

Morgan Lewis

# SECONDARY AND LIQUIDITY SOLUTIONS WEBINAR SERIES

Limited Partner Secondary Sales 101  
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# Presenters



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# Background

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# What Is a Secondary Transaction?

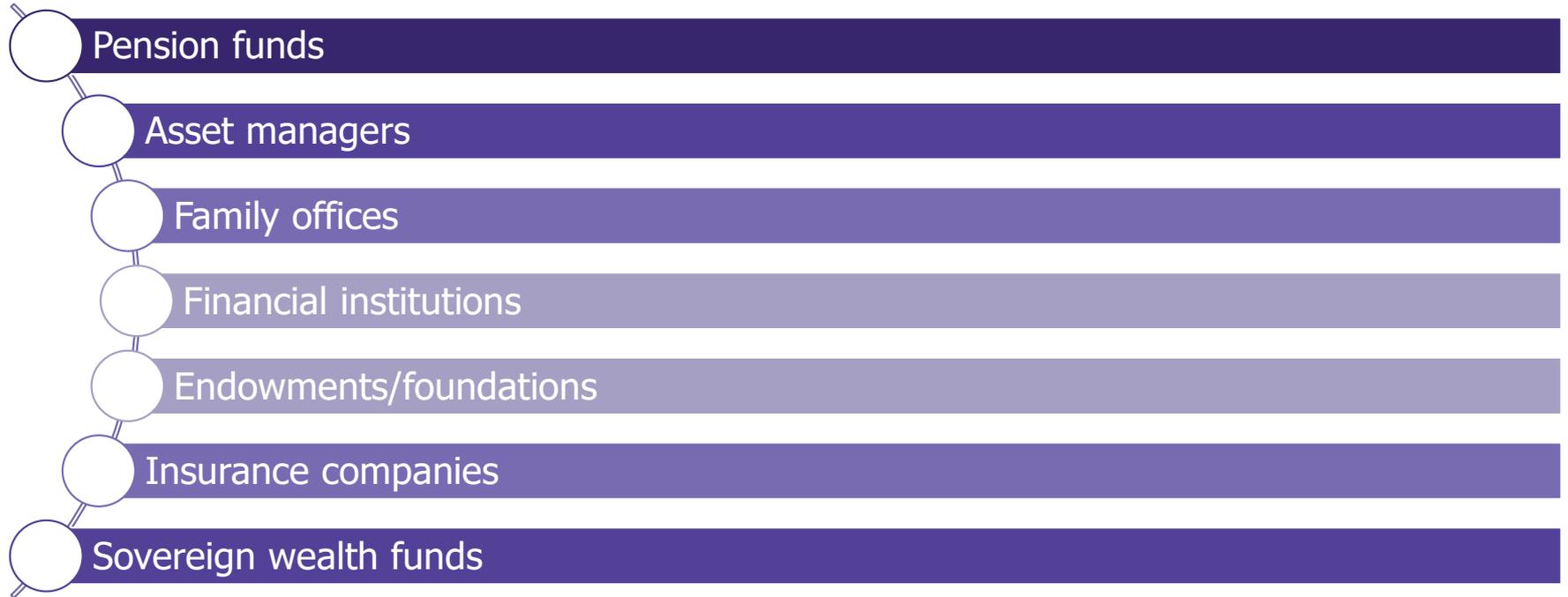
- ❑ Involves the transfer of the ownership of an investor's interests in private funds for a purchase price and the assumption of responsibility by the buyer for the remaining unfunded capital commitments of the seller to the funds
- ❑ Allows limited partners (LPs) to exit early from their investments
- ❑ May involve one fund or multiple funds (i.e., a portfolio transaction)
- ❑ Secondary transactions usually require the consent of the general partner (GP) of the underlying funds
- ❑ The secondary market exists principally to provide liquidity in an otherwise illiquid asset class

