



Role of the Secondaries Market and LP Trends

November 4, 2009

AKIN GUMP
STRAUSS HAUER & FELD LLP



Trends in Secondary Fund Transactions in the Current Market





The Current Environment

- The secondary market for private equity fund interests has grown in lock-step with the dramatic growth of the private equity industry
- Many are expecting that the financial crisis will continue to drive a dramatic growth in the secondary market
- The current crisis and dramatic growth in this market are presenting new issues that sellers, buyers and GPs should consider



Limited Partner Defaults

- Increase in both actual and threatened LP defaults as some have had difficulty meeting capital calls due to liquidity issues
- As market conditions improve, capital calls will resume at a normal (if not accelerated) pace, which may crystallize liquidity issues
- Buyers will want to enhance their due diligence with respect to LP defaults
- Buyers will also want to ensure seller is not in default and confirm from GP that it will receive an “interest in good standing”



Seller Solvency

- With many LPs being distressed sellers, additional due diligence and representations and warranties may be warranted
- Buyers should confirm -
 - Solvency of seller
 - Whether seller has pledged the interest to a lender
 - Any consents or other issues with lenders
 - Whether seller has created any other liens on the interest
- Buyers should also ensure that seller will be able to satisfy indemnity claims post closing either through -
 - Covenant not to dissolve
 - Parent/affiliate guarantee



LP Giveback Obligations

- Many are predicting an increase in fund indemnity claims which may lead to GPs invoking the LP giveback provisions
- Buyers, sellers and GPs should carefully examine how these giveback provisions operate to insure proper allocation and coverage of this liability
- Typical options include -
 - Buyer assumes 100%
 - Allocation based on the investment and relative distributions
 - Allocation based on time



Additional Due Diligence

- Buyers are conducting additional due diligence not only on fund assets, but on the fund itself
- Issues that some buyers are focusing on -
 - Fund liquidity and potential need for supplemental capital
 - The GP commitment and how it's funded
 - Stability of the deal team and key person status
 - GP clawback obligation
 - Interim GP communications
- GPs should carefully consider the scope of their involvement in the due diligence process



Limited Partner Defaults





Limited Partner Defaults

- LPs commit to provide capital (usually within 10 days) when called by the GP
- Failure to provide capital when called endangers existing fund positions in portfolio companies and limits opportunities to make new investments
- Uncertainty may force GP to overdraw which reduces IRR



Current Investment Environment

- 2008 financial meltdown has had a severe impact on LPs
 - Denominator effect caused by drop in public markets resulted in an over-allocation to private equity
 - Lack of private equity distributions impaired investors ability to fund current capital calls
 - Long term solvency issues caused by significant losses
 - Reluctance to contribute additional capital to what may be perceived as poor investments



Avoiding LP Defaults

- Reduce aggregate fund commitments
- Reduce LP capital commitments
- Drawdown early
- Drawdown more capital than required
- Defer capital calls
- Borrow defaulted amount
- Offset amounts otherwise distributable to LPs
- Opt-out provisions on future investments
- Facilitate sale of LP interest
- Permit withdrawal by LP



Sources of Guidance for GPs Facing LP Defaults

- Fund agreement
- Side letters and other agreements
- Applicable laws
 - Partnership / LLC law (fiduciary duties)
 - Applicable contract law (enforceability of remedies)
 - ERISA, securities and tax laws
 - Other defenses that defaulting LP may raise



Typical Remedies for LP Defaults

- Declare the LP in default
 - Undue delay in issuing notice may be considered a waiver
- Withhold defaulting LP distributions
 - Provided there are distributions to withhold
- Impose penalty, interest charges
- Sue for specific performance and consequential damages
 - Traditionally, GPs have been reluctant to sue LPs
 - Enforceability of default remedies is not entirely clear
- Reduce defaulting LP's capital account
- Attempt to sell defaulting LP interest on secondary market or to other LPs
- Note: potential limitations in the event of LP bankruptcy



Key Considerations for GPs

- Work through alternatives
 - Prevention is preferred alternative
 - Importance of maintaining LP communications
- Fiduciary duty owed to other LPs
 - GP must act in good faith and deal fairly with the fund
 - English and Cayman Islands laws require GP to act in utmost good faith
- Initial course of action with a defaulting LP may set precedent with other LPs
 - MFN provisions may limit extent to which defaulting LPs may be treated differently
- Reduction in fund size may impact the number and types of investments the fund can make in the future
- Existing credit facilities: does default require notice or acceleration of loans?
- Consider obligations to portfolio companies
- Consider any effect on D&O insurance
- ERISA considerations
- Broker-dealer and investment adviser issues in facilitating transfers
- Note: limitation in the event of LP bankruptcy



Brett A. Gordon

Managing Director, HarbourVest Partners, LLC

Brett Gordon is a member of HarbourVest's secondary investment team. He joined HarbourVest in 1998 as an analyst after receiving his MBA, became a principal in 2003, and was promoted to managing director in 2008. Brett is one of the leaders of the secondary team, focused on the purchase of U.S and non-U.S. investments in limited partnerships and portfolios of direct investments. Brett currently serves on the advisory boards of partnerships managed by American Capital Equity Management, Jerusalem Global Ventures, Macquarie Advanced Investment Partners, Vitalife Partners, and the valuation committees of EnerTech Capital and TL Ventures. Brett's previous experience includes serving as a vice president for The Princeton Review of Boston, Inc., where he managed all operational functions of the organization and was responsible for long range strategic planning. He received a BS in Management (magna cum laude) from Boston University in 1990 and an MBA (summa cum laude) from Babson College in 1998.

