

Proskauer's Secondaries School: GP-Leds & Continuation Funds

Before the Break

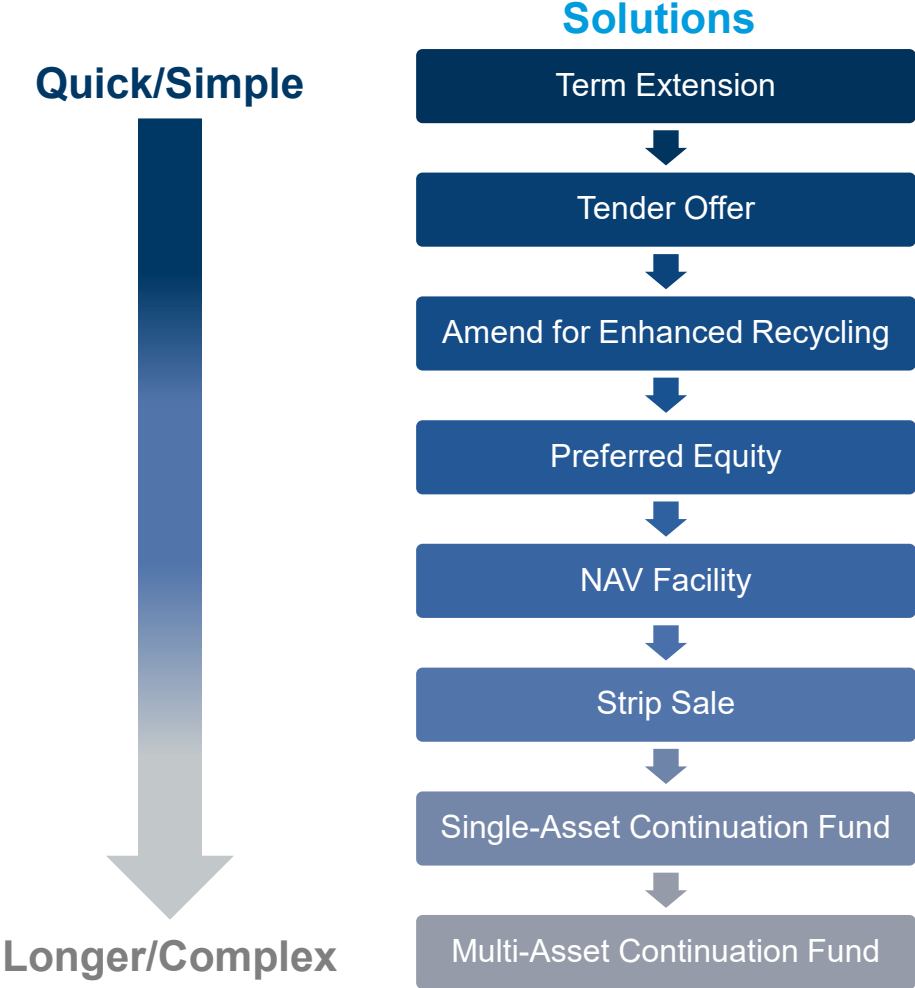
Introduction to GP-Led Transactions: The Spectrum of Options

