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Risk #5: Private Litigation Risk for GP-Led Secondary Transactions

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GP-led secondary transactions continued to soar in popularity in 2025. With mixed economic indicators potentially impeding other kinds of private equity exit events, the uptick in continuation funds shows no signs of slowing down in 2026. Their popularity should come as no surprise—under the right conditions, a secondary transaction creates a win-win scenario for all stakeholders, providing legacy investors with near-term liquidity and an option to roll over their investments, new investors with an opportunity to invest in portfolio assets with a proven track record but greater room for growth, and fund advisers with an extended period to capture future upside as well as the potential for new capital to support portfolio assets.

As we have previously covered in multiple articles, the rapid growth in continuation fund transactions has led to increased regulatory scrutiny, with the SEC expressing concern regarding, among other things, conflicts of interest for fund sponsors, portfolio asset valuations, and transparent and timely disclosures to all stakeholders. Another source of potential risk given the trend toward more continuation fund transactions is private litigation risk.

Many of the same concerns highlighted by the SEC can give rise to private litigation. Fiduciary duty claims may arise from the conflicts inherent in the process, which require the sponsor to seek the best price for portfolio assets for the benefit of legacy LPs, but also incentivize the transfer of assets at a compelling price point both to maximize the upside potential in carried interest and to successfully solicit new and roll-over investors. In practice, sponsors are well aware of these conflicts and take a range of approaches to mitigate them, consistent with their duty to their client. However, even where sponsors strictly adhere to their fiduciary duties and ensure a fair process, the presence of this incentive structure can attract litigation claims. Valuation disputes naturally arise from this same structure, and informational asymmetry between and among both the sponsor and LPs can likewise lead to claims that LPs and other stakeholders were induced to roll investments over or, conversely, misled into exiting based on the provision of incomplete information.

Of course, relationship and reputational factors within the industry provide a degree of protection against disputes between fund sponsors and investors erupting into litigation. Nevertheless, with the sustained increases in continuation vehicle use, as well as other cross-fund transactions, which raise similar risks, and the growing complexity of such transactions, disputes are sure to follow, whether they occur in civil litigation or private arbitration. Indeed, 2025 saw such disputes spill into the courts, drawing media attention.

The risks inherent in such transactions can be further magnified with respect to external co-investors, who are often given the same choice to either roll over their investments or cash out, but generally do not have a separate LP advisory committee that must be consulted before the transaction is approved. Further, for single-asset continuation vehicles, the portfolio company management and employee investors may, depending on the structure of investment, provide yet another group of stakeholders whom the sponsor must carefully consider in assessing litigation risk. These actors may lack the incentives to resolve disputes outside of the courtroom possessed by other transaction participants.

To mitigate such risks, sponsors should adhere to traditional best practices, including obtaining third party fairness opinions and valuations, making fulsome disclosures and pursuing a policy of transparency with LPs, and meaningfully engaging LPACs. But sponsors should also carefully consider other potential stakeholders in these increasingly complex transactions. External co-investors should be considered alongside LPs as a source of risk that is fundamentally similar, but not identical. And especially where such a transaction focuses on a single portfolio company, changes in economics among management and employees of the portfolio company should be closely scrutinized, and risks carefully assessed. Each of these risks will vary depending on structural considerations such as share interests, board seats, portfolio company control, and contractual variables, but sponsors can generally limit them by approaching GP-led secondaries with the same rigor as other types of exits, taking extra care to the extent this class of transactions can be characterized by challengers as lacking the same market protections as an "arm's-length" exit transaction.

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