APPENDIX 2

A PRINCIPLED APPROACH TO COMMINGLED FUND DOCUMENTATION

BY BARDEN GALE AND STEVE HASON

PREA QUARTERLY, FALL 2007

From time to time, PREA members submit commentary on issues they are focusing on within their businesses. Transparency, disclosure, governance, and other non-financial terms are important issues to both investors and managers contemplating an investment in a real estate partnership. Here is one investor's view on what model provisions would look like in fund documentation.

Barden Gale and **Steve Hason,** *ABP Investments US, Inc.*

A Principled Approach to Commingled Fund Documentation

Indirect investment in real estate through private, commingled vehicles (Funds) has become a widespread, global practice for many institutional investors over the past decade. In fact, from 2002 through 2007 alone, there have been over 850 high-yield real estate funds which have raised approximately $400 billion for investment in commercial real estate on behalf of public and private pension funds, endowments, insurance companies and other institutional investors.[1] In the mid-to-late '90's, fund documentation was often heavily negotiated between the manager (or sponsor) and one or more lead investors. As funds have grown larger, real estate returns have outperformed and capital has become more available; however, some managers have shown an increasing reluctance to engage in negotiations with investors, especially insofar as the non-financial terms and conditions are concerned. In many cases, this is interpreted as "take it or leave it; there are other customers waiting in the hall." To be sure, not all managers are so obdurate, but this is how many investors feel they are treated.

The purpose of this article is not to bemoan the fees associated with investment in some real estate funds or to take exception to the unvaried, non-differentiated strategies of many of them. Rather, this article will attempt to open a principled dialogue on other issues of key concern to investors such as:

- Governance
- Transparency and Disclosure
- Fiduciary Obligations
- Alignment of Interests
- Mechanics

1. Real Estate Alert, March 21, 2007. High-yield funds include Opportunity, Value-Added, Core-Plus, High-Yield Debt, and Fund of Funds.

Getty Images

We will also explore a miscellany of other concepts that Investors should consider when agreeing to invest in a commingled Fund.

Sample Provisions

Annexed to this article is a set of provisions which embodies many of the concepts discussed here. [Editor's note: Due to space constraints, the provisions are not attached, but may be found on PREA's website, www.prea.org.] The wording of these provisions is arbitrary as we are certain there are many other ways to voice the same concepts. However, without actually seeing an actual example of a well thought out provision which one might see in a limited partnership agreement, it may be difficult for the reader to understand fully the import or mechanics of the principles we discuss. Otherwise, it would be a bit like trying to describe a spiral staircase without a diagram. As the provisions have already undergone many refinements reflecting the comments of numerous investors, we are equally sure that further examination and discussion among investors or between investors and managers will result in variations, new provisions, or elimination of some. In short, they are not to be taken as gospel. They are, however, substantially similar to provisions the authors have used in numerous fund investment negotiations (but not all), and are not purely theoretical. We acknowledge that even if documentation does not reflect all (or even any) of these principles, it does not mean an Investor should not invest in a Fund; however, failure to address them could bring risks of one kind or another.

The provisions go beyond the principles outlined in this text, taking positions on less fundamental, but still important, issues, such as numbers of members of an Advisory Board and notice periods. Some investors and managers may find them useful as well as form a mental checklist in drafting or negotiating fund documentation, regardless of where they come out on the issues.

The numbers in parentheses following each header refer to the applicable paragraph of the provisions. Some provisions clearly achieve multiple objectives (such as better governance and a higher degree of fiduciary obligations); for simplicity sake, we put the note in the most appropriate section.

Governance

The guiding principles behind these provisions are to provide Fund investors with higher standards of governance, transparency, and disclosure, similar to those provided by a public company, while maintaining a high level of Manager discretion. For example, Fund investors should be entitled to independent Advisory Boards (similar to corporate boards) that are empowered to enforce and maintain Investor rights. These rights are not dissimilar from the rights which are typically afforded to public shareholders, such as the ability to approve material transactions and the right to approve conflicts. The sections which follow address the important role of Advisory Boards as they relate to Fund governance.[2]

■ Advisory Boards (1): *Most Funds' primary mechanism for governance vis-à-vis their Investors is through an Advisory Board or similar body.* Typically Advisory Boards are charged with resolving conflicts of interest or approving auditors and appraisers and the like. Increasingly, they are being utilized to provide flexibility in the delineation and execution of investment strategies, for example to approve or waive leverage limits or geographic investment limitations. In some cases, they are even being used to confirm that the Sponsor is in compliance with the Fund's documentation. Whatever the ultimate powers of an Advisory Board are, the mechanics of making decisions are critical to the execution of the Advisory Board's fiduciary duties. Accordingly,

