

GP-led Secondary Fund Restructurings

Considerations for Limited and General Partners

April 2019



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Overview

General Partner (GP)-led processes to restructure fund portfolios are not a new phenomenon; Limited Partners (LPs) are familiar with such transactions in an end-of-life or key person context. In recent years however, as the secondaries market has flourished, the profile of such transactions has evolved.¹ No longer solely the domain of challenged franchises or so-called “zombie funds”, GP-led secondary fund restructuring transactions are becoming more common in the private equity industry, and more oriented towards solutions, such as providing liquidity for Limited Partners or securing a pre-emptive extension of the fund term to maximize the value of a fund’s assets.²

While the stigma associated with such deals has diminished, their increasing prevalence raises questions for many LPs. Such transactions require the Limited Partner’s full attention, but the timing of the process is often difficult to predict and is therefore potentially disruptive for LPs, particularly when multiple deals overlap. The structure of these transactions can also be highly bespoke, making evaluating the impact of an election to buy, sell or hold challenging. These transactions can also present conflicts of interest, particularly where the benefits are believed to accrue chiefly to parties other than the current Limited Partners. Finally, as few Limited Partner Agreements (LPAs) were drafted to contemplate such transactions, the quality of transparency and level of Limited Partner engagement may not be directed by the contract and therefore can vary meaningfully.

Given the highly unique nature of these transactions and broad range in the scope of deals, the recommendations that follow may not be universally appropriate or applicable to every circumstance. Rather, they are intended to provide general parameters for well-run General Partner-led processes that will encourage productive dialogue and foster more informed decision-making by Limited Partners.

Summary Recommendations

- When General Partners initiate a process to provide fund-level liquidity for Limited Partners (e.g., a tender offer with stapled primary, recapitalization/continuation fund, single or multi-asset secondary sale) the process should be efficient and transparent.
- General Partners should engage Limited Partners as early as possible in the process to provide the rationale for the restructuring and any alternatives considered. The GP should allow LPs sufficient time to fully consider the terms of the proposed transaction, including the effect of any changes in economic terms or the potential dilution of the Limited Partner’s interest related to follow-on capital provided by acquirers.
- General Partners and Limited Partners must set clear expectations around identifying and mitigating conflicts. Limited Partners should receive detailed disclosures on the terms of the new entity created by the restructuring, particularly around any differentiation in terms for new or rolling LPs.

While no two deals are exactly alike, achieving greater consistency around disclosures and the structure of the process will ensure that investors are better informed in evaluating such deals, and that the processes themselves will be more transparent and efficient. Considerations and specific recommendations are detailed herein.

¹ Secondaries activity in 2018 exceeded \$70 billion USD, and GP-led transactions accounted for ~40% of the total, with continued growth anticipated.

² Of the two common forms that secondary liquidity opportunities often take, the Tender Offer and the Fund Restructuring, this guidance addresses considerations and best practices tied specifically to General Partner-led Fund Restructurings.

General Partner-led Fund Restructurings Defined

The Fund Restructuring offers flexibility to all parties—for Limited Partners, the option to achieve full or partial liquidity on their fund interests and to actively manage their portfolio; for General Partners, the opportunity to secure additional time and perhaps capital to maximize the value of remaining assets or to lock in results in anticipation of a fundraising.

In the Fund Restructuring, the target fund enters into an agreement with an acquirer to purchase a significant portion of the assets of the target fund for an agreed upon price. In connection with the Fund Restructuring, the acquirer offers the existing Limited Partners of the target fund the option: (a) to **sell**: receive a pro rata portion of the cash purchase price, (b) to **“roll”** their pro rata share of the Limited Partnership interests in the target fund into a special purpose vehicle (SPV) established to purchase the assets of the target fund or (c) in some cases, to receive a combination of options (a) and (b).

