Investor Insight

How First Leaside investors were victimized

By Steven G. Kelman | 05-10-12| E-mail Article to a Friend

Investors looking for reasons to avoid exempt market issues until there is better investor protection should look at the collapse of the First Leaside Group of Companies, the woes befalling its investors and, in my opinion, how better regulatory oversight might have saved investors millions upon millions of dollars.

First Leaside Group was in the business of putting together limited partnerships, primarily in the real- estate sector, which it sold through its own direct sales force. It raised more than $330 million, most of which was in promissory notes and equity positions through limited partnerships. Some investors received distributions over the years, but I doubt many will get any of their capital back.

On May 1 in Bolton, Ontario, more than 100 First Leaside investors attended a meeting of the First Leaside Investor Protection Association, which was formed after the firm entered creditor protection back in February. It wasn't a typical investor get-together and a far cry from the luxury parties that First Leaside Group used to throw for its investors.

It was a sombre event. People were there to find out what they would receive, if anything, from the money invested in more than 40 different First Leaside entities.

They were for the most part prepared for the worst. They were familiar with the 134-page report that Grant Thornton LLP, the court-appointed monitor of the company, had prepared on the First Leaside entities, which concluded that the future viability of the FL Group was contingent on its ability to raise new capital. The investors were well aware that distributions had ceased before year-end and that First Leaside was being wound down.

Now they were getting a new report addressed to them from Grant Thornton, and the news was bad. The various entities had losses and for the most part minimal or negative equity. A case in point is the largest entity, Wimberly Apartments Limited Partnership: it owns 11 properties that were appraised earlier this year at $59.6 million. If they were sold there would be mortgage payouts of $59.5 million including prepayment penalties.

On top of that there would be closing costs and broker's fees of another $3 million. But it's worse than that. In addition to the mortgages, promissory notes of $68.3 million have to be paid as well as $21.9 million owed to other First Leaside entities.

The end result is a partners' deficit of $93.5 million, which can best be described as the result of placing more debt on top of debt put in place to pay the interest on other layers of debt. In fact the total amount of debt and equity raised by this entity was $152.6 million.

What upset many investors at the meeting was that the deficits were funded in part by new money coming in from investors as well as intercompany loans. In essence, investors were told they were buying real-estate-related investment products when in reality, their money was used to finance previously contracted debt.

Some of the people in the room had invested all their savings in First Leaside investments, believing they were secure. Some may have thought their investments were diversified because they held more than one First Leaside issue. What they didn't realize was that the money they put into a specific First Leaside entity could be lent to any other First Leaside entity.

This was disclosed in the lengthy and complex offering documents, which unfortunately few investors read and fewer understand. This is not the sort of item generally included in a sales pitch.

Most of First Leaside's investment products were exempt issues, with information provided by offering memorandum and not with the protection of a prospectus. The initial Grant Thornton report stated that about 90% of the 1,000 investors were accredited investors, which means that buyers were supposed to have substantial income or substantial financial assets. The other 10% would have bought a minimum of $150,000 in a single investment.

Still, this was not an exclusive gathering of millionaires. There were many in the group who had simply invested their couple of hundred thousands of savings, their RRSPs, their RRIFs. One told me while we were lining up for coffee that she was trying to return to the workforce. She was totally unaware of the risks of the investment she had been sold. This was a common story told by many investors.

As I pointed out in a column last December, the regulators' premise behind the exemptions is that someone playing with large amounts has a certain level of sophistication, the ability to withstand financial loss, the financial resources to obtain expert advice, and the incentive to carefully evaluate the investment, given its size.

The key problem, as I see it, is that many exempt issues are sold to people who haven't a clue about what they are buying and are given information that they don't understand and, in many cases, is incomplete.

Furthermore, since First Leaside was a direct seller, there wasn't a layer of due diligence that investors are supposed to get when they buy from dealers who sell products from many sources.

On top of that, disclosure was dismal. A limited partnership is what is called a non-reporting issuer. They are not offered to the general public but only to accredited investors and individuals willing to invest a minimum of $150,000. They don't have to publish financial information or even notify investors about changes in its business. In fact an offering memorandum dated November 3, 2010 for Wimberly Fund unsecured promissory notes stated "You will not receive ongoing information about this issuer." The offering memorandum did not include financial information.

It's impossible to evaluate an investment without proper financial statements. In a report to partners written in late February 2010, David C. Phillips, the managing partner of the First Leaside Group of Companies, stated that in 2009, "after a delay of more than three years, Wimberly Apartments Limited Partnership's (WALP) audited financial statements for 2006-2008 were completed by KPMG."

The reason for the delay, however, was more than a little spat over a few numbers. The auditors included a going-concern note on the 2006-2008 Wimberly financial statements, questioning the continued viability of the entity.

I have no doubt that auditors and corporate managements may have disagreements over items and allocations. But from my perspective anything as important as a disagreement over the viability of the company is something that should be disclosed to potential investors before raising a single additional dollar.

The buyers I saw at the meeting were not sophisticated investors who were familiar with these companies' businesses and finances and could evaluate the investments offered. They were retail investors who were sold risky products without, in my opinion, full disclosure of the risks.

My suggestion to the regulators is that if something is aimed at retail investors, apply prospectus protection and require the same reporting standards for to all issuers. The markets have changed over the years, and many exempt offerings today are aimed at individual investors rather than institutions. First Leaside is an example of where the regulations failed.

In a follow-up article, I'll examine in further detail how investors were victimized in this case.

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Why wasn't First Leaside shut down earlier?

