ALLEN & OVERY

GREAT FUND INSIGHTS

Great Secondaries – Liquidity from PE and other illiquid asset fund investments

Introduction

While the private equity secondaries market is a relatively mature one, in recent years we have seen an increasing number of institutional investors who have sought exposure to yield-producing illiquid assets, such as infrastructure, real estate and private credit, using the secondaries market to create liquidity from all parts of their illiquid asset fund portfolios. As investors adjust to the post-lockdown environment and start to prepare for the longer-term impact of the pandemic on their fund investments and, more broadly, the global economy, we are being asked more questions by investors who want to understand how they can reshape their portfolios of private equity and other illiquid private funds. With that in mind, we thought it would be helpful to recap the key legal issues that arise when an investor is seeking to create liquidity from its investments in private equity and other illiquid asset funds by seeking to transfer its fund interests to a third party buyer.

Typically, the funds in consideration here are closed-ended, whereby an investor has no right to seek redemption, but will have a right to transfer its interests, subject to the prior consent of the general partner or, as applicable, the manager (referred to in this bulletin as the **GP**). It is unusual for an investor (referred to in this bulletin as the **LP**) to have a unilateral right to transfer interests, other than as may have been pre-agreed with certain regulated LPs which can only invest in a closed-ended fund with that freedom (such right being documented in either the fund's limited partnership agreement or equivalent constituting agreement (the **LPA**) or that LP's side letter).

Certain non-private equity illiquid asset funds, such as those that invest in core real estate or operating infrastructure, or funds of illiquid asset funds, may offer LPs some sort of "vertical" liquidity, ie a hard right to redeem (the timetable for which is generally set at least a year or two after the receipt of the redemption request due to the illiquidity of the assets) or a right to merely request redemption (the timetable for which is at the GP's absolute discretion in order to balance the interests of the redeeming and remaining LPs). However, even where such a right to redeem or request redemption exists, the uncertain timetable for redemption means that the "horizontal" liquidity offered by transferring interests is often the preferred option for many LPs.

Executive summary

Looking beyond Covid-19, LPs want to understand how they can reshape their illiquid private equity and other fund portfolios. This bulletin sets out the key legal issues for LPs to consider when seeking to sell (or indeed buy) fund interests, including: sharing fund-level information with potential buyers; ensuring that fund marketing laws are complied with; due diligencing the fund interests; negotiating the SPA (including structuring the price mechanism); allocating LP/carried interest clawback risks; and implementing a coordinated strategy to obtain GP consent. Understanding the key legal issues, structuring solutions and collaborating between the parties are the keys to succeed in what are increasingly complicated transactions.

Key Legal Issues

1. Confidentiality

All LPs will be subject to stringent confidentiality obligations in the LPA, limiting to whom information relating to the fund can be passed to. More modern iterations of those obligations often include a carve-out for situations in which an LP is seeking to transfer its interests but is subject to the potential buyer(s) entering into equivalent confidentiality undertakings.

Accordingly, any LP seeking to sell its interests will need to ensure that all potential buyer(s) enter into a confidentiality agreement prior to the seller passing over any information about its underlying fund interests. That confidentiality agreement should seek to use the rights of third party provisions applicable under its governing law or an equivalent mechanism (eg holding confidentiality undertakings from the potential buyer on trust) to allow the GP and its affiliates to have similar recourse to that potential buyer as they have to the selling LP under the LPA (and will have in relation to the buyer if it ultimately acquires those interests).

On a portfolio sale, and notwithstanding the use of a confidentiality agreement, a seller has to balance the risk that some of its confidentiality undertakings are breached because they do not contemplate transfers against the processes of reviewing the confidentiality undertakings in all of the LPAs and, where applicable, seeking the GP's waiver ahead of engaging with potential buyers. That can create a tension where the seller may be in breach through not obtaining the waiver and then later in the process having to seek the GP's consent to transfer its interests (as discussed below).

