A Primer on the Standard of Care for General Partners of Real Estate Funds

Pension plan investors have fiduciary duties to their stakeholders, so it is reasonable for these investors to seek out fund sponsors that exercise a prudent standard of care with investors' money. Despite initiatives such as the PREA Investor Toolkit and ILPA that strongly encourage fund sponsors to heighten their governance and standard of care, some fund sponsors continue to have partnership agreements with provisions that are not always obvious but often legally complex, which undermine the reasonably expected standard of care owed to investors. The language and underlying law of these provisions are technical and may sometimes be overlooked, resulting in an investor underestimating the risks associated with the investment. The following article focuses on these issues and provides guidance for investors on how to push fund sponsors to expressly state in the fund agreements the fiduciary duties that should be owed to the investors.

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ONE OF THE SEEMINGLY ETERNAL STRUGGLES in negotiating investments in real estate funds centers on the duty that the fund sponsor will owe to the investors. The usual situation is that the limited partner wants the general partner to acknowledge that it is a fiduciary of the fund and its investors as a group and, in that capacity, owes various duties to the fund and the investors so the investors can be assured that the fund sponsor is acting in the best interest of the investors. This would appear to be a perfectly logical and proper request: "I am giving you my money to invest, and I expect you to always act in my best interest in the way you invest that money."

To many fund sponsors, however, this opens a Pandora's box of potential problems. If the fund sponsor is a fiduciary, how does it handle the competing interests of other clients (for example, managed accounts) or other funds managed by the fund sponsor or its affiliates that have overlapping or competing investment strategies? Can the fund sponsor advise the fund to buy an asset at the same time it is advising other clients to sell that asset or asset class, without risking litigation by one or the other? Given that all investments carry some risk, if an investment fails despite the fund sponsor using its best business judgment, is the fund sponsor taking on added risk by acknowledging it is a fiduciary?

This article aims to frame the issues involved, summarize the laws of the key jurisdictions, and provide recommendations as to ways to address the standard of care issues.

The Basics

Most real estate funds are structured as limited partnerships under the laws of Delaware, the Cayman Islands, or the United Kingdom. For ease of discussion, the fund sponsor will be referred to as the *general partner,* the investors as *limited partners*, and the fund as the *partnership*.

A standard definition of a *fiduciary* is "a person having duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking."[1] In other words, a fiduciary is someone who, because of the role he or she has taken on, is in a position of particular "trust or confidence" with respect to the matters entrusted to him or her.

As a matter of law, a general partner is a fiduciary and owes the partnership and its limited partners certain duties. While the exact duties vary somewhat under the laws of different jurisdictions, they generally include (1) a duty of loyalty to the partnership and its limited partners, including prohibitions or limits on the general partner competing with, or taking opportunities appropriate for, the partnership, and (2) a duty of care in the conduct of the partnership's business. However, partnerships are governed by partnership agreements, and the jurisdictions all allow the parties to modify, reduce, or increase the duties that the general partner owes to the limited partners. This is why the general partners do their best to include provisions limiting their statutory duties to the limited partners and why the limited partners push back and seek to preserve the rights that limited partners expect from the general partners.

How does the issue present itself? The most prevalent ways are (1) express restrictions of liability in the partnership agreement and (2) disclosure of potential conflicts.

Restrictions on Liability

In the most extreme cases, certain partnership agreements state that to the fullest extent permitted by law, the general partner shall not be deemed to be a fiduciary of the partnership or its limited partners, with the general partner expressly permitted to act in its self-interest without regard to

1. *Black's Law Dictionary*

the impact on the other partners. Such a broad carve-back is generally viewed as overreaching and creates uncertainty as to what, if any, standard of care the general partner may owe to the limited partners. Fortunately, such broad carve-backs are rare.

More typical is a provision that provides that the general partner and its affiliates will not be liable to the partnership or its limited partners except for matters undertaken in bad faith or actions amounting to gross negligence or willful misconduct (a very difficult standard for the limited partners to establish). Adding insult to injury (from the limited partners' perspective), the general partner is not only exculpated from all other liability, it is indemnified against any claims other than those resulting from its bad faith, gross negligence, or willful misconduct. By way of example, this means that if claims are asserted against the general partner because of its own negligence or breach of contract (including breach of the partnership agreement), the partnership (read: the limited partners) must indemnify and hold the general partner and its affiliates harmless from the resulting damages.

