A SLEIGHT OF HAND: WHY NON-TRADED REAL ESTATE INVESTMENT TRUSTS ARE BECOMING AN INCREASINGLY FREQUENT SUBJECT OF SECURITIES LITIGATION AND ARBITRATION

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I. DÉJÀ VU: THE 2008 SUBPRIME THREAT BY A DIFFERENT NAME

The sharp housing market decline leading up to the 2008 Great Recession highlighted the significant risks associated with subprime debt instruments. Underlying the seemingly strong pre-Great Recession housing market was high personal debt and leverage levels.[1] In many instances,

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[1] *See* Martin Neil Baily, Robert E. Litan & Matthew S. Johnson, *The Origin of the Financial Crisis*, INITIATIVE ON BUS. AND PUB. POL'Y AT BROOKINGS (2008), at p. 11, https://www.brookings.edu/wp-content/uploads/2016/06/11_origins_crisis_baily_litan.pdf.

individuals and families had spent beyond their means when it came to a home mortgage.[2] When the housing market crashed leading up to the Great Recession, the true extent of the risks associated with subprime debt instruments, such as mortgage-backed securities ("MBSs") and collateralized debt obligations ("CDOs"), became clear.[3] What began in 2006 as a disruption in MBS and CDO markets quickly developed into the worst global financial crisis since the Great Depression.[4] The questionable practices employed by many financial institutions to create, market, and sell the risk-laden MBS and CDO investment instruments to purchasers aggressively seeking greater returns led to a wave of regulatory inquiries, securities litigation, and legislative and regulatory action by federal and state authorities.[5]

Despite efforts taken by legislators and regulators to address the sub-prime instruments that contributed significantly to the severity of the Great Recession,[6] similarly marketed and utilized investment vehicles now pose comparable risks for investors on an individual level and for the U.S. financial system in the aggregate. With the global economy heading toward what many financial experts believe is another economic downturn in 2020,[7] the financial exposure created by high-risk, illiquid instruments is likely to come to greater light. As significant losses in asset value are sustained or impending losses become imminent, a new wave of high-stakes securities litigation is likely to emerge around the creation, management, marketing, sale, and performance of these investment vehicles.

The most notable of these risky investments are non-exchange traded real estate investment trusts ("Non-Traded REITs"). This article explains the nature of Non-Traded REITs; the risk characteristics of Non-Traded REITs that increase the likelihood of losses and securities litigation; the likely targets of Non-Traded REIT-related securities actions; and the claims for relief most likely to be asserted.

II. NON-TRADED REITS V. PUBLICLY TRADED REITS

Non-Traded REITs are to be distinguished from REITs that are traded on public exchanges ("Traded REITs").[8] Both vehicles pool resources of numerous smaller investors into one large fund, which an investment management firm then uses to invest in income-producing real estate holdings.[9] Investors "buy in" to the real estate holdings when they purchase shares of the REIT.[10] The two types of REITs differ, however, in several fundamental respects. These differences

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[2] *Id.* at p. 11 ("One sign that house prices had moved too high is that they moved ahead much faster than real household income. People were stretching to buy houses.").

[3] *See generally* Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5 (2009) (providing an overview of factors that led to the 2008 global financial crisis, including discussion about MBSs and CDOs).

[4] Josh Bivens, *Worst Economic Crisis Since the Great Depression? By a Long Shot.*, ECON. POL'Y INST. (Jan. 27, 2010), https://www.epi.org/publication/snapshot_20100127/.

[5] *See* Gibson Dunn Subprime Working Group, *Subprime-Related Securities Litigation: Early Trends*, GIBSON DUNN (Mar. 23, 2009), https://www.gibsondunn.com/subprime-related-securities-litigation-early-trends/.

[6] *See* John Weinberg, *The Great Recession and its Aftermath*, FED. RES. HIST., (Nov. 22, 2013), https://www.federalreservehistory.org/essays/great_recession_and_its_aftermath.

[7] *See* Graham Vanbergen, *The Predicted 2020 Global Recession*, THE WORLD FIN. REV. (Dec. 1, 2018), https://www.worldfinancialreview.com/the-predicted-2020-global-recession/.

[8] *See Public Non-Traded REITs—Perform a Careful Review Before Investing*, FINRA (Nov. 30 2016), https://www.finra.org/investors/alerts/public-non-traded-reits-perform-careful-review-investing [hereinafter *Careful Review*].

[9] *Id.*

[10] *Id.*

highlight why Non-Traded REITs are riskier and more likely to be the subject of increasing securities litigation and arbitration.[11]

Liquidity, or the lack thereof, is the critical distinguishing factor between Non-Traded and Traded REITs. Traded REITs are, as their name implies, traded on stock exchanges and investors' stakes in the Traded REIT are thus relatively easy to sell.[12] In contrast, Non-Traded REITs are structured as "finite life investments."[13] This means that, at the conclusion of the specified life cycle, a Non-Traded REIT is required to: (1) be liquidated or (2) be listed on a national securities exchange.[14] Prior to the conclusion of the specified timeframe, the Non-Traded REITs do not have a primary trading market.[15] Rather, riskier secondary markets are the only avenue for selling such investments—typically at a fraction of the investments' cost.[16]

Further adding to illiquidity issues of Non-Traded REITs are: (1) restrictions on share volume redeemability, and (2) the complexity of valuing these investment vehicles.[17] Whereas the share value of Traded REITs is determined by traditional market mechanisms (*e.g.*, price setting on national exchanges), the value of Non-Traded REITs is largely determined by fund managers or a third party.[18] The complexity of Non-Traded REIT valuation is influenced by the portfolio of assets in the REIT, the trust's overhead expenses, the strength of the trust's balance sheet, and the cost of capital.[19] These variables lead to uncertainty in the secondary market and contribute to the Non-Traded REITs' illiquidity. Should investors wish to exit such investments, they may not be able to do so, or may only be able to so in part over time, and at a discount.

Traded and Non-Traded REITs also differ in their cost structures. The up-front underwriting fees for Traded REITs are usually approximately 7% of the price per share, with the investment potentially subject to brokerage fees when bought on the open market.[20] On the other hand, Non-Traded REITs may have underwriting fees as high as 15% of the price per share,[21] and are regularly subject to ongoing costs including asset management fees, disposition fees, financing fees, incentive fees, and acquisition fees.[22] With such high fees, the underlying business would have to be exceedingly successful and profitable for the investment to create a material, financial benefit for the client.

Despite the structural differences between Traded and Non-Traded REITs, both types of investment vehicles are theoretically subject to similar regulatory oversight.[23] This includes registration with the Securities and Exchange Commission and periodic regulatory filings (*e.g.*, a

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[11] As is explained later in the Article, many of these cases are brought as FINRA arbitrations because investment advisors and broker-dealers are involved. *See infra* Section III.
[12] *See Careful Review*, *supra* note 8.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] Eliot Bencuya, *stREITwise: The Non-Traded Crowdfunded REIT Explained*, STREITWISE, https://streitwise.com/streitwise-explained/ (last visited Oct. 2, 2019).
[23] James Chen, *Non-traded REIT*, INVESTOPEDIA (July 13, 2018), https://www.investopedia.com/terms/n/non-traded-reit.asp; *but see* Regulatory Note 15-02, *SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Program and Unlisted Real Estate Investment Trust Securities*, SEC (Apr. 11, 2016), https://www.finra.org/rules-guidance/notices/15-02 (announcing the SEC approved amendments to SEC and NASD rules to better regulate Non-Traded REITs).

prospectus and quarterly and annual reports).[24] Despite this regulatory oversight, the significantly increased risk and reduced lack of accountability associated with Non-Traded REITs has led financial regulators, including the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC), to increase their scrutiny of the way in which Non-Traded REITs are marketed to investors. The SEC issued a report in 2015 to educate investors about the dangers of investing in Non-Traded REITs.[25] The SEC, in discussing publicly-traded REITs in a 2016 investor bulletin, again warned about the serious dangers and shortcomings of Non-Traded REITs.[26]

Soon thereafter in early 2016, FINRA issued an Investor Alert warning investors about the features and risks of Non-Traded REITs, as well as ways to avoid the perils and misrepresentations that often surround the sale.[27] FINRA's report was updated and re-issued in November 2016 "because of concern—reflected in a recent enforcement action—that some investors may be the recipients of misleading information regarding certain public non-traded REITS."[28] Specifically, FINRA was worried that "[s]ome investors may also receive recommendations to purchase these products without adequate investigation by the firm or individual broker to determine whether these or similar investments are suitable."[29]

Investors have rightfully complained to banking regulators that some Non-Traded REITs have been deceptively sold as low-risk, high yield investments.[30] Such advertisements and marketing materials may have been made fraudulently in violation of securities and other laws that are discussed below.