# Reasons for Selling

## Why do investors sell assets in the secondary market?

- Private fund assets are generally illiquid asset classes – investors aim to achieve early liquidity
- To rebalance portfolios – by investment stage, investment type, or geography
- To comply with regulatory demands
- To consolidate GP relationships
- Financial distress
- Lock-in gains from older vintage funds
- Advantageous pricing
- GP-led transactions – GP offers liquidity options to its existing LPs to secure additional time and funding to maximize the value of its unrealized portfolios

# Sellers by Type

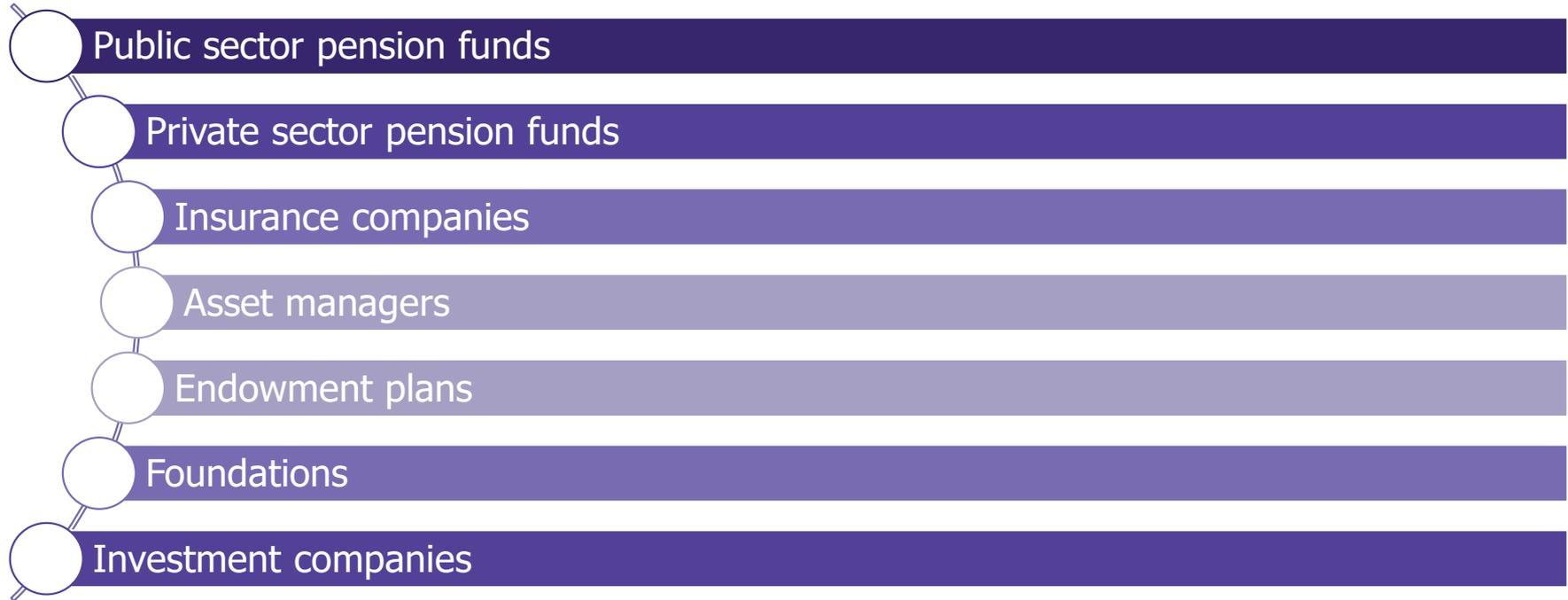


# Reasons for Buying

## Why do investors buy assets in the secondary market?

- Generate attractive returns with significantly lower risk
  - Mitigate the “J”-curve
- Diversify their portfolios
- Gain insight into individual GPs for potential future investments
- Access to oversubscribed funds
- Advantageous pricing

