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The Fellowship of the Fund: Zombies, Banks and the Appeal of Second-Hand Private Equity

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The last few years have witnessed enormous growth in the secondary market for interests in private equity funds and their portfolio companies. [1] Sales of "non-strategic" assets, the anticipation of regulatory reform, regulator- mandated sales and, more generally, greater interest among institutional investors in actively managing their portfolios have all helped to drive the market. Recent fund-raising activity by secondary managers attests to the recent strength of the market, as well as market expectations of continuing high levels of transaction activity.

The defining transactions in recent years include the sale of large fund portfolios by major United States financial institutions, including sales by Bank of America and Citibank N.A., which have largely unwound their once multi-billion dollar proprietary private equity fund portfolios. More recently, secondary players have assisted with the restructuring of millennial "orphan" or, more critically, "zombie," funds—purchasing funds or significant portions of the portfolios of funds launched in the early years of the millennium that were approaching, or had reached, their originally scheduled expiration dates.

These transactions are signs of not only the regulatory changes sweeping the industry, but also a maturation and increasing sophistication of the secondary market. In a world where most transfers of private equity fund interests continue to change hands in small, one-off transactions, larger, more complex transactions represent an increasing share of the market.

As the secondaries market evolves, prospective transactions are widely expected to involve sales by financial institutions, particularly European banks; institutional investors seeking to rebalance their portfolios, typically by paring individual names or positions; and, increasingly, secondary transactions that operate to close down or restructure funds that have reached or will soon reach their expiration dates. In a market defined by highly constrained private equity allocation limits, with demand for new products that still lags pre-financial crisis levels, each of these seller constituencies will drive the secondary market over the next few years.

Fund as Seller

All private equity funds seek to sell their portfolio companies. As the clock runs down, however, the ticking gets louder. In circumstances where the fund sponsor has suffered team losses, or is perceived as having insufficient resources to manage legacy portfolios, investors may seek to pressure the sponsor to sell more quickly than they might otherwise desire. Pressure can be brought to bear through advisory boards, threats not to extend fund terms, and more active discussions with well-capitalized, hungry secondary investment groups.

In "fund as seller" secondary transactions, transactions have typically involved the sale of interests in illiquid portfolio investments. The primary distinguishing feature of these transactions is the sale of all or substantially of such portfolio companies simultaneously, rather than the more gradual sale of individual portfolio companies. These sales can take the form of (i) sales of groups of portfolio company interests; (ii) distributions of interests in entities that hold illiquid assets; or (iii) distributions in kind to investors of interests in vehicles that own (a) retained assets and/or (b) interests in newly formed entities that are entitled to a continuing interest in particular assets that have been sold or recapitalized.

An interesting recent development has involved the sale of some or all of the actual fund, which is typically organized as one or more parallel limited partnerships. In these cases, the fund merges with newly formed limited partnerships, with a concomitant change of management and beneficial ownership of particular portfolio companies. This sale–through–merger process effectively introduces a common mergers and acquisition mechanism to transactions that had traditionally been regarded as immune to buyout transactions, let alone prospective squeeze-outs of hold-out investors.

While these transactions generally require majority or super-majority investor consent, motivated investor advisory committees (which routinely represent significant portions of a fund's overall capital) can help to herd the cats and generate support for the transaction among the broader investor base. It is interesting to note that one of the most recent transactions, which involved the sale of the illiquid holdings of a millennial buyout fund, received very high levels of investor support. To the extent that this transaction is a guide to broader market sentiment, it would appear that many limited partners welcome the chance to reduce their private equity exposure if pricing is reasonably strong (e.g., in a 90+ percent of NAV range, notwithstanding potentially deferred payments) and payouts occur more quickly than investors would otherwise expect.

Investor as Seller

While the secondary market is witnessing innovative approaches to the sale of mature portfolios, recapitalizations of zombie funds, and numerous variations on the theme of LP management team spinouts, stapled secondaries and equity syndications, the "investor as seller" transaction remains by far the most common form of transaction. Here, institutional investors seek to monetize their positions across multiple funds, alternative investment vehicles, co-investment funds and sometime managed accounts or managed account vehicles. The seller, either independently or with the assistance of financial advisors, seeks to identify prospective buyers and the highest purchase price. Constrained fund-raising markets mean that most placement agents have teams dedicated to assisting buyers and/or sellers and promoting secondary market liquidity. Bidding processes, whether or not subject to a formal auction process, are typically accompanied by preliminary terms discussions in order for the seller to identify the most compelling offers.

Transaction Terms and Potential Pitfalls

With growing transaction volumes and proliferating deal structures, key transaction terms remain consistent: Who will run the remaining portfolio? What kind of management fee and carry-reset, if any, will be required? How will indemnification obligations, including, in particular, the "LP clawback," be apportioned? What happens if some but not all of the assets in the portfolio are slated to change hands? How will rights of first offer or refusal affect the timing of the transaction and the composition of the portfolio? How will regulatory issues, such as the US Internal Revenue Code's "publicly traded partnership" rules, affect the transaction or the ability to complete a transfer in a given calendar year? What overarching indemnity baskets and caps will apply?

As ever, regulatory changes and macro-economic developments will continue to drive this important mechanism for reallocating capital devoted to private equity investments. Both GPs and LPs are advised to monitor developments closely in the months to come.

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[1] While this article focuses on private equity, the trends discussed here also affect interests in private real estate funds and the remaining illiquid side pocket and other illiquid investments that continue to be held by trading funds.

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Stephen's practice focuses primarily on representing sponsors of private equity, real estate, special situation and distressed investment funds, hedge funds and funds of funds with respect to the structuring, formation and operation of such fund products. Recent matters include private equity, US and non-US real estate opportunity and special situation fund products on behalf of global financial institutions and leading private fund managers. He also advises select institutional clients with respect to their investments in private funds and has extensive experience negotiating complex secondary transactions involving portfolios of fund and/or direct investments.

Stephen is regularly cited as a leader in the private funds industry; commendations include Chambers Global; Chambers USA: America's Leading Lawyers for Business in the area of fund formation; Legal 500 U.S.; The International Who's Who of Private Funds Lawyers; The Expert Guide to the World's Leading Private Equity Lawyers; The Expert Guide to the World's Leading Investment Management Lawyers and Best Lawyers in America.

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