While the sell option is relatively straightforward, the **“roll option”** is in fact an exchange of existing Limited Partnership interests for new Limited Partnership interests. The SPV, which is typically managed by the General Partner of the target fund, offers new terms for managing the acquired assets, new economics for the General Partner (carry and management fee resets) and, in some cases, additional capital for follow-on opportunities.

Limited Partners seeking to roll their partnership interests may be offered the opportunity to maintain the same relative interest in the SPV that they had in the original fund, with no change to their obligation to pay management fees or carry. This scenario is often referred to as the **status quo option**, with the only change being an extension of the fund’s term with no change in economic terms. The option of no transaction taking place, i.e., no resulting extension or continuation fund, is not typically offered as part of the election presented to Limited Partners. However, such a decision could result from the LPAC’s failure to provide any required waiver of conflicts associated with the transaction.

From time to time, Fund Restructurings take the form of a **Stapled Secondary transaction**. The Stapled Secondary combines the acquisition of the existing portfolio of fund assets with an agreement by the acquirer to provide a capital commitment to the General Partner's next fund.

Considerations and Recommended Best Practices

Limited Partner Engagement and the Role of the LPAC

Timing for LP Engagement – The rationale for the Fund Restructuring should be shared and tested with the LPAC, and in some circumstances a broader subset of all Limited Partners, as early as possible prior to a formal proposal. For end-of-life scenarios, the appropriate lead time should be no less than six months before the expiration of the term of the fund or the fund extension.

Stages of a GP-led Fund Restructuring

1. **GP presents rationale for restructuring** for consideration.
2. **Selection/engagement of an advisor** by the GP to structure the process, initiate the solicitation of bids and guide the transfer of fund assets.
3. **LPAC review** of the structure of the process and any conflicts related to the proposed transaction; LPAC approval of conflicts per the terms of the LPA.
4. **Solicitation and due diligence** including notification of Limited Partners, disclosures provided to acquirers and accessible to Limited Partners, e.g., data room, including the outlook for the underlying investments.
5. **Confidential disclosure document** circulated to all Limited Partners outlining the final proposed terms and conditions of the transaction, amendments to governing documents and framework for allocating transaction-related expenses.
6. **Election by** Limited Partners to: a) roll their interests on a pro rata basis into the new entity, b) sell their interests to the acquirer on the terms offered, or c) some combination thereof.

LPAC Review of Proposal –The specific mandate of the LPAC in a General Partner-led restructuring is defined by the LPA but is generally understood to include the review of any conflicts associated with the transaction and to provide guidance to the General Partner throughout to ensure that the process is transparent, efficient and fair. Engaging the LPAC at the earliest opportunity around the objectives and logic for the transaction, process, terms and framing of the deal is critical to ensuring that the proposal ultimately presented to Limited Partners will be met with full consideration.

Individuals serving on the LPAC act in their own interests and do not hold a fiduciary duty to the fund or other Limited Partners, and LPAC members should be appropriately indemnified in relation to any decisions made on the transaction. However, the LPAC’s consideration of the process and the terms of the proposal should support maximizing the value of the fund’s assets and obtaining the most optimal outcome for all Limited Partners. In this context, LPACs may choose to seek independent advice.

Rationale for the Transaction – In presenting the rationale for the restructuring, the General Partner should provide information on the quality and outlook for the fund’s remaining investments; the amount of (new) capital required; the projected time to realization, in general terms, for any remaining assets in the portfolio; and the reasoning for a General Partner-led transaction with the addition of new capital rather than a simple fund extension or other alternative.

Management of Conflicts – Before the terms of a deal are presented to Limited Partners as an election, any conflicts related to the transaction, particularly where the General Partner may receive a benefit that does not accrue to the Limited Partners, should be identified, mitigated where possible, and approved by the LPAC. This early and fulsome disclosure enhances the likelihood of obtaining any required waiver of conflicts and a more favorable reception of the proposal by all Limited Partners in the fund.