III. NON-TRADED REIT SECURITIES LITIGATION AND ARBITRATION

Over the past several years FINRA has seemingly paid greater attention to the risk Non-Traded REITs pose to investors.[31] Financial regulatory agencies are issuing investor bulletins and educational materials and pursuing enforcement proceedings to try to stem the negative effects of

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[24] *Id.*

[25] *Investor Bulletin: Non-traded REITS*, SEC (Aug. 31, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_nontradedreits.html.

[26] *Investor Bulletin: Publicly Traded REITs*, SEC (Aug. 30, 2016), https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-publicly-traded-reits.

[27] *Public Non-Traded REITs—Perform a Careful Review Before Investing*, supra note 8.

[28] *Id.*

[29] *Id.*

[30] *See, e.g.*, *Non-Traded REITs Lawsuits*, GIBBS LAW GROUP LLP, https://www.classlawgroup.com/securities-fraud/investment/real-estate-investment-trusts/lawsuits/ (last visited Oct. 5, 2019).

[31] *FINRA Disciplinary Actions Online*, FINRA, https://www.finra.org/rules-guidance/oversight-enforcement/finra-disciplinary-actions?search=%22non-traded%20REIT%22&firms=&individuals=&field_fda_case_id_txt=&field_core_official_dt%5Bmin%5D=&field_core_official_dt%5Bmax%5D=&field_fda_document_type_tax=All&page=0 (last visited Oct. 3, 2019) (providing overview of 33 Non-Traded REIT-related disciplinary actions undertaken by FINRA since late 2009).

some Non-Traded REITs. Regulatory agencies at both the state[32] and federal levels[33] have brought enforcement actions against brokers, investment advisers, and financial planners (singularly "Investment Professional" and collectively "Investment Professionals"), as well as investment firms, for unlawful practices relating to the marketing and sale of Non-Traded REITs.

Many of the targeted Non-Traded REITs were involved in several levels of the subprime market, including mortgage origination, the provision of capital for originators, the sale and trading of MBSs and CDOs, and the purchase of mortgages for investment and securitization. Investors who filed complaints in these matters often alleged that the defendants intentionally concealed the extent of the investors' exposure to sub-prime-related products and knowingly failed to appropriately value the CDO tranches retained on the REIT books, thereby causing investors to sustain significant losses when the value of MBSs and CDOs in question plummeted.[34] More recently, investment firms have suffered significant fines for purchasing more Non-Traded REITs than allowed in keeping an asset allocation suitable for their clients' portfolios.[35]

One would think that the wave of enforcement actions, regulatory reform, and costly litigation related to the aforementioned misconduct would dissuade other Investment Professionals and investment firms from undertaking comparable actions. However, this does not seem to be the case, as misleading or false and dishonest disclosures regarding Non-Traded REIT valuations

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[32] Aiman Farooq, *LPL Fined Nearly $1M Over Inappropriate REIT Sales*, BUSINESS TRIAL GROUP (Nov. 16, 2017), https://www.businesstrialgroup.com/news/lpl-fined-1m-reit-sales/ (New Jersey Bureau of Securities fined LPL Financial $950,000 and additional $25,000 to be put into state investor education fund over supervisory failures tied to sales of Non-Traded REITs); Alex Padalka, *New Hampshire Fines Next Financial Over Non-Traded REITs*, FINANCIAL ADVISOR IQ (Jan. 7, 2020), https://www.financialadvisoriq.com/c/2615133/309533/hampshire_fines_next_financial_over_traded_reits (New Hampshire Bureau of Securities Regulation fined Next Financial a total of $325,000 in connection with failure to supervise the sale of non-traded REITs by one of the firm's registered representatives, which resulted in unsuitable sales to clients and over-concentration of Non-Traded REITs in their portfolios).

[33] *See, e.g.*, *Department of Enforcement v. Pacific Cornerstone Capital, Inc. et al.*, DISCIPLINARY PROCEEDING NO. 2007010591702 (Dec. 11, 2009), https://www.finra.org/sites/default/files/fda_documents/2007010591702_FDA_JX16442%20%282019-1562359768020%29.pdf (FINRA enforcement proceeding); *Department of Enforcement v. Wells Investment Securities*, Inc., Disciplinary Proceeding No. 2OO9O19893801 (Nov. 22, 2011), https://www.finra.org/sites/default/files/fda_documents/2009019893801_FDA_TP26863%20%282019-1562674763630%29.pdf (FINRA enforcement proceeding); *Department of Enforcement v. David Lerner Associates et al.*, DISCIPLINARY PROCEEDING NO. 2009020741901 (December 13, 2011), https://www.finra.org/sites/default/files/fda_documents/2009020741901_FDA_RCPS9013%20%282019-1562703565637%29.pdf (FINRA enforcement proceeding); *see also In re Ameriprise Financial Services, Inc.*, Administrative Proceeding File No. 3-13544 (July 10, 2009), https://www.sec.gov/litigation/admin/2009/33-9051.pdf. (SEC administrative proceeding)

[34] *See, e.g.*, Robert Thomas, *Summit Healthcare REIT Declines 30%*, ABS NEWS & RESEARCH (Jan. 24, 2020), https://alphabetastock.com/2020/01/24/summit-healthcare-reit-declines-30/ (highlighting how the Summit Healthcare REIT – a Non-Traded REIT – was valued at $2.80/share by the REIT sponsor, but the actual trading range on the secondary market had dropped to $1.75/share to $1.83/share during the same period).

[35] *See, e.g.*, Farooq, *supra* note 32 (New Jersey Bureau of Securities fined LPL Financial $950,000 and an additional $25,000 to be put into state investor education fund for LPL recommending high concentrations of REITs in customers' portfolios that clearly violated New Jersey's REIT purchase limitations); Padalka, *supra* note 32 (New Hampshire Bureau of Securities Regulation fined Next Financial a total of $325,000 in connection with failure to supervise the sale of non-traded REITs by one of the firm's registered representatives, which resulted in unsuitable sales to clients and over-concentration of Non-Traded REITs in their portfolios).

have become a growing significant issue.[36] Prominent politicians, such as Senator Elizabeth Warren, have recognized such issues, suggesting increasing the scope of regulation and heightening burdens of care and loyalty for Investment Professionals to prevent them from implementing high-risk investment strategies that are not in alignment with their clients' investment goals.[37]

The problem, however, is two-fold: (1) increased regulation of Non-Traded REITs—particularly in the areas of advertising and sales—has not and is not receiving the attention it deserves at the federal and state levels; and (2) no regulation will achieve a catch-all solution, especially for investors seeking a remedy for financial losses already sustained.

One of the tools available to help investors alleviate the burden of poor-performing Non-Traded REIT investments, and to protect other potential investors from falling victim to dangerous, sub-prime non-Traded REIT vehicles, is the filing of securities litigation against Investment Professionals and/or their firms which heavily invest an account in Non-Traded REITs despite the investor conveying a low risk tolerance and preference. Such suits would not only enable the recovery of the investor's losses, but also impose a costly consequence on the Investment Professional and/or firm who encouraged and facilitated the risky investment strategy and sale. Both of these results, especially the latter, would be aimed at imposing such significant financial burdens as to decrease the likelihood of similar improper investment actions in the future—both for the Investment Professionals and firms involved in the litigation and other professionals and firms who are aware of the outcomes of such suits.

