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Secondary Transactions

# ILPA Makes Recommendations for LPs Participating in GP-Led Secondary Fund Restructurings

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Secondary transactions led by general partners (GPs) have been on the rise over the last few years to both provide liquidity for existing limited partners (LPs) and also extend the term of a fund to maximize the value of its assets. While the stigma attached to these transactions has diminished, their increased prevalence raises numerous questions for LPs about the transaction process and how it is structured; conflicts of interest to identify and avoid; and transparency to be requested from GPs.

To assist LPs in navigating these issues, the Institutional Limited Partners Association (ILPA) issued "GP-Led Secondary Fund Restructurings: Considerations for Limited and General Partners" (ILPA Guidance) to prescribe considerations and recommendations for LPs to weigh throughout the process. This article summarizes the ILPA Guidance and highlights the practical steps proposed by ILPA.

For coverage of ILPA guidance on other issues affecting the private funds industry, see "Trends in the Use of Subscription Credit Facilities: Advantages for PE Investors and Sponsors Have Led to Adoption by Some Hedge Funds and Credit Funds (Part One of Two)" (Jan. 24, 2019); and "How Managers May Address Increasing Demands of Limited Partners for Standardized Reporting of Fund Fees and Expenses" (Sep. 1, 2016).

## Overview of GP-Led Fund Restructurings

In GP-led secondary fund restructurings, the target fund and acquirer enter into an agreement for the sale and purchase of the target fund's assets at an agreed price. The acquirer offers the existing LPs of the target fund the option to:

1. sell its interests in exchange for a pro rata portion of the purchase price;
2. roll its pro rata share of interests into a special purpose vehicle (SPV) established to purchase the assets of the target fund; or
3. a combination of the selling and rolling options.

The SPV offered in the "roll option" is usually managed by the same GP as the target fund, but it will offer new management terms and economics. Sometimes the GP will seek additional funds from the rollover LP to support follow-on opportunities of the underlying investments. Also, a

"status quo option" may be available that allows LPs to keep the same interest in the SPV that they had in the original fund but with an extended term and no change to the economics.

Although it is uncommon for LPs to be offered the option of no transaction taking place (*i.e.*, no resulting extension or continuation of the fund), this can occur if the limited partner advisory committee (LPAC) does not provide any waiver of conflicts that may be necessary for the transaction.

In addition, these restructurings sometimes include a "stapled secondary transaction," which combines the acquisition of the target fund's existing assets with an agreement that the acquirer will provide a capital commitment to the GP's next fund.

A GP-led fund restructuring typically involves six stages:

1. The GP presents its rationale for restructuring for consideration.
2. The GP selects and engages an advisor to structure the process, seek bids and guide the transfer of fund assets.
3. The LPAC reviews the structure of the process and any conflicts arising from the proposed transaction. The LPAC will, if appropriate, approve any conflicts in accordance with the terms of the limited partnership agreement (LPA).
4. Solicitation and due diligence processes are carried out, including notifying LPs. Disclosures are provided to acquirers and made accessible to LPs (*e.g.*, data room access).
5. The confidential disclosure document is circulated to LPs outlining the final proposed terms and conditions of the transaction, amendments to the fund governing documents and the framework for allocating transaction expenses.
6. LPs make their election to sell or roll their interests – or undertake a combination of those options.

For more coverage of GP-led secondary transactions, see "Sidley Austin Partners Discuss Trends in GP-Led Secondary Transactions and Rep & Warranty Insurance" (Apr. 2, 2019).

# Considerations and Recommendations

The ILPA Guidance acknowledges that no two deals are identical. It also notes, however, that achieving greater consistency around disclosures and the process will ensure there is more information, transparency and efficiency that will benefit LPs.

To that end, ILPA offered specific recommendations on LP engagement and the role of the LPAC; disclosures; process structure and third-party advisers. ILPA also noted that the guidance is intended to provide general parameters for well-run GP-led processes, as well as to encourage effective dialogue and foster more informed decision making by LPs.

## LP Engagement and LPAC Role

The rationale for restructuring the fund should be shared with the LPAC – and, if appropriate, a broader subset of LPs – as soon as possible before the final proposal is presented. A minimum of six months' lead time should be given before expiration of the term of the fund or fund extension, if applicable.

See "How Fund Managers Can Address End-of-Life Issues in Closed-End Funds" (Mar. 19, 2019).

The LPAC's specific role in the transaction will be defined by the LPA, but it is generally understood that the LPAC will review any conflicts and provide guidance to the GP to ensure the process is transparent, efficient and fair. Fully engaging the LPAC at the earliest opportunity ensures that the final proposal presented to all LPs is properly considered.