Introduction to Continuation Funds

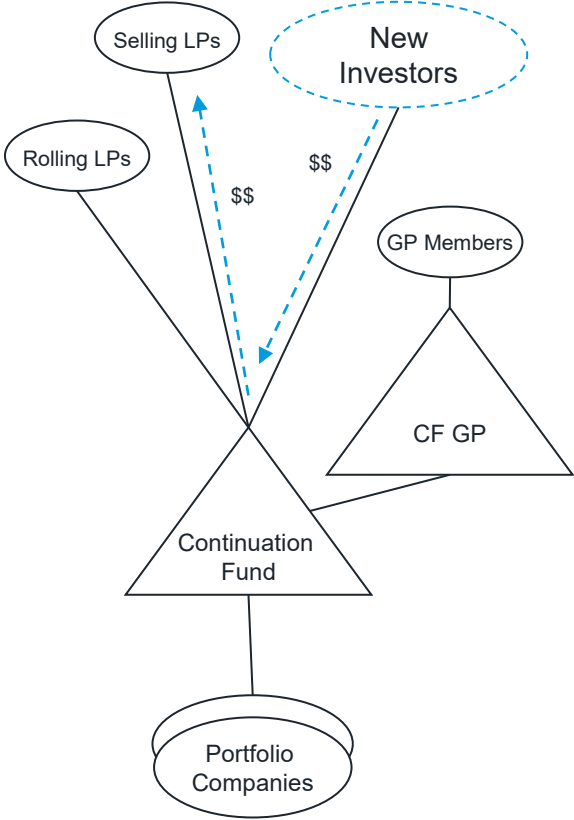
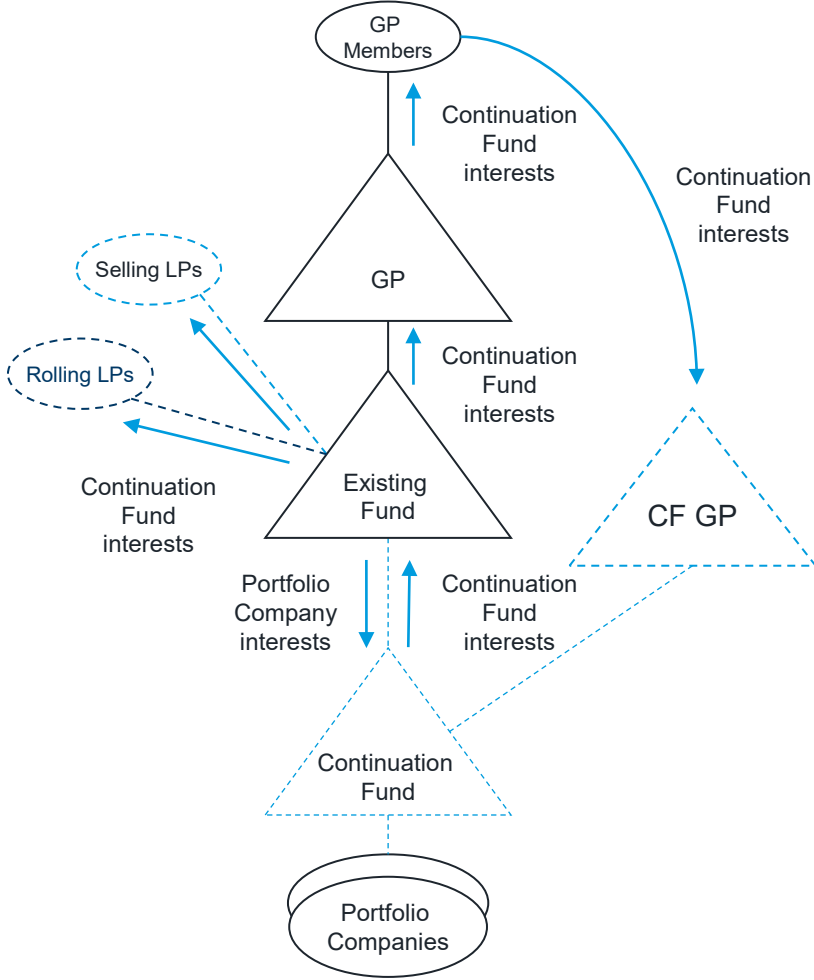
Continuation Fund Stakeholders: Goals & Concerns

Economic Concepts

GP-Led Transactions Options at-a-Glance



Continuation Funds: Rationale; Pros & Cons



Stakeholders

Sponsors

- Extended duration to optimize value of high performing assets
- Additional capital to support existing portfolio/investments
- Crystalize carry for GP
- Reset incentive economics
- Reset carry arrangements between executives who left and those who are still with the GP
- Sometimes seen as a solution to tail end assets

Existing LPs

- Current liquidity vs. future upside (what is being left on the table?)
- Ability to assess opportunity: roll or sell? Status quo offered?
- Conflicts of interest (what is GP receiving)?
- Internal allocation/portfolio management
- Proposed structure and economics
- Status Quo?

Buyers

- Access to a mature portfolio with unrealized upside
- Maximize return potential from IRR and multiple perspective
- Create GP/LP alignment that is not traditional 2/20
- Will there be a critical mass of selling LPs?
- How will GP manage conflicts and existing LP base?
- How much due diligence is possible?
- Unfunded commitment requirements for follow-ons and fees and expenses

Key Risks

CONSIDERATION

COMMENTS

Fiduciary duties and conflicts of interest

- Potential for intense scrutiny after-the-fact by aggrieved LPs and regulators
- Status quo option provided to existing LPs?
- Equal access to diligence in the dataroom?
- Fairness or valuation opinion provided to existing LPs?
- Improvement in GP economics?

LPAC/LP consent

- LPAC consent will typically be required given sponsor conflicts
- LP consents/amendments may also be required
- Socialization for consents should commence early in the process to avoid “dead” deals

Tax Structuring

- Consider whether blockers are being purchased or inserted
- Consider potential withholding taxes and how they will be addressed
- Impact of portfolio company tax characteristics (e.g., QSBS)
- Holding period

Regulatory Considerations

- Anti-trust, CFIUS, SEC, FCC?

Economic Interests: General Concepts

Crystallized Carry

The value of carried interest as *finally determined* based on a distribution of the target portfolio companies (valued at the negotiated transaction value) by the original fund pursuant to the fund waterfall.

