

Funds in Focus 2018: Private Investment Funds Annual Review Conference

The Rise of Specialist Secondaries
Transactions: GP-led deals, Fund
Restructurings, and other Trends

Howard Beber, Bruno Bertrand-Delfau,
Mike Suppappola, Brian Huber

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General Partner Led Secondary Transactions

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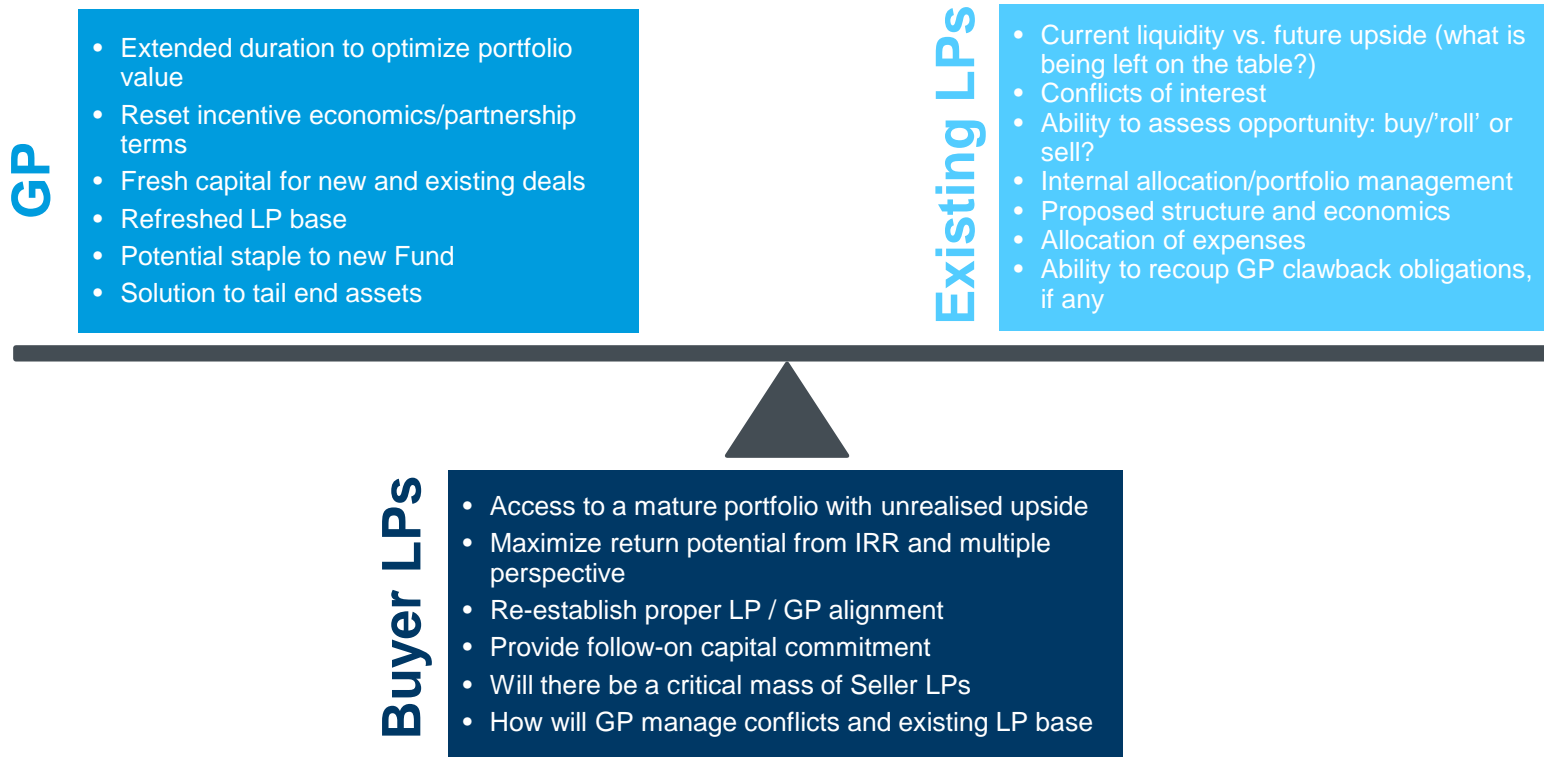
Overview