- ◆ *Advisory Boards should consist of Limited Partners who are experienced fund investors who understand the importance of their role and the nature of their participation. They must be free to acquit their obligations in full compliance with their duties as an Advisory Board member as a fiduciary (to its own stakeholders but not necessarily to other investors).[3] All investors, whether or not represented on the Advisory Board, must also be assured that the Advisory Board is able to function independently and free of any conflicts of the Manager and must not engage in self-dealing such that the interests of all Advisory Board members are closely aligned with those of unrepresented investors. As such, Advisory Boards and their members must be:*
  - ● *Independent of the Manager and only Investors.* We see no reason for the Manager to have members on the Advisory Board. The Manager makes proposals to the Advisory Board, so it is natural that he would support it. The Manager's vote adds nothing and is, by definition, conflicted. Further, given that many proposals involve conflicts of interest, having a Manager who also serves on the Advisory Board vote (especially if not forced to recuse himself) might lead to a situation where a majority of independent members might disagree with a proposal but it gets passed anyway. We are also not in favor of so-called "independent" (i.e. non-Manager and non-investor) Advisory Board members. These members are often hand-picked by the Manager and may not be truly independent. Also, almost all are not significant investors in the Fund and as such are not fully aligned with the other investors as they have no vested interest in the success or failure of the Fund.

2. IPLA Memorandum re: Advisory Committees—Best Practices Note, February 19, 2004 was part of the research that was utilized in the creation of the provisions and this article.
3. To the extent that a Fund is not governed by either Delaware or Maryland law, counsel for the investors should be consulted to ensure that there is no fiduciary duty to other investors.

- *Free of conflicts.* Not only may the Manager be conflicted, but so may Investor members. For example, from time to time (and too frequently for our tastes) we are asked to approve the transfer of an asset from one fund sponsored by the Manager to another fund sponsored by the same Manager. If any Investors are invested in both funds and others aren't (or not in the same proportions), a conflict may arise. Investor members should be required to disclose such conflicts and recuse themselves unless independent counsel opines otherwise.
- *Available and willing to commit sufficient time to their participation.* To the extent that an Investor does not have or is not willing to spend the time to understand the issues at hand and vote his position, the Investor should not accept an Advisory Board position.
- *Required to engage in open discussion and reach open agreements.* Except under extraordinary circumstances and with the consent of all members, Advisory Board actions should only be taken at formal meetings (whether by phone or in person) with a quorum of participation of the non-conflicted Advisory Board members. Too often, Managers contact and solicit the votes of Advisory Board members one by one. Needless to say, this is not in the spirit of good governance.
- *Able to access independent counsel and advisors.* As Advisory Board members are often asked to opine on conflicts of interest or approve valuations or related party fees, it makes sense that they should have access to independent advice, at the expense of the Fund. In our experience, the failure of a Manager to offer this provision (or provide it upon request) can be seen as a litmus test of probity. Of course, this may slow down a process and add a layer of expense, but it is the responsibility of the Manager to foresee this and plan accordingly. The added expense should be marginal to any material decision and the layer of validation to the process quite significant.
- *Provided with all requisite information to enable them to make decisions and given enough time to analyze and discuss that information among themselves and with the Manager.* A request for approval is the solicitation of a vote. In respect of this and shareholder votes as well, we take the view that they are akin to proxy solicitations. That is, whoever is soliciting the approval must give sufficient advance notice and supporting documentation to make his case, highlighting both the positives and the risks or issues. Also, it is critical that the Advisory Board members be able to discuss matters amongst themselves without the potentially "chilling" presence of the Manager. Management will always have ample time to present its case, but any opposition always seems, at least initially, to be at a disadvantage and needs consideration in the appropriate forum to redress the imbalances.

■ Removal for Cause (6): *Investors must be able to remove a Manager whose actions* may *adversely affect their investment, without delay.* Most Investors and Managers would agree that a member of the Manager (at least a senior professional) being convicted of a crime should allow investors to terminate not only the investment period of a Fund, but also the Fund itself. Inevitably, though, negotiations degenerate into issues as to what type of crime, expiration of appeals periods, level of personnel, and so forth. We feel this all misses the point. The real question is whether the occurrence of certain events, regardless of their ultimate outcome, in themselves, gives rise to a removal event.

