

Proskauer Secondaries School: Continuation Funds

First for Market Insights
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Proskauer»

Before the Break:

Introduction to GP-Led Transactions: The Spectrum of Options

Introduction to Continuation Funds

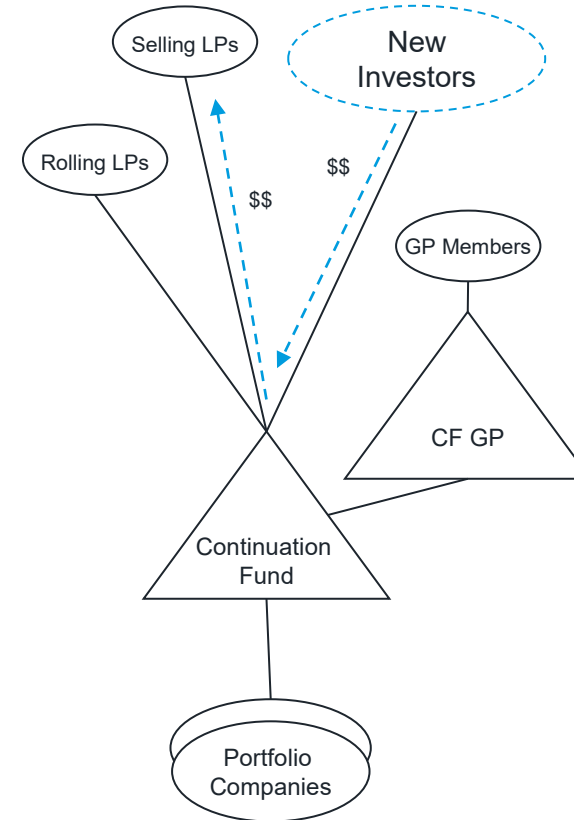
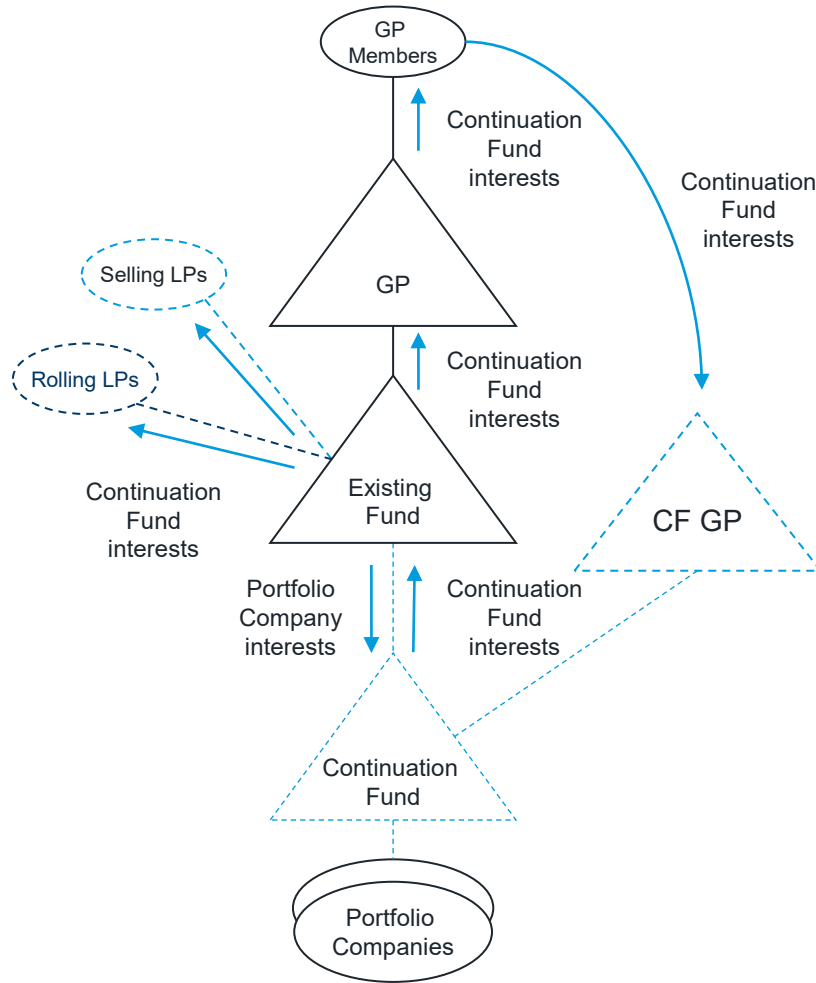
Continuation Fund Stakeholders: Goals & Concerns