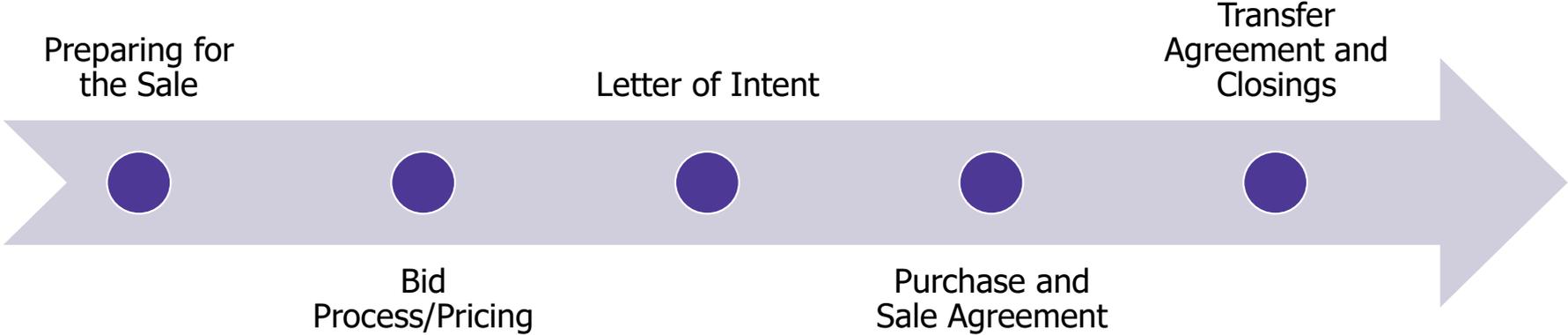
# Buyers by Type



# Stages of an LP-Led Secondary Sale

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# Stages of a Secondary Sale



# Stage 1: Preparing for the Sale

- **Seller identifies goal of secondary sale**
- **Seller reviews and confirms governance/authority structure to effect sale**
  - Board or CIO
- **Seller determines timeline for sale**
  - Secondary transactions generally close at quarter end
  - Planning should begin one to two quarters before target closing, especially for large sales
- **Seller assesses institutional resources and support**
  - Large transactions tax internal investment, legal, and operational staff
  - Confirm support to engage outside experts, i.e., broker/advisor and outside counsel

# Stage 1: Preparing for the Sale

- **Seller identifies the interest or portfolio of interests to be sold**
- **Seller engages a broker/advisor and enters into an engagement letter**
  - Identify roles and responsibilities (auction process, contacting managers, handling the NDA process, data-room hosting)
  - Transaction-based fee (structure, fee tail on termination, treatment of deferred deals)
  - Representations and warranties (including compliance with laws and private placement rules, FINRA membership, anti-money laundering (AML) and anti-bribery representations)
  - Termination rights
  - Indemnification (of both the broker and the Seller if the broker commits a “bad act”)
- **Broker provides feedback and potential pricing on contemplated portfolio**
- **Seller or broker engages in discussions with GPs, seeks initial consent**
  - Maintaining relationship with GPs important to the process

# Stage 1: Preparing for the Sale

- **Seller and broker gather all documentation relating to each interest to be sold and set up data room (fund governing documents, subscription documents, financials, prior 3 years K-1s, “material” correspondence)**
- **Seller and broker identify any special circumstances**
  - Alternative investment vehicles and blockers
  - Special feeders
  - Opt-outs from particular investments
  - Pending liquidations or distributions
  - Tax withholding (e.g., non-US sellers)
- **Seller and outside counsel develop form of purchase and sale agreement (PSA)**
  - Tailor outside counsel’s form as needed to reflect unique concerns of seller based on local law, policy, or portfolio
  - Broker shares final form in data room for view by potential buyers