- Selling LPs
 - GP crystallizes carry
- Rolling LPs (new economic deal)
 - GP crystallizes carry
- Status Quo LP
 - ***GP does not crystallize carry***

Economic Impact of Crystalizing Carry: An Example

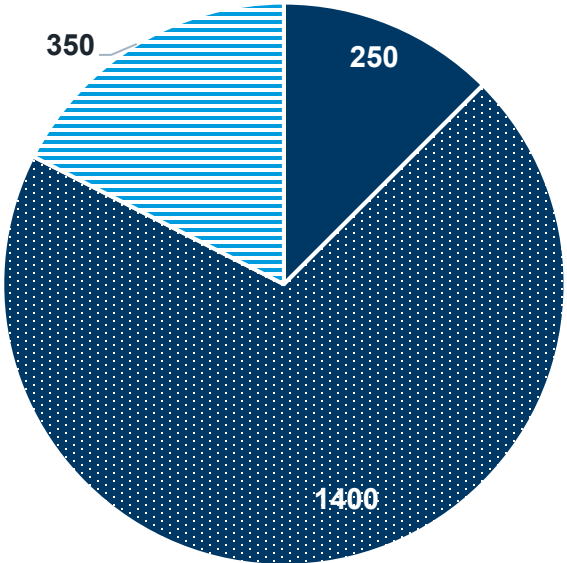
- Cost of target asset = 500
- Continuation fund transaction value = 2000
- Future gain (in CF) = 2000
 - Value of target asset at exit = 4000
- The carry rates for original fund and continuation fund = 20%
 - Assume no IRR/MOIC hurdles to carry
- LP elections: 50% sell & 50% roll

Economic Impact of Crystallizing Carry: Base Case

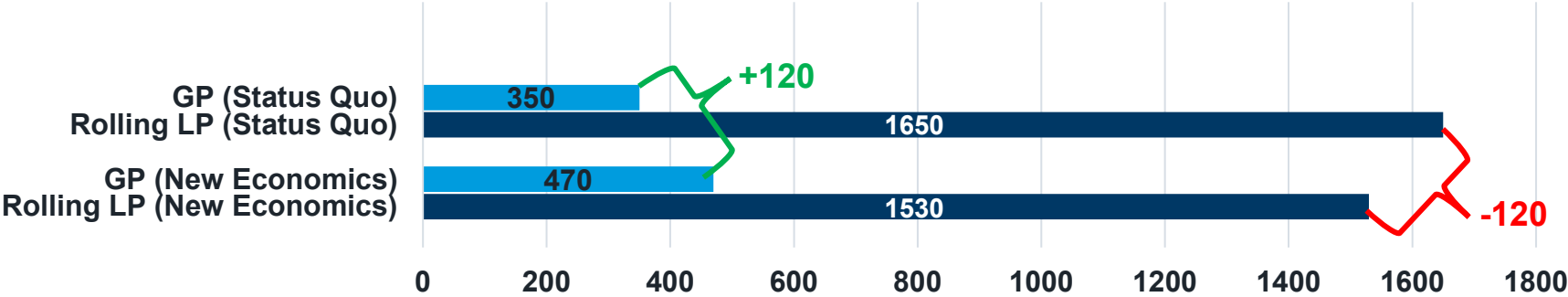
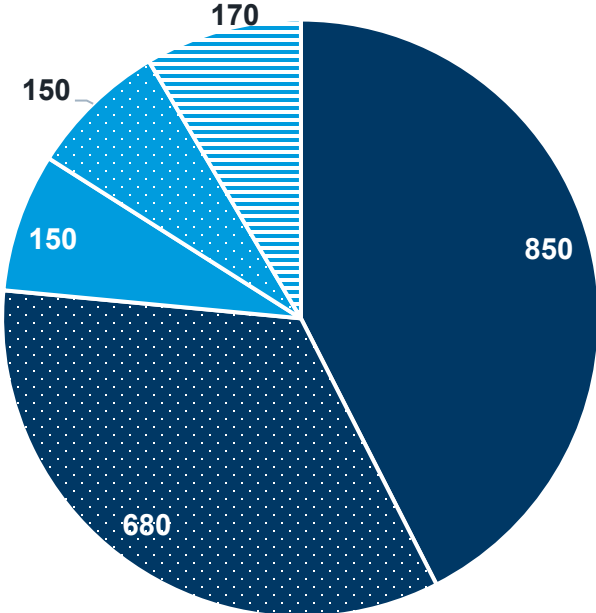
- Rolling LPs
- GP (in respect of Rolling LPs)
- New LP
- GP (in respect of Selling / New LPs)

