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# LIFE AFTER THE END OF THE LIFE OF A PRIVATE FUND

*Private equity sponsors may find that as their funds approach the limits of their terms, they need more time and follow-on capital to achieve the best outcome for themselves and investors. In this article, the authors discuss the ins and outs of 10 different methods that have been used to achieve that result, from term extensions to preferred equity interests. In closing, they note the paramount importance of full disclosure and compliance with fund documentation.*

By Victoria S. Forrester, Udi Grofman, and Matthew B. Goldstein *

As the private equity industry continues to mature, so does the menu of alternatives that private equity sponsors ("GPs") may consider as their funds reach the "end" of their "lives" upon the expiration of the funds' terms. The traditional "five-year" commitment period and "10-year" term have shown that in a maturing market exposed to various market cycles and dislocations, a rigid model can prove to be imperfect and, in some ways, ill-suited to aligning the interests of GPs with the investors in their private funds ("LPs"). In this article we will discuss strategies and structures that GPs may consider and may implement in their funds as they approach the end of the funds' terms, with a particular focus on the evolving GP-led secondary market. In the case of each of the alternatives described herein there are a number of legal, regulatory, and contractual considerations (including the terms of a fund's governing documents) to be taken into account.

Ordinarily, when a private fund approaches the end of its term, it will dispose of its remaining assets, make final distributions to its LPs, and wind up shortly thereafter. Evolving market cycles, the need for more time for portfolio companies to mature, and even the possibility that a GP could lose a company's management team to a competitor PE firm have shown that it is often impractical — and at times relatively economically inefficient — to wind up a private fund swiftly. Additionally, as a private fund approaches the end of its life, one or more of its portfolio companies may require follow-on capital to preserve value, achieve a targeted value, or to enhance an otherwise struggling company, or to achieve greater diversification across the fund's investments.

Often linked to the need for more capital is the need for more time. GPs may need more time than the prescribed "10-year term" in order to allow their investments to be liquidated at the valuations the GPs believe they can achieve. For example, exiting at a later date may permit monetizing one or several portfolio companies in a more attractive economic environment, may allow the GP's investment thesis more time to play out, or otherwise allow for portfolio companies to mature and appreciate in value. The economic split between GPs and LPs is another important consideration in respect of the alternatives discussed in this article, particularly since these economic incentives at the end of a private equity fund's life may not be aligned. More time often means more management fees and/or a

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***INSIDE THIS ISSUE***

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chance to increase potential carried interest (which in turn implies the potential for a higher return on investment). GPs may wish to consider these factors when determining which, if any, of the following strategies may work for their funds.

**Term Extension.** Often, the initial tool available for obtaining more time as a fund approaches the end of its term is the GP's ability to extend the fund's term. The ability for the GP to extend the fund's term has become increasingly important to both GPs and LPs in the market, and is often negotiated during a new fund offering. GPs often try to preserve the ability to initially extend without consent, but often term extension will require LP (typically, a majority-in-interest) or limited partner advisory committee ("LPAC") consent. In our experience, around half of private equity funds permit the GP to extend the initial term of the fund in its sole discretion (without obtaining the consent of either the LPAC or a specified percentage in interest of the LPs). An element of whether a GP may be willing to seek such consent is the mounting fee pressure many GPs face and will hinge on whether the term extension requires the GP to forego all or a portion of its management fee during the additional time. In some, but not all cases, GPs may agree to reduce management fees, often after a number of extensions or if the fund's performance is otherwise subpar.

It is worth noting that GPs (or other liquidators if appointed) of a fund organized as a limited partnership generally have a fair degree of discretion in respect of the time that is required to finally wind up the fund, although the general partner's duty shifts after the end of the term. A winding up period of multiple years may be appropriate, and a "flash sale" of assets is not required upon the end of the term. Accordingly, GPs may determine that the nature of the funds' portfolio investments and the requirement for time only (i.e., not more capital or other solutions) warrant a prolonged, orderly wind-down, but often this is not the case. When assessing follow-on investments after the expiration of the term, the analysis hinges on the *intent* of the follow-on investment, and often GPs are hesitant to permit the funds to make "new" investments other than in very limited circumstances when capital is necessary (often where the GP can make the case that defending or preserving the value of a portfolio company requires a follow-on investment).

**Liquidating Vehicle.** Another alternative is utilizing a liquidating trust. This solution is best suited to "tail end" assets which require little ongoing active management but which otherwise should not be liquidated for cash. In this scenario, the GP causes the fund to contribute or otherwise transfer the remaining assets from the underlying fund into the liquidating vehicle, where they will remain until finally liquidated and are generally not "actively managed." Interests in the liquidating vehicle are distributed in kind to the LPs, which allows the GP to finalize the winding-up and dissolve the underlying fund. In practice, however, we have not seen liquidating trusts used often.