Disclosures

Description of Solicitation Process and Bids Received – LPAC members should be provided enough information to assess whether the GP-led process was appropriate to ensure that a fair price was obtained. A fairness opinion from an independent financial advisor may be helpful in this context. The General Partner should provide to the LPAC a description of the solicitation process and overview of bids received, any factors that would have reasonably excluded certain acquirers, the identities of prospective acquirers, and a detailed overview of how the economics between the General Partner and the acquirer will be structured, particularly in transactions presenting potential conflicts of interest such as secondaries with stapled primary capital. The LPAC should also review and approve any break-up or termination fees payable in the event the transaction is not consummated.

Summary of recommended disclosures to the LPAC, and to electing LPs upon request

- Number, range and content of bids received
- LPAC member participation as acquirers, if any
- Management fee and carried interest amount for LPs in the continuation fund
- Management fee and carried interest for LPs allocating primary capital (i.e., staple), if any
- Any other meaningful changes in terms versus the original fund, e.g., approvals, key person, related to either the continuation vehicle of the stapled primary capital

Disclosures to Limited Partners beyond LPAC –

The LPAC should also advise the General Partner on the optimal frequency and means of disclosing information about the transaction more broadly to all Limited Partners. At the close of the process and once the final terms of the proposed transaction have been set, Limited Partners should have access, upon request, to the same level of information about the process as LPAC members, i.e., the number, range and content of bids considered, as well as whether any LPAC members participated and were considered as finalists in the bidding process.

Symmetrical Information for Both Acquirers and

Fund Limited Partners – General Partners should endeavor to achieve parity in the information provided to the acquirer and to the Limited Partners in the fund, such as financial information about the projected value of remaining assets in the fund. Data room access should be provided to all Limited Partners at the earliest opportunity as determined by the LPAC and the General Partner, such as the point at which a Letter of Intent has been agreed with the prospective acquirer. Such protocols for providing parity of information should respect any confidential or commercially sensitive information related to the transaction.

Additional Disclosures Related to Conflicts, Complex Deals – In the case of more complex transactions such as stapled secondaries, GPs should disclose to LPs whether discounted pricing or highly favorable economics for new investor commitments to the continuation vehicle were linked to acquirers also providing stapled primary capital in a new fund. Limited Partners should receive detailed information on the basis for the assumed price and multiple of the assets, including detail on valuations and modeling assumptions used. LPAC members whose organizations are also participating in the process as bidders should disclose their involvement and recuse themselves from any formal deliberation or vote on the transaction and/or any waiver of conflicts of interest related to the process.

Access to the Transaction Advisor or the GP – To ensure that Limited Partners can make a fully informed decision on whether to roll or sell their interests, the General Partner should consider making itself, and potentially the

transaction advisor, as well as portfolio company management where feasible, available to all Limited Partners at the appropriate time to address questions about the process, such as through a conference call.

Changed Fund Terms for Acquirers and Rolling LPs – All Limited Partners should be apprised of the terms for new Limited Partners investing into the new entity. To the extent there are differences in terms relative to the existing fund, those terms and the basis for the differences between existing and rolling Limited Partners should be fully disclosed. Where new economic terms are being proposed for Limited Partners participating in the new structure, a clear rationale should be presented to Limited Partners.

Key Person Provisions – To the extent that the continuation fund impacts the key person provisions of the existing fund, the General Partner should disclose an agreed retention and incentive plan for key investment professionals involved in the management of the assets in the continuation fund.

Structure of the Process

Timeline to Review Proposal – Limited Partners should be afforded sufficient time—no less than 30 calendar days/20 business days—to thoroughly evaluate the General Partner proposal and return their respective election forms. The timeline for Limited Partner consideration of the proposal should account for bank holidays that fall within the election period. Some Limited Partners may have institutional requirements, such as ERISA law or other statute, mandating additional layers of review. Longer review timelines that accommodate these requirements should be considered as long as the execution risk is not substantial.