- A fund restructuring or tender offer typically involves a buyer offering to buyout the positions of the existing LPs and the resetting of certain terms with the goal of maximizing the value of the portfolio going forward and helping realign LP and GP interests.
- Key Elements:
 - Must be some desire for liquidity among existing LPs
 - Willing “Secondaries” buyer
 - GP should be able to demonstrate traditional means for liquidity (i.e. selling assets) at present time is not in the best interests of the LPs
 - GP should give the existing LPs the opportunity to roll into the new structure on terms as near as possible to the status quo otherwise the process may be viewed as coercive by the LPs
 - GP needs to be as proactive and transparent as possible with existing LPs to avoid the perception they are acting solely in self interest

Overview

- A properly structured fund restructuring or tender offer can help: (1) resolve mis-alignment issues between the LPs and GP of a fund and (2) achieve the collective objectives of LPs and the GP
 - Example:
 - Consider a scenario where the fund is at the end of its life where one or more of the following fact patterns exist:
 - Certain LPs desire liquidity and another set of LPs are comfortable with a longer hold period
 - The GP believes it is in the best interests of the LPs to continue to hold the assets
 - The GP believes that in order to preserve or maximize value additional capital should be infused into the portfolio
 - Under the current terms the GP is unlikely to earn a carry

The Stakeholders – The Drivers and The Tensions



Objectives and Key Drivers

Existing Partnership Terms

- Conflicts provisions (in particular affiliate/principal transactions/successor fund)
- Amendment provisions
- Exculpation and indemnification provisions
- LPAC receptiveness to a liquidity solution compared to the receptiveness of the LPs

The GP

- Health of GPs working relationships with existing LPs
- Departed GP investment professionals
- Any GP clawback obligations

Profile of Existing LP Base

- Liquidity may be compelling for certain LPs (e.g. funds of funds and financial institutions) but less so for other LPs (e.g.. endowments and state plans)
- Certain LPs have been very unreceptive to fund restructurings
- Certain LPs may need to go their investment committees (creates timing issues)
- Buyer LP (and GP) will need a critical mass of interested Seller LPs in order for the transaction to be worth while

Portfolio

- Typically a mature portfolio
- GP should be able to demonstrate to existing LPs that traditional single asset liquidity options are not in the best interest of the LPs
- Nature of portfolio may require analysis of tax, legal and regulatory hurdles. Underlying transaction agreements may add structuring complexities (e.g. change of control, ROFR, minority shareholder rights, etc.)

Expenses

- Who bears the cost of the transaction and any agent fees? Typically Seller LPs and/or New LP

