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Capital and Liquidity Solutions for Private Equity Funds

By Nathalie Duguay, Phillip Isom, Arash Farhadieh, Mark Proctor, Solomon Wifa, Raphael Bloch, Colin Fulton, and Kevin Kim

The recent COVID-19 pandemic has caused many private equity sponsors (GPs) to assess their options for providing liquidity to portfolio companies, especially when these portfolio companies are held by older vintage funds that have insufficient undrawn or recyclable capital commitments. At the same time, many GPs are facing increasing requests from investors in their funds to provide liquidity.

This article summarizes certain funding options that may be available.

GP-Led Secondaries and Continuation Funds

GPs looking for a long-term liquidity solution may wish to sponsor a new fund, known as a "Continuation Fund," that would acquire and continue to hold interests in one or more pre-identified portfolio companies held by existing funds. Generally, a Continuation Fund will be anchored by one or more institutional investors that specialize in investing in secondary transactions and fund restructurings. These anchor investors usually will subscribe the majority of interests in the Continuation Fund, while a certain amount of the interests in the Continuation Fund will be made available to investors in the existing funds. If possible, existing fund investors who elect to participate in the Continuation Fund may be provided an opportunity to invest via a tax-free "rollover" of their existing fund interests, with potentially different carried interest terms. Existing fund investors that do not wish to participate in the Continuation Fund generally will receive a payout from the existing funds in respect of those portfolio companies that are acquired by the Continuation Fund. A portion of the capital committed by investors to the Continuation Fund will be used to fund additional investments in the portfolio companies as they are needed.

Such GP-led Continuation Fund transactions have become more common over the past several years because they offer GPs the opportunity to realize additional value by both holding their portfolio companies longer (to potentially sell in a better market) and investing additional capital to drive further improvements, while offering liquidity to existing fund investors who are seeking more immediate cashflow from their investments. In addition, Continuation Funds offer GPs the ability to accelerate the realization of all or a portion of their carried interest in respect of the investments that are rolled over.

Over the past few years regulators and certain limited partner groups, such as the Institutional Limited Partners Association (ILPA), have been critical of Continuation Funds and similar transactions primarily because of the potential conflicts of interest relating to such transactions, which arise from the fact that the GP is on (and often controls) both sides of the sale of portfolio companies from existing funds to a Continuation Fund. These conflicts of interest need to be addressed, including by (1) obtaining the necessary consents from the investors or the limited partner advisory committee (LPAC), of the existing fund and (2) retaining a third-party consultant to opine on the valuation of the assets to be transferred and/or run an auction process (typically with the assistance of an investment bank) in order to provide a third-party arm's-length price for such assets. As part of the process, the existing funds will need to provide the Continuation Fund with representations, warranties and indemnities with respect to assets that are transferred. The existing funds' LPACs may wish to drive or oversee this process, given the inherent conflicts faced by the GP. LPACs may desire to retain their own advisors to help them perform their functions, which adds time, cost, and often complexity to the process.

Before assets can be transferred to a Continuation Fund, due diligence must be performed to determine whether there are any change of control issues with underlying portfolio companies. Additionally, in certain instances tender offers may be used to solicit existing investors to roll over into the Continuation Fund or sell their interests in the existing fund, which require compliance with the tender offer rules under the US Securities Exchange Act of 1934.

Offering New Fund Interests

GPs may consider offering additional interests in an existing fund as an option to obtain additional capital, although this will most likely require consent from the limited partners to amend the fund's governing documents. Additional interests may either be offered as the same class of interests held by existing investors in the fund (that is, *pari passu interests*) or as preferred securities, which pay a fixed amount to new investors in priority to the fund's existing waterfall. An offering of *pari passu* interests requires the GP to address a number of issues and conflicts of interest. Chief among these are the valuation of the underlying portfolio in order to establish the subscription price for the offered interests (which may be challenging given the volatility in the current markets) and dilution of interests of the existing investors. Because of these issues, it is preferable in many instances for the fund to issue preferred interests.

As mentioned above, the principal legal hurdle for issuing new fund interests is that the fund's existing limited partners will need to consent to amend the fund's governing agreements to implement the arrangement. This consent may be challenging to obtain if the existing investors are concerned that the additional capital may reduce the potential returns or put at risk built-in gains on the fund's existing portfolio investments.

