Morgan Lewis

2017 ANNUAL PRIVATE FUND INVESTORS ROUNDTABLE

Certain Trends in Secondary Transactions

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CERTAIN TRENDS IN SECONDARY TRANSACTIONS

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Topics

- Tender Offers
- Funds-of-One
- Stapled Secondaries
- Earnouts
- Deferred Purchase Prices

Secondary Transactions (Generally)

- Involve the transfer of the ownership of an investor’s interests in private funds for a purchase price and the assumption of responsibility by the buyer for the remaining unfunded capital commitments of the funds.
- May involve one fund or multiple funds (portfolio transaction).
- Because private funds have transfer restrictions, secondary transactions usually require the consent of the GP of the underlying funds.

Tender Offers

- Potential buyer proposes to purchase up to a certain amount of the investments of the existing LPs of a fund.
- Either initiated by interested buyers or by managers seeking to restructure their funds or provide liquidity opportunities to investors.
- Raise unique considerations.

Tender Offers

- Manager Involvement
  - Private equity fund managers initiating a tender offer play a much more active role than in traditional secondary transactions.
  - Conflicts of Interest and Risk Disclosure – what is the extent of a manager’s role (current investors vs. potential buyer; maximizing price vs. stapled primary commitment, etc.)?
  - Fiduciary Duties – selecting buyer, approving price, negotiating terms of offer.
  - In the context of tender offers arising from fund restructurings, the GP may have conflicts if investors have to choose whether to sell interests in the fund to a third party (at a discount) or roll over interests to a new vehicle with new terms.

Tender Offers

- Allocation of Expenses
  - Broken deal costs – does the fund bear them or only the investors participating in the tender?
- Timing Considerations
  - Sufficient number of sellers to close?
  - GP has an incentive to recoup costs as quickly as possible; if a seller closes before other participants, it may be asked to repay more than its share of expenses.
- Structuring Considerations
  - Potential buyer should diligence whether (and how many) investors opted out or have been excused from certain investments, elected to participate in certain structures for tax reasons, or waived certain rights for regulatory reasons.

Tender Offers

- Baseline Pricing
  - Nonparticipating investors may gain useful information on the value of their interests and may shop around.
- Lack of Appetite
  - Potential buyers may be unable to purchase their desired investment amount.
  - If a buyer is making a stapled primary commitment, it may reduce its primary investment as a result.
- Lack of Control by Seller
  - Sellers often have less leverage, since they do not initiate the sale, run the process, draft initial documents, or select brokers.

Tender Offers

- Control of the Fund by Buyer
  - Is the buyer obtaining a controlling stake of the fund?
  - This magnifies the default risk by a buyer on the fund and increases the voting control of that buyer (e.g., removal rights, amendments, and other major decisions).
- Legal Considerations Due to Buyer’s Level of Ownership
  - HSR issues
  - ERISA issues
- Role of the Advisory Committee
  - Important in mitigating conflicts and representing interests of the investors.
  - Approving the broker, the buyer, the price, expense allocation procedures, and transactional documents.

Funds-of-One

- Different Forms
  - One investor purchasing all the interests in a fund-of-one
  - One investor purchasing all the interests in a commingled fund
  - Multiple investors purchasing all the interests in a fund-of-one
- Revising the Partnership Agreement
  - Voting rights, advisory committee, governance, and other considerations
- Side Letters
- Legal Issues from Concentrated Ownership (e.g., ERISA, HSR)
- Tax Structure

Stapled Secondaries

- Stapled Secondary: When the GP conditions its consent to a transfer on the buyer making a primary commitment to a new fund.
- Tends to reduce the price a seller can obtain from a buyer.
- GP faces conflicts of interest, as the requirement for a buyer to commit to a new fund may adversely affect the price a current investor can obtain by selling its interest in an existing fund.
- In the context of tender offers, a GP may be incentivized to steer the offer to a particular buyer or negotiate terms that are less favorable to the seller to secure a commitment from a buyer for the new fund.
- In 2015, SEC officials indicated at industry conferences that these transactions may face increased scrutiny by the SEC.

Earnouts

- Earnout: a method for a seller to maintain upside in an existing portfolio by continuing to receive a stream of profits from a fund even after it sells its interest in the fund.
- Generally negotiable, with no “market” terms established yet.
- Usually for a specified term or profit share period and only applies after a buyer achieves a hurdle rate (e.g., return of capital plus a preferred return thereon).
- True-up/reconciliation mechanism may be necessary (e.g., if earnout is paid but there is subsequent poor performance).
- Seller will often want materials and documents to verify that it was paid the appropriate amount.
- Buyer may have to agree to certain covenants on its operation (e.g., no transfer of the interest) to secure the seller’s earnout rights.
- GP agreement to earnout process (e.g., irrevocable instruction to pay).

Deferred Purchase Prices

- Deferred Purchase Prices: At closing, 100% of the interest is transferred to a buyer, but only a portion of the purchase price is paid at closing, with the remainder payable at some agreed-upon time after closing.
- Seller effectively becomes a creditor of the buyer and often seeks to include certain terms in the Purchase Agreement as a result.
- Most frequently, these additional terms include (1) financial covenants, (2) acceleration events, and (3) default penalties.
- These additional terms are fact-specific, depending on the buyer, the length and amount of deferment, and other relevant factors, and are often highly negotiated.

Deferred Purchase Prices

- Financial and Other Covenants (Negotiable)
  - Delivery of financial statements
  - Notice of default under Partnership Agreement
  - Judgments against buyer
  - Noncompliance with law
  - Maintenance of minimum capital (either as a covenant or a reserve account)
  - Continuation of legal existence
  - No sale or transfer by buyer of the interest until deferred purchase price is paid
  - Parent guarantee (sometimes)
  - Perfected security interest (sometimes)

Deferred Purchase Prices

- Acceleration Events (Negotiable)
  - Uncured breach of financial covenants
  - Breach/default under the Purchase Agreement or Partnership Agreement
  - Default on other debt
  - Judgments against the buyer over certain amounts
  - Insolvency, bankruptcy, dissolution, or change of control of the buyer or its GP
- Possible Default Remedies (Negotiable)
  - Interest payment
  - Acceleration of deferred purchase price
  - Transfer back a portion of the interest
  - Prohibition on distributing capital to the buyer's investors unless owed amounts are paid