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The Rise of the Zombie Fund: Managing Regulatory Risk Associated with Long-Lived Fund Vehicles

October 31, 2025

Private fund managers and investors have long been haunted by the risk of a “zombie” fund: an investment vehicle that lasts well past its initial term, potentially creating regulatory risk.[1] While every situation will present different challenges, certain issues arise time and again. Whether a sponsor is currently managing a fund that is at risk of exceeding its term or simply wants to plan ahead, these issues warrant careful consideration to avoid potential unwanted regulatory attention.

I. Valuation Issues

As the time since a fund’s inception grows, the valuation practices of its sponsor may become a source of operational risk. Specifically, sponsors managing long-lived funds should assess whether their valuation policies have evolved since a fund’s inception, as revisions over time may unintentionally create inconsistencies between the adviser’s current valuation policies and those that were disclosed to investors. In certain cases, a sponsor may have disclosed that it would follow (or contractually committed that it would follow) a particular procedure or use a specific methodology that is no longer applicable, meaning that risk can exist even when changes are not detrimental to investors and in line with the market. At the very least, these inconsistencies raise the possibility of a relationship issue with an investor who may not have been aware of the change and, depending on the materiality of the change, it is possible that the SEC or other regulators may also scrutinize it. Sponsors that are not currently managing such a fund should consider the disclosure they draft for future vehicles and the related contractual commitments in side letters. Frequently, it is preferable for such documents to refer to a valuation policy as it may be amended from time to time, which provides a greater degree of flexibility for the sponsor to adapt that policy as the sponsor’s practices change.

II. Fee Issues

Once a fund shifts from deploying capital to managing and exiting investments, the management fee base often transitions from being based on committed capital to invested capital, generally with reductions for investments that are permanently impaired or written off. In some cases, the governing documents of older-vintage funds are ambiguous as to certain aspects of how the "stepdown" should work. Even in cases where the documents themselves are relatively clear, the calculations can be complex and internal personnel frequently do not have as much experience with them, raising the risk that they inadvertently make an error calculating the fund's management fee. In either case, this creates the possibility of SEC scrutiny as fee and expense issues have long been a key issue reviewed by SEC examiners.[2]

In particular, advisers should pay attention to the language describing how the fee base will be adjusted when an investment is permanently impaired or written off. In recent years, numerous SEC exams have scrutinized sponsors' practices for deciding whether an investment was sufficiently impaired to meet the applicable definition in the fund's governing agreement, in certain cases resulting in a referral to the Division of Enforcement. Examiners frequently review whether a sponsor had a policy for determining whether an asset was impaired or whether decisions were made on an *ad hoc* basis (which can be easier for the SEC to challenge with the benefit of hindsight).

In addition, many funds' governing agreements provide that any impairment determinations are evaluated at the level of an individual investment into a portfolio company, rather than at a portfolio company level, which can frequently raise interpretive questions. For example, if a portfolio company is partially impaired but some of the fund's investments into the company are still "in the money," it is sometimes unclear to what extent the impairment should affect the management fee.

Finally, the definition of a "disposition" when determining whether an investment is no longer in the fee base can be complex. When an investment is made in the form of one type of security but is subsequently restructured, some funds' governing documents are unclear as to whether (and to what extent) such restructured investment should be part of the fee base. This is especially likely to occur when the original investment was partially realized and then encountered distress, since the restructuring could arguably constitute recognition of an impairment (as described above) and the way the partial realization and later impairment should interact can be unclear or complex.

When the language in the fund agreement and applicable disclosure is clear, operations personnel should ensure that they are carefully adhering to the applicable provisions, which may require complex calculations. When the language is unclear, as is frequently the case, it is important to have a consistent methodology for how to handle the situation and, potentially, to disclose this methodology to limited partners or the limited partner advisory committee.

III. Managing Conflicts Associated with Pressure to Sell

Sponsors of long-lived funds frequently face increasing pressure from investors to sell, even at fire sale prices, to allow the investors to achieve liquidity. While investor desires are an important consideration, it is important to recall that a sponsor's fiduciary duty flows to its client, the fund, and not to any particular investor, and the sponsor must balance investors' desire for liquidity with other investors' interest in achieving the best valuation for the asset. Continuation vehicles are frequently well-suited to balance these interests. A well-run process to establish a continuation vehicle can allow investors who desire liquidity a way to exit their investment, frequently at a price that takes into account relevant market information, while also allowing investors with a longer time horizon to continue to hold the asset until a later date. Given the SEC's longstanding concerns about conflicts in this area (whether or not such concerns are justified), fulsome disclosure remains an important safeguard against potential regulatory challenges arising from a continuation vehicle.

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"Undead" funds create special challenges due to their operation long after their initial term expires. Creating appropriate procedures before they are required and providing full and fair disclosure when unexpected issues arise helps to mitigate potential conflicts and manage regulatory risk associated with putting such a vehicle to rest.

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[1] While some articles in the popular press present this as a recent issue, it is not uncommon for a fund to face difficulty disposing of a small number of its positions. For example, an article from nearly 15 years ago states that more than half of institutional investors were invested in at least one such fund.

[2] The 2025 Examination Priorities released by the SEC Division of Examinations describe “appropriateness and accuracy of fee calculations” and related disclosure as a focus area. Previous editions of the priorities contained similar language.

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