- Capital/Crystallized Carry
- Return on Capital/CC
- ≡ Carried Interest

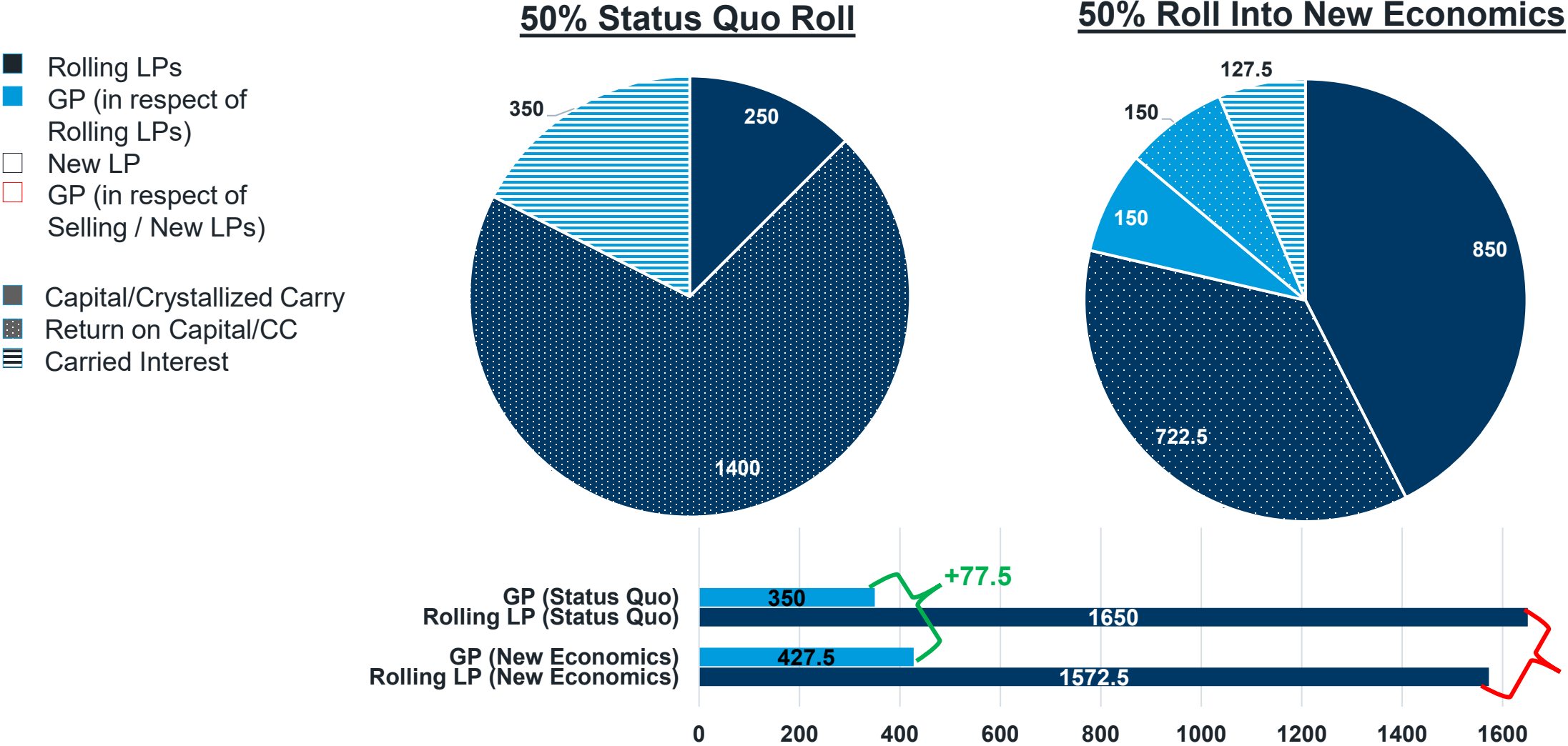
50% Status Quo Roll



50% Roll Into New Economics



Economic Impact of Crystallizing Carry: Impactful Even When Carry Rate in Continuation Fund is Reduced



Questions?

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After the Break

Structuring Continuation Funds

Process & Documentation

Key Fund Terms & Considerations

Key Transaction Terms & Considerations

Questions?