IV. CLAIMS FOR RELIEF

A major hurdle, however, is that REIT-related securities litigation or arbitrations are complex, and therefore can be very expensive. Successful litigation requires (1) an intimate knowledge of the assets that comprise the REIT(s) in question, which can be complex; (2) knowledge of the intricate financial regulations and related standards of care that apply to Investment Professionals and firms; and (3) that the defendant(s) have assets subject to collection and execution after a judgment or award is rendered against them. Despite the difficulties associated with REIT-related legal proceedings, they will nonetheless be a valuable tool utilized with increasing frequency as the anticipated 2020 economic downturn brings to further light the exposure created by high-risk investments like Non-Traded REITs.[38]CLAIMS FOR RELIEF

The most likely defendants in a Non-Traded REIT securities action or arbitration are the client's Investment Professional and his or her firm. Because every Non-Traded REIT securities case is different, the specific facts of each case will determine the availability of the below-listed claims for relief, among others. The following claims are based principally on Arizona law, as

[36] Nareit Staff, *REIT Insurance Experts Report Sharp Increase in Securities Class Action Litigation*, NAREIT (Apr. 23, 2018), https://www.reit.com/news/videos/reit-insurance-experts-report-sharp-increase-securities-class-action-litigation.

[37] *See, e.g.*, Mark Schoeff Jr., *Why Financial Advisors Hate Elizabeth Warren*, INVESTMENTNEWS (Sept. 4, 2016, 12:01 AM), https://www.investmentnews.com/article/20160904/FREE/160909989/why-financial-advisers-hate-elizabeth-warren (discussing Senator Elizabeth Warren's staunch support for the Department of Labor's fiduciary rule for retirement accounts, which seeks to stop advisers from putting their own interests in earning high commissions and fees over clients' interests in obtaining best investments at lowest prices).

[38] Miriam Rozen, *This Could Be A Litigation "Tsunami" Against Advisors*, FINANCIAL ADVISOR (Sept. 10, 2018), https://financialadvisoriq.com/c/2078503/244593 (predicting "[t]here will be a tsunami of investor complaints related to reverse churning when the market crashes," including against fee-based advisory firms for recommending investment in illiquid investment vehicles, including Non-Traded REITs).

well as federal appellate law. Other states have their own securities laws and own versions of the common law claims discussed herein.

A. Negligence

An investor will have a viable negligence claim where there is a duty owed to the investor, a breach thereof, and an injury caused by that breach.[39] Whether there is a duty owed, and if so, the extent of said duty, are questions determined on the basis of the parties' relationship.[40] Normally, the standard of care focuses on the conduct of a reasonably prudent person under the circumstances.[41] However, as the Arizona Supreme Court noted in *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, "a person who holds himself out to the public as possessing special knowledge, skill or expertise must perform his activities according to the standards of his profession. If he does not, he may be liable under ordinary principles of negligence."[42]

Investment Professionals hold themselves out as professionals with special and advanced knowledge and expertise in investing. As such, they are under a self-imposed duty to act with reasonable care and with the skill, knowledge, and training associated with their profession when handling their clients' investment funds.[43]

The rules of financial regulatory agencies, such as the SEC and FINRA, require Investment Professionals to deal fairly and honestly with the public, adhere to the highest standards of just and equitable conduct, know their customer's financial needs and objectives, and recommend suitable investments for their customers.[44] These rules, taken as a whole, represent the standard of care applicable to the investment industry.[45] Should an Investment Professional fall below this standard of care in providing investment services to a client, and the client suffers injury as a result, the Investment Professional may be liable for negligence. Such negligence claims against Investment Professionals have been recognized by state[46] and federal courts.[47] Arguably, alerts warning

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[39] Wisener v. State, 123 Ariz. 148, 149, 598 P.2d 511, 512 (1979).
[40] Petolicchio v. Santa Cruz Cnty Fair & Rodeo Ass'n, 177 Ariz. 256, 261, 866 P.2d 1342, 1347 (1994); Kesselman v. Nat'l Bank of Ariz., 188 Ariz. 419, 421, 937 P.2d 341, 343 (Ct. App. 1996).
[41] Lasley v. Shrake's County Club Pharmacy, 179 Ariz. 583, 586, 880 P.2d 1129, 1132 (Ct. App. 1994) (citing Bell v. Maricopa Medical Ctr., 157 Ariz. 192, 194, 755 P.2d 1180, 1182 (Ct. App. 1988)).
[42] 140 Ariz. 383, 398, 682 P.2d 388, 403 (1984); *see also* Sw. Auto Painting & Body Repair, Inc. v. Binsfeld, 183 Ariz. 444, 448, 904 P.2d 1268, 1272 (Ct. App. 1995).
[43] *See, e.g.*, Kimmell v. Schaefer, 89 N.Y.2d 257, 264 (1996) (holding defendants who "possess unique or specialized expertise, or who are in a special position of confidence and trust with the injured party" may be liable for negligent misrepresentation in investment context).
[44] *See, e.g.*, *Regulatory Notice 11-02*, SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations, FINRA, https://www.finra.org/rules-guidance/notices/11-02 (last visited Dec. 3, 2019).
[45] *See generally* 17 CFR § 276 (interpreting standard of conduct for investment advisers).
[46] *See*, *e.g*., Lucarelli Pizza & Deli v. Posen Constr., Inc., 173 So. 3d 1092, 1095 (Fla. 2d DCA 2015) (recognizing negligence claims against financial professionals); Cecka v. Beckman & Co., 28 Cal.App.3d 5, 11, 104 Cal.Rptr. 374 (1972) (holding that where an investment professional violates his professional duty of care, he is liable for the losses sustained by his employer as a result of said negligence); Abramowitz v. Westport Nat'l Bank, No. 09-60510-CIV, 2009 WL 10667468, at *8 (S.D. Fla. Nov. 5, 2009) (finding plaintiffs stated negligence claim under Florida law against investment advisors who managed money and actively promoted investment in a Ponzi scheme).
[47] *See*, *e.g.,* In re Old Naples Sec., Inc., 343 B.R. 310, 321–24 (Bankr. M.D. Fla. 2006) (finding an investor stated negligence claims against broker selling securities when broker failed to question validity of or investigate investments); Anwar v. Fairfield Greenwich Ltd., 118 F. Supp. 3d 591, 616 (S.D.N.Y. 2015) (applying Florida negligence law and finding securities broker-dealers had duty of care to conduct proper investigation of recommended investments); Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 461 (9th Cir. 1986) (holding that if it

Investment Professionals of the many dangerous characteristics of Non-Traded REITs—like the SEC and FINRA ones cited hereinabove—increase the duty owed by Investment Professionals to investigate Non-Traded REITs and to disclose the risks associated with these investments before recommending them to clients.

B. Negligent Misrepresentation

Investment Professionals selling Non-Traded REITs may mislead investors into purchasing investments that are illiquid, unsuitable, high risk, speculative, and/or fraudulent, all the while not disclosing the true nature of the investments, illiquidity-associated risks, conflicts of interest, and/or fees.[48] Investors often rely upon the information provided by Investment Professionals, who fail to exercise reasonable care and competence in communicating the information. Such negligent provision of false information in the course of business in which the supplier of information has a pecuniary interest—such as a commission or transaction fee—can impose liability for negligent misrepresentation on the Investment Professional.[49]

Negligent misrepresentation requires proof that: (1) the Investment Professional provided false information in a business or commercial transaction in which he or she has a pecuniary interest; (2) the Investment Professional intended for the customer to rely on the incorrect information or knew the customer reasonably would rely; (3) the Investment Professional failed to exercise reasonable care in obtaining or communicating the information; (4) the customer justifiably relied on the incorrect information; and (5) as a result, the customer suffered damages.[50] "The fact that the information is given in the course of defendant's business, profession or employment is a sufficient indication of such a pecuniary interest, even though he receives no consideration specifically for providing the information."[51]

C. Negligent Failure to Supervise by Investment and Brokerage Firms

Brokerage and investment firms have a responsibility and duty, via, *inter alia*, the FINRA and SEC rules as well as the legal doctrine of *respondeat superior*, to supervise all representatives who are registered through their firm.[52] For example, FINRA Rule 3010 provides: "Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance

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is established that investment brokers did not observe professional standards of their profession, that the brokers may be found liable for professional negligence); Waldemar v. Golden, Case No: 8:18-cv-313-T-36TGW, at *5 (M.D. Fla. Dec. 4, 2018).