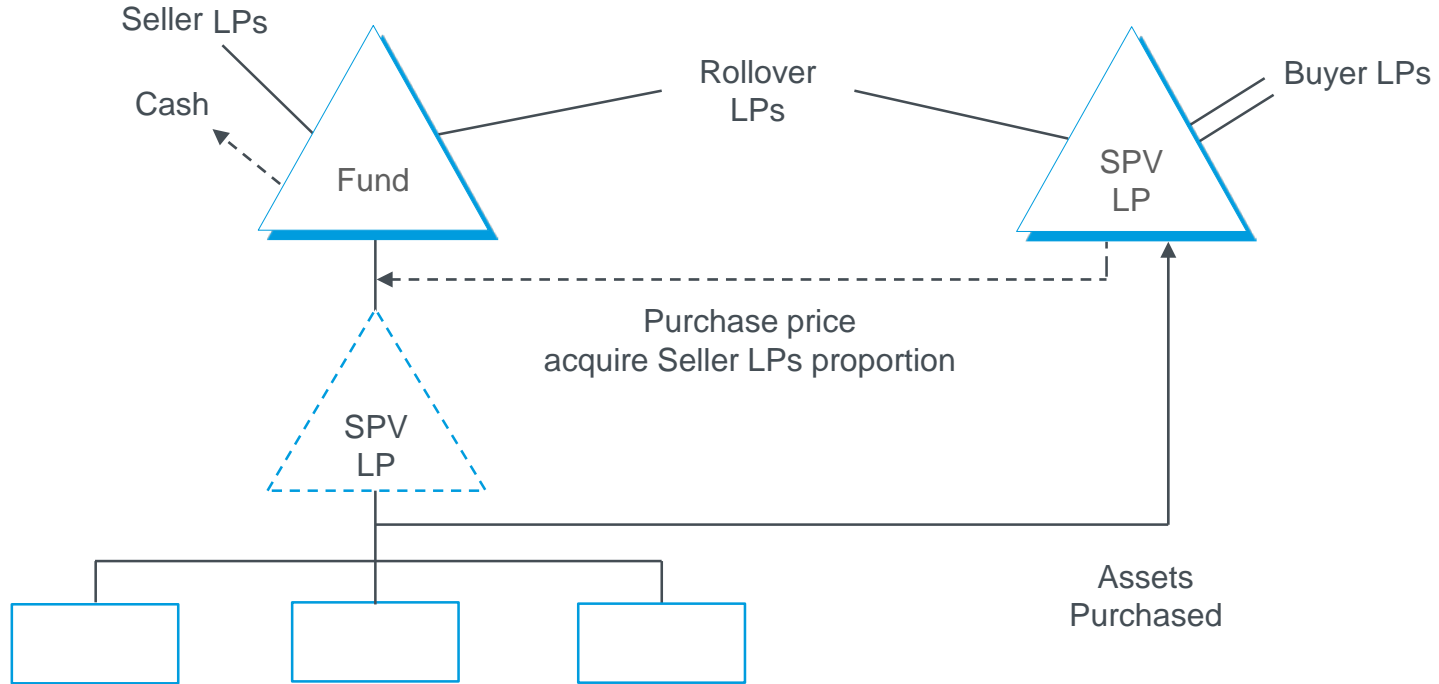
Transaction Structures

- Two primary liquidity options:



- The structure will need to help strike a balance between competing objectives of the stakeholders
- The structure and terms will either exacerbate or help alleviate transaction risks and conflicts of interest

Restructurings



Restructurings – Pros and Cons

Pros

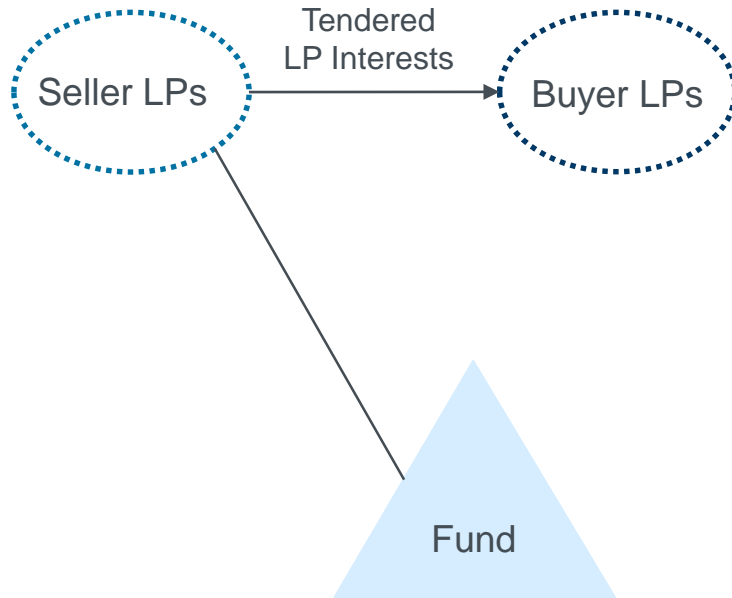
- GP and Buyer LPs can agree to modified terms that apply only to the Buyer LPs (e.g. reset of waterfall and new carry terms)
- Election form can be structured so that unresponsive LPs are deemed Seller LPs making it more certain the critical mass of Seller LPs for the transaction will be worthwhile for the GP and the Buyer LPs
- Easier for GP to exclude departed personnel from reset economics in the New Fund, although departed personnel have grounds to object to this approach
- Potential to structure in a manner to mitigate immediate impact of new ECI withholding rules
- Opportunity to reevaluate CFC structuring

