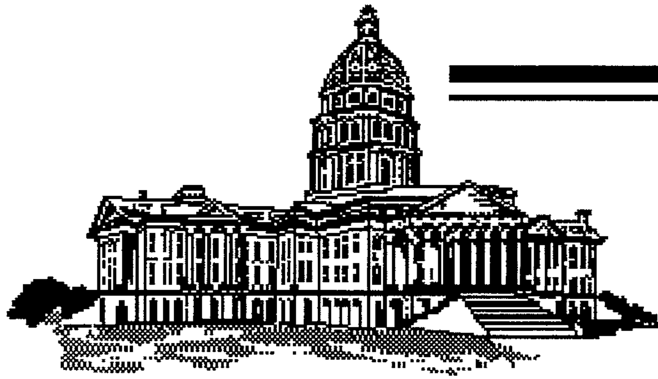

PERFORMANCE AUDIT REPORT

Kansas Public Employees Retirement System: Examining Investments in the Kansas City Merchandise Mart

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
December 1991

92-37

Legislative Post Audit Committee

Legislative Division of Post Audit

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PERFORMANCE AUDIT REPORT

KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: EXAMINING INVESTMENTS IN THE KANSAS CITY MERCHANDISE MART

OBTAINING AUDIT INFORMATION

This audit was conducted by Leo Hafner and Ron Green, Senior Auditors, and Rakesh Mohan, Auditor, of the Division's staff. If you need any additional information about the audit's findings, please contact Mr. Hafner at the Division's offices.

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KANSAS PUBLIC EMPLOYEES RETIREMENT SYSTEM: EXAMINING INVESTMENTS IN THE KANSAS CITY MERCHANDISE MART

Summary of Legislative Post Audit's Findings

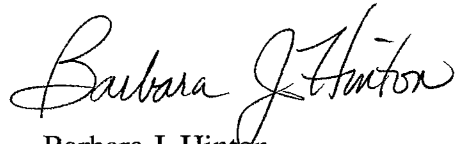
Did the investment in the Kansas City Merchandise Mart comply with the Retirement System's investment policies? The $30 million investment in the Kansas City Merchandise Mart complied with specific guidelines for direct placement investments, but only because the System's Board made a specific change to allow this investment. In addition, this change was made by a telephone vote that apparently was not a legally binding action. Certain aspects of the investment did not appear to meet "the prudent-man" rule. For example, the loan was based on the value of the Mart if it were fully leased, even though the investment manager knew the developers had lease commitments only for about half the facility. These commitments were not sufficient to fund the minimum mortgage payments. In addition, the loan was made without requiring the developers to commit significant personal funds, and without recourse against the developers' assets if the loan was not repaid. Finally, the loan was made even though the investment manager knew that some key provisions of the mortgage probably were not enforceable in the event of a default.

What factors may have affected the value of the Retirement System's investment in the Kansas City Merchandise Mart? The appraised value of the Merchandise Mart has decreased by 35 percent or more since the original appraisal on which the Retirement System's loan was based. The primary factor contributing to the decrease in appraised value is that the entire lower level has never been leased. Without lease income from the lower level, expenses for the Mart have exceeded income. This situation has reduced the investment income the Retirement System was supposed to receive through cash flow participation, and could increase the likelihood the developers may default on the loan. The developers report they have contributed personal funds of about $80,000 a month--or nearly $1 million a year--just to keep the loan current. Tax law changes and lease renegotiations have further increased the developers' expenses associated with the Mart. By not getting security for a significant part of the loan, Reimer and Koger reduced the amount the Retirement System could recover from this investment in the event of a default.

What rate of return has the Retirement System earned on its investment in the Merchandise Mart, and what was the investment manager paid to manage this investment? The 25-year loan calls for the Retirement System to receive a minimum of 10 percent annual interest, 45 percent of the cash flow from the Mart, and three special interest payments in the 7th, 8th, and 15th year of the loan. Based on interest payments to date, the average annual rate of return on this investment has been 10 percent--the minimum interest rate required on the loan. Even though the Mart has not had a positive cash flow, the developers still owe the Retirement System a portion of the money they would have paid from the cash flow. If the rate of return is computed assuming these amounts eventually will

be paid, together with a pro-rata share of the three future interest payments, the average annual rate of return to date has been about 12 percent. We estimate that Reimer and Koger was paid about $1.3 million to manage this investment.

This report includes recommendations for improving the Retirement System's direct placement investment program, if the program is continued. We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials.



Barbara J. Hinton
Legislative Post Auditor

Kansas Public Employees Retirement System: Examining Investments in the Kansas City Merchandise Mart

Since the mid-1970s, the Board of Trustees of the Kansas Public Employees Retirement System (KPERS) has allowed direct placement investments in companies having an impact on the Kansas economy. Direct placement investments are investments arranged directly with companies whose securities are generally not publicly traded. The intent behind making such investments was to provide financing to those companies, which would stimulate job growth and economic development in Kansas.

With the creation of the Kansas Investment Fund in the mid-1980s, the System's Board of Trustees broadened the types of permissible direct placements to include new or expanding businesses, not just businesses that were ongoing and in sound financial condition. Direct placement investments made since then usually have taken the form of loans or preferred stock convertible into common stock. These investments may be unsecured or secured by a second priority in the company's assets. Hence, they involve a higher degree of risk than more traditional investments such as stock in publicly traded companies. Accordingly, investors demand a higher potential rate of return on these types of investments.

As of November 8, 1991, the Retirement System's direct placement portfolio was valued at about $197 million after taking into account about $122 million in investments previously written off and subtracting a reserve for potential additional losses of $91.5 million.

Legislative concerns have been raised about these losses and potential losses resulting from direct placement investments. The Joint Committee on KPERS Investment Practices is carrying out a broad investigation of the Retirement System's investment practices, focusing on direct placement investments in particular. We recently completed performance audits of two of those direct placement investments — Tallgrass Technologies, Inc. and Hydrogen Energy Corporation.

This audit examines a third direct placement investment—the Kansas City Merchandise Mart. Over its life, this investment has been referred to by several names, including the AMIGO Mart, the Executive Hills Merchandise Mart, the Overland Park Merchandise Mart, and the Kansas City Merchandise Mart. Its current name, the Kansas City Merchandise Mart, is used throughout this report. This audit addresses the following questions:

1. **Did the Kansas City Merchandise Mart investment comply with the Retirement System's investment policies?**

2. **What factors may have affected the value of the Retirement System's investment in the Kansas City Merchandise Mart?**

3. What rate of return has the Retirement System earned on its investment in the Merchandise Mart, and what was the investment manager paid to manage this investment?

To answer these questions, we reviewed the investment policies established by the Retirement System's Board of Trustees and compared the terms of this investment with those policies. We reviewed correspondence and other documents that were collected from the investment management firm of Reimer and Koger Associates after its investment management contract was terminated. We also reviewed the mortgage documents and the master lease that was executed with the tenant, together with all the amendments to those documents. In addition, we examined appraisals of the Merchandise Mart by independent firms that conducted those appraisals for lending purposes and property tax purposes. We visited the Johnson County Register of Deeds office and reviewed the ownership history of the land on which the Merchandise Mart was built. Finally, we reviewed income generated from the investment in the Kansas City Merchandise Mart and estimated the investment manager's fees associated with this investment.

In conducting this audit, we followed all applicable government auditing standards set forth by the U.S. General Accounting Office. One of those standards states that individual auditors should be free from impairments to independence, and should maintain an independent attitude and appearance. Although all members of the Division's staff are members of the Retirement System, and the Executive Secretary of the Retirement System was formerly employed by our agency, we are confident that no impairment to independence occurred. We also made every possible effort to provide for and maintain an independent attitude and appearance while conducting this audit.

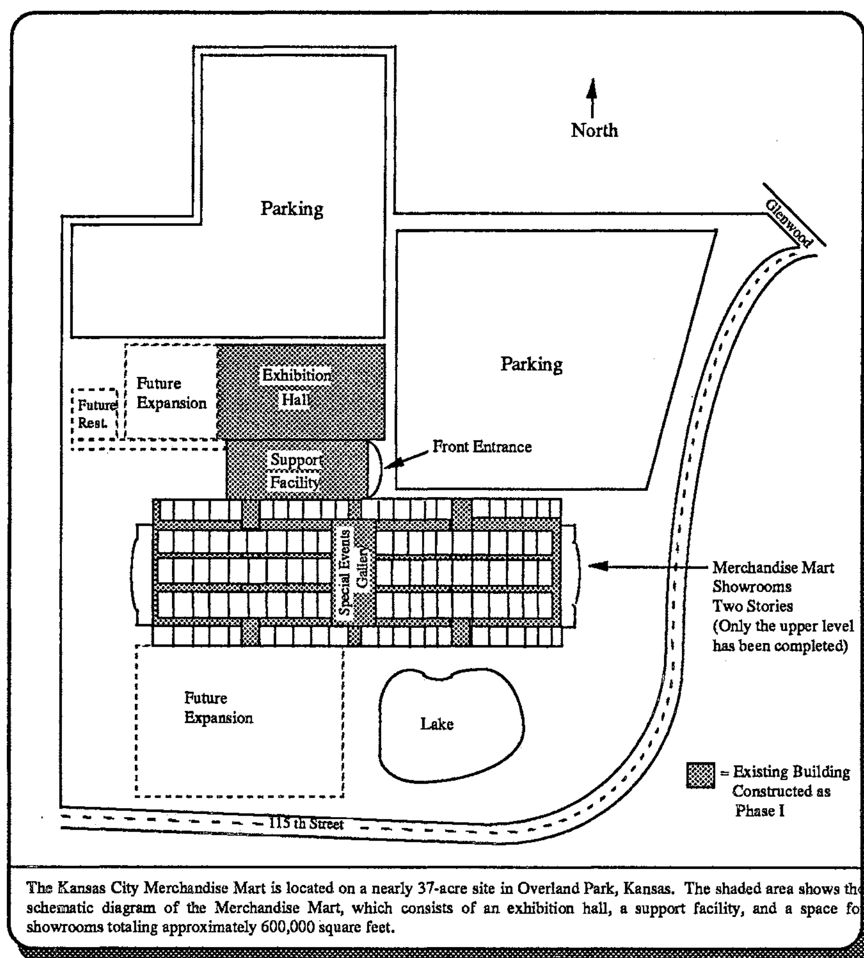
In general, we found that the investment in the Kansas City Merchandise Mart complied with the specific investment guidelines established for the Kansas Investment Fund, but did not appear to comply with the "prudent man rule" contained in the Board of Trustees' broader investment policy governing all Retirement System investments. The appraised value of the Mart has declined by 35 percent or more since it was built, primarily because the lower level has never been leased. Without a tenant for the lower level, the Mart has been operating at a loss which has reduced the Retirement System's investment income, and may eventually cause the developer to default on the loan. In the event of a default, the amount the Retirement System could collect from a repossession and sale of the Mart is probably less than the $30 million invested, because a significant portion of the loan is unsecured. To date, the Retirement System has received an average annual rate of return of 10 percent. The investment manager was paid an estimated $1.3 million to manage this investment over the last five years. These and other findings are discussed in more detail after some background information on the Kansas City Merchandise Mart.