**DIKs.** Depending on the nature of the assets, GPs may elect to distribute the remaining assets of the fund in kind to the LPs rather than converting them into cash and distributing the cash. In practice, this proves somewhat complex. There are often contractual restrictions in a fund's governing documents and LP side letters, and there may also be regulatory restrictions on the transfer of the assets in kind. Many LPs do not wish to receive assets in kind and may lack the requisite expertise or resources to sell their respective interests in an illiquid asset or otherwise do not like to hold illiquid investments directly. Accordingly, in addition to the investor relations implications, some LPs — via a side letter, for example — may require the GP to attempt to sell the securities on the LP's behalf, instead of receiving a distribution in kind.

**Annex Funds and other "New Capital" Funds.** For a multitude of reasons, including either good or bad performance and the fund's governing documents (i.e., single investment limit, limitation on ability to recycle capital or the term), there may be instances where GPs need to raise more capital for portfolio companies but are not able to or do not wish to make fund-level follow-on investments. The GP may decide to form an "annex fund." An annex fund is usually formed after the main fund's investment period has ended to support the main fund and provide follow-on capital to one or more existing portfolio companies. Annex funds often lean on existing fund LPs, but unless the fund's governing documents require otherwise, do not need to be limited to those LPs. There are, however, conflict mitigation and investor relations considerations that may result in GPs choosing to offer all existing fund LPs the opportunity to commit additional capital to the new annex fund. The formation process usually lacks the procedural complexities of a GP-led transaction but does require a supplemental fundraise. Relatedly, the GP may enlist other forms of "new money" co-investment from existing fund LPs or other investors. Though the GP needs to address pricing and dilution concerns, this type of co-investment can provide a quick, efficient means of capital injection. Additionally, to the extent there is a restructuring, potential capital structure conflicts (i.e., different advisory clients in different levels of a company's capital structure) could be exacerbated in poor performing companies. These types of annex funds and other pools of new capital will provide GPs with capital, other than the fund's capital, to continue supporting existing investments and from the LPs' perspective, often offer preferential economics.

## GP-LED RESTRUCTURING

As is evident in the many recent news headlines, the GP-led secondary transactions discussed below have become a robust part of the maturation of the private equity industry. Historically, such transactions often accompanied underperforming or "zombie" funds; however, these transactions are more frequently becoming an effective tool of GPs' portfolio management and, if executed successfully, can provide LPs and GPs with their sought-after outcomes. The COVID-19 pandemic has resulted in many GPs delaying the exit of, or otherwise seeking more time with undervalued but otherwise fundamentally stable, companies and has continued to trigger growth in secondary transactions. As with many alternatives in the market, GPs will sometimes deploy an amalgam of GP-led restructuring transactions depending on the motivating factors behind them, and the likelihood of LP participation and consent. These transactions warrant a deeper discussion and an overview of common structures, the potential pitfalls, and certain best practices, as discussed further below.

**Continuation Funds.** A continuation fund is meant to achieve two purposes: allowing the GP to continue to hold one or more portfolio companies for a longer period of time and creating liquidity for LPs seeking to exit portfolio companies. The continuation fund is set up to hold interests in the portfolio company (or in some instances multiple portfolio companies). Existing fund LPs are given the option to (1) "sell" their indirect interests in the portfolio company to the continuation fund and receive a cash distribution or (2) "rollover" into the continuation fund and continue to hold interests in the portfolio company indirectly. For those seeking cash, the continuation fund will use capital raised from secondary investors (the "buying LPs") in the continuation fund to pay out the selling LPs, while the secondary investors will receive limited partner interests in the continuation fund. Continuation funds also offer LPs the ability to "vote with their feet" and either maintain the status quo or exit in whole or in part, while giving GPs more time and often the ability to raise follow-on capital from the new secondary investors in the continuation fund. The terms of the continuation fund will often mirror those of the main fund with changes as a result of negotiations with secondary investors. Key terms include:

*Economic Terms.* Rolling LPs and buying LPs will seek to ensure that the GP remains incentivized to continue to grow portfolio companies. This results in pressure on GPs to roll all or a portion of the carried interest otherwise payable in the existing fund's disposition. If rolled, the carry is typically held as an equity investment in the continuation fund alongside the rolling and buying LPs. GPs will also seek to continue to earn management fees from the continuation fund. Rolling LPs may be given the option to continue to pay the same economics as in the existing fund (a "status quo option") or alternatively to roll into the buying LPs' terms.

*Follow-On Capital.* Continuation funds may require that buying LPs and/or rolling LPs commit additional capital for the purpose of follow-on investments over time or to provide capital for the companies' expected opportunistic M&A activity.

*Sponsor Commitment.* Rolling LPs and buying LPs will often seek a meaningful sponsor commitment alongside the LPs to ensure alignment of interests and preserve "skin in the game." Rolled carried interest may make up a portion of this commitment.

*Regulatory and Contractual Considerations.* In essence, a continuation fund is a fundraise and an M&A transaction occurring simultaneously — accordingly, the various regulatory considerations and contractual transfer and change-of-control restrictions may apply. GPs and LPs are also mindful of disclosure or regulatory filings and approvals.

