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Continuation Funds

Some Key Considerations

When Continuation Funds Are Used

Typically, continuation funds are used in two situations:

- where a manager is unable or unwilling to realise assets at (or near) the end of a fund's term, perhaps because those assets are problematic or distressed and there are no, or few, willing buyers prepared to pay the price being sought; or
- where a manager (and investors) wish to maintain exposure to certain assets, for example where they are of high quality or have reached maturity and may be highly income generative.

A new fund vehicle is created which purchases those assets from an existing fund by raising new capital – either from new investors or from existing investors. Either way, they can provide liquidity to investors in the existing fund who are seeking it which may not otherwise be available.

With private markets facing liquidity challenges in a number of sectors, LPs[1] can find themselves waiting longer for returns on some portfolio assets. Where a conventional fund term extension is no longer the right option, a continuation fund or other restructuring may be. Continuation funds are nothing new, but we are seeing an increase in their use, as some investors grapple with liquidity and high quality assets are perhaps not as readily available as they once were.

How Continuation Funds Work

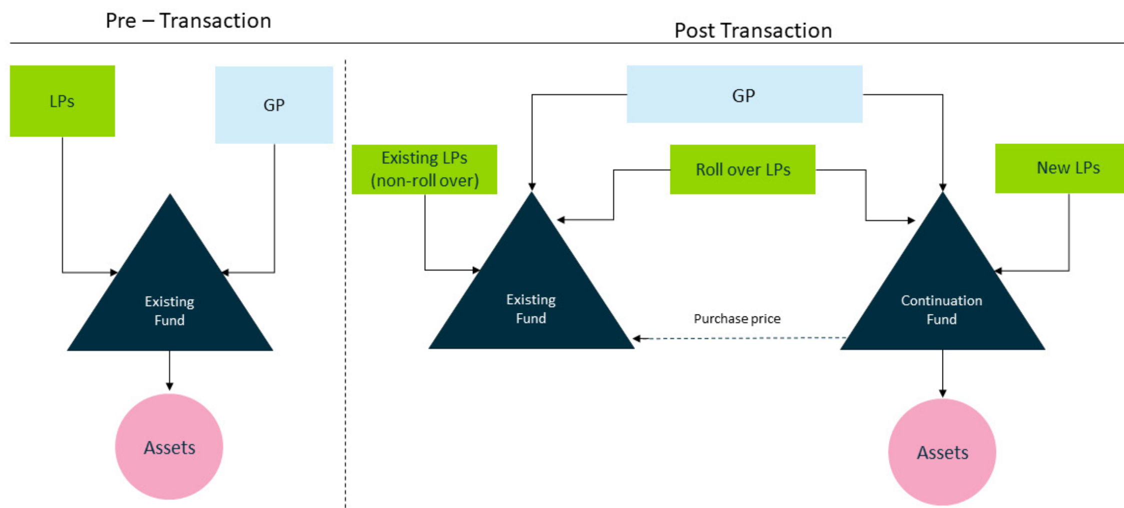
Existing LPs may be given the opportunity to "roll over" their interest in the underlying investment(s) into the continuation fund or cash out and take gains (or losses) from the realisation. A rolling LP makes a capital commitment to the new vehicle – which is effectively contributed in kind at the outset with its share of the assets being transferred in. The continuation fund can also be offered to new LPs who make capital commitments to the continuation fund, thereby providing the cash to generate liquidity for LPs in the existing fund who elect to sell. Commonly a buffer for anticipated follow-on capital is needed, particularly for turnaround assets or those which will benefit from capital expenditure or a bolt-on strategy, as well as ongoing costs of the continuation fund.

The terms of a continuation fund are typically negotiated extensively between the sponsor and the participating LPs, often reflecting asset-specific issues. As expected, manager economics and investor protection also provide key areas of focus, as participants look to achieve a better alignment of interests moving forward.

Why Set Up a Continuation Fund

A continuation fund is a useful tool which can provide various benefits to GPs and LPs. They offer flexibility for GPs looking to extend hold periods for assets where they are unable to realise them at optimum value in the short term and/or have potential for future upside. The GP will continue to manage the investment and may benefit from ongoing fees and carried interest (see below). The existing LPs benefit from a liquidity option (full or partial). If they choose to roll over their interest, they may benefit from a continued exposure to good assets and the opportunity to realise value from a longer-term investment. In addition, LPs have clear visibility on pre-identified assets, eliminating the blind pool risk they would otherwise face by making a new primary commitment elsewhere.

[1] In this note 'LPs' refer to limited partners and 'GPs' refer to general partners



Some Key Issues to Consider

Whilst there are many benefits to a continuation fund, there are a number of challenges in structuring them. We have noted below four key areas for consideration for participants, with a more in-depth view on conflicts of interest at the end of this note.