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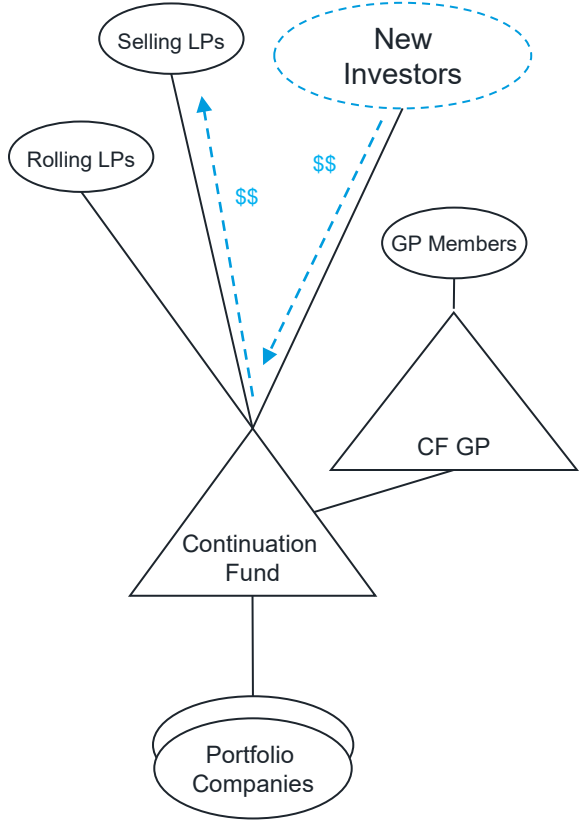
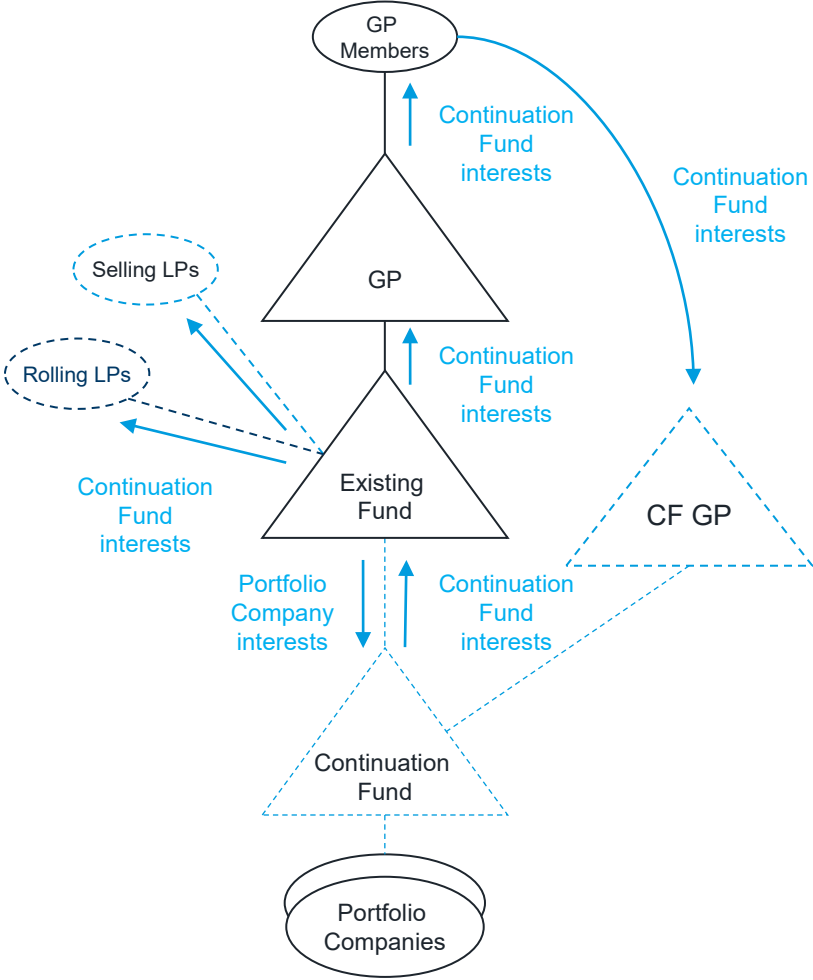
Structuring Continuation Funds

- Existing fund structure
- Tax considerations
- Life cycle of selling funds
- Sponsor goals
- Whether pre-closing restructurings are needed
- And many more...

Traditional (“Disguised Sale”) Structure

- **Pros**
 - Tax-free rollover.
 - Tacked holding period.