[48] *See, e.g.*, Suzanne Barlyn, *FINRA Warns About Misleading Investors in Non-Traded REITS*, REUTERS (May 3, 2013, 6:46 AM), https://www.reuters.com/article/us-finra-reits/finra-warns-about-misleading-investors-in-non-traded-reits-idUSBRE9420LE20130503.

[49] *See, e.g.*, St. Joseph's Hosp. and Med. Ctr. v. Reserve Life Ins. Co., 154 Ariz. 307, 312, 742 P.2d 808, 813 (1987); Cont'l Leavitt Commc'ns v. PaineWebber Inc., 857 F. Supp. 1266, 1270 (N. D. Ill. 1994) (holding that the law imposes liability on those who negligently supply false information to others in the course of business in which the supplier of information has a pecuniary interest, such as a commission or transaction fee); *see generally* Seth E. Lipner & Lisa Catalano, *The Tort of Giving Negligent Investment Advice*, 39 U. MEMPHIS L. REV. 663 (2009) (study of the development of common-law responsibility of investment advisors to exercise due diligence when providing advice to clients).

[50] *See* Mury-Ray Mgmt. Corp. v. Founders Title Co., 169 Ariz. 417, 422–23, 819 P.2d 1003, 1008-–09 (Ct. App. 1991).

[51] *Id.* at 423, 819 P.2d at 1009.

[52] *See* Anderson v. Gobea, 18 Ariz. App. 277, 280, 501 P.2d 453, 456 (1972).

with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for proper supervision shall rest with the member." This responsibility includes the requirement that brokerage firms take certain steps to ensure that their financial advisors not only follow the brokerage firm's internal policies, but also all applicable securities rules and regulations.[53] A brokerage firm may be liable for the investment losses sustained by customers where a brokerage firm has failed to exercise adequate supervision of its registered investment advisers.[54] As the court in *Hecht v. Harris, Upham & Co.* held, "stock brokerage firm[s] can act only through [their] various partners, employees and agents, and the acts of [their] employees and agents, in the course of their employment, are the acts of the firm."[55]

In an oft-cited SEC decision, *Reynolds and Co.*, the duty of supervision was summarized as follows:

> We have repeatedly held that brokers and dealers are under a duty to supervise the actions of employees and that in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication by irregularity reaches their attention . . .[56]

The SEC also stated in *Matter of Hodgdon & Co.*, that:

> It has long been established that <u>the relationship of a securities dealer or a salesman to an uninformed client is one of trust and confidence which approaches and perhaps equals that of a fiduciary</u> . . . [i]t arises out of the superior sophistication of the dealer, the reposal of special confidence by the customer in the dealer as specially qualified in the securities field and the dealer's acceptance of this reliance . . . <u>[i]t imposes upon the dealer the responsibility and duty to act in the customer's best interest in effecting transactions in his account</u>. (Emphasis added).[57]

These, and other, SEC administrative decisions recognize a comprehensive duty of supervision—one that extends well beyond the branch office level to include regional sales managers, compliance officers, and senior management of brokerage firms.

D. Breach of Fiduciary Duty

Investors often invest with an Investment Professional or investment firm because the investors view the professional or firm as skilled and reputable. Investors often trust the Investment Professional or firm and are led to believe that such trust is well-placed. A variety of

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[53] *See, e.g.*, Books and Records, FINRA, https://www.finra.org/rules-guidance/key-topics/books-records (last visited Dec. 3, 2019) ("You must follow the SEC and FINRA books and records requirements, and your individual firm's policies, which may require longer retention periods.").

[54] *See, e.g.*, Press Release, U.S. Sec. and Exch. Comm'n, *SEC Charges Broker-Dealer and CEO with Supervision Failures Related to Hedge Fund Valuation Scheme*, SEC (Aug. 21, 2019), https://www.sec.gov/news/press-release/2019-159.

[55] 283 F. Supp. 417, 443 (N.D. Cal. 1968) (alterations to the original) *modified on other grounds by* Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970).

[56] Reynolds & Co., 39 S.E.C. 902 (1960).

[57] Admin. Proc. File No. 3-533, 1969 SEC LEXIS 2920 at page 87 (5/15/69).

state[58] and federal courts[59] have found that such situations give rise to a fiduciary duty owed by the Investment Professional to the investor.

In *Duffy v. King Cavalier*, a seminal case regarding broker-dealer fiduciary duty, the California appellate court reiterated that the relationship between a stockbroker and his customer is that of a fiduciary, that the stockbroker has a duty to act in the highest good faith toward his customer, and that the broker must, where his recommendations are invariably followed, determine the customer's actual financial situation and needs, and advise the customer that speculative objectives are unsuitable.[60] The court in *Duffy* stated: "We conclude that the state common law of stockbroker fiduciary duty . . . is one of general application; it imposes a duty on all stockbrokers, regardless of the identity of their customers, and it runs in favor of all customers of stockbrokers . . . ."[61] The stockbroker in *Duffy* contended that because the customer was a "sophisticated" investor who understood the risks of options trading, the stockbroker did not owe a fiduciary duty to the investor when the stockbroker did not "control" the account.[62] Furthermore, the stockbroker contended that the customer controlled his account because he "had sufficient intelligence, experience, and understanding to evaluate the stockbroker's recommendations and to reject any which were unsuitable."[63] The court in *Duffy* rejected those arguments finding that "[n]either of these legal and factual premises has any merit."[64]

In coming to this conclusion, the court relied on the holding in *Twomey v. Mitchum, Jones & Templeton, Inc.*[65] The court in *Twomey* stated:

> Confidential and fiduciary relations are, in law, synonymous, and may be said to exist whenever trust and confidence is reposed by one person in the integrity and fidelity of another . . . . An agent is a fiduciary. His [or her] obligation of diligent and faithful service is the same as that imposed upon a trustee . . . . The relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal . . . . With respect to stockbrokers it is recognized, "[t]he

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[58] *See, e.g.*, Paine, Webber v. Adams, 718 P.2d 508, 516 (Colo. 1986) ("If a broker has acted as an investment advisor, and particularly if the customer has almost invariably followed the broker's advice, this is an indication that the broker exercises functional control of the account and that the broker-customer relationship is fiduciary.") (citing Leboce, S.A. v. Merrill Lynch, Pierce, Fenner, 709 F.2d 605, 607–08 (9th Cir. 1983); Robinson v. Merrill Lynch, Pierce, Fenner Smith, Inc., 337 F. Supp. 107 (N.D. Ala. 1971); Hecht v. Harris, Upham Co., 283 F. Supp. 417, 433 (N.D. Cal. 1968); Twomey v. Mitchum, Jones Templeton, Inc., 262 Cal.App.2d 690, 69 Cal. Rptr. 222 (1968)).

[59] *See, e.g.*, Conway v. Icahn & Co., 16 F.3d 504, 510 (2nd Cir. 1994) (finding relationship between stockbroker and customer is that of principal and agent and is fiduciary in nature); Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1215–17 (8th Cir. 1990) ("[S]ecurities brokers . . . are 'licensed professional[s] holding [themselves] out as trained and experienced to render a specialized service' . . . securities customers 'rely on the agent's expertise and expect the agent to act in their best interests.'"); Gochnauer v. A. G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987) ("The law is clear that a broker owes a fiduciary duty of care and loyalty to a securities investor."); Baker v. Wheat First Sec., 643 F. Supp. 1420, 1429 (S.D. W. Va. 1986) (holding agent owes fiduciary duty to principal and stockbroker is agent of client).

[60] 264 Cal. Rptr. 740, 749-–50 (Ct. App. 1989).

[61] *Id*. at 748.

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] 262 Cal. App. 2d 690 (1968).

> duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity."[66]

The court in *Duffy v. King Cavalier* went on to state:

> A stockbroker's fiduciary duty requires more than merely carrying out the stated objectives of the customer; at least where there is evidence . . . that the stockbroker's recommendations were invariably followed, the stockbroker must "determine the customer's *actual* financial situation and needs."[67]

Most importantly, for attorneys litigating in Arizona state courts, the Arizona Supreme Court has recognized a fiduciary relationship between investors and brokers in numerous cases. For example, the court in *Jennings v. Lee* stated: "[The broker's] liability is based on the breach of his fiduciary relationship with Mrs. Jennings . . . . A broker is under a duty to disclose to his client information which he possesses pertaining to the transaction in question."[68] Furthermore, the court in *Walston & Co. v. Miller* held:

> Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person . . . . There is no quarrel with the proposition of law that when a broker serves as a customer's agent, he is a fiduciary and owes his principal a duty to communicate certain information to him.[69]

As a result of such fiduciary relationships, the Investment Professional owes duties of utmost good faith, fair dealing, reasonable care, integrity, honesty, and loyalty in his or her transactions with the customer.[70] Included in this duty is the responsibility to provide only suitable investment advice, taking into consideration the investor's age and other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance.[71] Given what we know, it is likely many Investment Professionals violate these duties to make a quick buck via the steep commissions and/or fees associated with Non-Traded REITs, but in so doing, expose themselves to significant securities-related liability.

E. Arizona Securities Act Violations

A.R.S. § 44-1991(A)(1) prohibits any "device, scheme or artifice to defraud" in connection with the purchase or sale of a security. A.R.S. § 44-1991(A)(2) provides that it is a fraudulent practice to offer or sell securities by making "any untrue statement of fact" or "omit[ting] to state

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[66] *Id.* at 708–09 (citation and punctuation omitted).
[67] 264 Cal. Rptr. at 754 (alteration in original).
[68] 105 Ariz. 167, 173, 461 P.2d 161, 167 (1969).
[69] 100 Ariz. 48, 51 (1966) (citing Restatement (Second), Agency § 381); *see also* Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 44–45, 64 P.2d 101, 106 (1937); *accord* SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp. 2d 985, 992–95 (D. Ariz. 1998).
[70] *See* Musselman v. Southwinds Realty, Inc., 146 Ariz. 173, 175, 704 P.2d 814, 816 (1985); Jennings v. Lee, 105 Ariz. 167, 173, 461 P.2d 161, 167 (1969); Hassenpflug v. Jones, 84 Ariz. 33, 36, 323 P.2d 296, 298 (1958).
[71] *See* FINRA , Rule 2111, 75 Fed. Reg. 52562 (Aug. 20, 2010).

any material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." A.R.S. § 44-1991(A)(3) makes it unlawful to "engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit."

Investment Professionals and their firms may be accused of violating A.R.S. § 44-1991 by the act of soliciting and inducing clients to invest in Non-Traded REITs without disclosing the true nature of the investments and the fees, risks and conflicts of interest associated therewith. The conduct of Investment Professionals and their firms often alleged in Non-Traded REIT-related securities litigation also constitutes "dishonest and unethical" broker-dealer practices under the Arizona Securities Act, A.R.S. § 44-1801, *et seq.*, and Arizona Corporation Commission Rule R14-4-130. While successful cases will usually show scienter or intent under A.R.S. § 44-1991, such a showing is not required for an investor to recover for sustained injuries.[72]

Investment Professionals and investment firms are likely to contend they disclosed at least some of the risks associated with the investments. However, Investment Professionals and their firms are obliged to provide investors with all material facts that a reasonable investor would want to know in making an informed investment decision.[73] The "policy of deterring intentional misconduct in securities dealings outweighs the policy of deterring negligent behavior by investors."[74]

Potential claimants should be prepared for Investment Professionals and investment firm defendants to raise a "failure to read" defense.[75] The leading Arizona case addressing failure to read is in *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, which held that failure to read is not a defense if the customer reasonably relied upon the verbal statements of the agent.[76] The court in *Darner* based its holding on the countervailing need to ensure competence and integrity in those who hold themselves out as professional advisors. Specifically, the court stated "[w]e are a nation which also prides itself on a tradition of allowing a person to rely upon the words of another who, because of a special knowledge, undertakes to act as an advisor."[77] Although *Darner* involves the duties of insurance agents, it is no less applicable in the securities

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[72] Garvin v. Greenbank, 856 F.2d 1392, 1397 (9th Cir. 1988); Rose v. Dobras, 128 Ariz. 209, 214, 624 P.2d 887, 892 (Ct. App. 1981).

[73] *See* Aaron v. Fromkin, 196 Ariz. 224, 227, ¶¶ 14–15, 994 P.2d 1039, 1042 (Ct. App. 2000) (holding that the Arizona Securities Act imposes affirmative duty not to mislead and to prove materiality for purposes of statute, investor need only show statement or omission would have assumed actual significance in deliberations of reasonable buyer).

[74] Connor v. First of Michigan Corp., No. G89-50052 CA, 1990 WL 120644, at *14 (W.D. Mich. May 31, 1990) (refusing to give preclusive effect to signed disclosure statements and subscription contracts).

[75] The "failure to read" defense essentially posits that it is the responsibility of each party to a contract to read the contract's terms, and that a party's failure to read a contract before signing does not invalidate the fact that the contract is legally binding and enforceable. *See, e.g.*, Seekings v. Jimmy GMC of Tucson, Inc., 130 Ariz. 596, 602 (Ariz. 1982) ("(1) the failure to read a contract before signing does not invalidate it in the absence of fraud") (citing Apolito v. Johnson, 3 Ariz. App. 232, 413 P.2d 291 (1966)). Many other states have this defense available. *See, e.g.*, Hansen v. Wheaton Van Lines, Inc., 486 F. Supp. 2d 1339, 1346 (S.D. Fla. 2006) (applying Florida law and stating: "An individual's failure to read or investigate the terms of the contract she signed is not a defense to enforcement of the contract."). The defense is so strong in some states, that it presumes even illiterate people are presumed to know the contents of the contract. *See, e.g.*, Swift v. North American Co. for Life and Health Ins., 677 F.Supp. 1145, 1150 (S.D. Fla. 1987) ("The rule that one who signs a contract is presumed to know its contents has been applied even to contracts of illiterate persons on the ground that if such persons are unable to read, they are negligent if they fail to have the contract read to them.").

[76] 140 Ariz. at 398, 682 P.2d at 403.

[77] *Id.* at 398, 682 P.2d at 403.

context. Customers who pay commissions and fees for professional advice have the right to rely upon the advice provided by the Investment Professionals in question.

Consistent with *Darner*, Arizona courts have held a "person who violates A.R.S. § 44-1991(A)(2) is strictly liable for the misrepresentations or omissions he makes."[78] Because the statute was enacted for investor protection, an investor's failure to exercise due care is not a defense. As the court in *Trimble v. Am. Sav. Ins. Co.* noted: "[t]he statutes do not require investors to act with due diligence; nor do we find any judicial authority in Arizona for such a requirement. To the contrary, defendants have an affirmative duty not to mislead potential investors."[79] Clients regularly trust and rely upon the Investment Professional and the investment firm for full and complete disclosure of material information.

An Investment Professional and an investment firm may also be liable under A.R.S. § 44-2003 because the Investment Professional or firm made, participated in, or induced the purchase of the subject investments and/or were controlling persons under A.R.S. § 44-1999. A.R.S. § 44-2001 provides that where a violation of A.R.S. § 44-1991 has been committed, the securities purchaser—the clients—are entitled to rescission or to recover the clients' damages against the Investment Professional(s) and/or investment firms, with interest thereon, costs, and attorney's fees.

F. Fraud in the Provision of Investment Advisory Services.

Pursuant to A.R.S. § 44-3241, it is fraudulent for a person to, in the provision of investment advisory services, "make any untrue statement of material fact, or fail to state any material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading." Practically, this "imposes [on investment advisors] an affirmative duty not to mislead."[80]

Investment Professionals have challenged such claims in the past on several bases, including the materiality (or lack thereof) of an advisor's representations to a client.[81] Arizona courts have long analyzed the materiality of representations under securities laws using an objective standard.[82] The materiality requirement is deemed satisfied by "a showing of substantial likelihood that, under all the circumstances, the misstated or 'omitted fact would have assumed actual significance in the deliberations' of a *reasonable* buyer."[83] Thus, the test is not investor-specific and "there is no need to investigate whether an omission or misstatement was actually significant to a particular buyer."[84]

Pursuant to A.R.S. § 44-3241, it is fraudulent for a person to, in the provision of investment advisory services, "[e]ngage in any transaction, practice or course of business that operates or would operate as a fraud or deceit."

