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1. *Key Legal Issues for Secondary Fund Transactions*
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Introduction

The private equity secondary marketplace has grown significantly in the past few years and this growth shows no signs of stopping. Secondary transactions are particularly appealing to investors as they offer potential liquidity to holders of interests in private equity funds. As the industry has grown and matured over the last several years, numerous buyers have emerged including secondary funds, large institutional buyers, and sovereign wealth funds.

This practice note is intended to provide guidance on how to approach the review of fund documentation to prepare for a secondary transaction and to provide a high-level overview of the legal issues that should be addressed in a purchase and sale agreement with a single buyer and seller. This practice note is not intended to cover secondary auctions, stapled secondaries, synthetic secondaries, and other types of transactions that are seen in the industry. This practice note also does not discuss how the purchase prices of secondary interests are determined as pricing is typically business driven rather than legal driven. Given that most secondary transactions are bespoke, this guide also does not cover every single issue that could arise in a secondary transaction.

Fund Documentation Due Diligence

There is no consistency in the industry around the mechanics of a secondary transaction. Even different funds sponsored by the same manager may have different mechanics. In order to determine the mechanics of each secondary transaction, it is important for both buyers and sellers to first perform due diligence on the underlying fund documentation.

Typically, in a secondary transaction, a buyer will only be provided with three agreements: (1) the subscription agreement; (2) limited partnership agreement / limited liability company agreement of the fund (which we refer to as the “governing documents” in this article); and (3) a side letter, to the extent there is a side letter between the fund and seller. At a minimum, these are the three main documents you will need to review to understand how a secondary transaction can be effected for the specific fund in question. Sometimes, counsel is provided access to a full suite of fund documents that may also include offering memorandums, closing opinions, management agreements, and manager/general partner resolutions. If you are provided these documents, they should be reviewed as well.

Subscription Agreement

If you are representing the buyer, the subscription agreement should be reviewed primarily to determine what representations the buyer will need to make to the fund. Additionally, a review of the subscription agreement can be beneficial to both a buyer and seller as it may highlight certain restrictions on the interests being purchased. For instance, restrictions on transfers are sometimes built into subscription documents. Most important, many subscription agreements include elections that are made by investors to participate in certain fund structures designed to accommodate the specific tax status of an investor (e.g., U.S. taxable structure versus a U.S. tax-exempt structure). It is very important to note if any elections were made by the seller and whether such election applies to the buyer. If no changes are needed to the seller’s elections, then the transaction can generally move forward. However, if the buyer will need to participate in a different structure, then detailed conversations will need to occur with the fund manager. Transferring an interest one structure to another may cause tax complications and such structures should be analyzed by accountants and tax lawyers.

Fund Governing Documents

The most important document you can review when preparing for a secondary is the governing agreement of the fund. You will need to review this to determine each fund's unique process to sell or buy an interest in the fund from an existing investor. When reviewing the governing documents of the fund, the most important provisions to focus on is the transfer section of the document as this section will tell you the process required to transfer the fund interest from seller to buyer. Certain points to look for include the following:

- **Is there a notice period for a transfer?** It is not unusual for a manager to require a 30-day notice period before a transfer can be effected. You should also check if the notice period can be waived. Many managers will waive notice periods.
- **Is there a right of first refusal?** Governing documents often include a right of first refusal that allows the manager to purchase the interest, or, in some cases, allows the other investors to purchase the interest when it is transferred to a third party. A right of first refusal resting with the manager is often waivable since most fund managers typically use the right as a way to find out the pricing for the secondary interest and rarely exercise their right. If a right of first refusal is required to go to all investors, this will slow the process significantly and adds significant risk that the transaction will not complete.
- **Who pays transfers expenses of the manager and fund?** It is customary that the transferee pays these expenses. A $5,000 flat transfer fee is relatively commonplace.
- **Is a legal opinion required?** Most governing agreements will require a legal opinion on certain tax-related issues (publicly traded partnership (aka "PTP") status) and certain U.S. securities laws. The opinion requirement is almost always waived.
- **Will the buyer be admitted as a substitute partner or will the seller have some residual liabilities under the agreement?** Most sellers will want the buyer to be admitted as a substitute partner so no residual liabilities remain between the fund and seller.
- **When can the transfer close?** Typically, we see transfers effected at the end of each calendar quarter and more rarely, annually.
- **Will buyers need to be "creditworthy"?** Most newer governing agreements will require the transferee to be creditworthy. Often guarantees are required by funds if a special purpose vehicle is being formed to buy the fund interest and the special purpose vehicle has no real economic substance. The guarantee would typically be from an entity in the buyer's structure that holds significant assets. If the fund has limited capacity to call additional capital from its investors, the need for a guarantee is minimized.

When you are reviewing the governing documents, you should also pay attention to the fund's ability to form alternative investment vehicles (commonly referred to as an "AIV"), which are entities a fund can form for tax or regulatory reasons to make an investment outside of the fund. If representing a buyer, you should confirm with the seller or the fund manager if any AIVs have been formed and whether those interests should transfer to the buyer (which in most cases is yes). Additional focus should be made to any provisions in the governing documents that would limit the buyer's activities in any way, though this would be rare. Focus should also be made on any provisions relating to credit facilities. It is customary in the industry for funds to enter into subscription credit facilities where lenders lend against the creditworthiness of a fund's investors or a fund's net asset value. To the extent the seller is included in the borrowing base of the credit facility, the buyer should confirm whether the lender will replace the seller in the credit facility, what documentation may be required by the lender, and, to the extent the buyer will not replace the seller in the borrowing base, whether any sort of pre-payment of amounts drawn down under the credit facility would be required. Finally, focus should be made on the fund's ability to recall capital under a "partner giveback" as this will need to be addressed in the purchase and sale agreement, as further described below.