The Kansas City Merchandise Mart

The Kansas City Merchandise Mart is located on a 36.7-acre site in the City of Overland Park, north and east of the intersection of Metcalf and 115th Street. The Mart leases permanent showroom space to wholesalers and manufacturers' representatives who, in turn, sell their products to retailers. In addition, special shows and events are held in the exhibition hall space attached to the Mart.

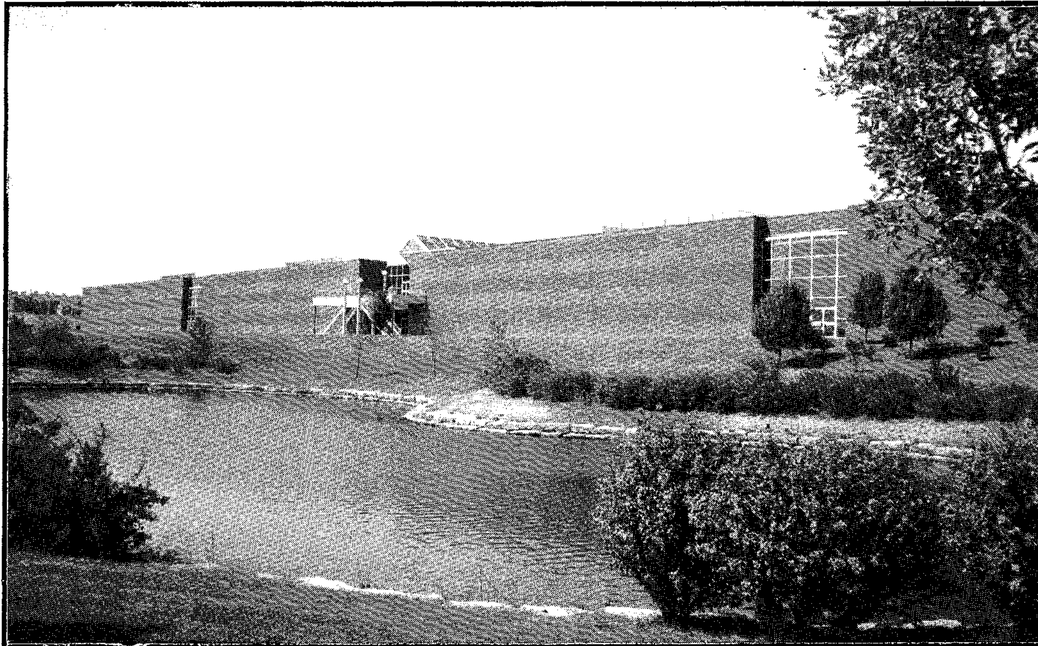
The Mart is a two-level facility encompassing more than 598,000 square feet of space. Each level has approximately 230,000 square feet of space available for permanent showrooms and approximately 39,000 square feet of support facilities. In addition, the upper level has an exhibition hall encompassing about 60,000 square feet.

Diagram of the Merchandise Mart



The Kansas City Merchandise Mart is located on a nearly 37-acre site in Overland Park, Kansas. The shaded area shows th schematic diagram of the Merchandise Mart, which consists of an exhibition hall, a support facility, and a space fo showrooms totaling approximately 600,000 square feet.

The Mart originally was planned to be constructed in two phases. Phase I was constructed as described above. Phase II anticipated additional showroom space on the southwest corner of the Mart, an expansion to the exhibition hall, and a free-standing restaurant. To date, Phase II has not been constructed. The figure above shows the basic layout of the Merchandise Mart and the expansion areas that were anticipated when the Mart was originally planned.



The majority of the facility's upper level has been leased to the Associated Midwest Independent Gift Organization, Inc. (AMIGO Inc.). AMIGO Inc. is a not-for-profit association of gift wholesalers that primarily serves the mid-America region—Kansas, Missouri, Iowa, Oklahoma, and Nebraska. AMIGO has a 20-year master lease, and subleases showroom space to its members. The accompanying photographs show a view of the showroom facilities from the south side of the Merchandise Mart, and a view of the main entrance on the east side of the Mart.

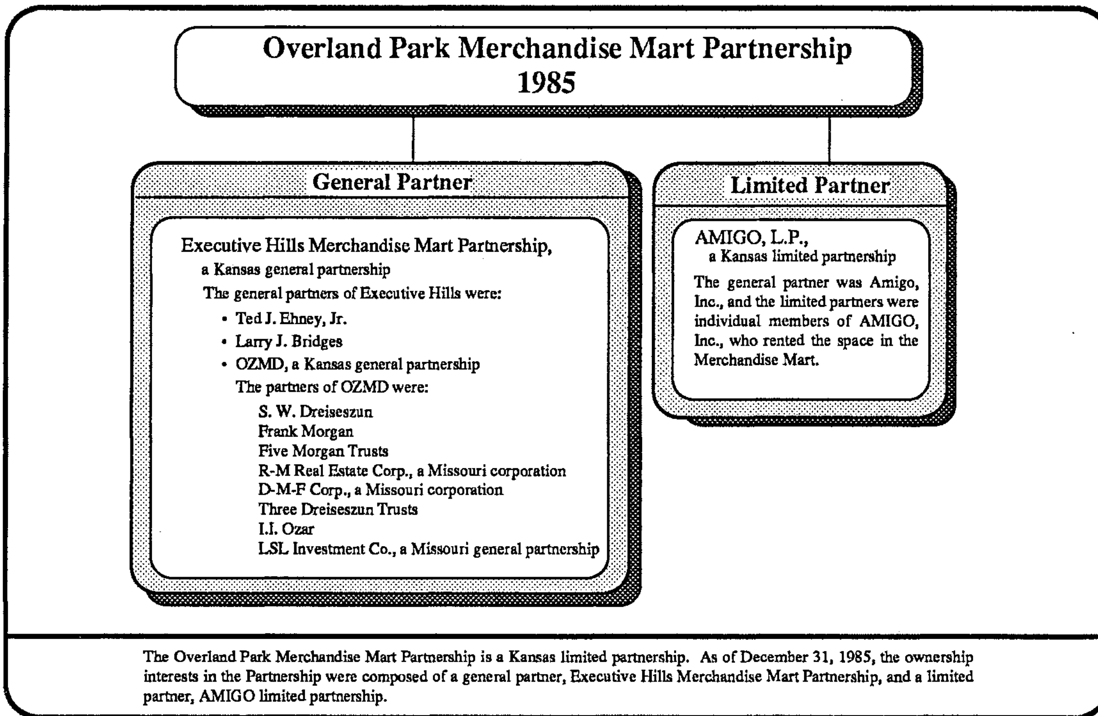
The entire 230,000 feet of the lower level of the Mart has remained unfinished, awaiting a tenant, since the Mart was constructed in 1986. The accompanying photograph shows the exposed beams and the floors, which are composed of crushed rock.

The developer and owner of the Merchandise Mart is the Overland Park Merchandise Mart Partnership, a Kansas limited partnership. The composition of the partnership has changed over the years. The charts on the following page show the composition of the partnership when the original investment in the Mart was made, and the current partnership structure.

When the Retirement System loaned money to Overland Park Merchandise Mart Partnership to develop the Merchandise Mart, the general partner was Executive Hills Merchandise Mart Partnership and the limited partner was AMIGO Limited Partnership.

