Reuters Legal News

Countdown to launch: top 10 considerations in GP-led secondary deals

By Fadi Samman, Esq., Krishna Skandakumar, Esq., and Amanda Butler-Jones, Esq., Akin Gump Strauss Hauer & Feld LLP

MARCH 2, 2022

This article explains 10 key launch considerations in a GP-led secondary deal and includes some tips for buyers, sponsors and investors.

"GP-led secondary" is an umbrella term referring to liquidation transactions instigated by fund managers or sponsors (i.e. asset managers, GPs or private fund managers); such transactions allow managers and sponsors to continue to manage an existing portfolio of assets in a newly formed vehicle – often with new investors. They are called secondary transactions because they involve trading interests in existing funds and assets (*c.f.* new or primary issues of fund interests).

GP-led secondary deals can be executed in a variety of ways, such as an asset sale (single or multi-asset), strip sale, fund restructuring or tender offer, amongst others.

The sponsors and fund managers work with existing investors to sell or transfer a portfolio of assets (which the sponsor currently manages and the existing investors indirectly own) to a newly formed fund with capital from new investors as well as existing investors who desire to continue to hold the assets -- while allowing other existing investors to cash out of their existing arrangements.

Most GP secondary transactions have three key features. First, existing fund investors are offered a liquidity option with respect to one or more fund assets to either cash-out or remain invested through a new vehicle. Second, new investors (or "buyers') inject fresh capital into a newly created fund vehicle (i.e., the continuation fund), which will acquire the target assets from the selling fund. Finally, the sponsor walks a "tightrope" trying to balance their own interests, the interests of their existing investors and the buyers.

1. Selecting a deal type

GP-led secondary deals can be executed in a variety of ways, such as an asset sale (single or multi-asset), strip sale, fund restructuring or tender offer, amongst others. These transactions often include optional elements which address a particular need of a sponsor. For example, a multi-asset continuation fund can be used by a manager whose fund is in liquidation or nearing the end of its term to continue to hold a portfolio of assets which the manager believes that, with continued active management, can unlock additional value for investors (and itself).

Sponsors considering a GP-led secondary should always consult with their advisors to identify the best method of executing a fund liquidity solution.

2. Tax structuring and diligence

Like most transactions, tax structuring and diligence form a key consideration for all parties involved. Buyers and sellers in traditional secondary sales of LP stakes typically focus on the withholding analysis and negotiating tax covenants and rarely undertake extensive due diligence of the fund assets. However, GP-led secondary transactions require a more detailed analysis.

In addition to structuring the continuation fund in an optimal (i.e., tax neutral) way for new investors, sponsors need to consider the roll option for those existing investors electing to participate in the continuation vehicle, as well as the sponsor. This roll option can be potentially structured as a tax-free roll (whereby investors retain their original cost basis and do not crystallize gain or loss) or an after-tax roll (whereby the rolled amount is net of any tax withheld or payable). Determining the viability of these options involves a detailed tax analysis which should always be undertaken at the start of a transaction.

3. Conflicts, consents and amendments

GP-led secondary deals require careful consideration of conflicts of interest in light of the sponsor's role on both the buy and sell side. To manage conflicts, sponsors should review the operating agreements, offering documents and other fund documents, including side letters, prior to launch. These documents can provide guidance on the approach to nonresponsive investors, advisory committee voting requirements, the scope of claw-back obligations, whether a waiver of specific rights of first refusal is required, and more.

Sponsors are encouraged to engage with investors and advisory committees as early as possible in secondary transactions and in a transparent fashion. Too often, sponsors engage with investors too late in the transaction. In addition, it is critical for sponsors to continually take the temperature of investors as market conditions can influence an investor's decision throughout the transaction process.

Existing investors should review their side letters, subscription agreements and other fund documents for consent and amendment rights, meeting and notice requirements, and anti-dilutive protections.

4. Pricing and valuation

Evidence of price discovery – evidence of the method and process by which the sponsor determined the sale price – is an essential part of the GP-led secondary process. This can be achieved through a variety of methods, including retention of a third-party advisor to conduct a competitive sale process and a comparison against other exit alternatives. Fairness opinions can also provide comfort on price.

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With the surge in volume of these transactions and influx of capital over the last few years, sponsors have become increasingly comfortable relying on extensive disclosure in conjunction with an advisor-run competitive process in concluding that the deal is "fair." More recently, some sponsors have leveraged traditional M&A processes to price part of a deal and use that price as the basis to transact a GP-led secondary with respect to the remainder of the portfolio.

However, the Securities and Exchange Commission has recently proposed a rule which requires sponsors in GP-led secondary transactions to obtain a fairness opinion.