# Stage 1: Preparing for the Sale

- **Seller and broker manage NDA process with potential buyers**
  - Prospective buyers will often be obligated to sign a confidentiality agreement to limit the disclosure of certain types of information
  - Managers may limit disclosure of confidential information about their fund to a specified list of prospective buyers
  - Seller as an LP in a fund is typically required to maintain the confidentiality of the fund's performance and portfolio information and cannot disclose confidential information without the manager's written consent
  - Final NDAs must comply with terms previously agreed to by managers at time of consent
  - Broker conducts a bid process for potential buyers
  - Bids detail interests proposed to be purchased and the purchase price
  - Often entails a round of PSA markups from potential buyers to gauge which buyers are serious and which buyers will be more difficult in negotiations

# Stage 1: Preparing for the Sale

## Compliance with the LPA

### Disclosure of Confidential Information

Sellers are expected to provide buyers with financials, governing documents (LPAs, sub-books), and potentially side letters. Buyers are expected to execute NDAs in order to access confidential information. Global NDAs are common, although some managers will require bespoke NDAs.

### Closing Timeline

Quarterly, semi-annually, or at month's end. Parallel negotiations of purchase agreements and transfer agreements are common. Minimum threshold for closing is less common – instead, parties agree to use "reasonable best efforts" to close by a certain date.

### Notice Periods

Many managers have a notice period (e.g., 30 days), which may be waived.

### Transfer Expenses

Payment of GP transfer expenses is often a condition to closing. As a practical matter, consider how invoices will be paid before closing.

### ROFRs

Factor in timeframe for running any ROFR. If the ROFR is not exercised, the seller typically has a certain period in which the transfer must be completed or the ROFR must be run again.

### Legal Opinions

Most partnership agreements require a legal opinion; however, this requirement is almost always waived by the manager if the parties can provide customary representations.

# Stage 1: Preparing for the Sale

## Process Reminders

1

### Deal Volume

- Larger portfolios
- Less negotiation of transfer documents
- Slower GP responsiveness
- Rolling closings more common than in years past
- Stapled commitments to new funds as a condition to approving transfers more common

2

### AML/KYC

- Condition to closing
- AML checks common on both buyer and seller at time of transfer
- Frequently handled by a third-party administrator
- Premium on early outreach

3

### Publicly Traded Partnership (PTP) Considerations

- Multiyear delays due to PTP
- Early notification to manager essential to be in the best position for on-time closing
- Partial transfers common
- Maintain ongoing communication with the GP for potential PTP openings
- Some GPs use QMS process

# Stage 1: Preparing for the Sale

## Process Reminders

4

### Tax Withholding

- Buyers may have withholding obligations under sections 1445 and 1446(f) of the Code if a seller is not from the United States. GPs will also be focused on this
- Sellers should look to their tax advisors early on in the process to determine what ECI/FIRPTA certificates can be provided

5

### Lender Consent

- Some lenders now requiring approval over LP transfers

6

### Pre-Existing Manager Relationships

- Provide greater deal execution certainty

# Stage 2: Pricing of the Interests

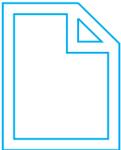
Buyer and seller negotiate the price of the LP interest(s)

Where buyer is purchasing multiple LP interests, the parties need to address confidentiality and strategic issues in connection with the pricing allocation of LP interests (significant assets / ROFRs and ROFOs)

Buyer may need to buy nonstrategic assets to acquire the desired portfolio

# Stage 3: Letter of Intent

A **Letter of Intent** is often used in a privately negotiated sale whereby a purchase price may be referenced along with an exclusivity clause that restricts the seller from shopping the LP interest to other buyers while the buyer is conducting its due diligence.



Other transactions proceed using less formal term sheets but may make execution less certain.



Generally not binding, other than the confidentiality, exclusivity, and expense clauses.

# Stage 4: Purchase and Sale Agreement

Agreement between the seller and buyer whereby they agree to the purchase price, terms of the sale, and fund interests to be sold.