Allocation of fees and expenses related to the transaction between the acquirer, the seller, and the General Partner should be clearly disclosed to all Limited Partners and allocated according to which parties benefit from the transaction. It is recommended that transaction-related expenses allocable to either the acquirer or to the Limited Partners rolling their interests into the new entity be capped, or subject to monitoring to ensure reasonableness. In cases where the General Partner clearly benefits from either additional fee revenue or through a stapled commitment, the General Partner should share some portion of transaction costs. In the event that the transaction does not progress, the allocation of broken deal fees and expenses should conform to the relevant provisions within the LPA. Limited Partners electing not to participate should incur no cost; where a General Partner incurs costs to solicit offers after the LPAC has approved a process but the deal does not ultimately proceed, such costs should be considered a fund expense. Any management fees charged of LPs participating in the new entity should be proportionate to the operational requirements of managing those specific assets, and not simply reflect an extension of the management fee charged to the former fund.

“Status Quo” Option – Limited Partners electing to roll over rather than sell should be provided the option to participate in the new structure with no change in economic terms, i.e., a “Status Quo” Option. In cases where the Limited Partner does not respond to the election in a timely fashion, the election for such LPs should be treated as an extension, i.e., to participate in the continuation fund, with no change in economic terms, rather than treated as an election to sell.

Follow-on Capital and Dilution of LP Interests – Where follow-on capital is a factor of the new structure, rolling Limited Partners should not be compelled to participate in the follow-on capital and any resulting dilution of existing Limited Partners should be done on a fair and reasonable basis. This dilution can be calculated at the same entry valuation as the original transaction, at a market value to be determined by independent advisors at

the time the capital goes in or mitigated via an alternative instrument that does not dilute the equity interests of the rolling Limited Partners.

Compliance with the LPA – The process should conform with the Limited Partnership Agreement, which should include high-level anticipatory language around the process, such as notice periods, disclosures, expense allocations including broken deal expenses, conflict approval protocols and voting processes, and procedures for third-party valuation of interests. It is recommended that such provisions provide sufficient clarity for all parties without unduly restricting or prescribing either the rationale or the exact means or parameters of such a transaction. Such provisions in the LPA should serve as the basis for the conversation around any Fund Restructuring proposal or as the fund approaches the end of the agreed term.

LPAC Review of Proposed Deal Terms – In advance of finalizing the acquisition agreement, but no less than 10 business days before finalizing the terms of the restructuring transaction for Limited Partner election, the General Partner should convene an LPAC meeting to review the proposed acquisition agreement and discuss the principal terms of the transaction.

LP Election – The LPA should determine the voting threshold required to approve such transactions. In cases where the transaction involves a continuation fund, i.e., an extension, an affirmative vote of the majority of LPs by interest should be required to approve such transactions. In some circumstances, such as where the transaction presents significant conflicts of interest, a two-thirds majority vote may be the more appropriate mechanism. Affiliates of the GP, i.e., employees and other related parties, should be excluded from the voting process.

Advisors to the Transaction

Engaging Third Party Advisors – The General Partner should engage an experienced advisor to solicit bids for the portfolio of assets. Any potential conflicts of interest and/or the advisor's past dealings with the General Partner should be disclosed to all Limited Partners. The General Partner should establish in the engagement letter that the advisor should represent the interests of the fund and not solely the General Partner in the solicitation process.

LPAC Review of Advisor Selection Process – The LPAC should review the General Partner's selection of the advisor, including the advisor's role, scope of services and the fee arrangement, including fee level, fee components, and how the fee is allocated among Limited Partners, the General Partner, and the acquirer. The LPAC is encouraged to review the engagement letter with the advisor to ensure that the compensation is fair and customary and structured in a way that optimizes outcomes for the fund. LPs should be aware that in cases where the advisor's compensation is based on a fixed fee rather than linked to the value of the transaction, should the transaction go forward at lower than anticipated volume, selling Limited Partners could bear a disproportionate amount of associated costs. The LPAC should have access to the advisor throughout the solicitation process to allow for questions on the relative merits of the respective bids.