Cons

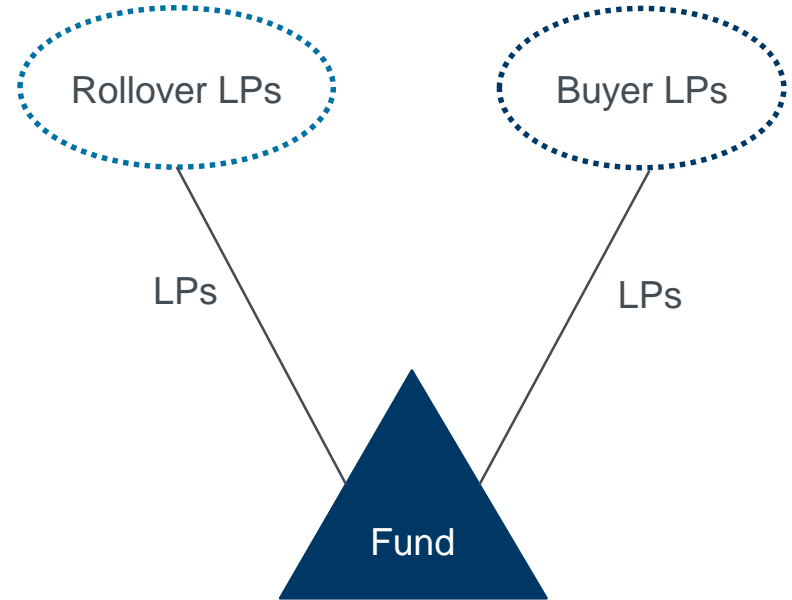
- Increased risk of claims for breach of fiduciary duty and conflicts of interest
 - GP is affecting the sale and must ensure the transaction is fair to both the Fund LPs and the New Fund LPs
 - Appreciation in the portfolio after the sale opens up the GP to second guessing
 - Stapled commitment to successor fund calls into question GP's motivations and presents conflict requiring explicit disclosure
- Accounting for change of control, ROFR, minority shareholder rights and similar provisions of underlying deal documents

Tender Offers

Transaction:



Post-transaction:



Tender Offers – Pros and Cons

Pros	Cons
<ul style="list-style-type: none">• Typically a much simpler process• Significantly less risk of claims for breach of fiduciary duty and conflicts of interest<ul style="list-style-type: none">• LP makes the decision of whether to sell or not• Change of control and similar provisions of underlying deal documents unlikely to be implicated• As with an Asset Purchase, the GP and Buyer LPs can potentially agree to modified terms for Buyer LPs• Change of control and underlying deal documents unlikely to be implicated	<ul style="list-style-type: none">• More difficult for the GP to control the tender offer process• Unresponsive LPs would normally default to a Rollover LP election making it less certain the critical mass of Seller LPs will be achieved for the transaction to be worthwhile for the GP and the Buyer LPs• Altering terms of the Fund with respect to existing LPs (e.g. additional new unfunded commitments, altering management fee, extending term, etc.) would likely implicate LPA amendment provisions which may require a super-majority consent or even LP-by-LP consent• More difficult for GP to exclude departed personnel from reset economics since the same fund still holds the assets• Impact of new ECI withholding rules

Managing the Process

Up-front diligence by the GP (both legal and commercial) is required to gauge whether a transaction is possible.

Understanding tax, legal and regulatory considerations that need to be accounted for in the Fund documents and the Portfolio documents

Need to gauge LP liquidity interest and willingness of Rollover LPs to remain invested on modified terms, litmus test with large LPs/LPAC can be helpful

GP will need to devote a great deal of time to one-on-one discussions with LPs

Reviewing internal GP arrangements and any concerns regarding departed personnel

Certain LPs may need to go to their investment committee in order to make their election

Mitigating and Managing the Risks

Restructurings may present more risk to GPs than Tender Offers:

- Heightened risk if no status quo option for Rollover LPs
- Can mitigate by tying the ability to rollover to waiving claims, conflicts and/or agreeing to amendments to Fund governing docs

Process must evidence a fair 'market-tested' purchase price has been obtained

- A proper competitive auction process and/or obtaining a fairness opinion
- Complete transparency from GP

Mitigating and Managing the Risks

Presentation of transaction to the LPAC and getting their support

Offering Memorandum

- Detailed disclosure of sale process, structure and terms
- Disclosure of GP conflicts of interest and risk factors
- Approval of the transaction itself
- Waivers of fiduciary duty and conflicts of interest and amendments to existing Fund docs