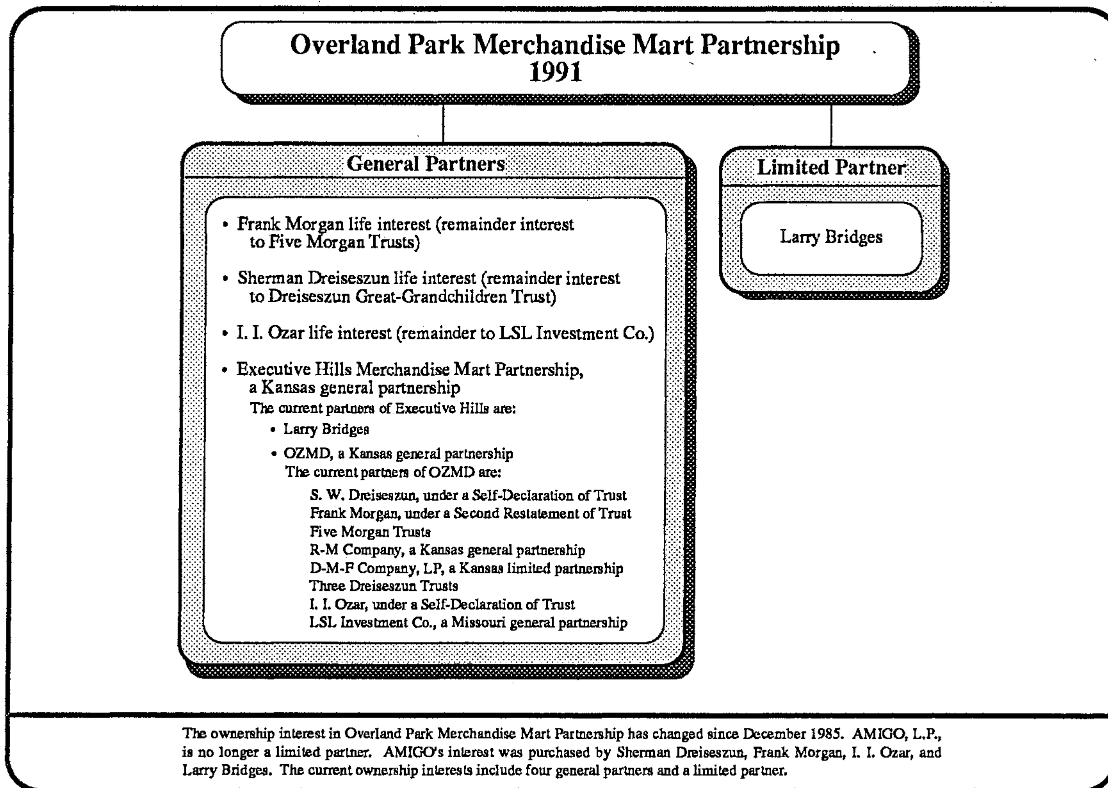
On July 29, 1988, AMIGO's interest as a limited partner was purchased by Larry Bridges, Sherman Dreiseszun, Frank Morgan, and I.I. Ozar. Although Larry Bridges chose to keep the interest he purchased from AMIGO as a limited partnership interest, the other purchasers chose to assume the role of general partners for the amount of the interest they purchased from AMIGO.

As the second chart shows, the individuals who purchased the limited partnership interest from AMIGO also had other ownership interests in the property through their interests in Executive Hills Merchandise Mart Partnership and OZMD.



The Overland Park Merchandise Mart Partnership is a Kansas limited partnership. As of December 31, 1985, the ownership interests in the Partnership were composed of a general partner, Executive Hills Merchandise Mart Partnership, and a limited partner, AMIGO limited partnership.

As the chart below shows, the individuals who purchased the limited partnership interest from AMIGO also had other ownership interests in the property through their interests in Executive Hills Merchandise Mart Partnership and OZMD.



The ownership interest in Overland Park Merchandise Mart Partnership has changed since December 1985. AMIGO, L.P., is no longer a limited partner. AMIGO's interest was purchased by Sherman Dreiseszun, Frank Morgan, I. I. Ozar, and Larry Bridges. The current ownership interests include four general partners and a limited partner.

The Retirement System's current investment in the Merchandise Mart consists of a 25-year, non-recourse mortgage on the property. A non-recourse mortgage means that in the event of a default, the Retirement System can repossess the land and building but cannot look to the assets of the Overland Park Merchandise Mart Partnership or the individual partners for payment.

The mortgage carries a base interest rate of 10 percent, but was designed to produce a higher rate of return through participation in the cash flow from the Merchandise Mart and from some additional interest payments in later years of the mortgage. The accompanying box spells out some of the key provisions of the mortgage.

Key Provisions of the Retirement System's Mortgage on the Kansas City Merchandise Mart

• Mortgage Amount -	$30 million
• Base Interest Rate -	10 percent
• Term -	25 years
• Cash Flow Interest -	The Retirement System is supposed to receive 45 percent of the net cash flow from the Merchandise Mart.
• Target Interest Rate -	The loan documents provide a target interest rate that is supposed to be achieved each year. The target interest rates range from 10 percent in early loan years, to more than 18 percent in later loan years. The sum of the base interest rate and the cash flow interest the Retirement System receives in a given year is supposed to at least equal the target interest rate. If not, 50 percent of the difference between the amount that would have been paid under the target interest rate and the amount that was actually paid is accumulated and must be paid in any year in which there is sufficient cash flow to pay it, or at the maturity of the loan.
• Additional Interest -	The loan documents require three special interest payments as follows: commencement of the 7th loan year - $225,000 commencement of the 8th loan year - $225,000 end of the 15th loan year - $1,610,000
• Interest Only -	The borrower pays only the interest on the loan for the first nine years. Payment of principal begins in the 10th year of the loan.
• Prepayment Penalties -	The loan may not be pre-paid before the 20th loan year. If the loan is pre-paid between the 20th and 25th loan years, a decreasing prepayment penalty applies, ranging from five percent of the loan balance in the 20th year to one percent in the 24th year.
• Other Penalties -	If the loan is pre-paid because of default or some other reason, there are substantial prepayment penalties that range from $500,000 to $10,063,050, depending on the year in which the loan was terminated.
• Option to Purchase -	If for any reason the loan is repaid before the 20th loan year, the Retirement System has an option to purchase the Mart for the lesser of $46 million or the fair market value as specified in the agreement.

The current mortgage is for $30 million, but under the terms of the commitment letter Reimer and Koger signed in connection with this investment, the Retirement System is obligated to provide up to an additional $5 million should the Mart be

expanded to include Phase II of the original plans. That additional $5 million commitment expires in June 1992.

History of the Kansas Public Employees Retirement System's Investment In the Kansas City Merchandise Mart

The following is a brief history of the investment in the Kansas City Merchandise Mart. We assembled this history from correspondence contained in files maintained by Reimer and Koger Associates.

March 9, 1985 - An agreement for base lease was signed by Amigo Inc., as tenant, and Overland Park Merchandise Mart Partnership, as landlord. Under the agreement, Amigo was to lease the land, the entire upper level of a "center building," and a restaurant building, all of which were to be constructed and ready for occupancy by July 1, 1986. The lease was to run for 20 years.

March 19, 1985 - Correspondence indicates that Ken Koger of Reimer and Koger met with Frank Morgan and Larry Bridges on this date to discuss what was then called the Amigo Merchandise Mart and Convention Center. Construction was to begin on June 30, 1985, with projected completion being July 1, 1986. Morgan and Bridges were proposing financing of $30 million for the project. Ken Koger indicated he did not have authorization to invest $30 million and would need to secure authorization from the Retirement System's Board of Trustees before proceeding.

April 10, 1985 - Ken Koger met with Larry Bridges to work out preliminary terms of a commitment for the project. They discussed having the Retirement System provide $30 million for phase I of the project, and another $5 million for phase II. The mortgage would be for 25 years, with the payments for the first 10 years being interest only.

Late April to early May 1985 - Ken Koger worked with the law firm of Stinson, Mag & Fizzell to develop a non-binding commitment letter that would spell out the terms for financing the Merchandise Mart project.

May 23, 1985 - Ken Koger attended a meeting of the Retirement System's Board of Trustees, and asked the Trustees to consider amending the investment guidelines for the Kansas Investment Fund to allow up to 20 percent of the Fund to be committed to one investment. The Trustees discussed the request, but could not vote on it because a quorum was not present. The Trustees directed the Retirement System's Executive Secretary to poll individual Trustees on the following day and record their votes on the matter.

May 24, 1985 - The Executive Secretary of the Retirement System contacted trustees in person and by telephone to record their votes on the proposed change to the investment guidelines. Records indicate that four trustees voted "yes" and three were unable to be contacted.

June 12, 1985 - Ken Koger sent a letter to the Retirement System's investment custodian, advising that Reimer and Koger had chosen to provide long-term financing for the Amigo Gift Mart and Convention Center.

June to September 1985 - During this period, the parties roughed-out the terms of a formal commitment letter on the project. Also, Reimer and Koger lined up the firm of Howard, Needles, Tammen & Bergendoff to review the plans for the Mart, to make periodic inspections during construction, and to certify that the building had been constructed according to approved plans.

September 12, 1985 - Reimer and Koger and Overland Park Merchandise Mart Partnership signed a formal commitment letter in which the Retirement System would provide permanent financing for the Merchandise Mart project. That commitment was for $30 million for phase I of the project, and an additional $5 million for phase II.

September 1985 - Rule & Company appraised the project, valuing it at $37.5 million. (The Retirement System's $30 million loan was 80 percent of the appraised value.)

December 26, 1985 - The base lease between Amigo and Overland Park Merchandise Mart partnership was amended to change the tenant from Amigo Inc. to Amigo Limited Partnership, which had Amigo Inc. as its sole general partner. Also, the Amigo Gift Association was removed as a guarantor of Amigo Inc's. obligations under the lease agreement. In addition, the principals of the general partnership (Overland Park Merchandise Mart Partnership) that served as the landlord made certain guarantees that amounts owed to Amigo would be paid.

December 31, 1985 - The $30 million promissory note was signed with Overland Park Merchandise Mart Partnership as the borrower. Wells Fargo Realty Advisors Funding Incorporated was the construction lender, and the Retirement System was the permanent lender. The note was secured by a first mortgage on the property and by an assignment of rents. Earlier in 1985, temporary funding of $4.95 million had been provided to the developer by Merchants Bank of Kansas City and Metro North State Bank.

January 27, 1986 - A "buy-sell" agreement was executed in which the Retirement System agreed to purchase the loan from Wells Fargo Realty Advisors Funding Incorporated when construction was completed. Also on this date, the base lease was amended a second time to accommodate technical changes that were required by Wells Fargo, to add a section related to the heating and air conditioning systems, to add further obligations that the principals of Overland Park Merchandise Mart Partnership were guaranteeing to Amigo, and to document Amigo's approval of the form of a non-disturbance agreement to be executed in favor of Wells Fargo and the Retirement System.