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[78] *Garvin*, 856 F.2d at 1398.

[79] 152 Ariz. 458, 453, 733 P.2d 1131, 1136 (Ariz. Ct. App. 1987).

[80] Aaron v. Fromkin, 196 Ariz. 224, 227, ¶ 15, 994 P.2d 1039, 1042 (Ariz. Ct. App. 2000) (citation omitted); *see also* Hirsch v. Ariz. Corp. Comm'n, 237 Ariz. 456, 463 352 P.3d 925, 932 (Ariz. Ct. App. 2015).

[81] *See, e.g.*, *Hirsch*, 237 Ariz. at 463, 352 P.3d at 932.

[82] Rose v. Dobras, 128 Ariz. 209, 214, 624 P.2d 887, 892 (Ariz. Ct. App. 1981) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 445, 96 S.Ct. 2126 (1976) ("The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.")); *see also Hirsch*, 237 Ariz. At 463-64, 352 P.3d at 932–33.

[83] Trimble v. Am. Sav. Life Ins. Co., 152 Ariz. 548, 553, 733 P.2d 1131, 1136 (Ariz. Ct. App. 1986) (quoting *Rose*, 128 Ariz. at 214, 624 P.2d at 892).

[84] *Trimble*, 152 Ariz. at 553, 733 P.2d at 1136. Ariz. at 553.

G. Federal Securities Violations

The misrepresentations, omissions, and other misconduct of Investment Professionals and their firms, as hypothesized herein, also constitute a violation of federal securities laws, including, *inter alia*, those set forth in Section 10(b) of the Securities Exchange Act of 1934 [15 U. S. C. § 78j(b)], SEC Rule 10b-5 [17 C. F. R. § 240.10b-5] and Section 206 of the Investment Advisers Act of 1940 [15 U.S.C. § 80b-1, *et seq.*]. These hypothesized fact situations are likely to reflect an intentional or reckless disregard for investors' interests.

H. Suitability Violations

To help ensure that customers receive sufficient investment advice, FINRA Rule 2111,[85] FINRA Conduct Rule 2310,[86] IM-2310-2(a)(1) in the NASD Manual,[87] NYSE Rule 405,[88] and other regulatory rules require firms and their Investment Professionals to learn as much about a customer's investment profile as possible before recommending a securities transaction or investment strategy, and to only make suitable investment recommendations in line with the investment profile.

Whether this suitability requirement is met is dependent upon the firm's or Investment Professional's reasonable diligence in obtaining information about the customer's desired investment profile and preferences more generally. Among the information that should be collected to help inform such a reasonable basis is: risk tolerance (a customer's willingness to risk losing some or all of his or her original investment in exchange for larger potential returns); liquidity needs (the customer's needs and ability to convert investments to cash in a short period

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[85] "A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."

[86] FINRA Conduct Rule 2310(a), concerning suitability of investments and fair dealing with customers, provides: "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

[87] "Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's rules, with particular emphasis on the requirement to deal fairly with the public."

[88] The "Know Your Customer Rule" or "Due Diligence Rule" reads in pertinent part:

Every member organization is required . . . to (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization . . . (2) Supervise diligently all accounts handled by registered representatives of the organization.

Rule 405 "also provides that members must supervise diligently all accounts handled by the firm and specifically approve the opening of an account either prior to or promptly after the completion of a transaction. Rule 411 of the American Stock Exchange is to similar effect." Faturik v. Woodmere Securities, Inc., 442 F. Supp. 943, 945 (S.D.N.Y. 1977). Importantly, "while not every violation of Exchange rules is per se actionable, a violation of Rule 405 can, in some cases, create a private claim for relief." Faturik v. Woodmere Securities, Inc., 442 F. Supp. 943, 946 (S.D.N.Y. 1977) (citing Buttrey v. Merrill Lynch, Pierce, Fenner Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838, 90 S.Ct. 98 (1969); Burns v. Bruns Nordeman Co., 1972–73 Transfer Binder, CCH Fed.Sec.L.Rep. ¶ 93,674 (S.D.N.Y. 1972)).

of time without incurring significant loss in value); investment experience; investment time horizon; and investment objectives (e.g., generating income, buying a home, funding retirement, preserving wealth, etc.).

These rules place an obligation on a firm and associated Investment Professionals to seek information from customers. Because customers are not required to provide this information, the suitability rule provides some flexibility when information is unavailable despite the fact that the firm or associated Investment Professional asked the investor for it.

It is well established that self-regulatory organization rules are properly asserted as standards of care against which respondents' conduct must be measured in determining liability. As the United States District Court in *Lange v. H. Hentz & Co.* stated:

> NASD rules . . . do prescribe conduct which the NASD member should attempt to achieve. Traditionally, rules of this sort have served as bench marks for a determination of the reasonableness of a defendant's actions . . . [A] proven violation of the rules is more than a mere irrelevancy and should be a factor [in] the determination of what standards should be applied to the stock brokerage industry . . . [i]t is therefore the decision of this Court that the NASD Rules may be used as evidence of the present standard of care which the NASD member should achieve.[89]

Further, the U.S. Court of Appeals for the Ninth Circuit has held in the oft-quoted case of *Mihara v. Dean Witter & Co., Inc.* that such rules are admissible as to the standard of care expected in the industry:

> Appellants' second point, that the Court should not have permitted testimony regarding the rules and regulations of the New York Stock Exchange, is without merit. New York Stock Exchange Rule 405 requiring that each securities broker "know (his) customer" has been recognized as a standard to which all brokers using the Exchange must be held, the violation of which is tantamount to fraud . . . [a]ppellants contend that the admission of testimony regarding New York Stock Exchange and NASD rules served to "dignify those rules and regulations to some sort of standard." The admission of testimony relating to those rules was proper precisely because the rules reflect the standard to which all brokers are held.[90]

Suitability will likely be an issue in every case where Non-Traded REITs were invested and the client has suffered a resulting financial loss. Non-Traded REITs are not "safe," but rather bear great risk because they are illiquid. Given the common characteristics of Non-Traded REITs (most importantly, their illiquidity), loading up a client with a number of Non-Traded REITs does not

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[89] 418 F. Supp. 1376, 1383–84 (N.D. Tex. 1976); *see also* Piper, Jaffray & Hopwood Inc. v. Ladin, 399 F. Supp. 292, 298 (S.D. Iowa 1975) ("[defendant's] conduct must be judged according to the generally accepted standards of the stock brokerage industry . . . [b]oth Rule 405 of the NYSE [the "Know Your Customer Rule"] and the NASD Suitability Rule are appropriate indicia of the standard of conduct required of a stock broker in the practice of his profession.").

[90] 619 F.2d 814, 824 (9th Cir. 1980); *see also* Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 200 (3d Cir. 1990) (recognizing violations of financial industry rules can be "probative in demonstrating a course of conduct amounting to fraud.").

constitute diversification of a portfolio, and such a situation likely would not meet Investment Professionals' suitability standards.