1. Conflicts of Interest (overview)

Transactions of this nature are inherently 'left hand to right hand'. Selling assets from an existing fund to a continuation fund, which are both managed by the same manager (and often the same GP), creates an inherent conflict of interest for sponsors. Many questions arise, for example:

- What should the existing fund sell for and what should the continuation fund pay? Who should determine the price?
- On what terms should the asset be sold – should they be arm's length, should they be market tested?
- What is motivating the manager to sell – is it simply acting in the best interests of the existing investors by a avoiding an unnecessary fire sale, or might the transaction constitute a realisation generating fees or carry for executives too early?
- What consents are needed – do investors or advisory committee representatives have a say? What is likely to convince them?
- Should the new vehicle operate purely as a continuation of the existing vehicle (as if it were not a distinct enterprise), or are participants better approaching it as an entirely new arrangement, with altogether different terms and an opportunity to re-align their interests?

For a more detailed view of these issues, see our 'closer look' section below.

2. Continuation Fund Fees and Carry

The terms of a continuation fund typically reflect (i) the level of ongoing work required from the manager and (ii) a need to incentivise eventual exit when more favourable conditions permit. Given the assets have already been identified and acquired, and the investment has not been realised as originally anticipated, management fees are often either low (and a multiple of invested capital rather than commitments) or, occasionally, nil – with LPs bearing only a continuation fund's set-up and ongoing costs and expenses.

Due consideration will need to be given as to whether the transaction will enable a realisation of carried interest from the original fund, and whether that is appropriate in the circumstances (after all, the assets were not realised when originally intended, and rolling LPs are not exiting). To the extent the transaction will generate carry, LPs participating in the continuation fund often like to see some or all of that being reinvested in the assets alongside them, to better align interests with the manager moving forward.

For the continuation fund, different carried interest terms may be agreed to incentivise an eventual exit (if that is what LPs desire) – or penalise failure to do so – with rates ratcheting down the longer assets remain in the portfolio. Alternatively, where assets have strong upside potential, managers may seek 'super' carry rates for exceeding anticipated performance.

Either way, managers and investors have an opportunity to re-align their interests, so care should be taken to reflect that in the terms.

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3. Structure of a Continuation Fund

Depending on the structure it takes and how its capital will be deployed, a continuation fund may constitute an AIF[2] (and, failing that, a CIS[3]). Managers therefore need to consider whether they have the necessary regulatory permissions to manage and operate the relevant vehicle. In addition, where relevant, sponsors must ensure continuation funds are marketed in accordance with applicable regulation, and disclose relevant risks to investors.

Care should also be taken to avoid a continuation fund constituting a 'successor fund' (or similar) of the existing fund, or otherwise contravening any binding exclusivity provisions.

Managers will often use the same legal structure as the existing fund, along with substantially similar documentation (varied where appropriate to reflect the new economic arrangements). Given how familiar the existing LPs will be with the existing suite, this is usually the most 'friction free' path to a close.

Consideration will also need to be given to tax, notably the consequences of the asset transfer and that the structure will continue to work for participating LPs.

4. Manager Duties

In addition to any general fiduciary duties, GPs and managers are ordinarily subject to duties under the fund's governing documents (for example, in a limited partnership agreement, a management agreement and any side letters). Identifying those duties and understanding how they apply to the transaction will be important.

Managers which are AIFMs[4] are subject to additional general regulatory duties, notably:

- to act honestly, with due skill, care and diligence;
- to act in the best interests of each fund (assuming each constitutes an AIF);
- to take reasonable steps to avoid conflicts of interest and, given this cannot usually be avoided in the establishment of a continuation fund, manage, monitor and disclose those conflicts; and
- to treat investors fairly.

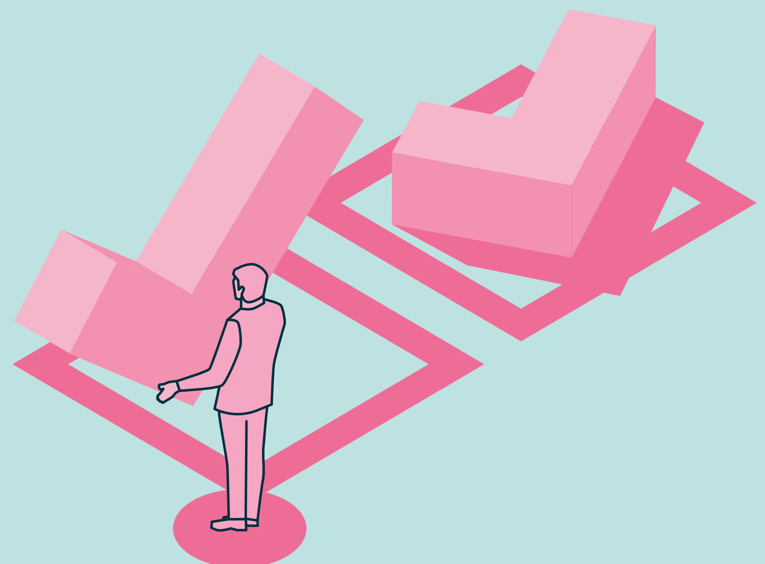
Finally, a manager may have internal policies and procedures to follow, such as an investment allocation policy, valuation policy and conflicts policy.