5. Status quo option

Sponsors often offer existing investors the ability to roll their interest in the existing funds to the continuation fund on the same terms and conditions as the original fund — a "status quo" option — in part, to mitigate conflicts. The status quo option provides existing investors the ability to preserve their current arrangements and interest in the assets.

A status quo option can, however, create a free rider issue whereby existing investors benefit from the new capital injected by the buyers without contributing anything for the value accretion to the portfolio, especially where follow-on capital is needed.

6. Hidden costs of GP-led secondary deals

GP-led transactions involve different layers of fees and expenses, some of which can be easily missed by investors, or, in some cases, are not correctly priced into the deal.

For example:

- Transaction costs, such as the success fee payable to the transaction advisor, are either borne by sellers alone or shared between the buyers and sellers.
- Costs in structuring the continuation fund are often capitalized in the continuation fund's organizational expenses and should be priced into rolling investors' "net" position.
- Lead investors may also negotiate for their legal costs to be borne by the continuation fund.
- Representation and warranty insurance is being increasingly used in these transactions in lieu of traditional indemnities. The costs of these policies can be significant and are often borne at least in part by selling investors.
- An investor's own legal costs are not usually significant, but these costs are typically not capitalized into the transaction and are therefore borne by investors directly.

7. Asset level diligence

Legal diligence in GP-led secondary deals is limited when compared to traditional M&A deals, with a primary focus on title, tax, capitalization, regulatory approvals, transferability and financials. Buyers should not expect to have the opportunity to do a legal deep dive on the assets. Ultimately, alignment of interest between new investors and the sponsor is a key factor in the lighter legal due diligence approach.

8. Buyer requirements

Buyers in GP-led secondary deals typically negotiate for a number of protections and points of alignment.

For example:

- Where a roll option is offered to existing investors, buyers will set a minimum volume of selling investors as a closing condition.
- If multiple buyers are involved, buyers will require a clear priority of capacity allocation in the letter of intent or transaction documents.
- Buyers generally require sponsors to make a new commitment to the continuation fund and roll a substantial portion of the economics from the selling fund to the continuation fund to ensure alignment.

9. Offering considerations (regulatory)

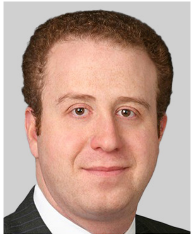
Unlike typical fund offerings, GP-led secondary deals are generally not caught by fund offering and marketing rules if structured appropriately. Typically, because there is no new "offering," investors are existing investors of the manager and/or the investors are all considered accredited or sophisticated under the appropriate regulatory framework. There are, however, a number of exceptions which require careful consideration before launching a transaction.

Sponsors should also be aware that GP-led transactions can trigger certain asset-level notice or consent requirements including, with respect to antitrust and merger control (Hart-Scott-Rodino Act), the applicable federal regulatory authority (FERC) and/or foreign ownership board (CFIUS). These filings may be required in both the jurisdiction in which the transaction occurs, as well as where the assets are operated or domiciled.

10. Transaction advisor

While it is possible to run a process without an advisor, GP-led secondary deals are time-intensive and complicated processes. A good advisor can lend credibility to the process and assist with structuring, negotiations and deal execution. In appointing a transaction advisor, sponsors should be aware of the key contractual terms of these agreements, including any applicable exclusivity periods, tail and success fees, confidentiality obligations, indemnity packages and termination rights.

About the authors



Fadi Samman (L) is a partner in **Akin Gump Strauss Hauer & Feld LLP**'s Washington, D.C., office. He represents domestic and international fund sponsors in connection with organizing, structuring and operating private investment funds, including private equity funds, real estate funds, venture capital funds, fund of funds, secondary funds and hedge funds. He advises institutional investors in connection with their investments in private investment funds, including acquiring and selling those investments on the secondary market. He can be reached at fsamman@akingump.com. **Krishna Skandakumar** (C) is a senior counsel in the firm's New York office. He advises private equity and real estate managers and sponsors throughout the life cycle of an investment arrangement and on all aspects of the establishment, operation and liquidation of private funds and companies across various asset classes with a focus on private equity, infrastructure, real estate and secondary transactions. He can be reached at kskandakumar@akingump.com. **Amanda Butler-Jones** (R) is a counsel in the firm's Washington, D.C., office. She focuses primarily on the formation and operation of domestic and offshore private investment funds, including hedge funds and private equity funds. She also represents institutional investors in connection with their investments in private investment funds, including acquiring and selling those investments on the secondary market. She can be reached at abutlerjones@akingump.com.

This article was first published on Reuters Legal News and Westlaw Today on March 2, 2022.