## Purchase Price:

- Typically based on the value of the LP interest as of a particular “reference date/valuation date” and increased for any capital contributions made by the seller (including management fee payments) made after the “reference date/valuation date” and reduced by any distributions made by the fund to the seller after the “reference date/valuation date.”
- Purchase price may reflect a certain discount or premium to the NAV of the interests.
- Some deals have deferred purchase prices where a portion of the purchase price is paid at an agreed-upon date after closing.

# Stage 4: Purchase and Sale Agreement

## Seller Representations and Warranties:

- Due authorization, valid existence and good standing
- Good title to LP interest free and clear of liens (with certain carve outs)
- No conflicts with respect to seller contracts, applicable laws, governing documents, etc.
- No default under the LPA or other operative fund documents and not required to return any distributions
- No voluntary or prepaid capital commitments
- Funded all capital calls timely and not excused from any investments
- No loans or other indebtedness to funds
- No undisclosed contributions to AIVs or blockers
- Anti-money laundering representations
- Provided complete copies of the fund documents and side letters to buyer, as well as certain financial documents
- No knowledge of litigation or claims that would delay sale of LP interest or have adverse effect on fund LP interest
- Not subject to bankruptcy proceedings
- Sophisticated representation re: valuation of interests
- Interests not being sold on public market; no general solicitation

# Stage 4: Purchase and Sale Agreement

**Buyer Representations and Warranties:** Same authorization, compliance with laws, etc., representations as seller, and the following buyer-specific representations and warranties:

- Status as accredited investor, qualified purchaser and professional investor
- No view toward resale of interests
- Buyer has had opportunity to ask for all relevant information regarding interests
- Sufficient funds

**Survival of Representations and Warranties:**

- Authorization and title representations typically survive until dissolution and final distribution from funds
- Representations re: broker fees typically survive until expiration of applicable statute of limitations
- All other representations and warranties typically survive for one to two years
- In the event that a representation or warranty is breached willfully or intentionally or is due to fraud, it will typically survive for the maximum period under applicable law

# Stage 4: Purchase and Sale Agreement

## Covenants:

- Mutual cooperation
- Seller to provide buyer with notices of distributions and capital calls
- Seller to provide buyer with other notices (e.g., claims relating to interests)
- Seller negative covenants (e.g., no disposition of interests, no voluntary contributions, no waiver of any rights with respect to interests)
- Treatment of GP-led transactions that arise in between signing and closing (e.g., how buyer and seller determine “roll/sell” elections)

## Closings:

- Required to close in one closing, or are multiple closings permitted?
- Outside date after which no more transfers may occur (potentially subject to extensions for interests delayed due to PTP or other issues)

# Stage 4: Purchase and Sale Agreement

## Excluded Obligations:

- Those liabilities that seller retains after the sale of the interests
- Examples are:
  - Liabilities arising from breach of seller of fund documents
  - Obligations to return distributions received by seller prior to the reference date/valuation date (sometimes with time limits)
  - Taxes of seller
  - Acts or omissions of seller prior to closing
  - Deferred fees and carry relating to periods prior to the cut-off date

**Excluded Interests:** Interests that are not transferring due to (i) mutual agreement of buyer and seller, (ii) manager unresponsive or unwilling to consent to the transfer, or (iii) a ROFR preempting the transfer.

- The PSA will typically provide that the corresponding LP interest that could not be transferred is removed from the sale with the aggregate purchase price being reduced accordingly
- If a manager is unresponsive or unwilling to consent to the transfer, buyer and seller may elect to proceed with an assignment of economic interest in the LP interest – this is not a common mechanism, in part because underlying fund LPAs may have restrictions on “indirect transfers” and/or transfers of economic value
- Some sellers may seek to exclude interests which are subject to withholding tax.