There are conflicts to mitigate and manage, primarily related to the role the GP plays in respect of both the existing fund (i.e., the selling fund) and the continuation fund (i.e., the buying fund). Often, approval of either the LPAC or LPs of the existing fund is required to mitigate these conflicts. In addition, rolling LPs and buying LPs (as well as the LPAC) are typically given disclosure by the GP of the material considerations, conflicts, and facts applicable to the transaction in order to inform their review and consent. The price at which the portfolio company is sold is frequently validated by way of an auction process with buying LPs and/or one or more large co-investors that independently diligence the company and agree to purchase its interest at the selling price. GPs may also wish — or be required — to obtain fairness or valuation opinions in respect of the same.

## TENDER OFFER

In a tender offer, the GP runs an auction in respect of LP interests in an existing fund, and LPs either tender their interests or remain in the fund. In this sense, it functions as the simplest way for the GP to provide options to LPs seeking liquidity and LPs seeking status quo. Unlike a continuation fund, which usually requires consent at the fund level, with a tender offer, each LP decides individually whether to tender. LPs can accept or reject the offer without the need for lengthy negotiation — selling LPs cash out and exit the fund, while those who do not tender retain their limited partner interests. While the fund's underlying economics (e.g., management fees and the distribution waterfall) usually remain in place after the tender, a term extension will generally be sought. The GP may fund the tender itself or solicit secondary investors for the capital. Though the fund's governing documents may require LP and/or LPAC consent for a term extension, the new — and rolling — LPs often will have committed to voting for the extension before the auction commences, giving the GP reliable votes when the time comes.

Importantly, the tender may be unsuccessful if an insufficient number of LPs elect to tender, such as when the buying offer is too low. Also, tenders trigger certain SEC rules, which delineate a specific timeline — replete with required waiting periods — for the transaction.[1] Perhaps more importantly for the GP, a tender offer does not result in new commitments or dry powder without further amendments to the existing fund's terms.

[1] *See, e.g.*, Regulation 14E (requiring the target company to state its position on the offer within 10 business days after commencement of the tender offer); *id.* (stating that at least 20 days must transpire from the commencement of the offer); Rule 14e-1(c) (requiring settlement to occur, in most cases, three business days after the announcement that an offer will be accepted.).

### *Strip Sale*

An equity strip sale involves a partial sale (e.g., 25-50%) of all or a subset of the portfolio companies in the fund at a pre-determined price (usually a percentage of the net asset value). The "strip" is often sold either to a direct strategic investor or to a pooled vehicle managed by the GP with buying LPs investing therein. In addition to creating recyclable capital in the fund (due to the fund-level disposition and generated proceeds), a strip sale can take some cash off the table for certain portfolio companies performing extraordinarily well. As with an annex fund, a strip sale may require LPAC or LP consent, and conflicts need to be managed appropriately, especially if the same GP will manage the strip of the investments within a new fund vehicle.

### *Preferred Equity Interest*

Issuing a preferred equity interest in one or more portfolio assets is another secondary option employed by GPs that has gained popularity. In essence, it provides financing with a mechanism similar to that of a margin loan or other asset-based financing. The GP seeks to sell a preferred interest that will subordinate the fund's common equity interest in the portfolio company(ies). The preferred stakeholder will typically receive fixed payment obligations (e.g., coupon payments) and a pre-specified rate of return on the investment, and the fund will receive cash which can be distributed to the LPs (and may be recyclable). GPs will need to carefully review the funds' governing documents to ensure this type of leverage is permitted under the terms thereof, but generally these transactions do not require LP or LPAC consent unless the fund's documents specify otherwise.

## LOOKING AHEAD

As this area of the private equity fund industry continues to evolve and mature, GPs and LPs may wish to consider improving a fund's governing documents s in order to mitigate the "imperfection" of the private equity model by addressing the need for liquidity alternatives and seeking to streamline the process. Such measures will, in turn, reduce the cost (often borne in whole or in part by LPs) and the time required for execution, and will minimize the risk of failure or purchase price haircuts from the buy-side. Enhancing pre-commitment disclosure of material conflicts of interest, and ensuring that the fund's governing documents and any side letter provisions do not inhibit a potential end-of-life solution unintentionally are paramount. Additionally, GPs may wish to review and consider the guidance provided by industry and regulatory organizations.[2]

In conclusion, early disclosure and a prudent process are critical to achieving both the GPs' and LPs' goals, and to enhancing alignment of interests. The inherent complexity of private funds means that a "one-size-fits-all" approach to end-of-life solutions and GP-led secondary transactions will not suffice. Rather, understanding the alternatives and continuing to enhance and improve the efficiency of the process will allow growth and success in this market. ■

[2] *See generally* INSTITUTIONAL LIMITED PARTNERS ASSOCIATION, GP-LED FUND RESTRUCTURINGS: CONSIDERATIONS FOR LIMITED AND GENERAL PARTNERS (2019), https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-Restructurings-Apr-2019-FINAL.pdf.