

# New York Law Journal

## Real Estate *Update*

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### Significant Players

#### *Non-economic Issues Part of Negotiations*

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As we indicated in our Nov. 30, 2005 article, real estate investment funds have become significant players in worldwide real estate markets. Our prior article provided background information regarding real estate investment funds and discussed certain basic economic features of these funds. This article focuses on certain non-economic issues that arise in the negotiation of fund documents—the ability of fund sponsors to make investments outside the fund or to form competing funds, the co-investment rights of limited partners, “key person” remedies which apply if key investment professionals are no longer involved in the management of the fund, and removal rights with respect to the general partner.

#### Outside Activities of Fund Sponsors

Partnership agreements for investment funds typically contain provisions limiting certain outside activities of the fund sponsor and its affiliates. First, the sponsor is often required to present investment opportunities to the fund before it may pursue those opportunities independently or through another investment vehicle. This requirement recognizes that it may be economically advantageous to the sponsor to direct investment opportunities to other entities in which the sponsor has an interest—for example, because the other entity pays the sponsor a higher “carry” or management fee, or because the other entity includes a major investor with whom the sponsor is attempting to forge a new relationship. The requirement that investment opportunities first be made available to the fund generally applies only during the fund’s commitment period (i.e., the period during which capital for new investments can be called from the investors) and is often subject to exceptions for investments that are not “core” investments of the fund although they may fall within the fund’s investment parameters.

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For example, an exception may be made for new development projects in a fund which has been established primarily to invest in existing income-producing properties, or for publicly-traded REIT shares in a fund which, while permitted to invest in such shares, is devoted mainly to making direct real estate investments. Exceptions may also be made for investments that are smaller than the fund’s target investments, for additional investments in properties in

investment parameters substantially similar to those of the fund. Where the sponsor is permitted to create a new vehicle during the existing fund’s commitment period because a sufficient percentage (but not all) of the existing fund’s capital is invested or committed, the partnership agreement will sometimes require that the existing fund be given the opportunity to co-invest with the new vehicle while the existing fund still has available capital. In addition, some partnership agreements provide that upon the formation of the new investment vehicle the asset management fee payable by the existing fund will be reduced or based on contributed rather than committed capital.

Most fund partnership agreements are explicit in stating that, except as expressly restricted by the agreement, the sponsor and its affiliates are free to engage in any activity, including investment in real estate and performing property management, development management and other services for third parties or for sponsor affiliates.

#### Co-investment

A fund will occasionally be presented with a potential investment that it cannot make because the size of the investment would violate the fund’s diversification restrictions or, alternatively, because the general partner determines that it would not be prudent for the fund to devote so much of its capital to a single transaction. In such a case, the general partner may seek co-investors to participate in the investment.

Co-investment raises a number of issues for sponsors and investors. The first is whether investors in the fund will be given a preferential right to act as co-investors alongside the fund. Such preferential rights, which are often sought by large institutional investors, are generally resisted by the general partner, who would prefer to have complete flexibility to determine the identity of co-investors and is often reluctant to accept procedural requirements that may impair its ability to act quickly when an investment becomes available.

If existing investors are to be given co-investment rights, a number of subsidiary issues will need to be addressed. The general partner generally will prefer that the right be limited to limited partners who have made substantial capital commitments, thereby reducing the administrative burden of offering the investment opportu-

#### INVESTMENT FUNDS



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which the sponsor already has an interest, and for investments by previous funds formed by the sponsor which still have capital to invest or by new funds permitted to be formed by the sponsor.

A related provision limits the sponsor’s

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ability to raise new pooled investment funds during the partnership’s commitment period (or at least until some threshold percentage of the partnership’s capital—often 75 percent—has been invested or committed to investments). This restriction supplements the fund’s “key person” requirements (discussed below) in seeking to ensure that the sponsor and its principals remain focused on locating investments for the fund and not for competing investment vehicles. The prohibition generally applies only to new funds which have primary

nity to a large number of investors and creating a vehicle through which they will co-invest. In addition, the general partner may attempt to carve out exceptions to the limited partner co-investment right—for example, where the fund is seeking to co-invest with a strategic third party who brings particular value or expertise to an investment, or where a third party brings a co-investment opportunity to the fund. Another issue is whether the general partner may look outside the fund's investor base if existing investors, after being presented with the co-investment opportunity on a pro rata basis, do not avail themselves fully of the opportunity, or whether the general partner must instead continue to re-offer the unclaimed portions of the co-investment opportunity to participating limited partners until no such limited partner shows any remaining interest in increasing its investment. Any such requirement of successive offers will entail an expenditure of time and effort which may result in the investment opportunity being lost by the fund.