# Stage 4: Purchase and Sale Agreement

## Indemnification:

- Each party to indemnify the other for losses arising from:
  - Failure to perform covenants or obligations
  - Inaccuracy or breach of representations or warranties
  - Taxes of such party
  - Claims by manager regarding failure to perform or breach of representations
- Seller also indemnifies buyer for losses arising from:
  - Excluded obligations
  - Involvement of broker
- Indemnification limitations:
  - Cap (e.g., 100% of final purchase price)
  - Floor (e.g., 1% of final purchase price) – tipping basket vs. deductible
  - Depends on nature of deal and portfolio
  - Certain carveouts for breaches of fundamental representations, breaches of covenants, excluded obligations, and obligations assumed by buyer
- Indemnification obligations to GP arising from losses in connection with transfer typically split 50/50 between buyer and seller unless they are as a result of one party breaching its representations in the transfer documents

# Stage 4: Purchase and Sale Agreement

## Conditions to Closing:

- Mutual:
  - Other party's representations and warranties are true
  - Other party has performed all agreements/obligations and complied with all conditions
  - No legal proceedings in effect questioning validity of PSA
  - All approvals obtained
  - Other party delivers closing certificate re: first two conditions above
  - Other party has delivered transfer documents
  - Other party has not rescinded authorization
- Seller conditions also include payment of purchase price
- Buyer conditions also include delivery by Seller of FIRPTA / ECI certificate (or W-9), as applicable
- Sometimes conditions include minimum number of transfers, minimum amount of NAV of overall portfolio, or certain specific interests to be included in the first closing of a portfolio sale

# Stage 4: Purchase and Sale Agreement

## Contractual Earnouts

### Earnouts (not common)

- **Earnout:** Method for the seller to maintain upside in the existing portfolio by continuing to receive a stream of profits from the 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)

# Stage 4: Purchase and Sale Agreement

## Deferred Purchase Price Deals

**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.

# Stage 4: Purchase and Sale Agreement

## Deferred Purchase Price Deals

### 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 the Buyer of the interest until deferred purchase price is paid
- Parent guarantee (sometimes)
- Perfected security interest (sometimes)

### Acceleration Events (Negotiable)

- Uncured breach of financial covenants
- Breach/default under the Purchase Agreement or Partnership Agreement
- Default on other debt
- Judgments against Buyer over certain amounts
- Insolvency, bankruptcy, dissolution, change of control of 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 Buyer's investors unless owed amounts are paid

### Credit Protections for the Seller (Negotiable)

- Security interest (in fund interest, in SPV, in cash flows?)
  - UCC filings
- Guarantee
- Equity commitment letter
- Escrow
- Contractual remedies
  - Representations and warranties
  - Covenants – what limitations are there on the Buyer's business?
  - Events of default

# Stage 5: Transfer Documents

## Transfer Agreements

- Agreements between the buyer, seller, and GP whereby they agree to the transfer of the specific LP interests and the GP of each fund consents to such transfer
- Each GP has its own form of agreement
- Buyer and seller have limited negotiating leverage

## Subscription Agreement/Investor Questionnaire

- Buyer completes subscription agreements for each fund in which it is purchasing LP interests

## Transfer Agreement Terms:

- **Alignment with PSA:** Add language providing that as between buyer and seller, the PSA governs in the event of any conflict between transfer documents and PSA
- **Indemnification:** Buyer and seller try to narrow indemnification obligations (a) to breaches of representations in the transfer documents (rather than losses arising from transfer generally) and (b) so that they are on a several, but not joint, basis
- **Expenses:** Attorney fees of manager typically split 50/50 between buyer and seller. Payment of attorney fees sometimes a condition to closing transfer
- **Disclosure:** Buyer may need disclosure rights with respect to fund information, especially if the buyer has its own reporting obligations (e.g., if the buyer is a fund of funds / 40 Act Fund)
- **Release:** Sellers often ask the GP to be released from their obligations after the transfer. GPs are often disinclined to grant a release, at least without heavy carveouts.

## Closing Occurs

# **Additional Considerations**

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# Managing Uncertainty



## Letter of intent

- Binding and/or more detailed
- Diligence of buyers and financings
- Broken-deal expenses?