To assuage the limited partners' concern regarding limitations of the standard of care, the general partner will sometimes provide that, regardless of what the partnership agreement provides, the general partner will remain liable for its acts or omissions that constitute a bad faith violation of the implied contractual covenant of good faith and fair dealing. This is an easy "give." Using Delaware as a typical example, the covenant of "good faith and fair dealing" is a long-standing, non-waivable implied contractual obligation. In other words, this covenant is included in the partnership agreement regardless of whether the document expressly includes the provision. The purpose is to enforce the reasonable expectations of the parties with respect to situations *not* expressly provided for in the contract.

Significantly, while a covenant of "good faith and fair dealing" seems to express a lofty and constructive standard, it ultimately offers little substantive legal comfort to the limited partners. Courts are generally loath to apply the "good faith and fair dealing" doctrine except to fill gaps in the contract or to impose obligations that necessarily follow from, and are implied by, the contract's express language. Courts also generally will not use the good faith and fair dealing doctrine to override express contractual terms (for example, language in a partnership agreement that limits the duties of the general partner).[2] As a judge recently said to opposing counsel in a case in which she ruled favorably on our client's motion to dismiss, reliance on the implied covenant of good faith and fair dealing is the "cry of a desperate man." Limited partners should not expect a judge to impose duties on the general partner that are not otherwise provided in the partnership agreement.

Conflicts

General partners and their affiliates often manage multiple funds and accounts, some of which may have similar strategies or invest in similar assets. Conflicts may arise regarding the allocation of investment opportunities among such funds and the fees paid to service providers affiliated with the general partner. Similarly, the general partners may contract with affiliates to perform certain services for the partnership. In the absence of partnership agreement provisions expressly permitting the general partner to manage such other funds and accounts, to retain affiliates, and to otherwise engage in activities that might pose conflicts of interest, such conflicts could give rise to a breach by the general partner of its fiduciary duties to the partnership.

Accordingly, general partners typically disclose in the partnership agreement and the private placement memorandum (PPM) the types of potential conflicts that may arise. In fact, the conflicts section is usually one of the longer sections in the PPM under the "risks" portion of the document. The general partner will often seek to retain discretion with respect to the retention of affiliated service providers and the allocation of investment opportunities among the multiple funds and separate accounts managed by the general partner (or its affiliates). These types of provisions allow the general partner to act for its own benefit

2. Paul M. Altman and Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law,* 60 Bus. Law. 1469 (2005).
3. For purposes of this article, DRULPA includes, by cross reference, certain provisions of the Delaware Revised Uniform Partnership Act.
4. Delaware Revised Uniform Partnership Act § 15-404(b).
5. Delaware Revised Uniform Partnership Act § 15-404(c).
6. Delaware Revised Uniform Limited Partnership Act § 17-1101 (c).
7. Delaware Revised Uniform Limited Partnership Act § 17-1101(f).
8. Delaware Revised Uniform Limited Partnership Act § 17-1101(e).

or the benefit of other clients, funds or affiliates, even if this might be to the detriment of the partnership. For example, if the general partner could generate higher fees for itself or its affiliates by allocating an investment appropriate for the partnership to another fund (or to itself), it could do so, thereby depriving the partnership of an excellent investment opportunity. In this way, the general partner effectively limits or eliminates various fiduciary duties it otherwise would owe the partnership and the limited partners.

A more subtle limitation on fiduciary duties relates to transactions with affiliates. Very often, the partnership agreement might provide that fees or other compensation paid to affiliates will be on an arm's-length, market basis. Left unsaid is that other terms and conditions do not have to be on an arm's-length basis. In fact, as noted above, the partnership agreement often has limitations on the liability of the general partner and its affiliates. As a result, while the partnership might have recourse against an unaffiliated third party for negligence or breach of contract, it cannot proceed against the general partner's affiliate for the same misconduct. Absent the subtle provision in the partnership agreement, this would not be permitted.

With this as an overview, we now turn to a brief review of the applicable laws to understand the obligations of the general partner and the rights of the limited partners in the absence of any limiting language in the partnership agreement.