I. Pattern of Unlawful Activity

Arizona recognizes a private claim for civil racketeering known as a pattern of unlawful activity, which requires the plaintiff to prove: (1) the defendant engaged in a pattern of unlawful activity for purposes of financial gain (i.e., any benefit, interest or property of any kind without reduction for expenses of acquiring or maintaining it or incurred for any other reason); (2) the defendant's pattern of unlawful activity caused the plaintiff's damages; and (3) the plaintiff's damages were a reasonably foreseeable result of the defendant's pattern of unlawful activity.[91]

A pattern of unlawful activity would include two predicate acts that occurred within five years of one another, that are related to each other, such as having the same or similar purposes, results, participants, victims or methods, or a common external organizing principle like the affairs of an enterprise, and were continuous or exhibited the threat of being continuous.[92] In the investment context, the two requisite predicate acts may include the intentional or reckless fraud in the purchase or sale of securities, intentional or reckless sale of unregistered securities or real property securities, or a scheme or artifice to defraud.[93] However, securities fraud can only be a predicate act for a pattern of unlawful activity if the defendant has been convicted of a crime in connection with that fraud, such as through a verdict, guilty plea or no contest plea, in which event the defendant cannot deny the essential allegations underlying the criminal conviction.[94]

If successful on a pattern of unlawful activity claim, a plaintiff may recover up to treble (three times) damages, pre-judgment interest on actual (not treble) damages, and the costs of the suit, including reasonable attorneys' fees for both the trial and the appeal, unless awarding such costs would be unjust due to special circumstances.[95] Punitive damages and emotional injury damages are not recoverable absent bodily injury.[96] A natural person or an enterprise can be held liable in damages or for other relief based on the pattern of unlawful activity of another or agent if the natural person or a director or high managerial agent of the enterprise authorized, requested, commanded, ratified or recklessly tolerated the unlawful conduct of the other or agent.[97] However, a natural person or enterprise cannot be held liable in damages for recklessly tolerating the unlawful conduct of another person or agent if the other person or agent engaged in intentional or reckless securities fraud, intentional or reckless sale of unregistered securities, or a scheme or artifice to defraud involving the purchase or sale of securities.[98]

J. Common Law Fraud & Intentional Misrepresentation

Investment Professionals and their firms may also be liable under common law fraud and intentional misrepresentation theories. Arizona courts have established that for a claimant to establish actionable fraud, that claimant must show a concurrence of the following elements:

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[91] ARIZ. REV. STAT. ANN. (hereinafter A.R.S.) § 13-2314.04(A), (S), (T)(2).
[92] A.R.S. § 13-2314.04(T)(3).
[93] A.R.S. § 13-2301(D)(4)(b).
[94] A.R.S. § 13-2314.04(A), (E).
[95] A.R.S. § 13-2314.04(A), (D), (M).
[96] A.R.S. § 13-2314.04(K).
[97] A.R.S. § 13-2314.04(L).
[98] *Id.*

> (1) A representation; (2) its falsity; (3) its materiality; (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 and in the manner reasonably contemplated; (6) the hearer's ignorance of its falsity; (7) his reliance on its truth; (8) his right to rely thereon; (9) his consequent and proximate injury.[99]

Investment Professionals advocating for their clients to invest in Non-Traded REITs may make misrepresentations or omissions of material fact to clients relating to the investments' risks, the Investment Professional's conflict(s) of interest, and the fees the Investment Professional will charge—both up front and as time goes on. Such misrepresentations and omissions would likely be material to the clients' willingness to conduct business with the Investment Professional and reliance upon the Investment Professional's statements in investing in the advocated-for vehicles. It is likely that if a client had known of the misrepresented and/or omitted material facts, he or she might not have agreed to invest with the Investment Professional, not invest in the Non-Traded REITs, or at least not have Non-Traded REITs comprise such a high percentage of the individual's portfolio.

Given the fact Investment Professionals will have suggested investment in Non-Traded REITs to induce action, should the client suffer harm as the result of the Investment Professional's misrepresentations and/or omissions, the client will likely be able to prove actual and proximate cause.

K. Aiding and Abetting Fraud & Breach of Fiduciary Duty

Investment Professionals and firms may also be liable for aiding and abetting any fraud[100] and aiding and abetting breach of fiduciary duty.[101] However, there are several states, such as Arizona, that have statutorily abrogated causes of action for aiding and abetting securities fraud.[102] Generally, aiding and abetting liability does not require the existence of a pre-existing duty of care.[103] "Rather, aiding and abetting liability is based on proof of a scienter."[104] Because it is a "theory of secondary liability, the party charged with the tort must have knowledge of the primary

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[99] *See* Staheli v. Kauffman, 122 Ariz. 380, 383, 595 P.2d 172, 175 (1979) (quoting Carrel v. Lux, 101 Ariz. 430, 434, 420 P.2d 564, 568 (1966)) (quotation marks omitted); *see also* Nielson v. Flashberg, 101 Ariz. 335, 338–39, 419 P.2d 514, 517–18 (1966).

[100] *See* Wells Fargo Bank v. Ariz. Laborers, 201 Ariz. 474, 485, 38 P.3d 12, 23 (2002) ("Arizona recognizes aiding and abetting as embodied in Restatement § 876(b), that a person who aids and abets a tortfeasor is himself liable for the resulting harm to a third person.") (citing Gemstar Ltd. v. Ernst Young, 183 Ariz. 148, 159, 901 P.2d 1178, 1189 n.7 (Ct. App. 1995), *vacated on other grounds*, 185 Ariz. 493, 917 P.2d 222 (1996); Gomez v. Hensley, 145 Ariz. 176, 178, 700 P.2d 874, 876 (App. 1984); Restatement (Second) of Torts § 876(b) (1977)).

[101] Sec. Title Agency, Inc. v. Pope, 219 Ariz. 480, 497, ¶ 76, 200 P.3d 977, 994 (Ct. App. 2008).

[102] Sell v. Gama, 231 Ariz. 323, 324, ¶ 1, 295 P.3d 421, 422 ¶ 1 (2013).

[103] Wells Fargo Bank v. Ariz. Laborers, 201 Ariz. 474, 485, 38 P.3d 12, 23 (2002) (citing Witzman v. Lehrman, Lehrman Flom, 601 N.W.2d 179, 186 (Minn. 1999)).

[104] *Wells Fargo Bank, 201 Ariz. at 485, 38 P.3d at 23Id.* (citing *Witzman*, 601 N.W.2d at 186); Pacific Mut. Life Ins. Co. v. Ernst Young Co., 10 S.W.3d 798, 804 (Tex.App. 2000) (to extent duty may be considered part of scienter element of fraud claim, such duty extends to all persons the fraud defendant intends or has reason to expect will rely on its misrepresentations (citing Restatement (Second) of Torts § 531)), *judgment rev'd*, 51 S.W.3d 573 (Tex. 2001)).

violation."[105] Such knowledge may be inferred from the circumstances.[106] To establish a successful claim for aiding and abetting tortious conduct, the claimant must prove three elements: (1) the primary tortfeasor committed a tort that causes injury to the plaintiff; (2) the defendant knew that the primary tortfeasor's conduct constitutes a breach of duty; and (3) the defendant substantially assisted or encouraged the primary tortfeasor in the achievement of the breach."[107] One can imagine a situation in which an Investment Professional and his/her firm owe a duty to the client, work in conjunction with one another to deceive and/or defraud the client, and thereby giving rise to the potential tort claims outlined in this Section.

L. Breach of Contract & Breach of Implied Duty of Good Faith and Fair Dealing

"For an enforceable contract to exist, there must be an offer, an acceptance, consideration, and sufficient specification of terms so that obligations involved can be ascertained."[108] Investment Professionals will likely either expressly or implicitly agree to manage a client's investment, make only suitable investment recommendations for clients, and to discharge the Investment Professional's obligations as a fiduciary and agent for the client by providing full and complete information about the investment recommendations made by the Investment Professional. Falling below this standard would result in a claim for relief under a breach of contract theory. Express, or at least implied, in every agreement between an Investment Professional and his or her client, is the commitment on the part of the Investment Professional and firm to follow the rules and regulations on FINRA, NYSE, and any other self-regulatory agencies and/or organizations to which the Investment Professional and firm are subject (e.g., the suitability, know your customer, and supervisory rules).

Further, there is implied in every contract the duty of good faith and fair dealing, which provides "neither party will act to impair the right of the other to receive the benefits which flow from their agreement or contractual relationship."[109] There is also an obligation to perform competently in handling a customer's investment funds. An Investment Professional may breach this implied duty of good faith and fair dealing by recommending and selling illiquid and high-risk Non-Traded REITs to customers. Courts have held that in the event of such a breach, a customer may not only recover out-of-pocket losses, but also benefit-of-the-bargain damages.[110]

M. Punitive damages

Punitive damages may be awarded for conduct done with an improper motive or with a reckless indifference to the interest of others.[111] The purpose of punitive damages is to both punish

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[105] *Wells Fargo Bank*, 201 Ariz. at 485, 38 P.3d at 23 (*citing* In re American Cont'l Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. 1424, 1436 (D. Ariz. 1992)).

[106] *Id.* (citing In re American Cont'l Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. at 1436).