## Timing of execution

- Delaying the signing of a purchase agreement
- Simultaneous sign-and-close
- Parallel negotiations of purchase agreements and transfer agreements



## Representation and warranty insurance



## Closing conditions – “MAC” clauses



## Enhanced or earlier due diligence (especially for deferred deals)



## Possibility of stapled commitments to new funds as a condition to approving transfers in existing funds



## Potential increase in syndication of portfolio sales to diversify risk (assignment rights more important)



## Other transaction structures

- Deferred purchase price deals
- Contractual earnouts

# Governmental Pension Plans as Sellers

## Indemnity Limits

(1) No indemnification; (2) indemnification limited “to the extent permitted by applicable law” or to “available sources of funds under state law”; (3) indemnification in the PSA limited to a certain defined sum, although may be difficult to limit indemnification for typically uncapped liabilities (such as fraud, breach of fundamental representations, and excluded obligations); (4) assignment agreement issues; (5) representation and warranty insurance.

## Sovereign Immunity

No waiver of Eleventh Amendment Rights; Governing Law; Dispute Resolution; Remedies

## FOIA/Disclosure

Possibility of PSA and terms being disclosed; trade secret exemption; competitive concerns

## Excused Investments

Seller opt-out of any investments (e.g., due to policy or legal reasons) may impact pricing; better to identify early in the process

# Other Considerations

- **Buyer Qualification Issues**

- Qualified purchaser status
- ERISA status
- Hart-Scott Rodino/Merger Analysis/Competition law analysis
- Non-US Local Ownership Issues (national security considerations, energy funds, FCC considerations, etc.)
- Investment Company Act issues (look-through of 3(c)(1) funds)
- Bank Holding Company Act issues

- **Publicly traded partnership issues**

- **Stapled Transactions**

- 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
- May be combined with a fund recap or tender offer
- 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

# Selling a “Seller SPV”

Certain types of sellers may own the underlying portfolio through a seller-controlled SPV.

## Consent Process

- **Parties do not need to go through the entire process of negotiating underlying fund transfer agreements**
  - Can potentially be a workaround for any underlying GP that will not consent to the transfer or whose consent is delayed due to PTP concerns
- **Notice vs. Consent**
  - Review underlying fund transfer provisions—do they restrict “indirect” transfers?
  - What underlying interests are key to the deal?
- **Set up a process for notifying/obtaining consent of underlying GPs**
- **What happens if an underlying GP objects to a transfer before or after closing it?**
  - Termination right
  - Disgorgement of underlying interest

## PSA and Other Considerations

- **Other PSA Considerations**
  - Hybrid purchase and sale agreement covering the seller and the portfolio
  - M&A-style diligence on the seller (concerns about inheriting the liability of the seller)
- **SPV governing documents and administration**
  - Buyer takes over SPV
  - Seller continues managing SPV
    - Level of control?

# Selling Through a Tender Offer

## ▶ Structural Considerations

- Minimum closing thresholds and timing of sale
- Diligence of investment structures

## ▶ 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 Documents

- Negotiation of form PSA with GP
- Renegotiation of the LPA
- Disclosure Memorandum

## ▶ Buyer's Level of Ownership

- EU Foreign Direct Investment screening, ERISA, FCC, and CFIUS issues
- HSR or other Filings?

## ▶ Lack of Appetite and Baseline Pricing

- Non-participating investors may gain information on value
- Potential buyers may be unable to purchase desired investment amount. If the buyer is making a stapled commitment, it may reduce its primary investment as a result

## ▶ Role of 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

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**Ted** advises clients on a range of private fund–related matters across asset classes with a particular focus on fund transactions. He has a significant background advising on both sponsor-led and investor-led secondaries transactions, including the sale and purchase of portfolios of private fund interests and continuation vehicles. He also advises clients on co-investments, complex fund-to-fund transactions, preferred equity solutions, and manager formation and investment.