July 17, 1986 - This was the date the Retirement System purchased the note from the construction lender. This was also the date of the first amendment to the mortgage, which clarified the computation of cash flow interest and the conditions of default on the mortgage. Also on this date, the third amendment to the lease was executed, which dealt with terms for ensuring that a $500,000 relocation fee and a $500,000 interest-free loan which the landlord had promised to Amigo by April 15, 1986, would be provided. The landlord and tenant also agreed that construction of a restaurant building would begin within 60 days after certain conditions were met. They also agreed that Amigo's July 1986 rent would be waived if the expenses that had to be paid by the tenant during the first year of the lease exceeded $1 million.

July 29, 1988 - The ownership of Overland Park Merchandise Mart Partnership changed. Larry Bridges, Frank Morgan, Sherman Dreiseszun, and I.I. Ozar purchased Amigo Limited Partnership's interest as a limited partner in Overland Park Merchandise Mart Partnership. The loan documents were amended a second time and the lease was amended for a fourth time. As part of the lease amendment, Amigo relinquished substantial portions of the property — including the parking areas and the exhibition hall — back to the landlord (Overland Park Merchandise Mart Partnership). In return, the landlord agreed to assume certain expenses that Amigo had been paying and to make substantial payments to Amigo over the remaining life of the lease.

October 26, 1989 - A second appraisal by Rule & Company valued the Merchandise Mart at $23.4 million.

November 1989 to present - There have been no additional changes to the loan documents or the lease. The Merchandise Mart continues to operate at a substantial loss because it lacks a tenant for the lower level. The developers of the Mart have kept the mortgage current. The developers have had ongoing talks with the City of Overland Park during the last several years concerning the City's possible purchase of part of the Mart for a convention center complex. As of the date of this audit, talks had been put on hold and no agreement with the City had been reached.

Did the Kansas City Merchandise Mart Investment Comply With the Kansas Public Employees Retirement System's Investment Policies?

Although the Retirement System's Board of Trustees ultimately is responsible for investing Retirement System moneys, neither the Board nor its staff were involved in day-to-day investment decisions before 1991. Such decisions were delegated to investment managers. The Board delegated management responsibility for the Kansas Investment Fund to Reimer and Koger Associates of Merriam, Kansas.

In making the investment in the Merchandise Mart, Reimer and Koger complied with the specific investment guidelines for the Kansas Investment Fund, but only because the Trustees changed the maximum amount allowed for any one investment. In addition, this policy change was made by a telephone vote that apparently was not a legally correct procedure for taking binding action.

Some aspects of the investment did not appear to comply with general investment policy governing all investments for the Retirement System—specifically the prudent man rule. Several decisions the investment manager made relating to the amount of the loan and the conditions under which it was made could be questioned under this standard. These findings will be discussed in detail in the sections that follow.

The Investment in the Merchandise Mart Complied with Specific Investment Guidelines, But Only Because the Board of Trustees Raised the Maximum Amount Allowed for a Single Investment

The Retirement System's investment in the Merchandise Mart was made through the Kansas Investment Fund. The System's Board of Trustees created this Fund in 1984 to invest directly in companies that could have a favorable impact on the Kansas economy.

During 1985, when Reimer and Koger Associates was contemplating an investment in the Kansas City Merchandise Mart, Retirement System guidelines said that fixed-income securities (such as bonds, mortgages, and the like) of any one company could not exceed 10 percent of the total value of the Kansas Investment Fund. (Securities of the U.S. Government or its agencies were excepted.)

During this period, the Kansas Investment Fund was valued at about $200 million. To comply with the investment guidelines, no fixed-income investment of the Fund could have been for more than about $20 million. Therefore, the policy in effect at that time would not have allowed the $30 million investment in the Merchandise Mart.

At a May 23, 1985, meeting of the System's Board of Trustees, representatives from Reimer and Koger asked the Board to consider changing the Fund's guide-

Definitions of Financial Terms Used in this Audit Report

Cash Flow. Cash receipts minus cash disbursements for a given period.

Cash Flow Interest. An amount defined in the loan agreement for the Kansas City Merchandise Mart as 45 percent of the cash flow for each loan year.

Collateral. Property which is pledged as security for a debt.

Construction Lender. A lending institution which grants a temporary loan to begin construction, with the understanding that, on a date mutually agreed upon by the borrower and the lender, the note will be transferred to a permanent lender.

Default. The failure to perform a legal or contractual duty or to meet a financial obligation.

Deferred Cash Flow Interest. A sum equal to one-half of the difference between the total of the minimum interest and cash flow interest actually paid on the Kansas City Merchandise Mart loan and the targeted interest for the loan.

Fixed-Income Securities. Investments that have a specified return in the form of interest for the lender.

Foreclosure. The process of a lender taking back collateral pledged by a borrower for repayment of a loan.

General Partner. A partner who participates fully in the profits, losses, and management of the partnership and is liable for partnership debts.

Limited Partner. A partner who is not liable for the partnership debts beyond his or her financial contribution, and has limited participation in the profits of the partnership by agreement.

Master or Base Lease. A contract granting authority to sublease the property to other tenants for a specified period in exchange for a specified amount of rent.

Minimum Interest. Defined in the Kansas City Merchandise Mart loan agreement as interest at the annual rate of 10 percent.

Mortgage. A contract or deed specifying a temporary pledge of property to a creditor as security for the repayment of debt.

Non-Recourse Mortgage. A type of security loan which prohibits the lender from taking action (other than foreclosure) against the borrower if the security value falls below the value of the unpaid loan.

Permanent Lender. A lending institution that provides long-term financing for a project.

Promissory Note. A written promise to pay or repay a specified sum at a stated time or on demand.

lines to permit the commitment of up to 20 percent of the Fund for one investment. Because no quorum was present, Board members directed the System's Executive Secretary to conduct a telephone vote of the Board members on May 24 to determine whether the members favored such an increase.

The Executive Secretary polled Board members in person and by phone to obtain their vote on the proposed change to the investment guidelines. The System's records indicate that four Board members voted "yes," and three were unable to be

contacted. The Executive Secretary informed Reimer and Koger of the results of the telephone vote, and the investment manager proceeded with the Merchandise Mart investment.

From the wording of the policy change, it was unclear whether the change was made solely for this one particular investment, or whether it applied to future investments from the Fund. In any event, the System's written investment policy was never amended to reflect this change.

The telephone poll vote that changed Board policy and allowed Reimer and Koger to invest in the Merchandise Mart apparently was not an official binding action of the Board. A 1980 opinion issued by the Kansas Attorney General states, "It is not a violation of the Kansas Open Meetings Act for a single member of a seven-person governing body to converse over the telephone with another member of the body. <u>However, any vote taken by polling of the members of the governing body is ineffective and does not constitute binding action</u>." (Underscoring added.) In the context of that opinion, "polling" meant making a separate phone call to each member to obtain the votes.

Because the vote to increase the limits for the amount of a single investment for the Kansas Investment Fund was taken by telephone, and a quorum of four Board members was not simultaneously present, it appears that the Board did not have an official meeting on May 24, 1985, (the day of the vote) and therefore could not have taken binding action. However, Board members apparently thought they had taken binding action, and the investment manager made the investment in accordance with the Board's action.

Some Aspects of the Investment in the Merchandise Mart Did Not Appear to Comply with the Prudent Man Rule Included in the Board's General Investment Policy

The Board's statement of investment policy contained general provisions applicable to all Retirement System investments. These general provisions included the Board's standard for investment—commonly known as the "prudent man rule"—which is mandated by K.S.A. 74-4921(4)(a):

> In investing and reinvesting moneys in the fund and in acquiring, retaining, managing, and disposing of investments of the fund there shall be exercised the judgment and care under the circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.

Several of the decisions made by the investment manager could be questioned under this standard. As explained below, those decisions related mainly to the amount of the loan and the conditions under which it was made.

Reimer and Koger made the loan based on the Merchandise Mart's value if it were fully leased, knowing the developers had lease commitments only for the Mart's upper level. The $30 million loan was 80 percent of the $37.5 million appraised value. The value shown in the appraisal was contingent upon the Mart being almost fully leased during its first year of operation.

The appraiser told us he assumed the lower level would be fully leased, because he had talked with representatives of the developer and AMIGO, who indicated that AMIGO might expand into the lower level. In addition, the appraiser told us there was a possibility that a builders mart or an apparel mart would locate in the lower level.

Although the developer had a tenant committed to leasing the upper level of the building (AMIGO Inc.), there was no commitment on the space in the lower level. Reimer and Koger knew that the rental income on the upper level was not sufficient to make the payments on the mortgage, yet the firm made the loan as though the building were committed to be fully leased. To our knowledge, Reimer and Koger did not question the valuation assigned by the original appraisal by Rule and Company, or the assumptions used in the appraisal.

Reimer and Koger loaned money to fund all the construction and start-up costs for the Merchandise Mart without any investment from the other parties. Reimer and Koger committed the Retirement System to a $30 million loan for the Merchandise Mart. That loan not only covered the entire cost of the land and the cost of construction, but it also covered $2.2 million in payments and loans the developer made to induce AMIGO Inc. to relocate from its previous headquarters in Kansas City, Missouri. In addition, the proceeds from the loan provided the developer with enough money to cover legal fees, leasing fees, survey costs, and most other costs associated with the construction of the Mart. See Appendix A for an itemized statement of the uses of the $30 million loan, as provided by the developer.

