

# LP members only

**Limited partner advisory boards are becoming a key focus of fund formation negotiations, but LPs need to be more assertive about the rights they already have.**

**By Lisa Lacy**

Real estate funds are being redefined as limited partners and general partners haggle in a changed fundraising environment. A key component of these negotiations is the often-overlooked limited partner advisory board.

It is a discussion that has become more frequent in the private equity asset class ever since the Institutional Limited Partner Association (ILPA) issued its private equity principles in September 2009.

The ILPA principles – described by the advocacy group as suggested guidelines for terms and conditions in limited partnerships – includes a section suggesting the structure and rights of the LP advisory board. The impact has yet to be felt on the real estate world, but as more and more real estate market participants discuss the issue of LP rights, these guidelines may well serve as a reference.

Despite these principles, it is unclear whether a new model for an LP advisory board will emerge anytime soon. Even though LPs find themselves wielding new powers, experts say they don't necessarily have the resources – or even the will – to properly execute them. In addition, some legal advisors warn that GPs must be careful not to agree to so many LP advisory board rights that it becomes difficult for them to execute their business strategies.

Indeed, negotiating a new balance of power, particularly when it comes to governance issues, has been a serious challenge for LPs and their advocates.

## What has changed

Most funds have a limited partner advisory committee that is composed of institutional limited partners appointed by the general partner. There are no set standards for the makeup of LPs on an advisory committee, according to Ted Leary, president of advisory firm Crosswater Realty Advisors, with some firms having just their largest investors on the committee, while others have a mix of LPs large and small.

Meeting periodically, it is the job of the advisory committee to deal with issues set out in the fund documents. Historically, these have been limited to conflicts of interest involving the general partner or its affiliates and investments outside of the stated guidelines of the fund, says Robert Insolia, co-chair and partner of Goodwin Procter real estate investment fund practice.

In the recent past though, the role of the advisory committee has expanded dramatically. In part, this has been dictated by

supply and demand as the balance of power has shifted from GPs to investors, according to Insolia. For instance, the investment manager of a popular, oversubscribed fund, of which he notes there are few today, is not going to agree to terms that give LP advisory boards significant powers.

Leary describes the historical arrangement as “an unmitigated disaster,” due, in part, to passivity among the LPs. GPs, he says, learned to take advantage of the situation. “The structure isn't the only problem, it's also at times the timidity of people sitting in the LP seats,” Leary explains, adding that investors simply didn't “appropriately exert their rights as LPs”.

“As a result, the GPs simply know how to game the system and get their way on everything,” the Crosswater president says. Leary points to struggling funds where LPs haven't stepped in to exert greater control and says this proves it's an LP assertiveness issue as well as a structural issue.

## What LPs want

It could be that LP behaviour changes will follow structural changes. Stephen Renna, president of the National Association of Real Estate Investment Managers (NAREIM), observes a shift in the way GPs and LPs have structured their partnerships after the dramatic market downturn of 2008 and 2009.

This new environment could lead to LPs getting more of what they've long asked for, which could embolden them to flex their advisory board muscles more often.

One of the noticeable shifts has been towards advisory boards asking for the kind of consent rights LPs have in joint ventures. Insolia says this is perfectly fine – especially in a fund with a small number of investors and when the LPs on the advisory board are putting up virtually all the money. However, when there are a multitude of investors and the board is making collective decisions, the largest LP may make decisions in his or her own best interests without necessarily considering the interests of the group overall. That could be problematic if the minority investors are not comfortable with the large investors having so much control, Insolia says.

Limited partners also need to consider whether they have the staff or resources to do the proper analysis and exercise the discretion they have negotiated for. For example, having demanded greater say over leverage specifics, will an LP be able to fully evaluate the terms of a proposed credit facility

against the wider credit markets, all in time for the GP to get it back to the lender? For most LPs, the answer is no – they simply don't have the staff to complete that task in two or three days, Insolia says.

"In many cases, institutional limited partners can add a lot of value to an investment manager and a fund when they have added discretion and rights. They can bring a perspective and offer a healthy counter balance to the general partner, particularly in down markets. In other cases, however, I think it's 'be careful what you wish for,'" Insolia says. "In these cases, limited partners have negotiated for increased rights, but I don't think in all cases they appreciate the burden that comes with having – and having to exercise – these rights."

### Looking to ILPA

In publishing its guidelines last year, ILPA had hoped to set new best practices for private equity GP-LP relationships, in the process, helping point the way for new industry standards for private equity real estate as well.

As part of those guidelines, ILPA came up with its own ideas on how to improve the effectiveness and efficiency of advisory committees saying that inconsistent practices, such as a lack

of uniformity in size, formation, role and responsibilities, was hampering the ability of committees to function as effectively as possible.

Most real estate professionals agree ILPA's effort was noble, but one that has yet to impact industry thinking. "I would say the majority [of real estate funds] were already structured consistent with ILPA guidelines," says one executive.

For his part, Leary adds that the ILPA guidelines haven't had much impact because they cover structure, not behaviour. "They tell you how to structure something, but they don't tell you how to act," Leary says.

Renna adds that he has also talked with members of NAREIM about the ILPA guidelines and they have responded that investors are incorporating some of the guideline's elements into their investment contracts, but each GP-LP relationship is unique. As a result, there isn't a wholesale or uniform incorporation of these guidelines. "GPs have spent significant amounts of time communicating with their clients and aligning their relationships to move ahead with existing and new investments," he says.

### Independent wo/man

Perhaps the way forward, therefore, is to come up with an alternative to furnishing LPs with additional rights they won't have the time, or perhaps the inclination, to exercise. For Leary, that alternative could be hiring a truly independent director or two to ensure proper risk management at a fund.

In a recent blog posting on Crosswater's website, Leary recommended funds hire "retired or semi-retired business people who are truly independent – not pawns or cronies of the GPs – but who are able to stand up to GPs and know as much about the business as the fund manager".

Not reliant on the manager for his or her income, the executive would have a real understanding of the risks and rewards of real estate investing.

But, at the same time, even if funds create a better structure, Leary says it's a moot issue until LP behaviour changes. "What's the point of negotiating for lots of rights and protections if you don't avail yourself of them?" he asks. □

### Setting the standard

Last September, the LP industry trade group, the Institutional Limited Partner Association, issued its private equity principles in an effort to introduce best practices for the asset class. Those guidelines have been seen as a basis for trying to introduce new standards for private equity real estate investing as well. Here is a summary of ILPA's best practices for advisory committees

- Limited partner advisory committees should have the core responsibilities of approving transactions that pose conflicts of interest, such as cross-fund investments and approving the methodology used for portfolio company valuations. In addition, the LPAC is ideally suited to engage with the general partner on discussions of partnership operations
- The LPAC generally should be made up of seven to eight voting representatives of limited partners, with larger funds having as many as 12 members, representing a diversified group of investors. A reasonable number of non-voting observer seats should be made available to certain limited partners
- Clear voting thresholds and protocols should be established, including requiring a quorum of 50 percent of LPAC members when votes are taken. LPAC meetings should be held in person at least twice a year with an option to dial-in telephonically
- A portion of each LPAC meeting will be set aside for an "in camera" session with only the limited partners present. Limited partners may elect one to three members of the LPAC to lead the discussion and report back to the general partner
- At any time, any two members of the LPAC should have the right to call for an LPAC meeting. This meeting should be arranged by the general partner if requested
- The LPAC should have access to partnership auditors to discuss valuations. A representative from the audit firm should attend each year-end LPAC meeting