the principals of the real estate partnership are involved in pending legal proceedings, a section should be included in the disclosure document discussing such proceedings.165

References should also be made throughout the disclosure document to any projections that may be used in connection with the offering. The Midwest Rules contain specific provisions concerning projections.166 Any projections used should be attached to the disclosure document as an exhibit along with a letter from the certified public accountant who prepared the projections.

The Midwest Rules further require the following financial information and financial statements to be provided as a part of the disclosure document: (1) a cash flow statement of the real estate project; (2) a balance sheet of the real estate partnership (assuming it has been formed and owns assets); (3) an income statement for the real estate partnership (assuming it has been formed and owns assets); (4) a balance sheet for each general partner, corporate or non-corporate; and (5) an income statement for corporate general partners.167 The above-listed financial documents need not be audited, but should be prepared in accordance with generally accepted accounting principles. The instructions as to financial statements of Form S-11168 also contain detailed provisions regarding the form and contents of financial statements that must be included in a prospectus registered with the SEC. Of course, the Midwest Rules and the instructions may be used as a guide but are not controlling because the real estate partnerships discussed in this article are exempt from such requirements.

CONCLUSION

The foregoing discussion illustrates that many securities problems arise in connection with an offering of limited partnership interests in real estate partnerships. Complying with the available federal and state exemptions from registration, analyzing the broker-dealer considerations, and preparing the formal disclosure document require considerable securities expertise. Although it is impossible to address all possible securities problems arising with respect to the formation of a real estate partnership

165. [1975] 1 Blue Sky L. REP. (CCH) ¶ 4821.
166. Id.
167. Id.
and to include all the information that should be disclosed in a disclosure document in a single article of this length, this article was intended to identify and discuss in general terms the securities considerations involved. It is advisable, however, that because the securities laws contain traps for the unwary and are in a constant state of evolution, a general practitioner who has little or no exposure to the securities laws should consult with experienced securities counsel when confronted with a real estate partnership that desires to sell limited partnership interests to outside, passive investors.