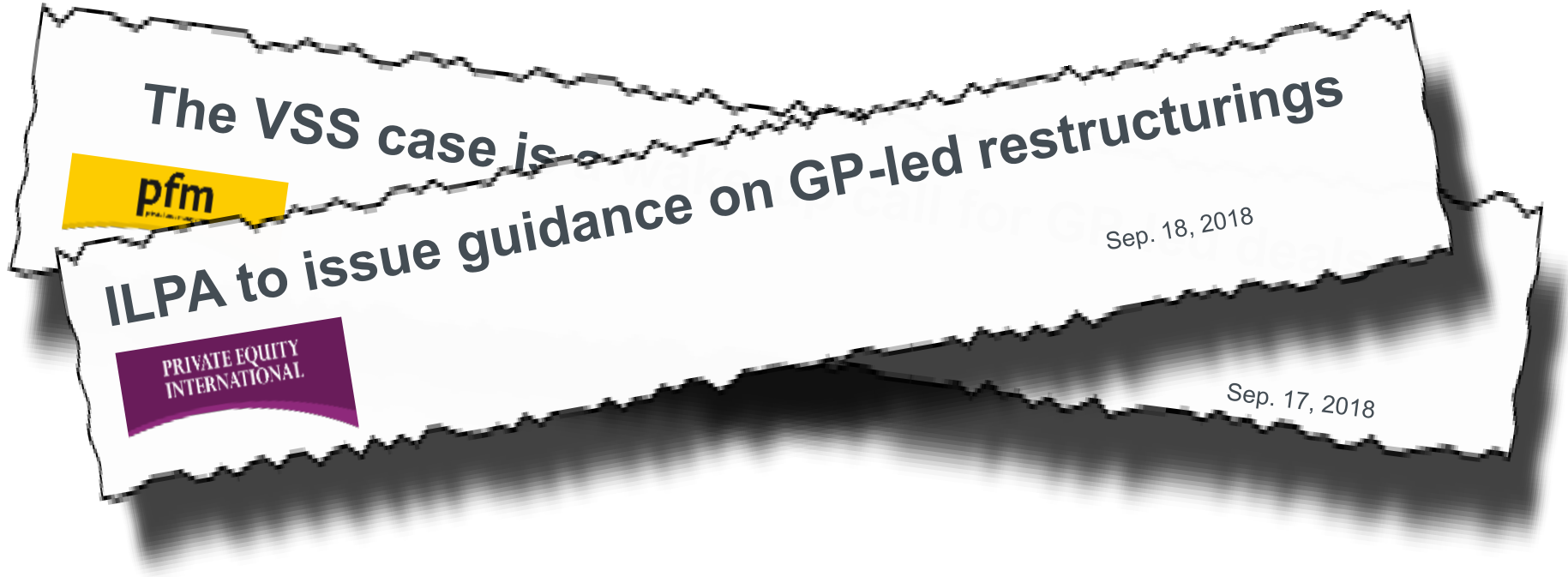
GPs must be completely transparent on valuations and the underlying performance of the portfolio – actual and projected

Existing LPs given full information and sufficient time

Other Considerations

- Intermediaries are often engaged to find Buyer LPs and help with message, LP communications, election process, etc.
- Very little of the disclosure and other legal documents will be “off the shelf”
- Certain segments of the LP community have voiced oppositions to these transactions and have been challenging to work with
 - Important to identify these LPs very early and work through the issues the structure, terms, election process etc. that are important to them
 - Important to engage the LPAC early in the process.

What the Future Holds



Certain US Tax Reform Considerations

- **New ECI Withholding Regime**

- 10% withholding obligation on sale of certain partnership interests by non-US sellers
- Increased diligence requests (including historic K-1s)
- Partnership liability for under-withholding

- **Carried Interest Taxation**

- Increased holding period for long term capital gain treatment (3+ years rather than 1+ years)
- Consider SPV (rather than direct asset purchase) in order to “tack” existing holding period

- **Expanded CFC attribution rules**

- may impact decision about where to form SPV (if restructuring)
- New Fund partners may impact CFC classification of non-US portfolio companies

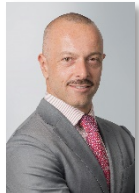
Contacts



Howard Beber

617-526-9754

hbeber@proskauer.com



Bruno Bertrand-Delfau

+44.02072802126

BBertrand-Delfau@proskauer.com



Mike Suppappola

617-526-9821

msuppappola@proskauer.com



Brian Huber

617-526-9675

bhuber@proskauer.com

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