Economic Concepts

GP-Led Transactions Options at-a-Glance



Continuation Funds: Characteristics; Motivations & Drawbacks



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 Considerations

CONSIDERATION	COMMENTS
Fiduciary duties and conflicts of interest	<ul style="list-style-type: none">• “Arm’s length transaction”• Increased potential for intense, after-the-fact, scrutiny by aggrieved LPs and regulators<ul style="list-style-type: none">• 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	<ul style="list-style-type: none">• LPAC consent will typically be required to “cleanse” conflicted transactions• LP consents and LPA amendments may also be required• Best Practice: Socialization for consents should commence early in the process to avoid “dead” deals
Tax Structuring	<ul style="list-style-type: none">• 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	<ul style="list-style-type: none">• Anti-trust, state and federal securities law, CFIUS, SEC, FCC, and Portfolio Company specific consideration?

Economic Interests: General Concepts

Crystallized Carry

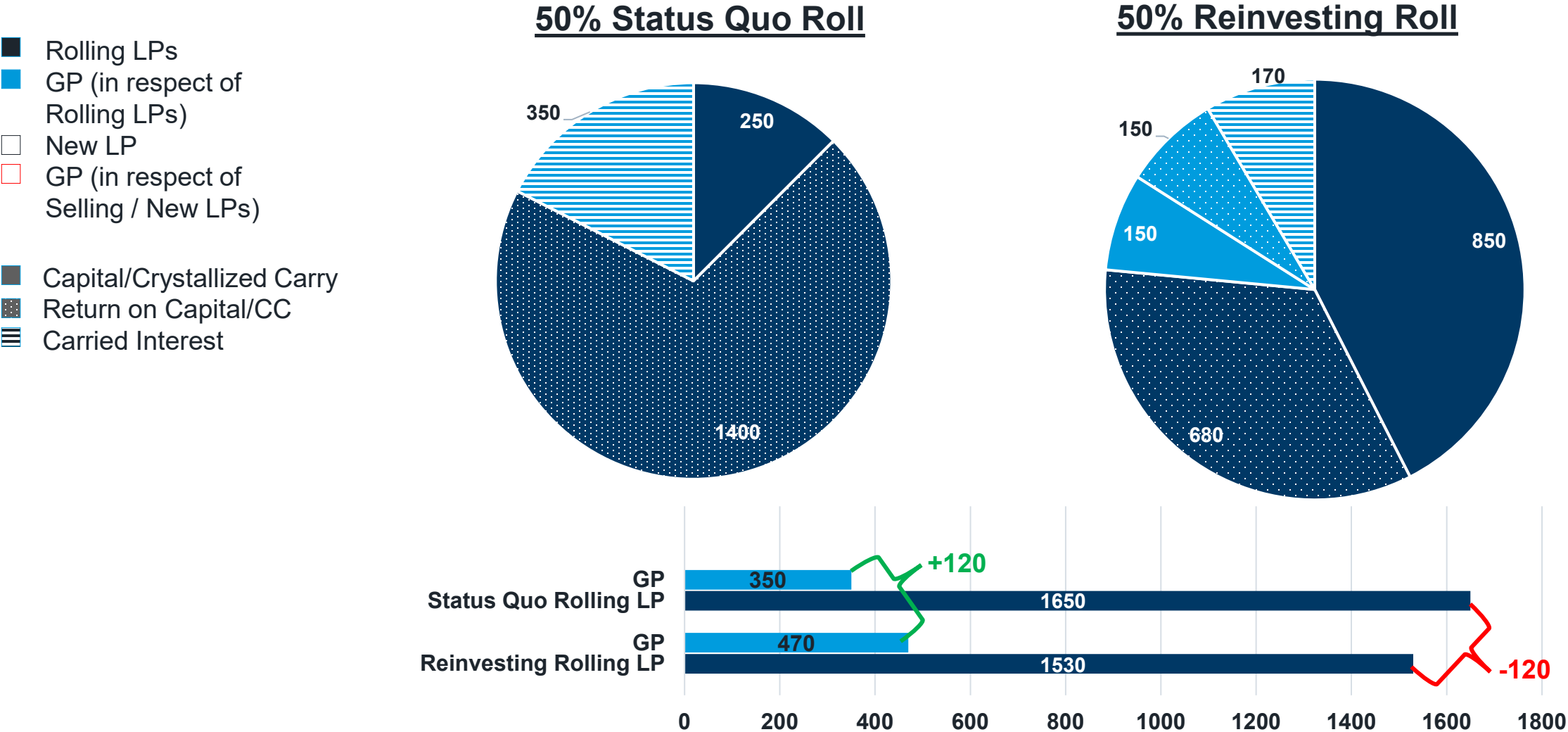
The value of carried interest as ***finally determined*** based on a distribution of the target portfolio companies (valued at the negotiated transaction value) by the original fund pursuant to the fund waterfall.