2. Prohibitive fund marketing laws

In offering a buyer the opportunity to purchase its fund interests, a seller may be seen in the potential buyer's (or its manager's) jurisdiction to be marketing that fund. Typically, the potential buyer, as an institutional investor, or its manager as a regulated person, is within a financial promotion exemption. However, this issue should not be ignored.[1]

3. Due Diligence

There can be different approaches to due diligence. Some sellers in a portfolio sale may take the position that the potential buyer(s) (especially through an auction process) will lead on conducting legal due diligence. In other situations, the seller may lead the due diligence so as to better understand the nature of the legal process it will have to work through with the eventual buyer.

Due diligence can cover a range of different areas, but the key focus points are:

– the GP's consent requirements, ie whether they are based on the GP having an absolute consent right, or a consent right not to be unreasonably withheld or delayed, and the process for getting the required consent (eg timetable, requirement for any legal opinion as to suitability for proposed transferee, etc);

– whether the seller is put into a joint and several liability position with the transferee (see discussion below);

– whether the transfer provisions in the LPA also seek to capture indirect transfers (ie where the beneficial interest, rather than the legal interest, in a fund is being transferred), as this is something that is not always clear in the drafting. In some situations, it may be that a portfolio sale is structured as a sale of the LP of record itself and for the seller and buyer to seek to deal only with GP consents that capture indirect transfers (albeit updated, KYC/AML information would need to be provided in relation to the new owners of the LP);

– provisions for covering the costs (including legal fees) of the GP in giving any consent – some LPAs provide for a pre-payment of a set amount before the GP will consider any consent;

– whether an undrawn commitment (ie the unfunded component of the seller's interest) is required to be proportionally stapled to the interest being transferred;

– LP clawback mechanisms and how they operate (see discussion below);

– what covenants of the seller under the LPA remain with the seller after the transfer, eg tax liabilities and indemnification obligations (see discussion below);

– any pre-emption rights in the hands of other LPs (albeit those are now less common in modern LPAs);

– where the fund has established any alternative investment vehicles, whether interests in those vehicles are stapled to the main fund's interests being transferred; and

– any side letter rights that the seller has in place and whether those can be assigned to the buyer, eg whether fee discounts attach to the seller's interest, which is a common issue for a GP to contend with and one that a buyer has often modelled into its calculations when pricing the interests (see discussion below).

Undertaking due diligence of the fund's underlying investments is a less common exercise, typically because the seller does not have the relevant information and the GP will not be willing to share it. It can occur in relation to a co-investment (but often the fund in question is an LP in the co-investment and so it is treated as a greater exposure to that relevant investment). It may also occur where there is a sale of a single fund interest and the fund has a significant exposure to a particular asset or an asset which is in distress, an issue that many GPs will be struggling with in the current climate.

[1] Allen & Overy's affiliate, aosphere LLP, offers an online subscription service, Marketing Restrictions – Asset Management, which provides colour-coded summaries of the law and regulation applicable to cross-border marketing of funds and asset management services in 70+ jurisdictions. Click here to find out more or to arrange a free trial: https://www.aosphere.com/aos/mr-am

4. Transfer Documentation – the Golden Triangle

From a documentation perspective, any transfer of a fund interest involves at least three distinct limbs:

(i) the sale and purchase agreement between the seller and buyer or its equivalent (the **SPA**);

(ii) the form of the consent between the GP and the seller (and sometimes the buyer as a party); and

(iii) the contract between the buyer and the GP by which the buyer agrees to adhere to the LPA as the transferee (the **Adherence Agreement**).

Where all or part of the seller's side letter is being transferred, or the seller requires certain side letter rights (eg for regulatory or reporting reasons), there would also be the new side letter to agree.