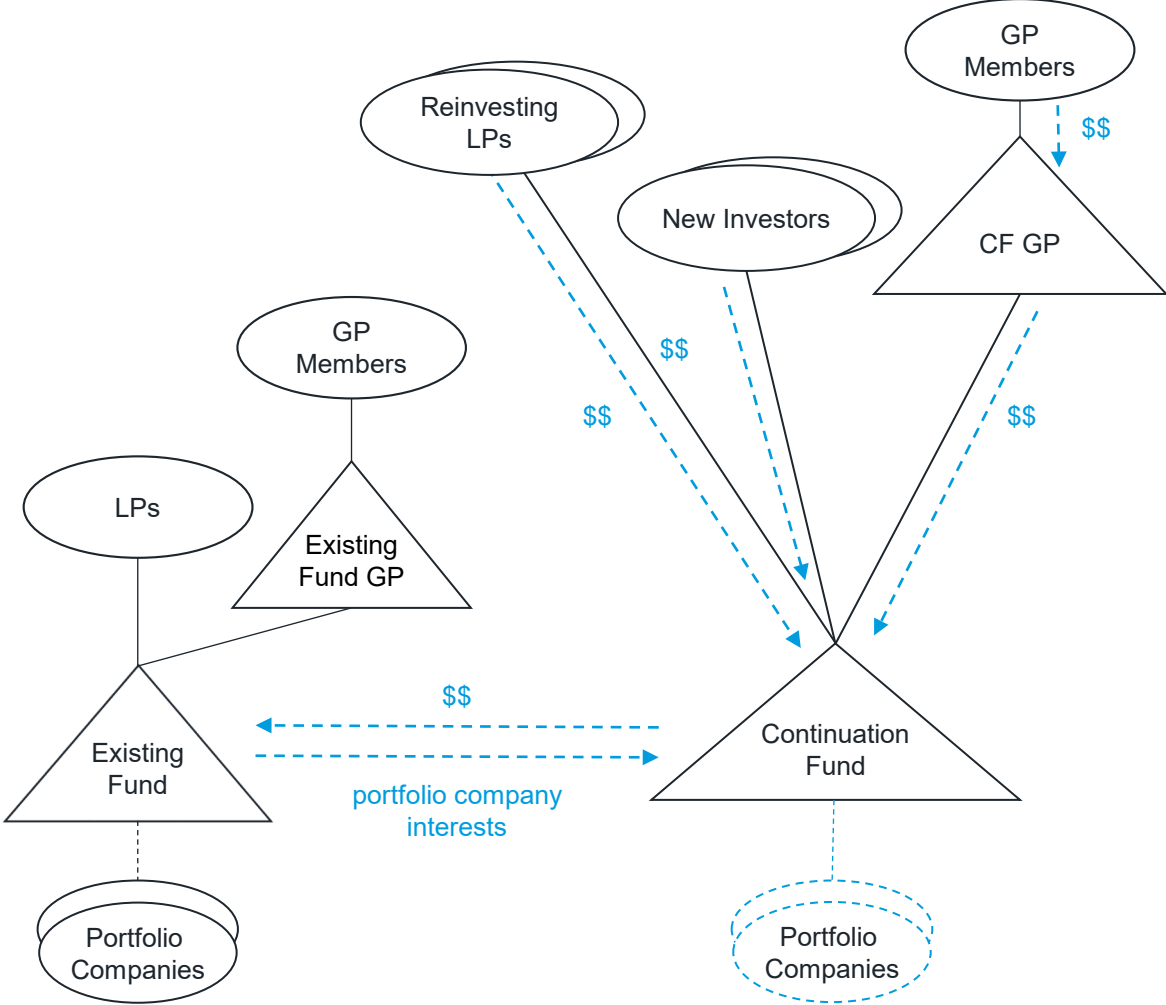
- **Cons**
 - Complexity.
 - Withholding tax considerations.
 - QSBS impact.



Cash Sale Structure

- **Pros**
 - Simplicity.
 - Taxable to investors.

- **Cons**
 - Taxable to investors.
 - Restarts holding period.



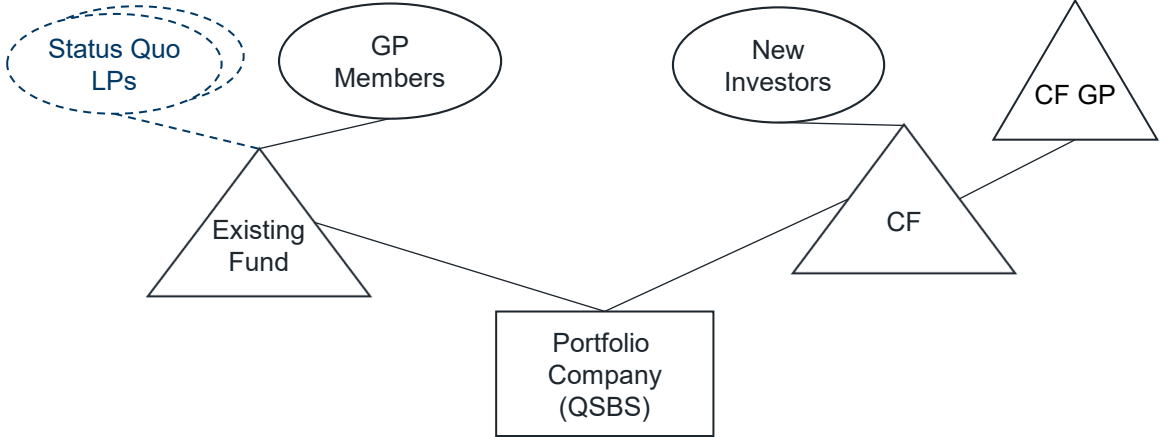
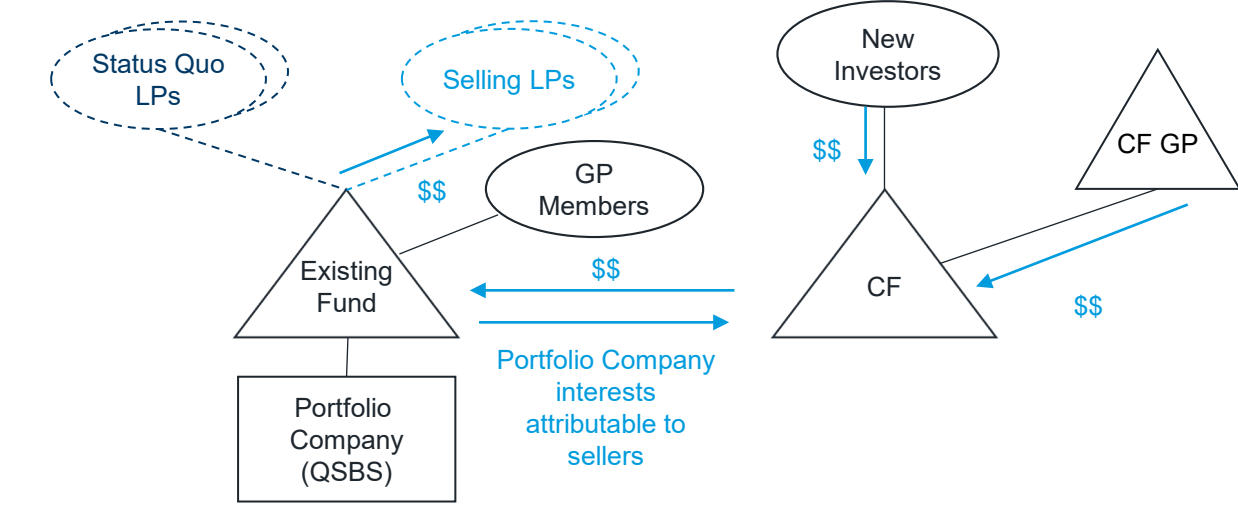
Stay-in-Place Structure (a QSBS Solution)