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

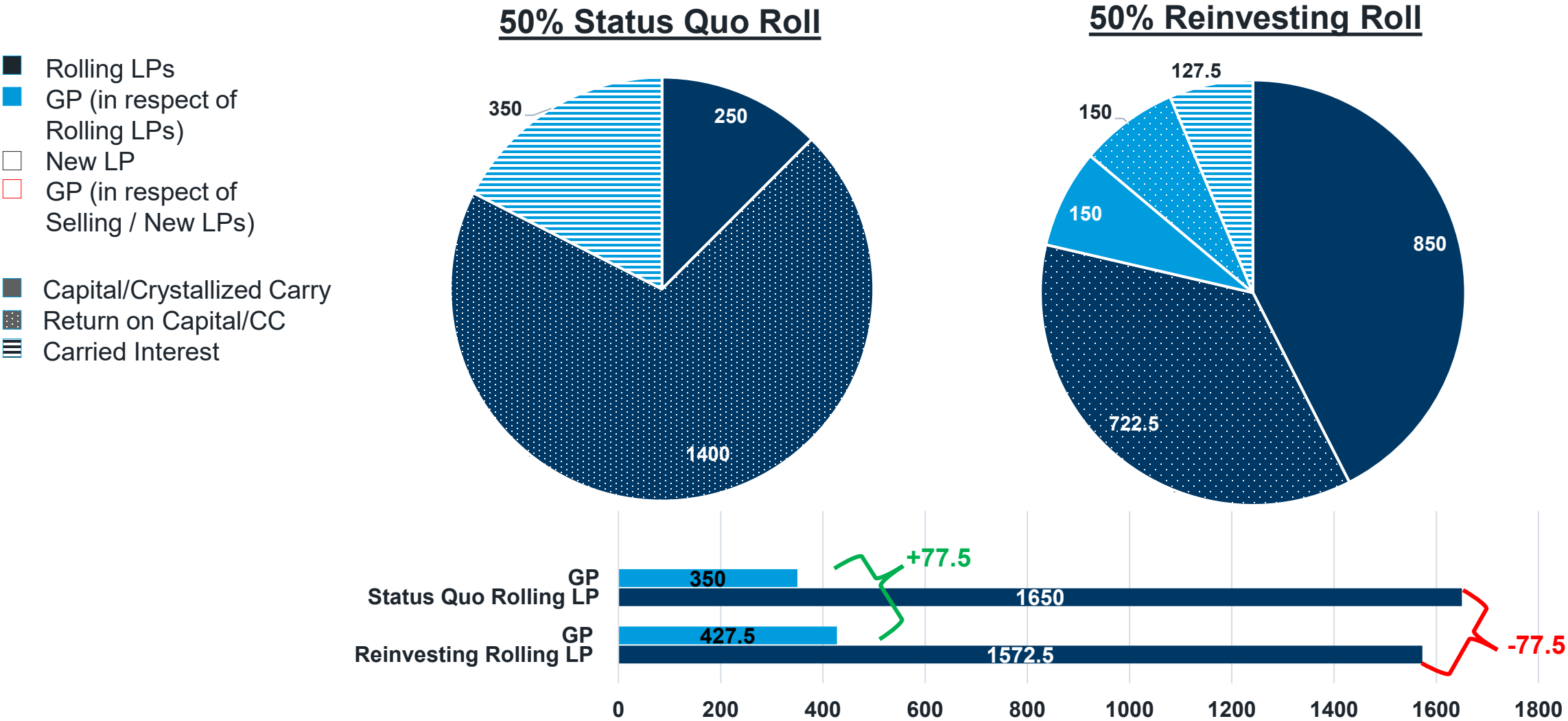
Economic Impact of Crystalizing Carry: An Example

- Cost of target asset = 500
- Continuation fund transaction value = 2000
 - GP is “in carry”
- 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



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



Questions?