Overall, a delicate balancing act is needed. Managers need to have investor interests front and centre of their thinking when considering what to do with assets in these situations. Where a continuation fund is the right option, transparency is often the key to managing associated conflicts of interest.

We note the Institutional Limited Partners Association has produced some helpful guidance[5] to refer to when considering continuation funds. These are worth bearing in mind by managers when structuring continuation funds and restructuring holdings in investments.

Concluding Remarks

There is no single reason for using a continuation fund. Nor is there a single approach to implementing one. The drivers will vary from one situation to another, so each one needs to be considered on its own merits, factoring in all positive and negative factors. In any case, taking an open minded and transparent approach can be instrumental in determining whether they succeed. Managers and investors alike benefit greatly from first accepting the situation they are in (which may be less than ideal), then grasping the opportunity to re-align interests and extract all possible value from their investments.



[2]AIF – Alternative Investment Fund
[3]CIS – Collective Investment Scheme
[4]AIFM – Alternative Investment Fund Manager
[5]GP- **led Secondary Fund Restructurings - ILPA**

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Conflicts - A Closer Look

1. Price to Pay

Managers have a difficult task in making sure the asset is fairly priced in the absence of a conventional exit mechanism such as an open market sale or initial public offering. Existing investors not rolling over their interest will be keen to ensure that the asset is being acquired by the continuation fund for a fair price, and not being undersold. Naturally, new investors will want to make sure the asset is not overpriced at their expense.

Managers seeking consensus on pricing may need to appoint external valuers (in some cases, more than one) and disclose the results, and relevant methodologies, to their investors. In addition, given the conflict faced by valuers who are instructed by a fund manager on other mandates as part of a broader relationship, a fund's limited partner advisory committee may wish to appoint its own independent valuer. In addition, advisory committees may ask for assets to be tested in the market, or separate fairness opinions be obtained, in each case to demonstrate that the process is fair and transparent.

2. Terms of Sale

As with any cross investment, there is a broader question – beyond price – of what terms an asset is to be sold on. Even if a fair price is paid, different groups of investors may still be unfairly disadvantaged if the asset is sold on unfavourable or one-sided terms. Levels of buyer protection and seller responsibility need to be considered carefully to ensure fair treatment of investors.

For managers handling a conflicted transaction, the effort to undertake a rigorous process is worth making. Not only does an approval from an advisory committee reduce the risk of challenge later on, but under some fund partnership agreements a manager will be exculpated from liability once that approval has been given.

In private equity funds in particular, we commonly see advisory committees requesting the sale be negotiated by separate counsels (one representing the existing fund and the other the continuation fund), to better ensure the terms of sale are arm's length.

Care should also be taken to check underlying investment documentation for any consents needed at that level, or inadvertent consequences for portfolio company management teams (e.g. exercising applicable 'tag' rights to the extent the sale to a continuation fund constitutes an exit).

3. Rationale for Transaction

A manager's motivation for selling assets to a related vehicle will need to be communicated clearly and openly. Concealing benefits can lead to delay and even mistrust among investors – potentially jeopardising the deal. Above all, managers need to demonstrate how their interests continue to be aligned with those of their investors – whether rolling or exiting. Managers also need to show participating investors why they are best placed to manage the assets going forward. Showing investors early in the process:

- why a continuation fund is the best option (as opposed to forcing a sale, extending the fund's term or other solution);
- the strategy to adopt to make the best of the assets in the future;
- possible benefits and downside risks;
- how much new capital may be required (if any);
- how long the continuation fund is likely to last; and
- all other material terms of the continuation fund, tends to help raise investor confidence and speed up execution.

4. Obtaining Investor Consents

A fund's constitutional documents normally provide for a review by the advisory committee of material conflicted transactions. Sometimes an advisory committee will have a consent right (veto) on such transactions. Occasionally, if there is no advisory committee, for example in funds with only a small number of investors, the investors themselves may have the say.

It is important to identify at the outset what consents will be needed. Managers can then develop a plan for obtaining them in timely fashion, perhaps targeting warm investors first to gather initial support before launching a broader charm offensive.

As above, transparency tends to be the key to securing advisory committee consent. Considering how investors are likely to view the transaction from the outset is essential and raises the chances for managers to generate confidence in the deal. Moreover, giving advisory committees sufficient time to digest information being provided and ample opportunity to question the transaction often lead to savings in the broader timeline. Finally, should investors wish to engage third party advisors, managers are advised to work constructively with them, to secure the all-important consent.

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Your dedicated team

George Metcalfe
Partner – Investment Funds

0345 030 5709
0781 564 0529
george.metcalfe@freeths.co.uk

Adam Edwards
Partner – Financial Services Regulation

0345 274 6909
0777 318 4422
adam.edwards@freeths.co.uk

Isabel Protheroe
Associate – Investment Funds

0186 578 1016
0797 389 5966
isabel.protheroe@freeths.co.uk

Claire Boyce
Partner – Tax

0345 274 6947
0780 660 4711
claire.boyce@freeths.co.uk

To learn more about the team please visit our **Private Funds** or **Financial Services Regulation** webpage.

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