While members of the LPAC act in their own interests and do not hold fiduciary duties to the fund or other LPs, their review of the process and terms of the proposal will be directed at maximizing the value of the fund's assets and, therefore, the overall outcome for all LPs. An LPAC may choose to obtain independent advice, and its members should be indemnified for any decisions about the transaction.

When presenting the rationale for restructuring, GPs should provide information about the quality and outlook for the fund's remaining investments; the amount of additional capital required; and the projected time to realization for any remaining portfolio assets. Also, if applicable, the GP should explain why the transaction was structured to include additional capital requirements, as opposed to simply extending the fund or other alternatives.

Any conflicts related to the transaction should be identified, mitigated and approved by the LPAC before the transaction terms are presented to LPs, particularly when the GP is expected to receive a benefit that will not accrue to the LPs. This approach increases the likelihood of obtaining any waiver of conflicts that may be required and the chances that all LPs will view the proposal more favorably.

For more on the role of LPACs, see "Current Scope of PE-Specific Side Letter Provisions: Co-Investment Rights, LP Advisory Committee Seats and Parallel Funds/AIVs (Part Two of Three)" (Mar. 26, 2019).

## Disclosures

LPACs should receive sufficient information to assess whether the GP-led process was appropriate to obtain a fair price, which should include, among other things, any factors that would have reasonably excluded certain prospective acquirers, the identities of bidders and any termination fees incurred if the transaction were not completed. It may be helpful to obtain a fairness opinion from an independent financial advisor for this purpose.

The LPAC should advise the GP on the best way to disclose information about the transaction to all LPs. Once the final terms of the proposed transaction have been determined, all LPs should have access to the same level of information provided to the LPAC, including:

- number, range and content of bids received;
- any LPAC member participation as acquirers;
- management fee and carried interest amounts for LPs in the continuation fund and for any LPs allocating primary capital (*i.e.*, staple); and
- any other meaningful changes in terms from the original fund (*e.g.*, approvals, key person changes).

GPs should endeavor to provide the same information to all LPs as was given to the acquirer and enable access to the data room at the earliest opportunity (*e.g.*, when the letter of intent has been agreed with the prospective acquirer). Protocols for accessing information should take into account the confidential or commercially sensitive nature of the information.

LPs should receive additional disclosure in more complex transactions, including whether economic incentives for new investor commitments in the continuation vehicle are linked to acquirers providing stapled primary capital in a new fund. LPAC members whose organizations are bidding should disclose their participation and recuse themselves from formal deliberations and voting related to the transaction, including conflicts issues.

The GP should consider making itself, its advisors and the portfolio company management available to all LPs to address questions about the process at an appropriate time and manner (*e.g.*, via conference call) to ensure LPs can make fully informed decisions about their options.

All LPs should be notified of the terms for new LPs investing in the SPV. If those terms are different from the existing fund's terms, the changed terms and the basis for the differences between existing and rolling LPs should be fully disclosed. Clear rationale should also be provided for any new economic terms proposed for LPs.

Finally, the GP should disclose any changes to, or impact on, the existing fund's key person provisions, including an agreed retention and incentive plan for key persons involved in the continuation fund.

See "Current Scope of PE-Specific Side Letter Provisions: MFN Clauses, Overcall Limitations and Key Person Provisions (Part Three of Three)" (Apr. 2, 2019).

## Structure of the Process

ILPA recommended that LPs receive no less than 30 calendar days or 20 business days, including bank holidays, to evaluate the GP's proposal and submit their election forms. Longer review times may be appropriate and should be considered where LPs are subject to institutional requirements with additional review processes (*i.e.*, under Employee Retirement Income Security Act of 1974 (ERISA) or other statutes).

For more on ERISA, see "Becoming a Plan Assets Fund May Limit Private Funds' Abilities to Charge Fees" (Apr. 21, 2016); and "RCA PracticeEdge Session Highlights the Key Points of Intersection between ERISA and Private Fund Investments and Operations" (Jul. 18, 2014).

Transaction-related fees and expenses should be disclosed to all LPs and allocated between the acquirer, seller and GP according to which parties benefit from the transaction. Specially, ILPA recommended the following:

- Transaction-related expenses allocable to either the acquirer or to LPs rolling their interests into the SPV should be capped or subject to monitoring to ensure reasonableness.
- When GPs benefit from additional fee revenue or a stapled commitment, they should share some portion of the transaction costs.
- Broken deal fees and expenses should be allocated according to the LPA.
- LPs that elect not to participate should not incur any costs.
- If the GP incurs costs to solicit offers after LPAC approval but the deal does not proceed, the costs should be considered a fund expense.
- Any management fees charged to LPs participating in the SPV should be proportionate to the operational requirements of those specific assets, rather than an extension of management fees charged to the former fund.