After the Break:

Structuring Continuation Funds

Process & Documentation

Key Fund Terms & Considerations

Key Transaction Terms & Considerations

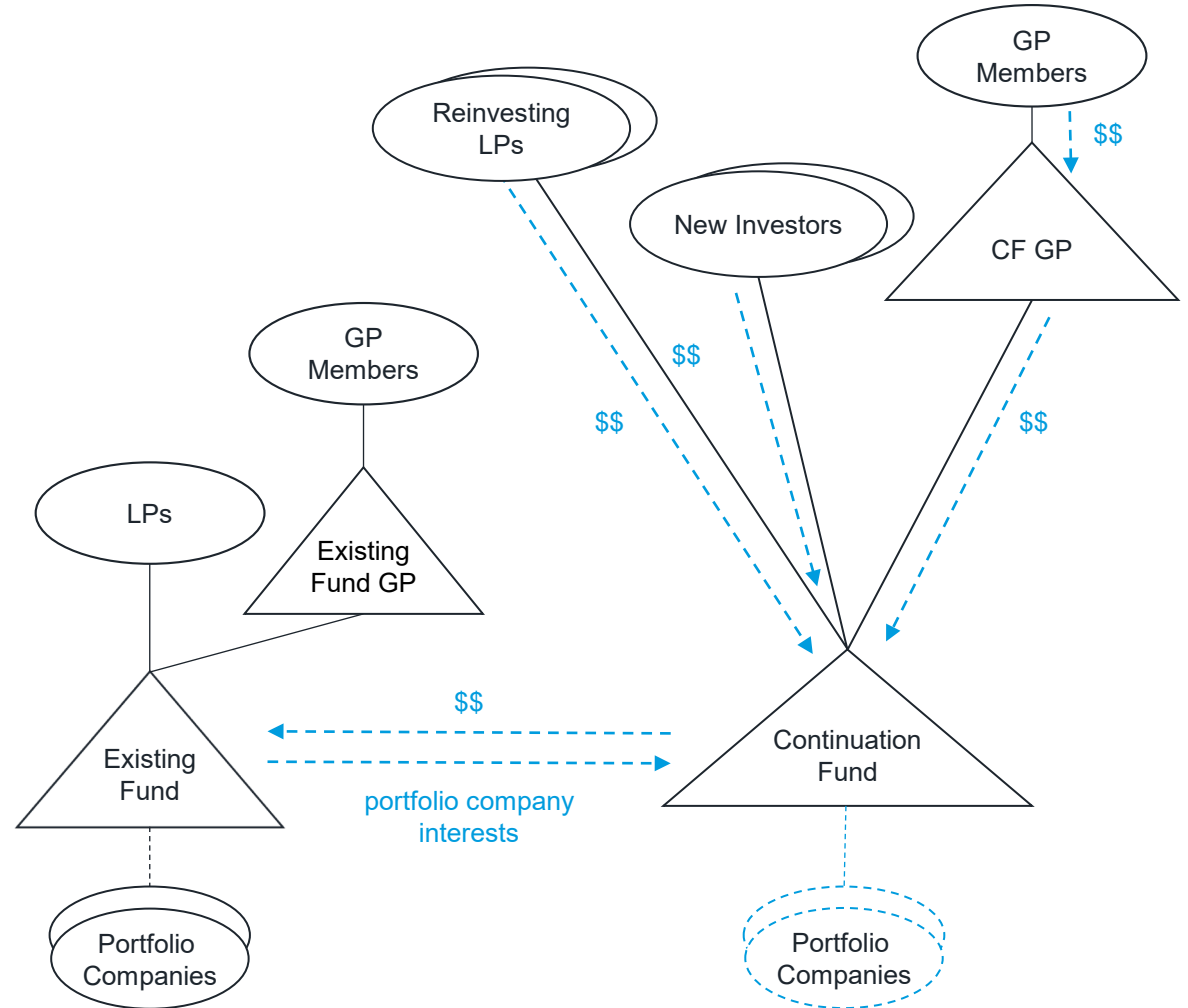
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Structuring Continuation Funds