At the time this investment was made, the Retirement System's Board had no specific requirement that other investors be involved. But given the size of the investment and the fact that only half the facility had lease commitments at the time of the investment, it did not seem prudent to put the Retirement System in the position of bearing all the risk of this investment. At the time the Mart was built, the developer had no personal funds at risk. In fact, according to the developer's financial statements, in 1986 almost $2.8 million was distributed to the developer's general partner—Executive Hills Merchandise Mart Partnership—from the proceeds of the loan. When we asked about the distribution, the developer said, "the $2.8 million was always considered necessary to cover first year operating deficits as a result of tenant concessions to AMIGO as well as tenant improvement and other lease costs. The withdrawal was made because the money was temporarily not needed in the partnership. Eventually the $2.8 million was put back into the partnership along with an additional amount greater than $7 million."

In addition, Reimer and Koger made the loan without any recourse against the developers. A construction loan for the Merchandise Mart was provided

by Wells Fargo Realty Advisors Funding Incorporated. As part of its loan agreement, Wells Fargo required personal guarantees from the partners of the Overland Park Merchandise Mart Partnership (the developer of the Mart). In contrast, Reimer and Koger allowed the loan documents to be drafted so that those guarantees were canceled when the Retirement System took over permanent financing for the facility.

Reimer and Koger ignored advice from legal counsel that some provisions in the mortgage may not be enforceable if the developer defaulted. Loan documents signed by the Overland Park Merchandise Mart Partnership and Reimer and Koger call for a 10 percent base interest rate on the loan, plus 45 percent of the net cash flow from the operation of the Mart. Other major provisions include special interest payments of $225,000 each during the seventh and eighth loan years, and $1,610,000 during the 15th loan year. The loan documents prohibit the loan from being prepaid before the 20th loan year. But in the event of a default and foreclosure, a prepayment penalty of as much as $10,063,050 could be due, depending on the year in which the loan was extinguished.

The commitment letter Reimer and Koger signed with the Overland Park Merchandise Mart Partnership stated that the parties recognized that the 10 percent minimum interest rate assigned to the loan was below the market rate of interest, and that Reimer and Koger would not make the loan were it not for the anticipation of receiving some of these additional payments.

Correspondence we reviewed indicated that Reimer and Koger was counseled by its attorneys on several occasions that some loan provisions—particularly those related to penalties in the event of a default—may be contrary to Kansas law, and thereby unenforceable. Even though Reimer and Koger considered the additional payments to be an important consideration, without which the loan would not have been made, the firm still chose to make the loan knowing that those payments probably could not be enforced in the event of a default.

What Factors May Have Affected the Value of The Retirement System's Investment in the Kansas City Merchandise Mart?

Estimates of the Merchandise Mart's value have decreased by 35 percent or more since the Retirement System made its investment in the Mart in 1986. The primary factor contributing to the significant decrease in the Mart's appraised value is the lack of a tenant for the lower level of the facility. Concerns that the value of the original appraisal of the Mart was inflated through land sales or the switching of leases did not appear to be founded. The lack of a tenant also has reduced the investment income the Retirement System has received to date, and may significantly reduce that income over the life of the loan.

The decrease in appraised value is of concern only if the developer defaults on the loan and the Retirement System must repossess the property and sell it. To date, the developer has made the minimum payments to the Retirement System that are required by the loan agreement. However, during the past several years, tax law changes and renegotiation of the lease with the Mart's only tenant have significantly increased the developer's expenses in operating the Mart, which could increase the likelihood of default. In the event of a default, the amount the Retirement System might recover is probably less than the $30 million invested in the property. These and related findings are discussed in detail the the sections that follow.

In 1985, the Merchandise Mart Was Valued at $37.5 Million

During 1985, before the Mart was constructed, Reimer and Koger Associates arranged for an appraisal of the Mart to help determine its value for lending purposes. That appraisal was completed in September 1985 by Rule and Company of Kansas City, Missouri. In making its appraisal, Rule and Company used an "income approach," an approach that most appraisers use to arrive at appraised values for properties such as the Mart. Under the income approach, the appraised value is heavily influenced by the anticipated income over a period of time.

Questions have been raised about whether a new lease reducing AMIGO's basic rental payments was substituted for the lease the appraiser used to complete the 1985 appraisal. Our review showed that the rental rates shown in the first lease that went into effect were the same as those cited in the appraiser's report.

There were also concerns that the land was sold several times before the appraisal to inflate its appraised value. Although title to the land did change several times, we did not find evidence that the land value was inflated. More information about the land transfers can be found in the box on the next page.

The Cost of Land Had No Significant Impact on the Amount of the Loan

In this audit, we were asked to determine whether the land on which the Merchandise Mart was built was resold several times to increase the amount of the loan the Retirement System made on the property.

The total cost assigned to the 36.7 acres is $5,193,944, or about $3.25 per square foot. Compared to similar sales cited in the first appraisal, this price was not out of line.

The cost of the land had little, if any, impact on the appraisal of the Mart for loan purposes. The appraised value was determined by using an income approach, which assigns a value based on the net income generated from the facility.

To determine the ownership history of the property, we visited the Johnson County Register of Deeds office and reviewed deeds recorded on the property since 1983. For the most part, we did not have access to the amounts paid in each transaction.

In general, we found that Overland Park Merchandise Mart Partnership acquired title to the land from Executive Hills Merchandise Mart Partnership on December 31, 1985. Executive Hills acquired title to the 36.7 acres of land in two series of transactions, as explained below.

The majority of the property — 29.5 acres — was purchased from Stanley and Geraldine Goldberg on August 20, 1985. The Goldbergs were nominee owners for a consortium of other people who had ownership interest in the property. It appears that the Goldberg group had been long-term owners of the property.

The remainder of the 36.7 acres was carved out of a larger tract that belonged to Anna Marie Buelli. Ms. Buelli sold the tract to Peter C. Boylan, *et al*, on January 10, 1985. On July 7, 1985, the Boylan group sold the tract to Executive Hills, Inc. Executive Hills Merchandise Mart Partnership acquired title to the Merchandise Mart portion of the tract on September 30, 1985.

The transactions involving the Goldberg group, Ms. Buelli, and the Boylan group appeared to be actual sales of land. In contrast, the transactions between the Executive Hills entities and the Overland Park Merchandise Mart Partnership appeared to be name transfers on the deed, rather than arms-length sales.

The initial appraisal clearly stated that the appraiser assumed the lower level of the Mart would be completed and occupied by the time the Mart opened. The appraiser also assumed that the lower-level rent would be higher than the rate for the upper level, because AMIGO Inc. had been given concessions as the original, key tenant. Finally, the appraiser assumed the rental rates on the lower level would increase by four percent per year. As a result of these assumptions, the appraiser projected that income for the lower level actually would be greater than income for the upper level.

Using this approach, Rule and Company assigned a value to the Mart of $37.5 million. Based on that appraisal, the Retirement System made a $30 million loan for the project, the amount the developers had requested.

The Mart's Appraised Value Has Dropped at Least $14 Million Since Then, Primarily Because The Lower Level Has Not Been Leased

Subsequent appraisals by Rule and Company and others have placed the Mart's value in a range between $21-$24 million. The primary reason for this lower appraised value is the lack of a tenant for the facility's lower level. After almost six years, the lower level of the Mart has never been completed or leased.

As noted above, the rental income a lower-level tenant would would pay was a key factor in determining the value of the Mart. But because the anticipated income failed to materialize, subsequent appraisals have taken into account the lack of income from the lower level and have assigned lower appraised values to the facility.

In Addition to Its Affect on the Mart's Appraised Value, The Lack of a Tenant for the Mart's Lower Level Has Decreased the Retirement System's Investment Income

Because the lower level of the Mart has not been completed or leased, revenues have fallen substantially short of the amounts needed to make even the minimum interest payments on the loan. Those minimum payments have been made by the individual partners of the developer. According to testimony in July 1991 before the Joint Committee on KPERS Investment Practices, individual partners were contributing about $80,000 per month, or $960,000 per year, just to make the minimum interest payments required by the loan.

In addition to the 10 percent minimum interest payment, however, the System is supposed to receive 45 percent of the net cash flow from the operation of the Mart, and three special interest payments in the 7th, 8th, and 15th years of the loan. The Retirement System's participation in the Mart's net cash flow was designed to allow it to receive target interest rates that were much higher than the minimum 10 percent interest rate. In fact, loan documents specifically state that Reimer and Koger would not have made the loan for 10 percent interest were it not for the anticipation of participating in the cash flow and receiving other additional interest payments. The table below shows the target interest rates through the 25-year life of the loan.

Summary of Target Interest Rates For the Retirement System's Loan for The Kansas City Merchandise Mart

Loan Year	Target Rate	Loan Year	Target Rate	Loan Year	Target Rate
1	10.00%	10	15.60%	18	17.33%
2	10.00%	11	15.85%	19	17.33%
3	13.60%	12	15.85%	20	17.33%
4	13.96%	13	16.50%	21	18.36%
5	13.96%	14	16.50%	22	18.36%
6	14.11%	15	16.81%	23	18.90%
7	14.37%	16	16.81%	24	18.90%
8	14.37%	17	16.81%	25	18.90%
9	15.40%				

As the table shows, for the 5th year of the mortgage (1991), the targeted interest rate was 13.96 percent. To achieve this interest rate, the Retirement System would need to receive the minimum 10 percent interest payments, plus $1,204,500 in net cash flow payments for the year. Because the lower level has not been leased, however, the Merchandise Mart has not yet had a positive net cash flow.

The Retirement System does not lose all this income just because the Mart has not had a positive net cash flow, but it does lose half the expected cash flow income. Under the terms of the mortgage, half the difference between what the Retirement System should have received (the target rate) and what it actually received (the 10

percent minimum rate) becomes payable in a later year or when the loan matures. The other half is essentially written off. The following is an example of how this worked for the 1991 loan year.