5. Clawback

In most LPAs, an LP is at risk of being required to repay amounts to meet the fund's liabilities from distributions previously received, which are typically (but not always) linked to the investment which gave rise to the distribution. The LP clawback provisions in an LPA can be difficult to navigate and may be drafted so that liabilities can be met either by drawing down an undrawn commitment or by clawing back prior distributions. Most LP clawbacks have a time cap applied such that distributions can only be clawed back within a certain period of time since the date of the distribution (eg within two years), subject to that cap being switched off where in that period the GP puts the LP on notice of litigation or another event that means a liability will need to be met. There are a number of different ways in which the seller and buyer can allocate the LP clawback risk, and this is often a point of significant focus in an SPA.

Another issue to consider (albeit one that is often overlooked) is carried interest clawback. Where a fund has paid out carried interest on previously realised investments and, subsequent to the buyer becoming an LP, there is a clawback of that carried interest on a later true-up date (including through an LP clawback), the buyer may disproportionately benefit because the agreed purchase price for the transferred interest was calculated on the value of unrealised investments only (and not previously realised investments). A well-advised seller may look for a mechanism to protect itself against that risk and, again, there are a number of different ways in which the parties can allocate that carried interest clawback risk.

6. Key issues in the SPA

Exchange and staggered transfers

To manage the fact that the timetable for any GP's consent is outside the control of the seller and buyer, the SPA will normally be structured to provide for a series of transfers of fund interests when GP consents are received, usually with a long-stop date. Typically, transfers completed over time are batched into distinct closing dates under the terms of the SPA. There may be a sweep-up mechanism to deal with situations in which a GP will not give its consent, or its consent has not been received by the long-stop date. In a portfolio sale there may be mechanisms to require that certain identified fund interests, and/or a certain proportion of the portfolio, are transferred at the first closing date, and that this must be within a prescribed time, otherwise the buyer can walk away.

Sale price

The requirement to obtain the GP's consent to transfer fund interests means that the SPA should address how the purchase price for the interests is to be calculated and paid. That calculation needs to take into account that, in the period after the date on which that price is agreed (which may be the exchange date or an earlier date) and before the buyer becomes an LP in the fund, the seller may be required to pay into the fund amounts of its remaining undrawn commitments (which the buyer will then benefit from). In addition, if an LP clawback is applied, the seller would need to return prior distributions (which the buyer may then benefit from – see discussion below), and the seller may receive distributions from the fund (which the buyer will not benefit from). It is a commercial point, but typically the purchase price is increased on a dollar-for-dollar (or equivalent currency) basis for capital contributions and similarly reduced for distributions.

The second element is timing for payment. Typically, on a portfolio sale, the purchase price is allocated across the relevant fund interests to be transferred and, as they are transferred, the purchase price for that interest is payable (subject to the adjustments mentioned above). In some cases, the seller may require the buyer to pay the full purchase price upfront and then the seller will return amounts at the long-stop date, to the extent interests cannot be transferred. The latter structure creates more tension on the buyer engaging in the GP's consent process but can affect pricing (particularly in an auction process).

Obligations to get the GP's consent

Any successful transfer of a fund interest, particularly with a portfolio sale, is a team effort involving the seller and buyer working together in a coordinated manner to get all required GP consents, provide all documentation in relation to the Adherence Agreement (eg KYC/AML information), and sort out new side letter arrangements and the other elements of the sale. In a seller choosing an eventual buyer there is often a clear bias towards buyers who have the experience and resources to make the interaction with a series of GPs as easy as possible and to therefore maximise the number of interests being transferred. Obtaining a GP's consent is further complicated when a buyer (often a secondaries fund manager) seeks to split the transferred interests in a fund across a number of vehicles it manages. Therefore, the SPA should have a clear set of reciprocal cooperation provisions covering these areas.

Clean break – assumptions of seller's obligations

The seller may want to have a clean break such that the buyer simply takes over from the seller in relation to all future demands from the GP as if that buyer had been the LP from the time the seller became an LP. The buyer may not be willing to accept that position, and so typically the SPA will provide that the buyer will take on all obligations from each closing date, subject to a list of excluded obligations which will remain with the seller.