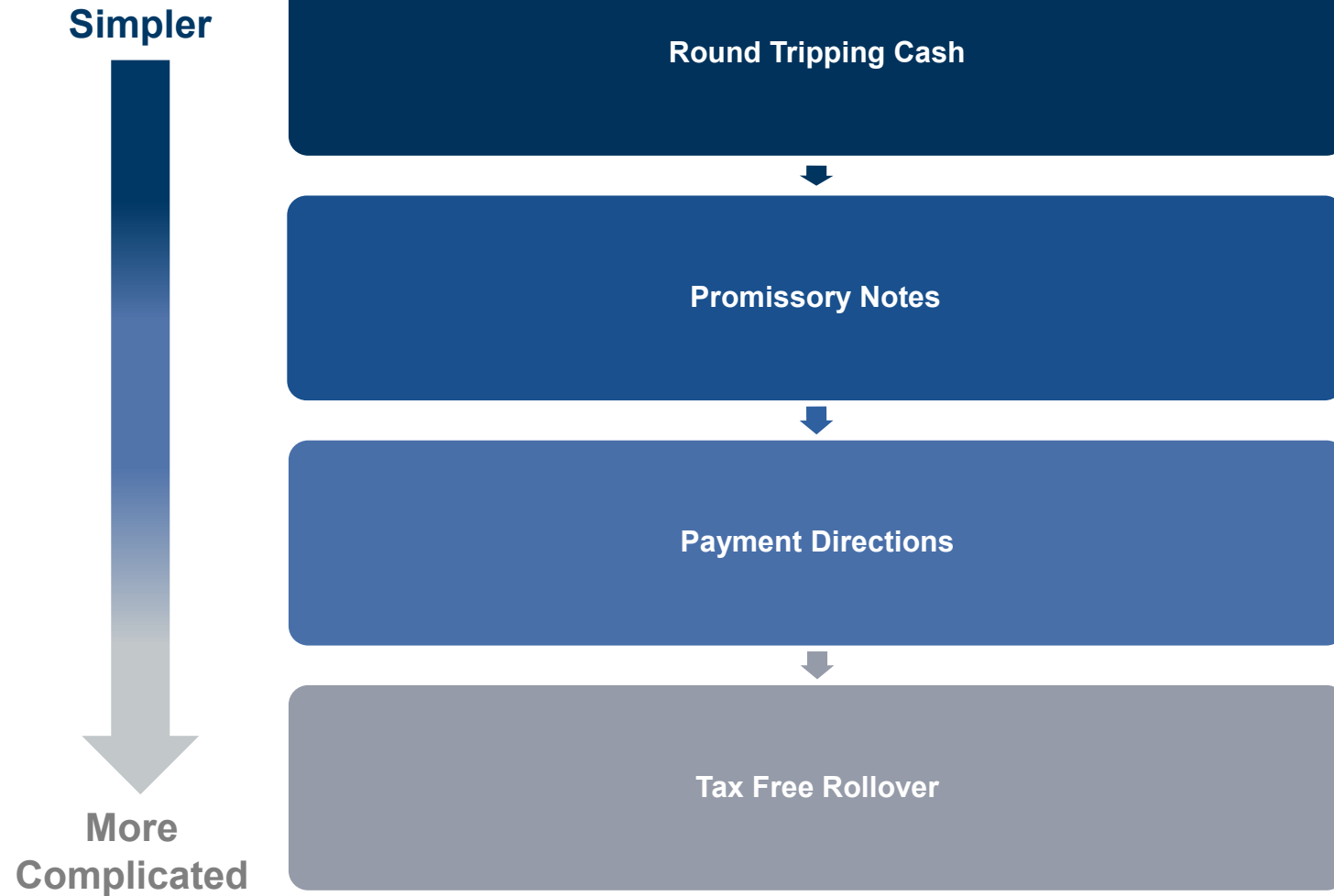
- Existing fund structure
- Tax considerations
- Life cycle of selling funds
- Sponsor goals
- Whether pre-closing restructurings are needed
- And many more...

Cash Sale Structure

- **Pros**
 - Simplicity.
 - Taxable to investors.
- **Cons**
 - Taxable to investors.
 - Restarts holding period.
 - Cashflow issues for reinvesting LPs.