Aside from the consent issue, the issuance of preferred interests has certain advantages for GPs including, among other things: (1) the relative ease of implementation; (2) the lack of the need to obtain a third party valuation and mitigation of some of the conflicts of interest inherent in issuing *pari passu* interests; (3) limited dilution associated with the issuance of preferred interests; and (4) the elimination of the need for changes to the fund's distribution waterfall (other than those changes required to allow for priority distributions to the preferred interest holders and perhaps adjustments to diversification or follow-on capital limits). It should be noted that follow-on investments made with the capital provided by the preferred interest holders may be invested as preferred securities in underlying portfolio companies so as to limit dilution of the existing investors' indirect interests in the portfolio companies. There are a number of financial firms that specialize in investing in preferred equity interests in private equity funds and their portfolio companies.

Top-Up Funds

As an alternative to (or in combination with) the fund-level financing, GPs may wish to create a separate top-up fund that would invest additional capital in some or all existing portfolio companies, at the GP's discretion. Generally, the investors in the existing fund would be afforded a right of first refusal to invest in the new top-up fund, with new third party investors taking up the remaining capacity.

Raising a top-up fund can present its own set of complexities in implementation and management of potential conflicts of interest. For instance, if the top-up fund invests in the same class of portfolio company securities held by existing funds, its investment will be dilutive to the existing funds. This raises the same valuation and dilution issues as described above in connection with the issuance of new *pari* *passu* interests in the existing fund itself. These issues can be mitigated in a similar fashion if the top-up fund invests only in preferred securities issued by underlying portfolio companies. Unlike with issuing additional interests in an existing fund, the GP must fully negotiate the top-up fund's documentation with investors, which may include side letter requests, a "most favored nation" election process, etc., potentially resulting in a more lengthy capital raising process. This can be mitigated by using the existing fund's documentation as the basis for the top-up fund insofar as there is substantial overlap between the investors. The top-up fund option provides the GP with more flexibility in establishing economic terms for capital committed to the new top-up fund.

NAV or Asset-Based Facilities

Net asset value (NAV), or asset-based, facilities may be a viable alternative for GPs managing older vintage funds with limited available capital commitments. Generally, a NAV facility is a credit facility that is non-recourse to the fund and secured by pledging the fund's interests in all or some of its portfolio companies, and the proceeds from the NAV facility, when drawn by the fund borrower, will be used to provide additional capital to its portfolio companies. The fund's governing agreements should be carefully reviewed to ensure that entering into such NAV facility is permitted and is consistent with the terms of the governing agreements, relating to, among other things, recycling, borrowing, diversification, and follow-on investment limitations. In addition, the governing documents of each portfolio company must be reviewed to ensure that the fund is permitted to pledge its portfolio company securities. If not, consent will need to be obtained from the board or, potentially, other owners, of the portfolio company. To the extent there are certain tax exempt investors in the fund, a tax analysis should be undertaken to assess whether the use of such a NAV facility would generate UBTI.

Preferred interests, described above, have several commercial advantages over the use of NAV or asset-based facilities: preferred interests generally have no maturity date or fixed required payments, are paid only out of investment proceeds when those amounts are received and distributed by the fund, and have limited covenants. However, it is generally more expensive to issue preferred interests (that is, investors require a higher rate of return) than it is to borrow under NAV or asset-based loans.

Other Alternatives

Where GPs anticipate imminent exits from certain of their funds' portfolio investments, they can seek fund-level amendments to permit adjustments to recall and reinvestment provisions, including extending relevant time periods; raising caps on follow-on investments and diversification limits; and, in certain situations, permitting recycling of gains (subject to tax considerations). These alternatives should be examined before, or in connection with, any of the other alternatives mentioned in this article as they are generally faster and easier to implement.

Conclusion

Valuation will be a key determining factor in the GP's ability to provide additional funding to the portfolio companies, whether through accepting additional commitments to the fund, through establishing a top-up fund or a Continuation Fund or putting in place a NAV facility. GPs who wish to pursue a funding option that requires the consent of the fund's investors (or the fund's limited partner advisory committee) should, particularly given the current market uncertainty, communicate with all stakeholders early in the process, including by setting out the rationale for the transaction, delineating intended next steps and proactively responding to the concerns of their existing limited partners.

Ms. Duguay, **Mr. Isom**, **Mr. Farhadieh**, **Mr. Proctor**, **Mr. Wifa**, **Mr. Bloch**, **Mr. Fulton**, and **Mr. Kim** are lawyers in the Asset Management practice at Willkie Farr & Gallagher, LLP in New York, London, and Paris.