About HarbourVest

HarbourVest Partners, LLC is an independent global alternative investment firm and an SEC-registered investment advisor. HarbourVest provides investment programs for institutional investors to invest in venture capital, buyout, mezzanine debt, distressed debt, and real estate. HarbourVest invests in these sectors globally through primary partnerships, secondary purchases, and direct investments. HarbourVest and its subsidiaries have 235 employees, including 82 investment professionals deployed in Boston, London, and Hong Kong. In over 25 years of investing in private equity, the team has committed \$21.7 billion to newly formed funds, representing relationships with 200 private equity managers. The team has also completed \$6.2 billion in secondary purchases and invested \$3.7 billion directly in operating companies. The firm's clients consist of 250 institutional investors, including pension funds, endowments, foundations, and financial institutions throughout the U.S., Canada, Europe, Australia, and Japan. To learn more about HarbourVest, visit www.harbourvest.com.

Trends and Opportunities in Hedge and Private Equity Fund Investing

Karl Hartmann, Esq.

Managing Director
Franklin Park

Karl is the Chief Operating Officer of Franklin Park. Karl co-founded Franklin Park in 2003 and has nine years of private equity industry experience. Previously, Karl was Vice President at Hamilton Lane, where he was responsible for reviewing and negotiating all legal documentation for the firm's partnership investments and was a member of the due diligence group. Prior to that, he practiced law with Harris Kessler & Goldstein in Chicago, where he concentrated on corporate, real estate, tax and business formation issues. He received a J.D. from Loyola University of Chicago and a B.A. from the University of Notre Dame. He is a member of the State Bar of Illinois.

Trends and Opportunities in Hedge and Private Equity Fund Investing

Brian Mooney, CFA

Managing Director
Cogent Partners, L.P.

Mr. Mooney is a Managing Director and co-founder of Cogent Partners and has over 10 years of secondary market experience. Previously, Mr. Mooney was part of the investment team at The Crossroads Group (now part of NB Private Equity Partners and Neuberger Berman), where he focused on secondary acquisitions as well as primary and equity co-investments.

Mr. Mooney holds an M.B.A. from Columbia Business School and a B.B.A. in finance from the University of Texas at Austin. Mr. Mooney is a CFA charterholder.

FADI G. SAMMAN, Partner
fsamman@akingump.com

Washington, D.C. T (1) 202.887.4317
F (1) 202.887.4288

Practice Areas: **Investment Funds**
Private Equity
Distressed Real Estate Asset Services
Corporate

Fadi G. Samman is a partner in the Washington, D.C. office of Akin Gump Strauss Hauer & Feld LLP and is a member of the investment funds and private equity practices.

Mr. Samman's practice focuses on the domestic and international private investment funds industry, representing fund sponsors in connection with the organization, structuring and operation of private investment funds, including private equity funds, real estate funds, venture capital funds, fund of funds, secondary funds and hedge funds. Mr. Samman also advises institutional investors in connection with their investments in private investments funds, including the acquisition and sale of those investments on the secondary market. His clients include KK daVinci Advisors, Grove International Partners, GE Capital, Oak Hill Investment Management, Warburg Pincus and AllianceBernstein, among others.

Mr. Samman also represents his investment fund clients in connection with their investment activity, including leveraged buyouts, joint ventures and minority equity investment transactions. In particular, he has represented private equity and venture capital funds in connection with numerous preferred stock investments in technology and emerging growth companies. Mr. Samman also regularly counsels emerging growth companies from their initial start-up phase through multiple rounds of financing, strategic growth and exit opportunities.

Mr. Samman received his B.A., cum laude in English from Georgetown University in 1996 and his J.D. from the University of Michigan Law School in 1999. He is a member of the Maryland, District of Columbia and Virginia bar associations.



Bar Admissions

District of Columbia
Maryland
Virginia

Education

J.D. University of Michigan Law School, 1999
B.A. Georgetown University, 1996

WILLIAM L. STURMAN, Partner
wsturman@akingump.com

New York T (1) 212.872.1035
F (1) 212.872.1002

Practice Areas: **Private Equity**
Investment Funds
Corporate

William L. Sturman advises financial institutions and boutique firms as sponsors of leveraged buyout, international private equity, merchant banking and other private investment funds on a wide range of fund formation and regulatory issues, as well as on seeding arrangements for early generation funds and fund managers. In addition, Mr. Sturman advises investors in private equity funds and has extensive experience advising on investment professionals' carried interest arrangements.

Mr. Sturman received his B.S. with honors in 1988 from Boston College, his J.D. in 1995 with honors from Suffolk University Law School and his LL.M. in 1996 from the New York University School of Law.



Bar Admissions

New York

Education

LL.M. New York University School of Law, 1996

J.D. Suffolk University Law School, with honors, 1995

B.S. Boston College, with honors, 1988