Reinvestment Options



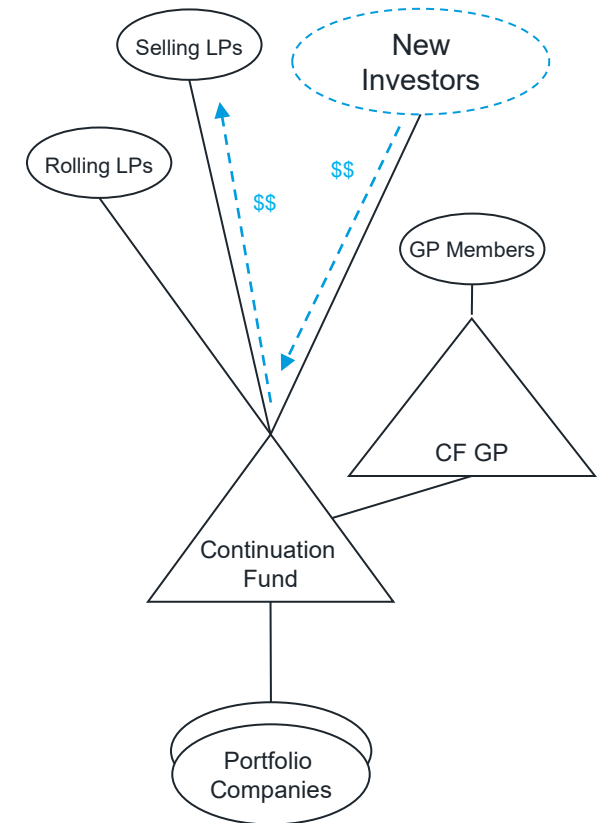
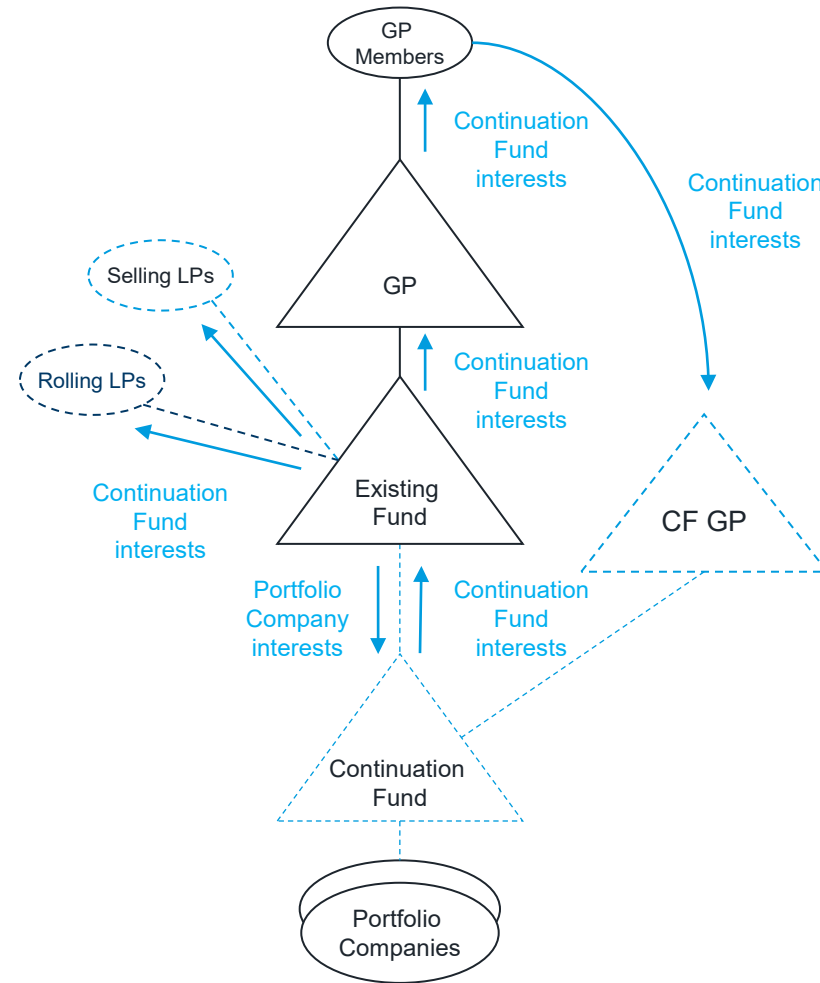
Traditional (“Disguised Sale”) Structure

- **Pros**

- Tax-free rollover.
- Tacked holding period.