For more on disclosure of expense allocations, see "Absent Proper Disclosure, Allocation of Manager Expenses to Funds May Bring significant SEC Penalties" (Sep. 29, 2016).

LPs that elect to roll their interests should be given a "status quo" option to participate in the new structure on the same economic terms as the existing fund. An LP that fails to make a positive election in a timely manner should have its interest rolled into the new fund with no changes to its economic terms, rather than be treated as an election to sell.

LPs taking the roll option should also not be compelled to participate in any follow-on capital. If there is a resulting dilution of existing LP interests, that should be dealt with fairly and reasonably. ILPA suggested that the dilution be calculated at the same entry valuation as the original transaction at a market value assessed by independent advisors when the capital goes in. Another option is that the follow-on capital can be via an alternative instrument that does not dilute the rolling LP's interests.

The fund restructuring process should comply with the LPA, which should include provisions about key issues such as notice period, disclosures, expense allocations, conflict approval protocols and procedures for the valuation of interests by third parties. Those provisions should address the issues at a high level as clearly as possible without unduly limiting the permitted rationale, scope or mechanisms of the GP-led restructuring transaction.

GPs should convene an LPAC meeting to review the proposed acquisition agreement and discuss the principal terms. The meeting should be held before the acquisition agreement is finalized and at least 10 days before finalizing the terms of the restructuring transaction on which LPs which make their elections.

Also, the LPA should set the voting requirements to approve fund restructurings, although those may vary according to the specific circumstances. For example, ILPA suggested that extension transactions can be approved by a simple majority vote, but a two-thirds majority is appropriate for transactions involving significant conflicts of interest or other complexities. No GP affiliates should participate in the voting process.

## Third-Party Advisors

The GP should engage an experienced advisor to solicit bids. The terms of engagement should specify that the advisor represents the interests of the GP and the LPs in the solicitation process, and any potential conflicts of interest should be disclosed to all LPs.

The LPAC should review the GP's selection of the advisor (*i.e.*, its role, scope of services, fee allocation, etc.) and the terms of engagement to ensure that the advisor's compensation is fair and structured to optimize outcomes for the fund. LPs should be aware that a fixed fee – rather than one based on the transaction value – may result in a higher cost burden on the selling LPs if there is lower interest in the transaction on the secondary market than anticipated. The advisor should be available to respond to the LPAC's questions about the merits of bids received throughout the solicitation process.

The LPA should permit the LPAC to engage independent counsel and specialist advisors, which in most cases should be treated as a fund expense. This may be valuable in a range of situations, including in a highly complex transaction, if the GP does not consult the LPAC before engaging fund advisors or when there are significant potential conflicts of interest (*e.g.*, future financial benefits to the GP are not aligned with the LPs' interest in maximizing the value of underlying assets).

See "Failure by Fund Manager to Disclose Updated Valuation Data in Connection With an Offer to Purchase LP Interests Results in SEC Sanctions" (Dec. 6, 2018).

In addition, selling LPs may consider engaging an independent advisor to value the underlying assets and provide a formal opinion confirming that the cash price offered is fair. The LPs may also request that the GP obtain a fairness opinion for the fund on the price being offered for the existing fund's assets, which should be provided by an advisor that is independent from the GP's selected advisor.

Although it was outside the scope of the ILPA Guidance, ILPA noted that specialist distressed fund advice should be sought if fund restructuring occurs in a distressed context

## Anticipating a GP-Led Secondary Process

ILPA stated that it believes that LPs are best able to protect their interests in a fund restructuring if, in advance, they think about how to engage in the process and request adequate disclosures. The ILPA Guidance contains the following six key recommendations for LPs that are anticipating a GP-led secondary transaction:

1. Initiate an internal discussion within the LP's organizations to establish a protocol to deal with these transactions when they arise.
2. Review the full scope of documentation relevant to any restructuring, including the LPA.
3. Review existing fund documents, including side letters, to understand new economics from the transaction and to identify any opportunities to request additional changes.
4. Consult with counsel to understand all steps necessary to avoid breach of any fiduciary duties under ERISA or other similar requirements when making an election.
5. Work with GPs to set expectations around the timing of early reviews and approvals.
6. Ask GPs to provide documentation, models and materials that inform the rationale behind the transaction and its structure when conducting due diligence on the specific deal.