PRIVATE EQUITY

Continuation Funds – The Rise of GP-Led Secondary Transactions & Managing Risk Transfer

Continuation funds have established a permanent presence in the private equity industry over the past few years as geopolitical tensions, a volatile public equities market, and a sluggish post-pandemic rebound have triggered underperformance in several industry sectors. Historically, structured secondary transactions were largely limited to "zombie funds" that were unable to find profitable exit opportunities for underperforming assets. Now, private equity (PE) sponsors are increasingly using the investment structure to hold trophy assets as an existing fund nears the end of its lifecycle. For limited partners (LPs), continuation funds have provided an attractive liquidity solution in an environment where fund terms have continually lengthened.

Representation and Warranty Insurance: Alternative Process, Same Benefits

The surge in secondary transactions has drawn strong interest and active participation from representation and warranty insurance (RWI) underwriters. Underwriters have been willing to modify their customarily rigid underwriting requirements/process to meet the unique nature of these transactions, and have even been willing to offer more favorable rates than those provided in traditional M&A transactions given the limited set of reps that are knowledge qualified at the PE sponsor level.

However, the benefits of RWI for continuation fund transactions are similar to those in a traditional M&A transaction:

Exiting LPs

- Avoid exposure to significant post-closing indemnity payments and claw-backs
- Lock-in proceeds from sale for faster distribution
- Reduce the time and money spent on negotiating indemnity provisions

New LPs

- Supplement or replace indemnity amount provided by the general partner (GP)
- Extend survival period of representations and warranties provided by the GP
- Distinguish bid by scaling back indemnity requests
- Avoid potentially significant claims against the existing GP

RWI underwriters conventionally rely on comprehensive third-party diligence reports provided by the buyer and an underwriting call to assess a transaction. This is not possible in a continuation fund transaction where new LPs typically rely solely on the historical performance and reputation of the PE sponsor when doing their analysis. As such, underwriters commonly ask for portfolio company governing documents, limited legal due diligence (i.e., a title and transferability report/analysis), a fund capitalization table, limited tax diligence at the fund level, access to the data room, and underwriting calls (one with the PE sponsor and the other with the lead investor of the continuation fund).

RWI has been a staple in the M&A industry for many years, but it wasn't until recently that PE sponsors started leveraging the product to shift specific risk exposures customarily negotiated between the transaction parties. Given the benefits to PE sponsors, it appears safe to say that continuation funds are here to stay, with the use of RWI likely going to become a standard feature of these transactions.

General Partnership Liability: Are continuation funds driving up your premium?

The growth in continuation funds has been so explosive that the insurance industry has been pressed to catch up. While underwriters recognize a continuation fund offers LPs the flexibility to either cash-out or continue to hold an asset, the complexity and often short notice of the transaction causes concern regarding potential LP litigation. The most fundamental issue underwriters have with continuation funds is how the PE sponsor manages the inherent conflict of interest in acting as both the "seller" (existing fund) and "buyer" (continuation fund) in the transaction. Generally, underwriters view the formation of a continuation fund as an increase in risk exposure and will consider the transaction with heightened scrutiny.

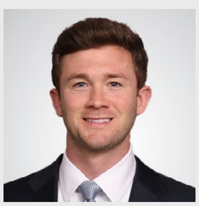
Outlined below is a short list of items our client PE sponsors have used to manage some of the potential pitfalls of a continuation fund:

1. <u>LP Advisory Committee.</u> The LP Advisory Committee is the first stop for vetting a continuation fund and addressing a potential conflict of interest. Specifically, the committee will explore why the continuation fund is the best option for existing investors. However, since the advisory committee members may also have a conflict of interest, this step alone is insufficient.
2. <u>Third-Party Valuation.</u> To determine a fair price for the asset, it is common to use a third-party to conduct a valuation. However, it can be an even better arrangement if another GP or institutional investor is brought in to set the price. Notably, the U.S. Securities and Exchange Commission ("SEC") has proposed a third-party fair price review as a necessary condition for any advisor-led secondary

transactions. In addition, the SEC may require GPs to disclose any material business relationships they, or others in their firms, have had with the third-party valuation provider in the previous two years.

3. Transparency. Be as transparent with LPs as possible throughout the process. Clearly outline the terms of the continuation fund and potential conflicts of interest, including how such conflicts are being addressed.

With the complexities of these transactions and potential for additional risk exposure to insurers, it's crucial to work with an experienced broker that can effectively navigate the market. Over the past few years, Risk Strategies Private Equity Practice has successfully guided our client PE sponsors through countless insurance renewals involving continuation funds. In doing so, our goal is to present our clients to insurance markets in the best possible light to deliver the most favorable policy terms, while providing underwriters with the transparency needed to get comfortable with these new exposures and appropriately assess the risk.



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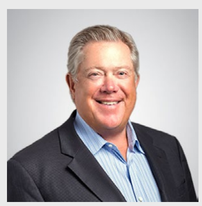

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