WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

Capital and Liquidity Solutions for Private Equity Funds

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The recent COVID-19 pandemic has, among other things, caused many private equity sponsors ("GPs") to assess their options to enhance the ability to provide financial support to their portfolio companies, in particular, in respect of portfolio companies that are held by the GPs' older vintage funds that may have insufficient undrawn commitments and/or may have exhausted their recycling and follow-on capacities, while also facing increasing requests from investors in their funds to provide liquidity.

This alert summarizes certain funding options that may be available to the GPs.

GP-Led Secondaries and Continuation Funds

GPs looking for a more long-term solution may wish to sponsor a new fund that would acquire and continue to hold interests in one or more pre-identified portfolio companies held by the existing fund (a "Continuation Fund"). Generally, Continuation Funds will be anchored by one or more institutional investors that specialize in investing in secondary transactions and fund restructurings, with a certain amount of interests in the Continuation Fund being set aside and made available to the investors of the existing fund. Any existing fund investor that does not wish to participate in the Continuation Fund will receive its share of distributions from the existing fund, while those that have elected to participate will be provided an opportunity to invest in the Continuation Fund, including, where possible, through a tax-free "rollover" of their interests, with potentially different carried interest terms.

Such GP-led Continuation Fund transactions have become more common over the past several years because a Continuation Fund can provide GPs the opportunity to continue to manage a company they would otherwise be obligated to realize and provide a fresh new pool of capital that the GPs could use to fund continued growth and management of the portfolio companies, while creating liquidity for investors of the existing fund who are not able or willing to rollover or reinvest into the Continuation Fund. In addition, the approach provides for full flexibility on the renegotiation of the financial terms applicable to the ongoing management of the capital invested in the portfolio allocated to the Continuation Fund.

Continuation Fund and similar transactions have been under the scrutiny of regulators for the past few years as well as certain LP associations, such as the Institutional Limited Partners Association (the "ILPA"), primarily because of the perceived potential conflicts of interest relating to such transactions. GPs considering sponsoring a Continuation Fund should bear in mind that: (i) as the GP will control both sides of the transaction (and may gain financial and/or reputational benefit as a result), related potential conflicts of interests will need to be addressed, including by obtaining the necessary consents from the investors or the limited partner advisory committee of the existing fund, (ii) given such potential conflicts, investors often expect GPs to, among others, retain a third-party consultant with respect to the valuation of the assets to be transferred and run an auction process (typically with the assistance of an investment bank) in order to obtain a third-party arm's-length price for such assets, and (iii) there may be possible tax consequences for investors that roll over into the Continuation Fund.

New Fund-Level Financing

One of the available fund-level financing options for an older vintage fund with limited unfunded capital commitments available is an offering of additional interests in the fund in order to secure additional commitments available to support the needs of the fund's portfolio companies. Because an offering of the same class of interests as the existing class of interests in the fund would require the GP to address a number of related issues and conflicts of interest, including those relating to 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, the fund would generally issue one or more classes of preferred interests with a fixed return attached to it without the additional capital being subject to carried interest.

The principal legal hurdle for GPs who wish to pursue the aforementioned fund-level preferred interests option is that the consent of the fund's investors will be required to amend the fund's governing agreements to implement such an arrangement. The fund's governing agreements may require the consent of a supermajority of the fund investors for such amendments because such amendments will involve revisions to the existing fund terms relating to capital contributions and distributions. Obtaining such consents from the existing investors may be challenging 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 aforementioned fund-level preferred interests option has certain advantages for GPs including, among other things, (i) the relative ease of implementation, (ii) the mitigation of valuation and some of the conflicts of interest challenges, and (iii) the elimination of the need for changes to the existing investors' distributions 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 also be noted that follow-on investments made with the capital provided by the preferred interest holders may be invested as a preferred security in the underlying portfolio company so as to avoid diluting the existing investors' indirect interests in the portfolio company and therefore relieving pressure on the GP's valuation at the portfolio company level.

Top-Up Funds

As an alternative to (or in combination with) the fund-level financing, GPs managing older vintage funds with limited unfunded commitments available may wish to create a separate top-up fund that would invest in the portfolio companies of the existing fund that are in need of additional capital. 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 subscriptions.

While the top-up fund option can present its own set of complexities in implementing and managing potential conflicts of interests, at both the portfolio company and the fund level, as well as in requiring the GP to engage with investors in organizing the subscription process and obtaining any necessary consents, 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

NAV facilities may be a viable alternative for GPs managing older vintage funds with limited remaining unfunded or 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 by the GP on behalf of the fund to provide additional capital to the 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, borrowings and diversification and follow-on investment limitations. 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 NAV facilities would generate UBTI.

Other Alternatives

Where GPs anticipate imminent exits from certain of their funds' portfolio investments, GPs can seek fund-level amendments to permit adjustments to recall and reinvestment provisions, including extending relevant time periods, raising caps and, in certain situations, permitting recycling of gains (subject to tax considerations).

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 LPs.

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