- **Cons**

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



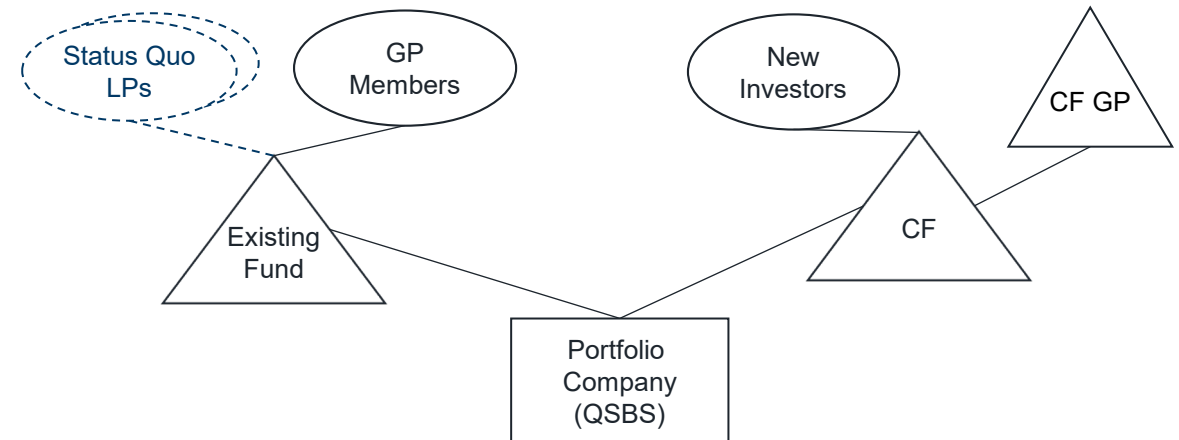
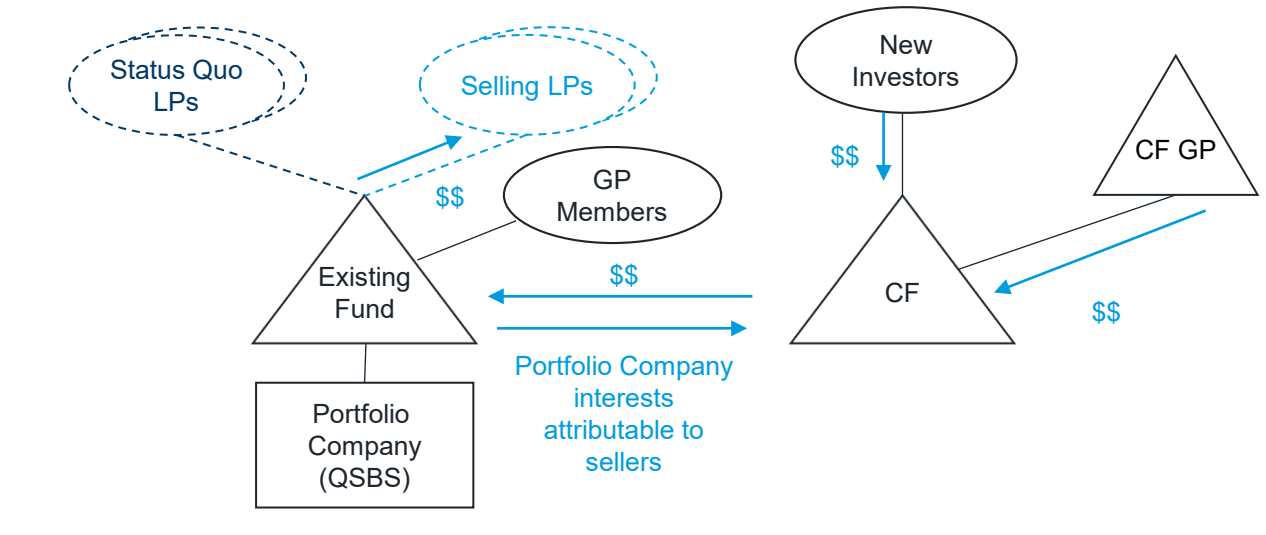
Stay-in-Place Structure (a QSBS Solution)

- **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
- Sources and Uses Table

Indicative Timeline: Continuation Fund

Start to Finish: 3-9 months

Prepare and circulate initial diligence materials:

- ▶ Prepare teaser presentation highlighting Selling Fund and portfolio company key financial metrics
- ▶ Commission Fairness Opinion
- ▶ Conduct change of control and consent analysis
- ▶ Upload relevant portfolio company equity & credit agreements, material litigation, key employee compensation matters, co- investment rights and commercial contracts to data room
- ▶ Conduct tax and structuring diligence

Consider if R&W Insurance will be used.