A third issue is the extent to which the general partner or its affiliate will be permitted to earn a carried interest or fees on funds contributed by the co-investors. The general partner may argue that in the case of a successful investment it should be rewarded by the co-investors (whether drawn from inside or outside the fund) on the same basis as by the limited partners in the fund. The investors, on the one hand, may view the co-investment opportunity as one which exists only because of the investors' commitment to provide capital to the fund, and that the investors should therefore share in (or not pay) any carry or fees. The parties may end up by providing that the general partner will earn a reduced carry on co-invested funds contributed by existing limited partners.

### Key Person Provisions

The "blind pool" nature of real estate investment funds makes the identity and composition of the general partner critical from a limited partner's perspective. In order to assure investors that their expectations regarding the individuals who will manage the affairs of the fund will be met, fund agreements often contain a so-called "key person" provision described below. To protect against general partner mismanagement or misconduct, nearly all fund agreements permit removal of the general partner for cause (though the definition of cause will vary from fund to fund). Moreover, to provide the limited partners with a 'safety valve' in the event that a sufficient number of them are simply dissatisfied with the performance of the general partner—even though no disqualifying conduct is apparent—some funds also have a non-cause removal right that may be exercised by a supermajority of limited partners (sometimes only after a specified number of years have elapsed)

Key person provisions recognize that most investors in a real estate fund are participating in large part because of the expertise and track record of one or a group of principals of the sponsor. Such provisions vary based on the particular skills and activities of the sponsor and its principals, but usually one or two of a group of key persons must devote a specified portion of their time to the business and affairs of the fund; otherwise a "key person event" has occurred.

The remedies for the occurrence of a key person event are not automatic—most fund agreements require the affirmative vote of not less than a majority, and often a supermajority, in interest of the limited partners before key person remedies are invoked. Upon the vote of the requisite percentage of limited partners, the predominant remedy available to limited partners is termination

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of the limited partners' commitment period. Even though one might argue that this remedy is inadequate—the expertise of the general partner, while important in selecting and negotiating the investments of the fund, may be equally important in managing and/or repositioning of the fund's assets to maximize return—it is nevertheless a widely accepted market term. A minority of funds go further and permit the limited partners to elect to cause a dissolution of the fund upon the occurrence of a key person event (dissolution may also be a somewhat ineffective remedy if, as a result of market conditions or for other reasons, it is not an opportune time to liquidate the fund's assets). Some funds permit the limited partners to cause the removal of the general partner upon the occurrence of a key person event, although such a provision is unusual.

### Removal of General Partner

Removal of a general partner for cause is a remedy that is generally available to limited partners in real estate investment funds. Cause typically consists of fairly egregious conduct, such as fraud, bankruptcy of the general partner, gross negligence or willful misconduct, or on occasion negligent management that has a material and adverse effect on the fund assets. Removal of the general partner usually requires the affirmative vote of a majority or supermajority of the limited partners.

Some funds also permit the limited partners to remove the general partner

without cause, although this right is unlikely to be invoked—exercise of the right usually requires a supermajority vote of 75 percent or more in interest of the limited partners, and many limited partners would, absent cause, be reluctant to vote in favor of removal because of the disruption to the portfolio that would result from the departure of a general partner who has experience and familiarity with the fund assets.

In any case where the general partner may be removed, whether for cause or without cause, the issue that tends most often to be negotiated in the fund agreement is the impact of removal on the general partner's management fees and carried interest. Not unexpectedly, the results will often differ depending on the cause of removal.

Management fees are not typically covered in the removal provisions (and are not payable post-removal). However, if the general partner is being removed without cause, some fund agreements provide for a liquidated damages payment equal to a portion of the management fees that the general partner would have earned absent termination.

The removed general partner's right to retain its carried interest can be the subject of extensive negotiation. Although the general partner invariably loses its carried interest with respect to investments made after removal, its rights with respect to pre-removal investments vary from fund to fund. In many cases, the removal provisions provide for a third-party valuation of the fund's assets as of the date of termination, with the general partner being entitled to a payment based on the carried interest distributions it would have received in a liquidation of the fund at the aggregate asset valuation (sometimes with a discount, or an offset or escrow for damages, if removal was for cause). If the termination is without cause, the general partner may be given the election to receive payment of the value of its carried interest or to convert the interest into a limited partnership interest in the fund based on its value. Depending on the value of the general partner's interest, current payment in redemption of the interest may require a capital call, fund-level borrowing or, though less likely, an asset disposition. If the termination is for cause, the limited partners sometimes have the right to elect whether the general partner's interest will be converted to a limited partnership interest or paid out currently. In addition, in the event of a cause termination, the fund often has the right to redeem the general partner's interest and defer payment by delivering a promissory note to the general partner in lieu of a cash redemption payment.

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