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Investors in First Leaside Group should be asking why sales of its products weren't closed to new investors several years before the Ontario firm entered creditor protection in February.

The severe financial problems should have long been apparent to its directors and regulators. For that matter, even ordinary investors would have realized the high risks of catastrophic losses, had they been given all the facts.

As noted in my previous column, First Leaside was in the business of putting together limited partnerships, primarily in the real- estate sector, which it sold through its own direct sales force. It raised more than $330 million, most of which was in promissory notes and equity positions through limited partnerships.

On Nov. 7, 2011, First Leaside Group informed its investors by letter that accounting firm Grant Thornton had concluded that the "future viability of the FL Group was contingent on their ability to raise new capital." The trouble is, the directors had known this material information since Aug. 19, 2011 -- almost three months earlier.

The November letter was signed by David C. Phillips, president; Douglas Hyatt, chairman, and Leo de Bever, a director. (De Bever, whose involvement had lent credibility to First Leaside, is also CEO and chief investment officer of the Alberta Investment Management Corp.)

Even had the First Leaside directors disagreed with Grant Thornton's bleak assessment, the accountants' opinion should have been shared with investors in a timely manner. Clearly, there were serious risks. In my opinion, there was at minimum a moral obligation to inform investors of the contents of the report without undue delay.

Instead, by the time the report was released, investors were trapped in money-losing investments. Worse still, new investors had come aboard.

The Ontario Securities Commission had requested in late October that trading cease on First Leaside proprietary products, and the company complied voluntarily to give it time to reorganize its affairs.

OSC staff advised First Leaside that in their view, "it is not appropriate to use money raised from new investors to fund the operating losses, rehabilitation costs and distributions of existing limitation of existing partnerships."

Even so, many investors fell between the cracks. Between the time the Grant Thornton report was delivered to management but not yet shared with investors and the time that trading ceased, $20 million of new investment was received from investors. (Currently, a group of these investors are weighing their legal options.)

In a Dec. 23 letter to investors in the partnerships, Phillips attempted to put the best face on a bad situation. In the letter, the First Leaside president referred to a new model, a new reality, and a new plan to move forward.

This message of hope to the partners was in sharp contrast to the prolonged delays in producing financial statements, and blunt warnings from Grant Thornton of the very real prospects of business failure.

Then in February 2012 the other shoe dropped. First Leaside was placed under the control of a court-appointed chief restructuring officer.

As I noted in my previous article, there was a more than three-year delay in producing the 2006 to 2008 audited statements for Wimberly Apartments Limited Partnership, the largest First Leaside issue.

When the statements were finally produced, they included going-concern notes from the auditors that questioned the continued viability of the entity. A going-concern note -- essentially a red warning flag for investors -- was also included in the 2010 financial statements.

From my perspective, anything as important as the audit of financial statements that is three weeks overdue -- let alone three years -- should make investors nervous. On this basis alone, there was reason for concern as far back as early 2007 as to the viability of the Wimberly Apartments LP.

Also withheld for months from investors were the contrasting views between the hopes expressed by First Leaside management, and the warnings issued by Grant Thornton.

In Grant Thornton's August report, First Leaside management was on record as stating that they could put together a bail-out package by throwing in $5 million in 2011.

Grant Thornton disagreed emphatically. It noted that the projections in management's model were not fully supported by the information presented, or by historical trends. It projected a cash-flow deficiency of approximately $15.9 million over the three-year period ended in 2013.

Some investors believe at least parts of First Leaside can be rescued. Several days after the May 1 investors' meeting in Bolton, Ontario, I learned of someone who would like to head up a group of fellow investors to go to the Texas properties and fix them up for approximately $100,000 in materials and $40,000 for air-conditioning units and appliances. This faint hope assumes that investors will supply their labour free of charge.

At some point, First Leaside directors are going to have to answer some very pointed questions: When did they first learn about the delays in completing audited statements? Did they consider this a material fact that should be disclosed to potential investors? Why would they allow sales to continue on after learning this?

On what basis did they allow sales to continue after the OSC required a third-party analysis of the viability of the companies? Was this not a material fact that should have been conveyed to investors?

Also facing scrutiny are the two First Leaside entities that sold the securities. They are First Leaside Securities Inc., an investment dealer regulated by the Investment Industry Regulatory Organization of Canada (IIROC), and F.L. Securities Inc., an exempt-market dealer regulated by the OSC.

Like other IIROC-regulated investment dealers, First Leaside Securities has specific obligations to the regulators and to clients, including recommending only investments that are suitable for specific investors. Salespeople are obligated to know their clients.

This raises the question as to whether and when IIROC reviewed know-your-client forms against the securities purchased. The Wimberly Apartment securities were risky and illiquid and in my opinion speculative given the auditors' concerns.

Some provinces require purchasers of exempt issues to sign a Schedule D risk acknowledgement that includes the following sentence: "I acknowledge that this is a risky investment and that I could lose all the money I invest."

That signed disclosure document may be designed to give the dealer and its salesperson some protection. But if it wasn't a suitable investment when recommended -- based on the investor's age, investment knowledge, objectives and risk tolerance -- all this piece of paper shows is that a salesperson recommended an unsuitable investment.

Investment dealers are supposed to keep a minimum amount of capital and adequate errors-and-omissions insurance. What coverage did the two dealers have? I assume more than a few lawyers are looking into this.

Here's yet another stewardship issue that raises questions: Grant Thornton's report to investors, dated May 1, points out that $500,000 was authorized to be paid to a holding company of First Leaside president Phillips. These funds cleared on Nov. 3, 2011. On what basis were these funds paid? Were the directors aware of this payment?

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