■ Removal Without Cause (7): *Investors should be able to remove a Manager in whom a substantial majority of investors have lost confidence.* Trust is the essence of a partnership. Loss of that trust should permit the dissolution of the partnership. This principle is embodied in common law, although it may be contracted away. To the authors, this is a common sense right which would only be exercised in extreme circumstances, with the only real question being what compensation is owed to the Manager in such a circumstance. The attached provisions take one position, but there are clearly others as well.

■ Key-Person Event (5): *In many instances, the loss of certain investment professionals of the Manager—upon whose track record Investors relied upon when making their decision to invest in the Fund—should allow investors either to terminate the investment period or liquidate the Fund, or both.* This provision is analogous to removal with and without cause: an underlying basis of the investment proposition has been lost and the Investor may or may not have confidence in a proposed replacement (nor should he be forced to accept one). This is therefore both a matter of trust and fulfillment of express or implied expectations. In such a case, Investors should have defined options, which may vary. The attached provisions take one tack.

Transparency and Disclosure

■ Partnership Expenses; Audits (3): *Investors should be fully aware of all expenses which they are obligated to bear and have the right to audit them.* Depending on the situation, either the Fund will bear the expense of the audit or the individual Investor will. In either event, the Investors, acting alone or as a group, should have the right to audit themselves or call for an audit.

■ Service Providers (10): *Investors must be fully apprised of any party standing in a fiduciary position to the Investors*. In the event of a change to an existing service provider or the provision of a related-party service provider, these changes or provisions must be approved by the Investors or through the Advisory Board, as the case may be.

■ Change in Investments (13): *Investors are entitled to prompt and accurate disclosure of material adverse changes to their investment.* A detailed explanation of the change and a course of action to mitigate loss is a reasonable expectation of the Investors.

■ Reserves Following the End of the Investment Period (15): *Investors are entitled to certainty regarding the duration of their financial commitments.* We recognize that in certain cases Managers may need to reserve capital or call capital after the expiration of the Investment Period. However, these cases need to be defined and limited and should not create an open-ended, infinite forward equity commitment by the Investors.

■ Distributions (17): *Investors are entitled to an adequate degree of specificity regarding the categorization, definition and calculation in the reporting of distributions.* In fact, each waterfall calculation that results in a promoted interest payment to the Manager should be audited and affirmed by a third party.

■ Placement Fees (18): *Investors are entitled to transparency and clarity on the allocation of all costs and expenses of the formation of the Fund.* Although many Investors take the position that placement fees are most properly borne by the Manager, most Investors do recognize the appropriateness of bearing a share of certain other out-of-pocket formation costs, such as legal fees. Whether or not Investors are being asked to bear any of these costs and expenses and the magnitude of them should be adequately disclosed and clearly treated as a capital contribution for waterfall calculation purposes.

■ Reporting Requirements (20): *Investors are entitled to prompt, detailed reporting regarding the performance of the Fund.* We hope that there will be some degree of industry standardization of minimum reporting requirements and format, led by industry groups such as PREA and INREV. Differences in accounting requirements based on the focus of the Fund or Investor in question as well as idiosyncratic requirements will always lead to variations, regardless of the standard. In all cases, we believe it important that both the Investor and Manager agree on the level of detail and frequency of reporting prior to making the investment, not after.

Fiduciary Obligations

■ Exclusivity (11):

◆ *A Manager's investment strategy should be exclusive to a Fund during its investment period.*

◆ *A Manager should complete substantially all of its obligations to a Fund prior to initiating the marketing or investing of another fund with a similar investment strategy.*

◆ *To the extent that an investment strategy is not exclusive, a Manager must disclose how it plans to fairly allocate investment opportunities among competing or overlapping funds.*

In a perfect world, Managers would have just one Fund and no competing or overlapping funds or strategies. Only then may Investors be assured of no adverse selection of investment opportunities. Investors should also be assured that the Manager's attention is heavily weighted toward the fulfillment of the current Fund's investment plan and not overly concerned with the launch of subsequent funds or stockpiling or sharing investments for such funds. If a Manager does have competing funds or mandates, measures need to be in place to allow the Investor to audit and ensure that any allocation policies that are promised are implemented.

■ Related Party Transactions (2) (10):

◆ The cost and qualifications of related-party service providers must be competitive to highly qualified unrelated service providers. In an ideal world, these services would be provided as part of the overall fee structure or "at cost" and the qualifications of the providers, unassailable. In reality, the Investor often doesn't have a choice, as the Managers believe that their affiliates' qualifications are competitive. Still, the authors believe that there is no substitute for a competitive selection process. To the extent the contract, personnel and qualifications of such related providers is not mandated by Fund documentation, Advisory Board assent on both the competitive fee levels and qualification is critical.