1991 target interest rate on the loan	
(13.96 percent x $30 million)	$4,246,167
Actual interest paid for 1991:	
Minimum rate required on the loan (10 percent x $30 million)	$3,041,667
45 percent of the cash flow for 1991	0
Total Interest Paid for 1991	$3,041,667
Interest to be paid later	
Half of the difference between the targeted interest amount and the amount actually paid. (half of $1,204,500)	$602,250

In the first five years of the loan, the actual interest paid has fallen short of the target interest amounts by a total of $3.5 million. Half that amount, or $1.75 million, has been written off. If this condition were to continue throughout the life of the loan, we estimated the developer would owe a lump sum payment for half of the deferred cash flow payments, plus interest on that amount, totaling about $65 million. An estimated $20.7 million in potential cash flow payments would have been written off over the years.

Other Factors Have Increased the Mart's Operating Expenses Without a Corresponding Increase in Revenue, Thus Increasing the Chance of a Default on the Loan

As noted earlier, the developer has been contributing about $960,000 a year just to meet the minimum interest payments on the loan. Over the past five years, several factors have increased the developer's expenses without a corresponding increase in revenues. Among those factors is a renegotiation of the lease with the Mart's only tenant in 1988, and changes to State and federal tax laws in 1986. The increase in expenses does not appear to have directly affected the value of the investment, but it eventually could increase the likelihood of a default.

In August 1988, AMIGO gave up part of the space it was leasing on the upper level of the Merchandise Mart in return for significant cash payments from the developer. The lease between the developer (Overland Park Merchandise Mart Partnership) and the tenant (AMIGO) had been amended three times by the time the mortgage loan was closed in July 1986, but those amendments were mainly technical, non-monetary items.

The most significant amendment to the AMIGO lease occurred in August 1988. Until then, AMIGO had leased the entire upper level of the Merchandise Mart, including the exhibition hall, plus all of the land and the parking areas. AMIGO also was responsible for maintaining all areas of the property and paying all expenses.

The table below shows the major changes that occurred with the August 1988 lease amendment.

Changes Made to the AMIGO Lease in August 1988

BEFORE August 1988	AFTER August 1988
AMIGO leased the upper level of building, including the exhibition hall.	AMIGO no longer leases the exhibition hall and other common areas of the building.
AMIGO received the revenue from the exhibition hall.	Developer receives revenue from the exhibition hall. AMIGO can use exhibition hall three weeks per year, without paying additional rent.
AMIGO had a right to purchase the Mart, under certain circumstances.	AMIGO has no right to purchase the Mart.
AMIGO was responsible for all maintenance and repairs for the Mart and parking areas.	Developer is responsible for maintenance and repair of areas surrendered by AMIGO.
AMIGO was responsible for all expenses, except for capital improvements.	AMIGO pays 20% of parking lot expenses, 25% of dock expenses, and 50% of landscaping expenses.
AMIGO paid all general taxes.	AMIGO pays two-thirds of general taxes.
AMIGO paid for all utilities.	AMIGO pays a prorated share of utility costs.
AMIGO was guaranteed to receive $200,000 per year from food and liquor operations.	AMIGO's guaranteed income from restaurant operations is terminated.
AMIGO's rent for years 2-8 was $2,154,800 per year. Rent for years 9-20 was set at $2,653,800 per year, with an inflation adjustment for years 16-20.	AMIGO's rent payments were not changed, but developer must make a series of payments to AMIGO over an 18-year period. Annual payments through 2002 should be nearly $850,000.

The benefits to AMIGO from this transaction were that its overall expenses were greatly reduced, it no longer had to manage the exhibition hall, and it no longer had to maintain the entire building, parking areas, and landscaping.

The developer gained full control over the exhibition hall and the revenue from the hall, as well as the land surrounding the building. The overall financial impact of the August 1988 lease amendment is difficult to determine, but it appears that the short-term effect for the developer has been negative. In addition to direct payments to AMIGO of $850,000 per year, the developer also assumed greater responsibility for taxes, maintenance and repair costs, and expenses associated with the exhibition hall. The only offsetting revenue has come from renting the exhibition hall, which brought in about $766,000 in 1990.

The renegotiation of the lease appears to have had no direct affect on the Retirement System at this time. Correspondence we reviewed during the audit indicates Reimer and Koger wanted to be sure the Retirement System's position was unchanged before it would approve the lease amendments. This was accomplished by keeping AMIGO's rent at the same level and having the developer make cash pay-

ments to AMIGO for the space they were no longer leasing. The cash payments the developer makes are not counted as expenses for computing net cash flow, nor are any revenues or expenses that would have been attributable to AMIGO before the lease was amended. As a result, the computation of cash flow and the Retirement System's share of that cash flow would appear to be unchanged.

Tax law changes also have increased the financial burden on the Mart's developer. In 1986, federal tax laws were changed to eliminate some of the earlier incentives for investing in real estate, such as tax credits and accelerated depreciation on commercial property. These changes decreased cash flow and net income.

Also in 1986, Kansas voters approved a property classification system that shifted more of the tax burden to commercial property. After reappraisal and classification of property took effect in 1989, taxes on commercial property in Johnson County went up substantially. For more information about property taxes, see the accompanying box. General property taxes on the Merchandise Mart property went from $200,000 in 1987 to $496,000 in 1991. That increase would have been much higher had the developer not won a reduction of its 1989 appraised value through the State Board of Tax Appeals. Johnson County had set an initial value of nearly $30 million on the property (using a cost approach), which was reduced to about $24.2 million through appeal at the County level. The State Board overruled the county's decision and set the appraised value at about $13.1 million for tax purposes.

**Property Taxes on the Merchandise Mart
Went Up Sharply in 1989**

After the Merchandise Mart was completed in 1986, the appraised value assigned by Johnson County in 1987 and 1988 was $4,556,100. When classification and reappraisal took effect in 1989, Johnson County initially assigned an appraised value of nearly $29.9 million, based on a replacement-cost approach. The property owner appealed first at the County level, then to the State Board of Tax Appeals. Using an independent appraisal based on an income approach, the parties agreed to an appraised value of slightly more than $13 million. The table below shows the appraised value and taxes on the property for each year, starting with 1987.

Year	Appraised Value	General Taxes	Special Assess.	Total Taxes
1987	$ 4,556,100	$ 199,095	$ 389,234	$ 588,329
1988	4,556,100	222,736	328,226	550,962
1989	13,075,300	463,827	291,892	755,719
1990	13,075,310	485,334	283,453	768,787
1991	13,074,340	496,305	268,198	764,503
% Change, 1987-1991	187%	149%	-31%	30%

As the table shows, general taxes have gone up by nearly $300,000 during the period, for a 149 percent increase. That increase could be attributed mainly to the impact of classification and reappraisal. During the same period, special assessments have gone down by more than $120,000 per year, a decrease of 31 percent. Special assessments are due mainly to the construction of 115th Street along the south and east sides of the property.

If the Developer Were to Default on the Merchandise Mart Loan, The Liquidation Value of the Property and Existing Lease Could Be Less Than the $30 Million the Retirement System Has Invested in the Mart

Several factors could have a negative impact on the liquidation value of the System's investment. Some of these factors have been mentioned earlier, and some are new. They are summarized below:

- **The fact that a large portion of the loan was unsecured by the mortgage would reduce the value of the investment in the event of a default.** The $30 million the Retirement System loaned covered not only the cost of the land and building, but also incentive payments to lure AMIGO Inc. to the facility, and other start-up and operating expenses. By loaning $30 million on the project, Reimer and Koger essentially made an unsecured direct placement loan of about $6-7 million to the developer, leaving that amount of money potentially exposed to loss.

  To protect the unsecured portion of the loan, Reimer and Koger could have required personal guarantees from the Mart's developers. The developers had given their personal guarantees for repayment of the loan when construction funding was provided from another funding source. But when the Retirement System provided permanent funding for the project, Reimer and Koger waived the Retirement System's right to go after the personal assets of the developers in the event of a default. This action diminished the value of the Retirement System's investment by limiting the amount it could recoup to what could be generated from a repossession and sale of the property.

- **The developer's lease amendment with AMIGO could have a direct impact on the Retirement System.** If it repossessed the Mart, the Retirement System eventually would become responsible for operating the exhibition hall and maintaining the parking lots and other areas relinquished by AMIGO. Depending on the revenue generated by the exhibition hall, the overall impact could be a substantial increase in expenses that is not offset by revenues.

- **A general downturn in the value of commercial real estate, brought on in part by changes in the tax laws, could affect the price the Retirement System might get if it had to sell the Mart.** However, it does appear that the land on which the Mart was built may have become more valuable. Several factors have contributed. For example, United Telecommunications has purchased an adjoining 247-acre tract for development of its corporate office complex, which could make land in the area more attractive. In addition, the land immediately surrounding the facility was rezoned in 1990 to allow the property to be used for business park purposes, which could increase the options for using the lower level and vacant land around the Mart. Comparable land sales that were cited in appraisals of the Mart done in 1989 and 1990 show prices ranging anywhere from $2.20 to $17.50 a square foot, with the most common prices paid generally

in the range of $6 to $9. Compared with the approximately $3.25 per square foot that was paid for the Merchandise Mart land in 1985, it appears that on the whole, the land has appreciated in value.

In sum, it appears that the liquidation value would be equal to the value of the land and the building as leased at the time of a sale. Although only an actual sale could determine that value, recent professional assessments have placed the value of the Mart in a general range between $21-24 million.

What Rate of Return Has the Retirement System Earned On its Investment in the Kansas City Merchandise Mart, and How Much Was the Investment Manager Paid To Manage That Investment?

The rate of return on the Retirement System's investment in the Kansas City Merchandise Mart depends on the time period examined and what is counted as income. Through July 1991, the average annual rate of return based on cash received by the Retirement System has been 10 percent, which is the minimum interest rate established for the loan. The loan agreement also calls for the Retirement System to receive a percentage of the cash flow from the Merchandise Mart, as well as some special interest payments due in later years of the loan. No money has yet been received beyond the minimum interest payments.