[107] *Gomez*, 145 Ariz. at 178, 700 P.2d at 876 (citing Restatement (Second) of Torts § 876(b)); *see also Wells Fargo Bank*, 201 Ariz. at 485, 38 P.3d at 23.

[108] K-Line Builders, Inc. v. First Fed. Sav. & Loan Ass'n., 139 Ariz. 209, 212, 677 P.2d 1317, 1320 (Ct. App. 1983).

[109] Rawlings v. Apodaca, 151 Ariz. 149, 153, 726 P.2d 565, 569 (1986).

[110] *See* Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1218 (8th Cir. 1990); Hershock v. Fiascki, No. CIV. A. 90-0497, 1992 WL 164739, at *7 (E.D. Pa. July 2, 1992); Levine v. Futransky, 636 F. Supp. 899, 900 (N.D. Ill. 1986) ("[P]laintiffs suffered damages even though the investment portfolios incurred a net gain. Plaintiffs may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded . . .").

[111] *See* Echols v. Beauty Built Homes, Inc., 132 Ariz. 498, 501, 647 P.2d 629, 632 (1982).

wrongdoers for their misconduct and deter them and others from committing other wrongful acts.[112]

The standard for punitive damages is set forth in *Linthicum v. Nationwide Life Ins. Co.*[113] In *Linthicum*, the Arizona Supreme Court held a punitive damages award requires finding: (1) an "outwardly aggravated, outrageous, malicious, or fraudulent conduct;" and (2) the "wrongdoer's intent to injure the plaintiff or his deliberate interference with the rights of others, consciously disregarding the unjustifiable substantial risk of significant harm to them," referred to sometimes as the "evil mind" standard.[114]

Claimants may meet the standard by clear and convincing evidence, either direct or circumstantial, regarding the respondents' evil mind.[115] As the Court in *Thompson* noted:

> A plaintiff can, of course, satisfy this [clear and convincing] burden of proof through direct evidence, i.e., an admission by the defendant. Because such admissions are relatively rare, however, the plaintiff can also make its case with indirect and circumstantial evidence . . . "[e]ven if the defendant's conduct was not outrageous, a jury may infer evil mind if defendant deliberately continued his actions despite the inevitable or highly probable harm that would follow . . . ."[116]

No doubt, some Non-Traded REITs will perform so poorly, the recommendations made will be so unfounded, and the concentration in portfolios so risky, that exposure to punitive damages will be found to exist.

N. Attorneys' Fees

There are a number of ways to recover attorneys' fees and costs. For example, Arizona is among the minority of states[117] that allow the successful party to recover its attorneys' fees incurred "[i]n any contested action arising out of contract, express or implied . . . ." via A.R.S. §

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[112] *See* Michael v. Cole, 122 Ariz. 450, 452, 595 P.2d 995, 997 (1979); Carter-Glogau Lab., Inc. v. Constr., Prod. & Maint. Laborers' Local 383, 153 Ariz. 351, 357, 736 P.2d 1163, 1169 (Ct. App. 1986).
[113] 150 Ariz. 326, 723 P.2d 675 (1986).
[114] *Id.* at 331, 723 P.2d at 680.
[115] Thompson v. Better-Bilt Aluminum Prod. Co., 171 Ariz. 550, 557, 832 P.2d 203, 210 (1992).
[116] *Id.* at 557, 832 P.2d at 210.
[117] David Farren & Roger Cohen, *Attorney Fee Shuffle - The Arizona Supreme Court has Imported the Fee Shifting Provision of A.R.S. § 12-341.01(A) Into Private, Mandatory Contractual Fee Provisions*, JABURG WILK (Sept. 11, 2017), http://www.jaburgwilk.com/news-publications/attorney-fee-shuffle.

12-341.01(A).[118] The "arising out of contract" language is interpreted broadly[119] such that it includes tort claims that are based in contract or could not exist but for a contract,[120] as well as tort claims that are intertwined or interwoven with contract claims.[121] This statutory fee provision is discretionary and can be based on a number of factors, including: (1) whether the claim or defense presented by the unsuccessful party had merit; (2) whether the litigation could have been avoided or settled and whether the successful party's efforts were completely superfluous in achieving the result; (3) whether assessing fees against the unsuccessful party would cause an extreme hardship; (4) whether the successful party did not prevail with respect to all of the relief sought; (5) whether the legal question presented was novel; (6) whether the claim or defense had previously been adjudicated in the jurisdiction; and (7) whether the award would discourage other parties with tenable claims or defenses from litigating or defending legitimate contract issues for fear of incurring liability for substantial amounts of attorneys' fees.[122] Arizona also allows the successful party to recover its costs, which is a mandatory provision and not limited to actions arising out of contract.[123]

Other relevant statutes that allow for recovery of attorneys' fees and costs include: A.R.S. § 44-2001(A), which provides a person who has been the victim of a securities violation like the sale of unregistered securities or securities fraud may bring an action "to recover the consideration paid for the securities, with interest, taxable court costs and reasonable attorney fees," A.R.S. § 44-3241(B), which provides "[a] person who violates this section [fraud in the provision of investment advisory services] is liable to any person for all losses incurred by that person as a result of the violation, together with interest on losses incurred, court costs and reasonable attorney fees," and A.R.S. § 13-2314.04(A), which provides a person who has been injured by a pattern of unlawful activity may recover "up to treble damages and the costs of suit, including reasonable attorney fees for trial and appellate representation."

V. CONCLUSION

This tide may be coming in. A number of Non-Traded REITs have already failed or are failing and sale upon the secondary market is likely to yield only pennies on the dollar invested. Holders of these illiquid, high-risk Non-Traded REITs should investigate their investments carefully to make appropriate decisions about whether it is prudent to try to redeem or sell them

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[118] The Arizona legislature made clear this statute is not intended to override contractual fee provisions. *See* Ariz. Rev. Stat. § 12-341.01(A) ("This section shall not be construed as altering, prohibiting or restricting present or future contracts or statutes that may provide for attorney fees."). Resultingly, Arizona courts have consistently held contractual fee provisions, if otherwise legally valid, supersede Ariz. Rev. Stat. § 12-341.01. *See, e.g.*, Sweis v. Chatwin, 120 Ariz. 249, 252, 585 P.2d 269, 272 (Ct. App. 1978) (applying Ariz. Rev. Stat. § 12-341.01 instead of the contract "would in effect cancel the unqualified contractual right to recover attorney's fees given to the successful party by their agreement" and "would clearly be an alteration of the agreement of the parties"); *see also* Geller v. Lesk, 230 Ariz. 624, 627, ¶ 9, 285 P.3d 972, 975 (Ct. App. 2012) (parties' contractual provision, "not the statute," governs an award of fees); Lisa v. Strom, 183 Ariz. 415, 418 n.2, 904 P.2d 1239, 1242 n.2 (Ct. App. 1995) ("when a contract has an attorney's fee provision it controls to the exclusion of the statute"); Connor v. Cal-Az Properties, Inc., 137 Ariz. 53, 55, 668 P.2d 896, 898 (Ct. App. 1983) (statute "is not to be considered" when parties' contract provides conditions under which attorney fees may be recovered).

[119] ML Servicing Co., Inc. v. Coles, 235 Ariz. 562, 570, ¶ 30, 334 P.3d 745, 753 (Ct. App. 2014).

[120] Marcus v. Fox, 150 Ariz. 333, 335-36, 723 P.2d 682, 684-85 (1986); Sparks Republic Nat'l Life Ins. Co., 132 Ariz. 529, 543, 647 P.2d 1127, 1141 (1982).

[121] Modular Mining Sys., Inc. v. Jigsaw Techs., Inc., 221 Ariz. 515, 522, ¶ 23, 212 P.3d 853, 860 (Ct. App. 2009).

[122] Associated Indemnity Corp. v. Warner, 143 Ariz. 567, 570, 694 P.2d 1181, 1184 (1985).

[123] Ariz. Rev. Stat. § 12-341; *see also* Ariz. Rev. Stat. § 12-332 (defining taxable costs).

or to seek out legal counsel and weigh the various potential legal claims that may exist against the Investment Professionals and their firms that recommended and sold these high-risk and illiquid investments.