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**Tayne** focuses her practice on the private investment fund industry, including fund formation, separate accounts, secondaries, and co-investments. Tayne has developed a market-leading transactional practice on all types of secondary deals on both the buy- and sell-side. Tayne also provides legal and transactional advice to leading international fund managers on the structuring, formation, and launch of commingled funds and on more bespoke discretionary and non-discretionary investment management arrangements across a variety of jurisdictions and asset classes (e.g., infrastructure, private equity, funds of funds). She also represents sovereign wealth funds and institutional investors in co-investments and separate account negotiations.

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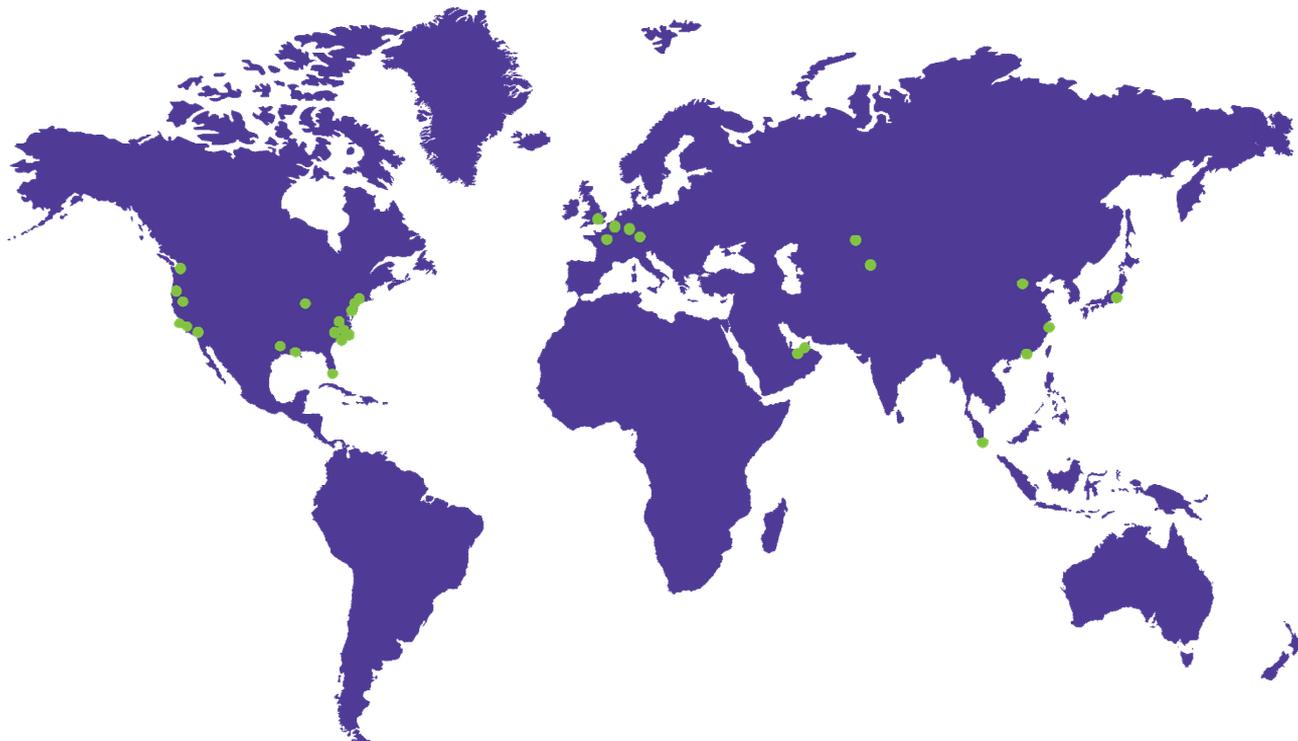
**Oli** advises global private investment managers investing funds across multiple strategies including venture and growth, private equity, private debt, funds of funds and impact. He has wide-ranging private investment fund experience, which includes fund restructurings, secondary transactions, and co-investments, as well as providing counsel on management operations, carried interest arrangements, and co-investment schemes.

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