Assuming the amounts due will be paid, the average annual rate of return based on total interest accrued through the end of July 1991 has been about 12 percent. We estimated that Reimer and Koger was paid approximately $1.3 million to manage this investment. These and other findings are discussed in the sections that follow.

The Retirement System's Investment in The Kansas City Merchandise Mart Produced an Average Annual Rate of Return Of about 10 Percent Through July 1991

The Retirement System loaned $30 million in the Overland Park Merchandise Mart Partnership on July 17, 1986. In addition, the Retirement System has reimbursed Reimer and Koger Associates for more than $10,000 in out-of-pocket expenses related to this investment. As of July 1991, the only returns the Retirement System has received from this investment have come in the form of minimum interest payments on the loan, at the rate of 10 percent. Through July 1991, more than $15 million in interest had been received.

As mentioned earlier in the report, the Retirement System is supposed to receive part of the cash flow from the operation of the Merchandise Mart in order to achieve pre-determined target interest rates each year. If that money is not paid, part of it accumulates and is deferred until later in the life of the loan. Also, three special interest payments come due in later years of the loan.

Through July 1991, more than $1.9 million in deferred cash flow payments and interest was owed to the Retirement System. We also calculated a prorated share of the additional interest payments for the same time period. That amount was $854,482. If these amounts are added to the interest payments the Retirement System has actually received, they produce a total rate of return in individual years that ranges from 10.7 percent to 14.8 percent, and an average annual rate of return of about 12 percent as shown in the table on the following page.

Annual Rates of Return to the Retirement System

Calendar Year	Rates of Return... Based on Cash Interest Paid to KPERS	Based on Total Interest Accrued
1986	8.3%(a)	10.7%
1987	10.0	10.7
1988	10.0	10.7
1989	10.0	12.5
1990	10.0	12.9
1991	10.0	14.8
Average Annual Rate of Return	10.0%	12.0%
Total Interest, 1986 - 1991	**$15,116,396 Paid**	**$18,120,231 Accrued**

(a) The computed interest rate on a cash basis is below the 10 percent minimum interest rate for the year because the December 1986 interest was paid in January 1987.

The table shows that the owners of the Merchandise Mart have paid a total of $15.1 million in interest, or about 83 percent of the $18.1 million in total accrued interest through July 1991, leaving a deferred interest balance due of about $3 million at that time.

We Estimate that Reimer and Koger Was Paid Approximately $1.3 Million to Manage the Retirement System's Investment in the Kansas City Merchandise Mart

For managing investments in the Kansas Investment Fund, Reimer and Koger Associates received three types of fees — base management fees, income incentive fees, and gains incentive fees. Gains incentive fees are paid only when an investment is sold. Base management fees and income incentive fees are explained in the following paragraphs.

Base management fees were paid according to the amount of funds under management. Reimer and Koger received 0.5 percent on the first $100 million managed, and 0.375 percent on any amounts in excess of $100 million. Base management fees were paid quarterly in advance, based on the amount of investments managed at the end of the preceding quarter. For example, if Reimer and Koger had $300 million under management in the Kansas Investment Fund for one year, its annual base management fee would have been $1.25 million. Base management fees increased whenever an addition was made to the total funds being managed by Reimer and Koger.

Income incentive fees were paid according to the amount of accrued interest and dividends received for investments in the Kansas Investment Fund. If the combined accrued interest and dividends received exceeded the preferred return (the average 91-day Treasury Bill rate) for the invest-

Some Questions Could Not Be Completely Resolved
Within the Time Available for this Audit

Was there a problem with title insurance? Members of the Joint Committee on KPERS Investment Practices reviewed a copy of an October 1985 Reimer and Koger memorandum referring to "another turndown from the title insurance company." Although we asked representatives of the title company and the developer, neither could explain exactly what the "turndown" referred to.

When we sought to determine whether there was any kind of title defect on the Merchandise Mart property, we found that Reimer and Koger apparently was trying to use title insurance to guarantee some additional interest payments, prepayment penalties, and liquidated damages in the event of default — none of which related to the validity of the title.

The documents we reviewed did refer to a restriction against shopping centers on this property, but that restriction was apparently released before the loan was closed. The title insurance company issued a $40 million policy on July 18, 1986.

How much money is paid to AMIGO under the 1988 Lease Amendment? According to the lease amendment that took effect in August 1988, the annual payments from the developer to AMIGO should have been almost $850,000. However, notes to the Partnership's 1988 financial statements showed annual payments due of only about $750,000. We were unable to resolve this discrepancy within the time available.

How did the Merchandise Mart property become 36.7 acres? The official survey of the Merchandise Mart property showed a total of 36.7 acres. Our review of the land transactions that formed the Merchandise Mart parcel showed that the parcel was assembled in two parts. The major part was a direct purchase of 29.5 acres. The remaining 7.2 acres was originally part of a 12-acre tract Executive Hills Inc. purchased in July 1985. Records showed that Executive Hills sold 2.2 of the 12 acres in August 1985, leaving 9.8 acres owned by the developer. We were unable to find any record of an additional 2.6 acres being sold to arrive at the 7.2 acres that became part of the Merchandise Mart property.

Was a restaurant required by the original plans? The first appraisal of the Mart, issued in September 1985, indicated that a restaurant building was planned as a "future expansion." However, the first lease amendment (January 1986) included a 9,000 square foot restaurant building as part of the premises to be leased to AMIGO, rather than as part of the defined expansion areas. A July 1986 lease amendment guaranteed that the developer would begin construction of the restaurant building within 60 days after the City of Overland Park either approved the City's plans for expansion of the Mart or advised the developer that the City terminated its discussions concerning the Mart.

When the Mart opened in July 1986, the lease provided AMIGO with a $200,000 annual guarantee of gross income from food and liquor operations in the Mart. This amount was credited against the rental payments due from AMIGO to the developer. This $200,000 annual guarantee was discontinued after the August 1988 lease amendment.

We were not able to determine whether the restaurant building was supposed to be part of the original construction or not. In any event, the restaurant building has not been built yet.

ments, Reimer and Koger received 13 percent of the amount in excess of the preferred return. Although the firm would not receive compensation for the performance of the individual investment, recognizing accrued income from the individual investment added to accrued income for the entire fund. However, any accrued interest that had not been collected for over a year would be deducted before payment of the fee. Income incentive fees were to be paid within 30 days after the end of each quarter.

Because base management fees and income incentive fees were based on the entire Kansas Investment Fund, it was not possible to accurately determine the amount of fees associated with a single investment. Retirement System officials did a rough estimate of fees paid for managing the Merchandise Mart investment. By prorating the actual fees paid to Reimer and Koger based on the annual average cost value of the investment, the Retirement System staff estimated a total of almost $1.2 million in fees associated with the Merchandise Mart investment between

1986 and 1991— about $640,000 in base management fees, and $547,000 in income incentive fees.

Reimer and Koger estimated it had received somewhat less in base management fees— about $578,000. However, no detailed information was available through either the Retirement System or Pacholder Associates (the current investment manager for the Merchandise Mart) that would show details of what income Reimer and Koger included in its' computation of income incentive fees for the Merchandise Mart investment.

When we estimated income incentive fees based on the accrued interest income solely generated by the Merchandise Mart investment, we determined that about $735,000 in income incentive fees would have been paid to Reimer and Koger for income received from the investment. By adding the $735,000 in income incentive fees to the $578,000 of base management fees calculated by Reimer and Koger, our total estimate of fees paid for the Merchandise Mart investment is about $1.3 million.

Conclusion

The investment in the Kansas City Merchandise Mart is different in many ways from previous direct placement investments we have reviewed. In both the Tallgrass Technologies and Hydrogen Energy investments, the Retirement System's initial investment consisted of loans that were convertible to stock ownership in the company. In each case the Retirement System invested additional moneys to pay interest on loans it had previously made to the companies and to keep the companies afloat. The loans were unsecured, and in both cases the Retirement System ended up owning the majority of the business.

In contrast, the Retirement System does not own the Merchandise Mart. There have been no follow-up investments since the initial loan was made in 1986, and at least a portion of the loan is secured by a mortgage on the land and building. To date, the minimum interest payments required by the loan have been made.

Despite these differences, this investment exhibits some of the same characteristics of the other investments. The direct placement manager entered into a large and risky investment—in which the Retirement System bore almost all the risk—essentially without any oversight or monitoring by the System's Board of Trustees and its staff.

Since mid-1991, the Retirement System has made numerous changes to improve its investment oversight process and to make its direct placement managers more accountable. Through its Joint Committee on KPERS In-

vestment Practices, the Legislature also is trying to address weaknesses in the System's direct placement investment practices. These and other efforts must be made to ensure that public retirement moneys are invested in the best interest of the System and its members.

Recommendations

In previous audits of the Retirement System's direct placement investments, we made numerous recommendations that were concerned with oversight and were applicable to direct placement investments in general. Those recommendations are repeated below, with necessary modifications to address specific risks or control weaknesses found during the audit of the Merchandise Mart.

If the Kansas Public Employees Retirement System continues to invest at least a portion of its moneys in direct placement investments, the following actions should be taken:

1. To limit the amount of Retirement System moneys that are at a high risk of loss, the Legislature or the Retirement System's Board of Trustees should establish a specified limit on the portion of the Retirement System's funds that may be invested in direct placements.

2. To ensure that amounts invested are reasonably related to the value of the investment acquired, the Retirement System should explicitly require due diligence reviews by its investment managers before any initial direct placement investment. The results of those due diligence reviews should be made available to the Retirement System's staff and Board.

   To provide even greater oversight, the Legislature or the Board of Trustees could require Board approval of all direct placement investment transactions.