Independent Counsel and Specialist Advisor to the LPAC – The LPAC should have the right to avail itself of an experienced independent legal and specialist advisor, separate from the GP-selected advisor, to offer counsel on the structure of the process, the transaction terms and valuation and, in particular, the waiver of any conflicts. Independent counsel and a specialized advisor working on behalf of the LPAC, (or in some circumstances, by

Distressed Restructurings – A Special Case

In cases where the fund restructuring is occurring in a distressed context, the restructuring proposal should be formulated with the advice of counsel experienced in distressed funds and include a meaningful role for a specialist distressed fund advisor. Such an advisor would be mandated to address and stabilize the source of the fund's distress and develop a strategy for the fund going forward. Distressed fund restructurings, as opposed to a recapitalization coupled with a continuation fund or additional primary capital, present an even stronger case for independent counsel or an advisor commissioned by the LPAC or all LPs, subject to the terms of the LPA. In distressed situations, such transactions will imply specific disclosures around discussions with LPs, the lender or creditor, as well as consideration of specific amendments to the fund's governing documents. *The scope of these disclosures and related recommendations are beyond the scope of this particular guidance.*

extension on behalf of all Limited Partners of the fund), may be particularly valuable in certain situations. These scenarios include highly complex transactions that may overburden the LPAC, or when the GP failed to consult with the LPAC on the advisor selection and compensation. Additionally, the use of independent advisors may be recommended in transactions that present greater potential conflicts of interest, such as when the transaction offers significant future financial benefits for the General Partner that may not align with the interests of Limited Partners seeking to maximize the value of the underlying assets. The LPA should provide for the LPAC to engage such independent counsel, which, in most cases, will be considered a fund expense.

Independent Fairness Opinion Provider – In certain instances, particularly in complex restructurings, in addition to the advisor managing the solicitation process, selling Limited Partners may benefit from an independent assessment of the value of the underlying portfolio, together with a formal opinion stating that the cash price

Anticipating a GP-led Secondary Process: Recommendations for LPs

1. In anticipation of a General Partner-led secondary process, Limited Partners should consider initiating an internal discussion within their own organizations to establish a protocol for addressing such transactions when they arise, to include approvals, underwriting process and any steps that are statutorily defined.
2. Limited Partners should review the full scope of documentation around any such transaction, including the new LPA (if any), as well as any amendments; it is critical to understand what will change as a result of the transaction.
3. Limited Partners should review existing fund documents, including side letters, especially in cases where the transaction will result in new economics; Limited Partners should be cognizant of the opportunity to update the side letter in cases where they may be rolling into a new fund (and new agreement).
4. For organizations governed by ERISA requirements in the US (or similar statutorily mandated fiduciary requirements), Limited Partners should consult counsel to ensure they are apprised of all steps necessary to avoid any fiduciary breach in responding to an election.
5. Limited Partners should work with General Partners to set timing expectations early around reviews and approvals, particularly where the transaction entails new documentation that will require internal approval and sign-off.
6. In conducting due diligence on the specific deal being offered to inform their election, Limited Partners should request that General Partners provide documentation, models and materials that inform the rationale behind the transaction and its structure.

offered is fair from a financial point of view. This is relevant as the NAV is determined by the GP, and typically, a trailing number will be used for discussion purposes, which may or may not be relevant to the current valuation. LPs as a group may request the General Partner to commission a fairness opinion for the fund, conducted by an advisor independent of the party selected as the GP's advisor, with regards to the price being offered for the assets in a GP-led transaction.

Conclusion

As GP-led transactions increase in prevalence, greater transparency and consistency in these deals will be critical to their efficiency and quality of execution. As such, General Partners should pursue processes and deal structures that maximize alignment and Limited Partner engagement. For Limited Partners, by anticipating how to successfully engage in the process and requesting adequate disclosures, they can transact in a manner that serves the best interest of their beneficiaries.

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