◆ A Manager should not enter into capital transactions (i.e. buy, sell, finance) with a related party. Although this proposition is self-evident, many Funds actually provide that they will do so. Accordingly, if an Investor wishes to accept such a proposition he should at a minimum be entitled to have Advisory Board consent.

■ Co-investment Opportunities—Fees and Promotes (14): *Fees and promotes generated by co-investments by third parties, whether or not investors in the Fund, should inure to the benefit of all the Fund investors, not solely to the Manager.* Co-investment income represents a partnership opportunity and the benefits derived belong to the Fund, not the Manager. But for the existence of the Fund, there would be no co-investment income. Additionally, the Manager should only be incentivized to maximize Fund returns, not personal income. The Manager still benefits through his participation in the promote as it is passed through the Fund's economic waterfall.

■ Change in Investments (13): *Investors are entitled to timely notification of a significant adverse change to a Fund investment.* Investors are entitled to know what is happening to their investments on more than a quarterly basis if something material (on a reputational basis or an absolute or relative dollar basis) occurs. Not only does this make sense from a fiduciary point of view, but also a Manager should recognize that many Investors expect timely and pertinent market information from their standing investments to aid them in other endeavors.

Alignment of Interest

■ Co-investments by Principals (4): *Investors are entitled to know which principals are providing the capital for the co-investment, how the individuals will benefit by the performance of the Fund, and how those benefits will vest.* Co-investments by principals of the Manager are important in creating and maintaining alignment with the Investors and ensuring that the Fund will be adequately managed throughout its life. Moreover, the principal's investment should be maintained throughout the life of the Fund. These principles dictate disclosure to create an understanding and, if needed, discussion on these issues.

Mechanics

■ Limited Partner Approval (8): *There must be a clear process for seeking and obtaining Investor approvals, to the extent they are sought, and the process must ensure that investors are adequately apprised regarding the matter at hand, including disclosure of all material benefits and risks.* Most Fund documentation is silent on how Investor approvals are solicited. Without a clear process, there is the potential for abuse. The attached provisions take the basic positions that Investors are entitled to adequate notice and the same level of disclosure as in the original PPM, if not more.

■ Liquidation (9): *Investors are entitled to a clearly defined process of liquidation to protect their investment in the event of an early termination of the Fund.* Although many Funds provide for liquidation upon the occurrence of certain events, there is rarely any clear process as to how this would be accomplished, thereby rendering the right (or obligation) null or very weak. Once again, the attached provisions attempt to address this process surrounding this issue.

■ No Buy-Sell (12): *A Manager should not be able to obligate the Fund or its Investors to fund a buy-sell provision which could be triggered beyond the Fund's investment period. Surprisingly, many Funds enter into joint ventures which do not provide for an absolute right of sale and instead rely on a buy-sell process.* To the extent that these provisions provide for time frames which are outside the investment period or invoked after all commitments are funded, the Fund could be at a serious negotiation disadvantage or at risk of defaulting on its Fund guidelines.

■ Co-investment Opportunities (14): *Investors should be given ample time and information to make decisions regarding co-investment opportunities.* As Investors are given ample time to make their initial Fund investment decisions, they should be given enough time to make subsequent co-investment decisions for significant transactions that are beyond the investment parameters of the Fund and the discretion of the Manager.

■ Bridge Fundings (16): *A Manager should not be able to exclude low-return temporary investments from his promote calculation for an unreasonable period of time.* Bridge investments are entered into to facilitate a Fund transaction before a permanent capital structure can be put in place. For example, a Manager may draw down excess equity capital to bridge the closing of a debt financing; it is anticipated that this funding is short-term. Typically, any return associated with this temporary financing will be distributed to Investors on a pro rata basis. To the extent that these funds do not get repaid within a short time period (e.g. one year), they should be considered a permanent investment and treated as capital for waterfall calculations.

As mentioned at the outset, these provisions are not aimed at interfering with the business strategy or economics of a Manager. Rather, the purpose of these provisions is to address the imbalance typically present in the negotiation of Fund documents. We believe there are managers who don't even know what their own documents say, let alone understand their consequences in practice. Even the Manager's lawyers drafting a Fund's documents have not given a great deal of thought to the implications for Investors or how to implement the provisions mechanically. This article and the referenced provisions attempt to remedy this situation and provide for equitable fund documentation which is ultimately principle based. ■