Delaware

Domestic real estate funds are often organized as Delaware limited partnerships under the Delaware Revised Uniform Limited Partnership Act, or DRULPA.[3] Under DRULPA, unless otherwise agreed to in the partnership agreement, a general partner owes the partnership and the other partners the specific, defined fiduciary duties of loyalty and care.

There are three aspects of the duty of loyalty under DRULPA:

1. The general partner must account to the partnership and hold as trustee for the partnership any property, profit, or benefit derived by the general partner in the conduct or winding up of the partnership business or affairs or derived from a use by the general partner of partnership property, including the appropriation of a partnership opportunity.
2. The general partner must refrain from dealing with the partnership in the conduct or winding up of the partnership business or affairs as or on behalf of a party having an interest adverse to the partnership.
3. The general partner must refrain from competing with the partnership in the conduct of the partnership business or affairs before the dissolution of the partnership.[4]

In addition, under DRULPA, the general partner owes a duty of care to the partnership and the other partners in the conduct and winding up of the partnership's business or affairs, which duty is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.[5]

The foregoing specific duties are default rules only. Freedom of contract and the enforceability of partnership agreements are key principles recognized by DRULPA.[6] The partnership agreement may limit or eliminate the general partner's liabilities for breach of contract and breach of duties (including the aforementioned fiduciary duties), with the exception of the general partner's liability for acts or omissions that constitute a bad faith violation of the implied contractual covenant of good faith and fair dealing inherent in all Delaware contracts.[7] Further, unless otherwise provided for in the partnership agreement, the general partner is not liable for breach of its fiduciary duty if it acts in good faith reliance on the provisions of the partnership agreement.[8]

Cayman Islands and United Kingdom

The Cayman Islands and the United Kingdom are also popular jurisdictions for the formation of real estate funds. As in Delaware, there are statutes in each of such jurisdictions governing the formation, governance, and operation of limited partnerships. In the Cayman Islands, the applicable statute is the Exempted Limited Partnership Law (2010 Revision), or the EPL.[9] In the United Kingdom, the applicable statute is the Limited Partnerships Act 1907.[10]

Like DRULPA, the EPL contains an express statement of statutory duty applicable to general partners. Under the EPL, a general partner is required to act at all times in good faith in the interests of the exempted limited partnership.[11] In addition, both the EPL and the Limited Partnerships Act also impose certain other express duties on general partners, including a duty to render accounts to the other partners, a duty to account for private profits, and a duty not to compete with the partnership.[12] Such duties are consistent with the traditional fiduciary duties arising under English common law.

Notwithstanding the foregoing, as in Delaware, the Cayman Islands, and the United Kingdom, partnership laws also generally recognize freedom of contract principles, and both the EPL and the Limited Partnerships Act permit the partners to vary their mutual rights and duties by agreement.[13]

ERISA Matters

General partners of real estate funds that permit investments by "benefit plan investors" under the Employee Retirement Income Security Act that equal or exceed 25% of the total interests of such funds must comply with the requirements of ERISA, including, among other requirements, ERISA fiduciary duties and standards. Fiduciaries under ERISA are generally duty-bound to

- act solely in the interest of plan participants and their beneficiaries;
- carry out their duties prudently;
- follow plan documents.

Significantly, ERISA imposes a stringent "prudent person" standard of care, meaning that "a fiduciary must act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[14] Unlike the duties of general partners that arise under the respective partnership laws of Delaware, the Cayman Islands, and the United Kingdom, the fiduciary standard of care arising under ERISA cannot be contractually modified or curtailed in the partnership agreement. For this reason, many real estate funds are structured to come under exemptions to ERISA (for example, limiting investments by ERISA plan investors to less than 25% of the fund or structuring the fund as a real estate operating company). In this way, the general partner avoids the need to comply with the ERISA standard of care.

It is important to note that the ERISA standard will apply only to investors who are subject to ERISA, unless the partnership agreement includes a provision extending these duties to all investors.

What Should an Investor Do?

Keep in mind, negotiating leverage is not always equal. A small investor going into a large fund will have far less ability to address these issues than a large investor going into a small fund. At the same time, there are a number of things that can help the parties reach agreement and move forward.