3. To ensure that the Retirement System does not assume all the risk of loss when the value of a direct placement investment declines, the System should require co-investors for all direct placement investments, or it should require its investment managers to ensure that owners of the businesses in which the investments are made have committed significant personal funds to the enterprise.

4. To help ensure that direct placement investment managers are acting in the best interest of the Retirement System, the System's Board of Trustees should consider requiring attorneys representing the System

to provide a formal written opinion on each investment regarding the legality and enforceability of any of the investment provisions, and any conflicts of interest they may be aware of before the investment is made.

5. To ensure that direct placement losses are identified on a timely basis, the Retirement System should do the following:

   a. Require periodic independent valuations of all significant direct placement investments. Results of these valuations should be presented to the System's staff and Board.

   b. Require the consultant that conducts performance reviews of investment managers to use the information provided by these independent valuations.

   c. Ensure that the findings and recommendations arising from the annual financial-compliance audits of the Retirement System are presented to the Board of Trustees, and ensure that these findings and recommendations are addressed on a timely basis.

   d. Require investment managers to establish clearly defined performance expectations for each investment at the outset, and to report periodically on the actual performance of each investment compared to those expectations.

   e. Require investment managers to report a default on any condition required by a Retirement System investment, and provide options for dealing with that situation.

6. To eliminate the monetary incentive for direct placement investment managers to hide investment losses, the Retirement System should ensure that compensation paid to investment managers takes into account the results of periodic independent valuations.

7. To ensure that problems encountered with direct placement investments are addressed, the Retirement System should exercise timely and active oversight for any individual investment that is troubled. This oversight could include the following:

   a. Requiring written approval from the Retirement System before an investment manager can restructure a direct placement investment or invest any additional Retirement System moneys.

   b. Requiring periodic written reports from the investment manager covering the problems with the investment, the changes in value

of the investment, and plans for addressing the problems with the investment.

8. If the Retirement System determines that effective oversight of direct placement investment managers cannot be provided cost-effectively, the System should consider managing these investments using in-house staff rather than outside investment managers. In making this decision, the System should consider the following:

   a. The cost of additional Retirement System staff, office space, and equipment compared to the fees paid to outside investment managers and the cost of effective oversight.

   b. The Retirement System's ability to attract and retain qualified staff to manage direct placement investments.

Appendix A

Itemized Statement of the Use of the $30 Million by the Developer

The following is a detailed accounting of the use of the $30 million in financing for the development of the Merchandise Mart. This information was provided by the Merchandise Mart's developers. The accuracy of these figures was not audited by Legislative Post Audit.

<u>**Use of Funds**</u>

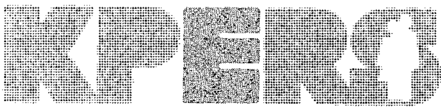
Item	Amount
Purchase of Land - Additional $739,291 contributed by Partners to equal total land cost of $5,193,944	$4,454,653
Construction Contract (Rau Construction) - Construction includes items other than Rau contract; survey costs vis-a-vis other engineering costs cannot be determined without examining each specific invoice	17,893,239
Amounts Paid to AMIGO	
Buyout of Previous Lease	1,200,000
Payment for Moving Costs	500,000
Loan for Tenant Finish	500,000
Fees and Commissions	
Leasing Commissions (Moseley)	100,000
Project Management Fees	680,000
Fees Paid to Howard Needles Tammen & Bergendoff	7,190
Fees Paid to Stinson & Mag for representing Reimer & Koger	65,000
Fees Paid to Lewis, Rice, Fingersh for representing OPMMP	24,372
Other Items	
AMIGO Organization Costs	10,000
Legal Expenses	3,542
Capitalized Interest	1,326,301
Other Loan Costs	138,459
Credit for Real Estate Taxes on Earlier Financing	(6,321)
Proceeds Utilized to Reimburse Previously Paid Expenses	303,565
Distribution of Excess Cash	2,800,000
Total	$30,000,000

Note: Approximate additional capitalized costs funded by the Partnership	
Building Costs	$2,283,310
Lease Costs	288,296
Loan Costs	61,950
Total Additional Costs	$2,633,556
Total	$32,633,556

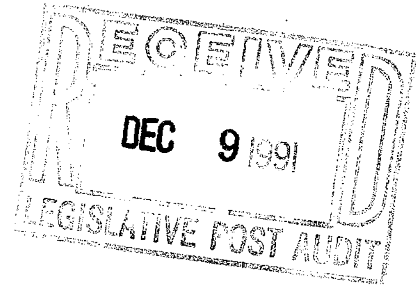
APPENDIX B

Agency Response

On December 2, 1991, we provided copies of the draft audit report to the Kansas Public Employees Retirement System and the Chairman of the Board. Kansas Public Employees Retirement System's response is included as this Appendix.



Kansas Public Employees Retirement System



December 9, 1991

Barbara J. Hinton
Legislative Post Auditor
Legislative Division of Post Audit
8th and Jackson
Topeka, KS 66612-2212

Dear Ms. Hinton:

We appreciate the opportunity to respond to the draft copy of the completed performance audit, Kansas Public Employees Retirement System: Examining Investments in the Kansas City Merchandise Mart.

While the audit contains an accurate chronology of the Retirement System's investment in the Kansas City Merchandise Mart, through May, 1991, the audit does not chronicle the many changes that have occurred in the Retirement System's direct placement investment oversight since that time. Specifically, the following changes have been implemented by the Retirement System's Board of Trustees:

--At its May 24, 1991, meeting, the Board heard a presentation of the FY90 audit report. In response to a recommendation in the report, the Board passed a resolution directing staff to develop and implement a direct placement investment monitoring system.

--At its May 24, 1991, meeting, the Board terminated the existing direct placement managers, Reimer and Koger and Peters, Gamm, West & Vincent.

--At its May 24, 1991, meeting, the Board retained the firms of Pacholder Associates, Inc. and Chemical Bank to manage the direct placement portfolio.

--Effective May 24, 1991, the direct placement managers are now compensated on a flat fee basis. Effective September 1, 1991, the only manager expenses that will be paid by the Retirement System are pre-approved services such as attorneys and accountants.

--At its May 24, 1991, meeting, the Board placed a moratorium on additional direct placement investments. In addition, add-on and follow-on investments were restricted to $2 million per investment, and $20 million for the entire portfolio.

--At its September 13, 1991, meeting, the Board received a current valuation of the direct placement portfolio. This valuation will be completed on an annual basis, and any resulting impairments will be recognized as a reserve in the Retirement System's financial statements.

--Controls have been implemented that require written approval by both direct placement managers as well as the Retirement System's Investment Officer prior to the consumation of any add-on investments, follow-on investments, or restructurings.

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The auditors indicate that they believe that the Kansas City Merchandise Mart investment was not prudent. The Retirement System wishes to note that civil charges have been filed against the Reimer and Koger investment management firm, and criminal charges have been filed against one of the principals of the firm. We anticipate that the question regarding the prudence of the investments made by the Reimer and Koger firm will be answered in the courts.

The first recommendation contained in the audit report has been implemented by the Board's action to place a moratorium on additional direct placement investments, and to limit add-on and follow-on investments to $2 million per investment and $20 million total. In addition, the Legislative Joint Committee on KPERS Investment Practices is considering legislation that would place a statutory limitation on the allocation of assets to direct placement and real estate investments.

With respect to the second recommendation, the fiduciary responsibility under which the investment managers operate, as well as the statutory Prudent Man Standard that governs the contractual relationship, continues to require a due diligence review for all investments. The requirement that both investment managers and Retirement System staff review and approve all add-ons, follow-ons, and restructurings of investments also effectively controls the direct placement investment process. In addition, as investment manager contracts are negotiated (including both the current direct placement managers as well as other managers and consultants) the prudent expert standard is being incorporated to better define the responsibility of the managers. The Board of Trustees of the Retirement System is taking steps to ensure that it has adequate investment staff to monitor the fulfillment of each manager's fiduciary responsibility to the Retirement System.

In March, 1990, the Board of Trustees adopted Addendum G to the Statement of Investment Policy, which sets out Direct Placement Portfolio Guidelines. Addendum G requires institutional co-investors for all initial and add-on investments in portfolio companies. The policy also states that all co-investors shall provide at least 25% of the total initial or add-on investment made in a portfolio company.

The Retirement System has no objection to the recommendation that attorneys representing the System provide a formal written opinion on each investment regarding the legality and enforceability of any of the investment provisions, and any

conflicts of interest they may be aware of before the investment is made. The Retirement System staff will insist that any future real estate and direct placement investments be reviewed by counsel representing the Retirement System.

The recommendations pertaining to the monitoring of the direct placement investments either have been or are in the process of being implemented by Retirement System staff.

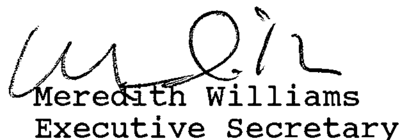
As mentioned above, the investment managers are now compensated on a flat fee basis. Therefore, the monetary incentive for direct placement investment managers to hide investment losses has been eliminated.

With respect to the seventh recommendation, all restructurings require written approval from both investment advisors as well as Retirement System staff, as do additional investments. Investment managers are providing monthly written reports of the portfolio companies, as well as interim reports regarding specific troubled investments, which document any changes in value, and propose plans for addressing any problems.

Finally, the Board of Trustees continues to consider the option of managing these assets using in-house staff. Both the Joint Legislative Committee and the Board of Trustees are engaged in discussions regarding this option, including the cost and the Retirement System's ability to attract and retain qualified staff.

The Retirement System's staff and Board of Trustees are committed to aggressive, proactive and ongoing oversight of the direct placement investments. We look forward to discussing this audit and our response with the Legislative Post Audit Committee in the near future.

Sincerely,



Meredith Williams
Executive Secretary