- Pros**

- Preserve “qualified small business stock” (QSBS) status for all rollers.
- Can be combined with disguised sale structure for non-QSBS.

- Cons**

- Complex.
- Restarts holding period.



How Blockers Can Impact Economics

- Corporate tax on sale of target assets out of the blocker.
 - Up to 44.7% tax drag (based on current tax rates).
- Magnitude of unrealized gain in the blocker.
- Size of blocked interest being acquired relative to total transaction value.
- Ability of new investors to make future investments/follow-on investments unblocked.
- Blocker sale covenants.
- Where the sponsor takes its new carried interest pre- and post-transaction.
 - Above the blocker (i.e., net of any applicable blocker taxes)?
 - Below the blocker?
- Purchase price discount?

Continuation Funds – Process & Documentation

1. Pre-Bid Submission Documents

- NDAs
- Teaser

2. Bid-Submission/Short Form Documents

- Term Sheet
- RW Outline
- Consent/Approval and Transfer Analysis

3. Long Form Documents

- LPA
- Transaction Agreement
- Side Letters
- Sub Docs
- RWI Policy (if applicable)
- Amendments to existing fund vehicle LPAs (if applicable)

4. Election Materials and Closing Docs

- CIM
- Transfer Agreements
- Election Forms
- Pre-Closing Notices and proof of satisfaction of closing conditions

Indicative Timeline: Continuation Fund

Typically 3-6 months (for buy side)

Buy side due diligence

- ▶ Review of any relevant publicly available information or any teaser presentations
- ▶ Selling fund analysis and key metrics
- ▶ Change of control analysis: portfolio company equity & credit agreements, material litigation, regulatory issues, employee compensation matters, co-investor rights, commercial contracts, etc.
- ▶ Investor tax / ERISA considerations

Consider if desirable

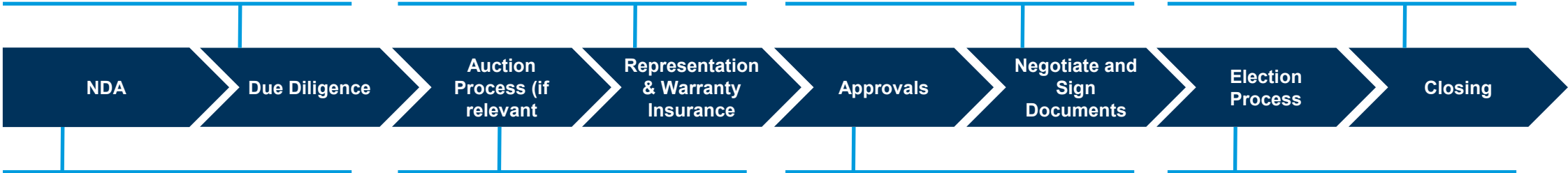
- ▶ If so, start process early
- ▶ Agree allocation of cost and scope of coverage
- ▶ Consider exclusions and who bears liabilities not covered by RWI

Key documentation:

- ▶ Term Sheet
- ▶ Rep & Warranty Outline
- ▶ Transaction Agreement
- ▶ New Fund LPA Side Letter
- ▶ Confidential Information Memorandum

Closing

- ▶ Closing occurs once conditions have been satisfied (including regulatory consents and Approvals)
- ▶ Payment of Purchase Price



Process run by secondaries advisor

Investors to consider:

- ▶ Appropriate pricing, including impact of any fairness opinion process
- ▶ Syndication process
- ▶ Process, number of rounds involved
- ▶ Acquisition finance

Determine/confirm required LPAC and/or investor approvals, as well as any third-party approvals

Existing LPs decide whether to sell or roll

Key Fund Terms – Commitments

CONSIDERATION

COMMENTS

Allocation Waterfall

- Minimums & Maximums
- Handling Excess Sell Side Demand

Purchase Price Commitment

- Purchase Price Adjustments:
 - Cash Flows
 - Portfolio Fees
- Deferred Consideration
- Earnouts