Conflict of Interest. As a practical matter, potential conflicts arising out of structural affiliations and the management of multiple funds may be difficult, if not impossible, to avoid. In such cases, investors should seek to retain a measure of control over such potential conflicts by insisting on the formation of an independent advisory committee made up of representatives of a subset of the fund's limited partners that are not affiliated with the general partner (typically five to seven of the largest investors). The advisory committee should be provided with reasonable advance notice of, and the right to reject, investments and other transactions in which the general partner may have a conflict of interest. Ideally, all such conflicts should

9. For purposes of this article, the EPL includes certain provisions of the Partnership Law (2002 Revision) incorporated by reference therein.
10. For purposes of this article, the Limited Partnerships Act includes certain provisions of the Partnership Law 1890 incorporated by reference therein.
11. Exempted Limited Partnership Law (2010 Revision) § 4(3).
12. See Partnership Law (2002 Revision) §§ 28-30; Partnership Act 1890 §§ 28-30.
13. Partnership Law (2002 Revision) § 20; Partnership Act 1890 § 19.
14. ERISA § 404(a)(1)(B).

> Diligent investors should carefully review the limited partnership agreements of the funds in which they invest and negotiate to secure provisions that provide them adequate assurances that the general partners are acting in accordance with the fiduciary duties that the investors expect.

be subject to the advisory committee's consent, without regard to materiality; that is, the general partner should not be permitted to exercise its discretion as to whether any particular conflict is material.

In addition, where possible, we recommend that investors seek representations from the general partner—either in the partnership agreement or in a side letter—that

- it will not cause the partnership to pay any fees to any of the general partner's affiliates other than those paid on an arm's-length, market basis, and any agreement with affiliates otherwise will be on the same terms (economic and otherwise) as would be available if the work were performed by a comparably qualified and unaffiliated third party;
- it will not invest in the same or competing assets as the partnership on behalf of others or for its own account without presenting the opportunity or consistent terms to the partnership;
- it will fairly and equitably allocate all investments among its various clients consistent with the fiduciary duties it owes to each such client and in accordance with a written allocation policy that documents the general partner's allocation methodology and that the general partner will share with investors upon request;
- it will not delegate any of its duties if the consequence of such delegation would be the cessation or material reduction of the active involvement of any key persons in the management of the partnership;
- it will enforce, in the event of a breach of any advisory or other agreement between the partnership and any affiliate of the general partner, the partnership's rights against such affiliate.

Exculpation and Indemnification. Investors should push for fulsome, robust exceptions to exculpation and indemnification provisions. These exceptions should include, in addition to fraud, willful misconduct, and gross negligence, other "for cause" events that may be of importance to investors in a particular fund, such as the following:

- a material breach of the partnership agreement (with materiality determined by the advisory committee)
- a breach of fiduciary duty
- criminal conduct
- a violation of securities laws

Investors should receive prompt notice of the occurrence of any of the foregoing conduct, and the right, by majority vote of the limited partners not affiliated with the general partner, to remove the general partner or terminate the partnership for cause based on any of the foregoing conduct.

Finally, investors should seek representations from the general partner—either in the partnership agreement or in a side letter—as to an appropriate standard of care. Ideally, that would be the prudent person standard required by ERISA. If that is not possible, the general partner should affirmatively acknowledge that

- it is a fiduciary to the partnership and the partnership's investors as a whole and that it owes the fund and the investors all duties resulting from such fiduciary status;
- no delegation by the general partner of the exercise of its investment discretion to any third-party advisor shall affect the ultimate liability of the general partner to the partnership with respect to the investments undertaken through such delegate.

Conclusion

There is no perfect solution to the fiduciary issue. Both parties have legitimate interests and concerns. Although statutory default rules exist that provide for duties and standards of care applicable to general partners of real estate funds, general partners can and do contractually seek to limit the extent to which such duties and standards of care apply, as well as such general partners' liability for breach of such duties and standards of care. Diligent investors should carefully review the limited partnership agreements of the funds in which they invest and negotiate to secure provisions that provide them adequate assurances that the general partners are acting in accordance with the fiduciary duties that the investors expect. ■

The authors gratefully acknowledge the contributions of the Employees Retirement System of Texas to this article.

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