Those excluded obligations may include tax liabilities and indemnification obligations owed by the seller under the LPA and LP clawback obligations attaching to distributions made to the seller. The parties may agree, for example, that the seller will remain liable for any clawbacks made against the buyer after the closing date which relate to distributions received by the seller in a period (eg two years) prior to the closing date. However, LP clawback and carried interest clawback provisions can be areas for debate.

Care should be taken where an LPA has put the seller in the position of retaining liability for a transferee (eg for breach of warranties made by the buyer). In those situations, the seller will be reliant on seeking recourse from the buyer and so may want to consider the creditworthiness of the buyer (particularly in the longer term).

Tax, including transfer taxes

Due to the typically fiscally transparent nature of illiquid asset funds, tax matters can sometimes be given a less prominent consideration than they might receive when selling other investment assets. Typical issues that should be considered are:

(i) whether the seller is selling interests in a fund vehicle which is not suitable to the buyer (eg a feeder for U.S. tax-exempt investors where the buyer is or includes U.S. taxable investors);

(ii) whether the transfer of the interests itself will create a tax event, including any direct transfer tax (eg stamp duty); and

(iii) whether the nature of the underlying assets will create an indirect transfer tax event.

In real estate and infrastructure funds, indirect real estate transfer taxes can arise where fund interests are transferred and create liabilities at a lower level in a fund structure, which then need to be allocated to the seller or buyer. Otherwise, the tax liability is left with the fund as a whole, something that is often only picked up when the fund seeks to sell the underlying asset. Accordingly, any seller and buyer will need to consider how they allocate the tax risks associated with the sale of interests between them.

Seller's warranties

Typically, the seller will give only fundamental warranties, such as: due authorisation and capacity; free title to transferring interests; confirming the financial data and any other agreed information the buyer is relying upon (eg the amounts committed, drawn down, undrawn and distributed); compliance with the LPA, side letters and other fund agreements to which the seller is a party; lack of knowledge of any LP clawbacks; no litigation; and tax warranties. Those warranties may be time-capped and quantum-capped, and may also be subject to indemnification provisions.

All warranties from the seller and buyer will be repeated as at each closing date and typically there is a mechanism for the seller to provide information on post-exchange drawdowns, clawbacks and distributions that go to the adjustment to the different tranches of the purchase price payable for that closing date.

7. GP's consent

As discussed above, the LPA will normally contain detailed provisions covering how an LP may transfer its interests (with the term "transfer" being widely drawn to include assignments or create security interests such as pledges). Even where that consent is in the absolute discretion of the GP, from an investor relations perspective, the GP will generally want to facilitate liquidity for the seller, provided it does not adversely affect the other LPs in the fund or the GP and its affiliates.

As such, the seller and buyer, particularly in a portfolio sale, will want to prepare a clear explanatory pro forma letter to go to all relevant GPs, potentially including or making available all relevant KYC/AML information about the buyer. It may be that, as part of its relationship with the GP, the seller seeks assistance from the GP in relation to due diligence access for any potential buyer(s). In giving such assistance, the GP may enter into a hold harmless letter with the seller and any potential buyer(s).

In determining whether or not to give its consent, a GP will work within the terms of the LPA. That LPA will typically have a list of scenarios in which consent will not be given (or where it is not unreasonable to withhold consent). Those may include matters such as causing the fund to be licensed with a regulator, or creating ERISA issues (eg the fund assets being deemed "plan assets"), as well as generally wide sweep-up provisions. Those matters are not triggered typically in practice, but they still need to be worked through by the GP and its counsel (as well as the buyer or seller in its due diligence).

Two key matters that are frequently glossed over are subscription line arrangements and the risk that the fund may be treated as a "publicly traded partnership" (a **PTP**) under U.S. federal income tax rules.