Unfunded Commitments

- Follow-On Investments
 - Status Quo/Dilution
 - Preemptive Rights
 - LPAC/Lead Buyer Consent Rights
- Expenses:
 - Inside or Outside Commitments
 - Capped vs. Uncapped
 - Payment of Expenses for Status Quo

Sponsor Commitment

- GP Rollover & Unfunded

Key Fund Terms – Expense Sharing

CONSIDERATION	COMMENTS
Expense “Buckets”	
▶ Seller Expenses	Not typically borne by Continuation Fund: <ul style="list-style-type: none">• LPA amendments; LPAC consents; LP CIM & Election Forms• Fairness or valuation opinions• Placement agent and professional advisor fees and expenses to the extent relating to the M&A transaction• Transfer taxes relating to pre-transaction restructuring
▶ Transfer Expenses	Often split in an equitable manner (e.g., 50/50) between Sellers and Continuation Fund: <ul style="list-style-type: none">• Portfolio company transfer expenses• Regulatory expenses (e.g., HSR filings)• Contribution/PSA expenses• Cost of rep and warranty insurance• Transfer taxes relating to “sold” interests
▶ Continuation Fund Expenses	Often borne by Continuation Fund: <ul style="list-style-type: none">• Organizational expenses (typically subject to a cap)• Lead investor expenses (typically subject to a cap)• Placement agent fees relating to new commitments to the Continuation Fund (subject to management fee offset)

Key Fund Terms – Economics & Cashflows

CONSIDERATION

COMMENTS

Distribution Waterfall

- Carried Interest
- GP Clawback & Guarantees
- Historical Clawbacks?
- RWI Proceeds & Expenses – Inside or Outside?
- Tax distributions on Rolled Interests (i.e., 704(c) allocations)

Management Fee

- Will New Investors & Rollers pay the same management fee?
 - If not, will Rollers receive any offsets?
- How will the management fee be calculated?
- Termination

Indebtedness; Recycling & Reinvestment

- Appropriate?
 - If so, consider caps, timings and uses

Continuation Funds – Dilution & Governance

CONSIDERATION


COMMENTS

Governance

- Term and Extensions
- LPAC vs. Lead Investor Consent
 - Weighted Voting
 - Special Lead Investor Rights
- GP Removal: Cause vs. No Fault
- Key Persons
- ROFRs
- Side Letters
 - New Investors
 - Rollers
 - MFN

Questions?

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Key Transaction Terms & Considerations

Key Transaction Terms – Indemnification

CONSIDERATION

COMMENTS

Source of Recovery

- Representation and Warranty Insurance
- Holdback/Deferral
- LP Clawback Provisions
- Recovery Challenges

Caps/Deductibles/ Thresholds

- Non-Fundamental Reps; Tipping Basket v. Deductible
- Non-Fundamental Reps Cap
- Fundamental Reps Cap
- Excluded Liabilities Cap
- Fraud Cap

Key Transaction Terms – Reps & Warranties

CONSIDERATION

COMMENTS

Representations and Warranties; Survival

- Fundamental Representations and Warranties
- Non-Fundamental Representations and Warranties
- General Partner Representations and Warranties
- Cure Provisions

Definition of “Knowledge Parties”

- Identity
- Due Inquiry

Key Transaction Terms – Excluded Obligations; Fraud

CONSIDERATION

Excluded
Obligations/Tax
Liabilities/Fraud;
Survival

COMMENTS

- Excluded Obligations
- Excluded Tax Liabilities
- Fraud

Key Transaction Terms – Closing Conditions & Tax Covenants

CONSIDERATION

COMMENTS

Customary Closing Conditions

- **General**
- **Customary Examples of Closing Conditions:**
 - Receipt of all anti-trust/competition approvals
 - Representations and warranties are true both as of the signing date and the closing date
 - No portfolio company is in default of any financing arrangement, nor is any portfolio company reasonably expected to be in default
 - Required approval of applicable limited partners
 - Required level of financial commitment by sponsor
 - Tax forms/certifications required to reduce/eliminate FIRPTA/ECI withholding

Tax Covenants

- 754 election
- Push-out election for pre-closing partnership tax liabilities imposed on audit

Questions?

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Event Speakers



Janicelynn Park
Partner
T: +1.212.969.3152
jpark@proskauer.com



Jamiel Poindexter
Partner
T: +1.617.526.9773
jpoindexter@proskauer.com



Natalie Scott
Senior Counsel
T: +1.212.969.3167
nscott@proskauer.com



Corey Dietrich
Senior Associate
T: +1.212.969.3935
cdietrich@proskauer.com



Blake Halperin
Senior Associate
T: +1.561.995.4721
bhalperin@proskauer.com



Philip Lenertz
Senior Associate
T: +1.617.526.9666
plenertz@proskauer.com



Jordan Shelton
Senior Associate
T: +1.973.681.6401
jshelton@proskauer.com

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