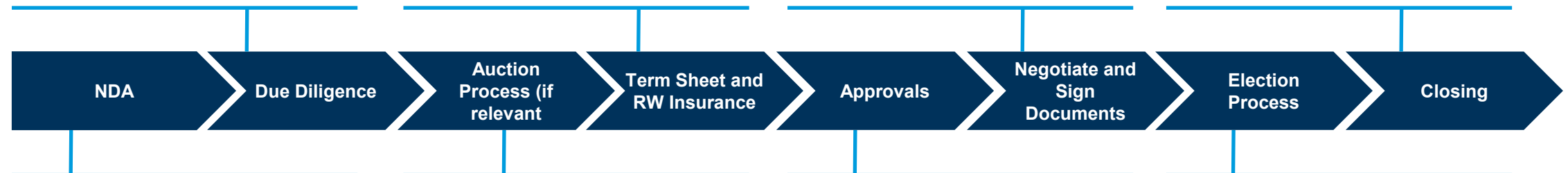
- ▶ If so, start process early
- ▶ Agree on allocation of cost and scope of coverage
- ▶ Consider exclusions and who bears liabilities not covered by RWI
- ▶ Determine treatment of proceeds

Key documentation:

- ▶ Term Sheet
- ▶ Rep & Warranty Outline
- ▶ Transaction Agreement
- ▶ Continuation Fund LPA and Side Letters
- ▶ Confidential Information Memorandum
- ▶ R&W Insurance Policy

Fund and Deal Closing

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



Process run by secondaries advisor and legal counsel

Lead Investors to consider:

- ▶ Appropriate pricing, including impact of any fairness opinion process
- ▶ Syndication process
- ▶ Process, number of rounds involved
- ▶ Acquisition finance
- ▶ Change of control and consent analysis findings

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	<ul style="list-style-type: none">• Minimums & Maximums• Handling Excess Sell Side Demand
Purchase Price Commitment	<ul style="list-style-type: none">• Purchase Price Adjustments:<ul style="list-style-type: none">– Cash Flows– Portfolio Fees• Deferred Consideration• Earnouts
Unfunded Commitments	<ul style="list-style-type: none">• Follow-On Investments<ul style="list-style-type: none">– Status Quo/Dilution– Preemptive Rights– LPAC/Lead Buyer Consent Rights• Expenses:<ul style="list-style-type: none">– Inside or Outside Commitments– Capped vs. Uncapped– Payment of Expenses for Status Quo
Sponsor Commitment	<ul style="list-style-type: none">• 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?

Key Transaction Terms & Considerations

Key Transaction Terms – Indemnification

CONSIDERATION

COMMENTS

Source of Recovery

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

Caps/Deductibles/ Thresholds

- **Non-Fundamental Reps; Split Retention v. No Seller Indemnity**
- **Non-Fundamental Reps; Tipping Basket v. Deductible**
- **Non-Fundamental Reps; Cap**
- **Fundamental Reps and Excluded Liabilities; Cap**
- **Fraud Cap**

Key Transaction Terms – Reps & Warranties

CONSIDERATION

Representations and Warranties; Survival

COMMENTS

- **Typical Fundamental Representations and Warranties**
 - Survival under TA vs RWI
- **Typical Non-Fundamental Representations and Warranties**
 - Survival under TA vs RWI
- **General Partner Representations and Warranties**
 - Survival
- **Cure Provisions**

Definition of “Knowledge Parties”

- **Identity**
- **Due Inquiry**

Key Transaction Terms – Survival for Excluded Obligations; Fraud

CONSIDERATION	COMMENTS
Excluded Obligations/Tax Liabilities/Fraud; Survival	<ul style="list-style-type: none">• Typical Excluded Obligations<ul style="list-style-type: none">– Survival under TA vs RWI• Excluded Tax Liabilities<ul style="list-style-type: none">– Survival under TA vs RWI• Fraud<ul style="list-style-type: none">– Survival

Current Highlights on Rep & Warranty Insurance

- Base policy terms
- RWI provides extended survival for breaches of claims and typically facilitates negotiation of the TA (at least in regard to reps, indemnification, scope of recourse)
- Cost on all-in basis (i.e., premium, taxes, underwriting fees and broker compensation)
- Tax RWI

Key Transaction Terms – Closing Conditions & Tax Covenants

CONSIDERATION	COMMENTS
Customary Closing Conditions	<ul style="list-style-type: none">• General• Customary Examples of Closing Conditions
Tax Covenants	<ul style="list-style-type: none">• 754 election• Push-out election for pre-closing partnership tax liabilities imposed on audit

Questions?

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