(i) A fund's subscription line may be substantially reliant on the seller being treated as part of the lender's borrowing base and so the proposed buyer may affect the amount the fund can borrow under the line. It should also be noted that most subscription line facility agreements are strict on the GP updating the lender, and seeking the lender's consent, on transfers. This point is generally reinforced in the LPA but is, nonetheless, often missed. Therefore, all the parties involved in the "triangle" should be wary of seeking the lender's consent to the transfer.

(ii) With regards to PTP concerns, the rules are complex and beyond the scope of this bulletin. Broadly speaking, however, U.S. taxpayers benefit from holding investments on a flow-through basis, ie through entities that are treated as partnerships (or disregarded) for federal income tax purposes. A fund that is intended to be treated as a partnership for U.S. tax purposes may instead be taxed as a corporation if it is treated as a PTP, ie because its interests are: (a) traded on an established securities market; or (b) readily tradeable on a secondary market. The latter prong is a facts and circumstances determination which can present uncertainty other than where certain safe harbours and specific exceptions apply. For this reason, GPs tend to tread very carefully in determining whether a PTP risk may warrant refusing consent to a transfer (particularly if consents have only recently been given).

Finally, the actual consent between the GP and the seller should make sure the GP is obliged to implement any relevant formalities to give effect to the transfer, such as any public notices as to the seller ceasing to be an LP (ie is no longer a limited partner).

8. Adherence Agreement

The Adherence Agreement can be seen as a mere formality but it is akin to a subscription agreement (and typically started its life as one). Each fund will have a different Adherence Agreement and normally a buyer simply has to go through the laborious process of individually completing each in relation to any transfer. Things to watch for are the drafting and whether it clearly speaks to the buyer as a transferee and not as a subscribing investor, and to what extent the buyer, in agreeing to become an LP, is relying on materials originally prepared by the GP for primary investors and from which it raised commitments. With regards to the latter, the private placement memorandum for a closed-ended fund is often excluded from the list of reliance documents (and certainly should be from the GP's perspective, particularly where the transfer is taking place several years after the expiration of the fund's offering period, which is often the case).

9. Other points to note

Co-investment transfers

We mentioned at the outset that sellers sometimes seek to include co-investments they have made alongside a fund within a selling situation. That is possible but it requires initial due diligence on the terms of each co-investment where the transfer provisions are likely to have other constraints. Those can include rights of first offer (which will need to be complied with before any potential buyers are solicited) and/or rights of first refusal. There can also be pre-emption rights, drag-along and/or tag-along rights that need to be navigated. As such, in a portfolio sale situation, co-investments should only be included in the knowledge that seeking to create liquidity can be more cumbersome.

Synthetic secondaries

We have seen a significant growth in clients working with banks to create arrangements to transfer the economic returns on illiquid fund investments, using derivatives, trusts, assignments or other techniques. These can be used, on their own or as part of a clearing-off of those interests that are not able to be transferred by a long-stop date, to give a buyer indirect exposure to the seller's interests. However, those arrangements still need to go through the same analysis as to GP consent and involve the buyer taking credit risk on the seller or another person holding the relevant interests.

Next steps: applying these key issues to your scenario

When looking to create liquidity from private equity and illiquid asset funds, identifying the key issues is just as important as applying them carefully to your individual scenarios. Our Funds & Asset Management Group has extensive experience in reviewing, drafting and negotiating SPAs for private equity and other secondary transfers (both from a buyer's and seller's perspective), as well as navigating the requirements for purchasing and selling interests within limited timeframes.

We advise many of the world's best-known institutional investors, including sovereign wealth funds, pension funds, DFIs and insurance companies. We also advise a number of prominent GPs, so we are well-versed in navigating LPAs as we are frequently the ones drafting them. Our team, comprising over 70 specialist funds lawyers based in all major global financial centres, would be delighted to answer any questions you may have on these key issues, as well as assist you in the early planning stages of your secondary transfers.

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