Side Letter

One last item to diligence is the side letter, if one was given to the seller. Side letters often contain provisions relating to transfers, such as waivers of the manager’s consent, waivers of an opinion requirement, or waivers of a right of first refusal. Additionally, side letters often provide investors with certain benefits which can range from preferential economics, seats on investor advisory committees, co-investments rights, and other information-related rights. These rights may be particularly beneficial to a buyer. If it is important that side letter rights transfer to a buyer, consider vetting this with the seller and manager before continuing the transaction as side letters often do not follow to a buyer in a secondary transaction.

Purchase and Sale Agreement Key Issues

The purchase and sale agreement (PSA) between buyer and seller is the key document that governs a secondary sale. The PSA governs the terms and conditions of the sale between buyer and seller, sets forth the closing process between buyer and seller, and sets forth the various rights the parties may have to adjust the purchase price or terminate the sale. Given that the PSA typically only addresses issues between buyer and seller, it is unusual for the fund or its manager to be a party to the PSA. The actual transfer of the fund interest will occur using a transfer agreement between the fund, buyer, and seller and this is always provided by the fund. The transfer document provided by the fund is rarely negotiated and is typically a form document provided by the fund.

The following is a list of the material issues that are included in nearly every PSA:

Purchase Price

As noted in the introduction of this practice note, the buyer’s business team will determine the amount to be paid, but the PSA should address certain adjustments to the purchase price. First, the agreement should fix a purchase price to a prior date. This is known as the cut-off date. The cut-off date can be any time in the past, but typically it is the most recent valuation date of the fund, either the date of its last audited financials or quarterly unaudited financials. The PSA should always adjust the purchase price in two situations. First, the purchase price should be decreased on a dollar-for-dollar basis by the amount of any distributions made from the fund to the seller after the cut-off date until closing. Second, the purchase price should be increased on a dollar-for-dollar basis for capital contributions made by the seller to the fund after the cut-off date until closing.

Excluded Obligations

Typically, the PSA (and the transfer agreement with the fund) will have the seller transfer to the buyer all obligations and liabilities of the seller after the date of the closing of the transaction. In order to address certain situations where it may be unfair for a buyer to bear liabilities that occurred prior to the sale’s closing, a PSA will typically exclude certain items that the buyer will need to bear. While the list of excluded obligations varies by transaction, there are typically three excluded obligations in all PSAs:

- **Breaches of certain representations.** It is common for a PSA to have the seller bear all liability for any breaches of representations made in their original subscription agreement, side letter, and other agreements that the seller has signed. Any breaches of these representations are borne by the seller as they typically include fundamental representations allowing the seller to initially purchase the interest in the fund or representations that allow the fund to comply with applicable law.
- **Taxes.** Taxes related to the sale of seller’s interest in the fund are typically borne by the seller.
- **Clawback obligations.** Typically, clawbacks contained in the governing documents, as further described below, are excluded to the extent they relate to investments sold before the closing of the secondary, but this is a highly negotiated point in all secondary transactions.

Material Adverse Change

Many PSAs, but not all PSAs, contain clauses that allow a partner to terminate the transaction if material changes to the fund occur before the transaction closes. To the extent the PSA you are negotiating contains a material adverse change provision, such provisions are generally linked to very specific circumstances, such as key person event at the fund or a significant devaluation in the portfolio of a fund.

Transfer Costs

Every PSA will describe how the costs of the transaction are borne. Typically, the seller and buyer will bear their own costs for their lawyers and accountants, however, depending on the negotiating strength of the parties, one party may bear the other's legal and accounting costs. Typically, the fund manager will charge its fees only to the buyer, but these fees can be allocated between buyer and seller in the PSA.

Clawbacks

Most fund documents contain two clawback provisions. The first clawback provision is the general partner clawback that requires the general partner to return amounts to the investors in a fund if the general partner received too much carried interest through the fund's distribution waterfall. A clawback situation typically occurs when the fund has early "winners" and late "losers." If there is a likelihood that the fund may enter a clawback situation, the PSA should address how such payments from the general partner will be split between buyer and seller.

The second clawback is the "partner clawback" or "lp clawback" mentioned above that requires partners to return distributions and capital for indemnification obligations and expenses of the fund. The PSA will need to describe how to allocate the payment of a partner clawback between buyer and seller. Key questions that should be addressed are how to deal with a situation where money is recalled for a deal was disposed of before closing and how to deal with partner givebacks that do not relate to a specific investment. Often a PSA will include limitations on the amounts each party bears, such as caps or baskets.

Representations and Warranties

A typical PSA will contain numerous representations and warranties of both the buyer and seller. Typically, the buyers will make a limited set of representations with respect to good standing, no conflicts to enter into the transaction, and ability to fund the amounts required under the PSA.

For a buyer, the representations and warranties made by the seller are far more important. Typical representations and warranties of a seller are as follows:

- **Excuse.** A representation that the seller has not been excused from any investments.
- **Default.** A representation that the seller has never defaulted of any capital contribution.
- **Conduct of seller.** This is usually a lengthy representation about the seller's conduct since the cut-off date until closing. The seller will generally represent that it has not sold the interest it is selling to buyer, redeemed its interest in the fund, forgiven any debts owed to the seller by the fund, amended the governing documents of the fund, failed to exercise material rights with respect to the interest in the fund, or created any liens on the interest in the fund.
- **Good title.** A representation that the seller has good and valid title to the interest of the fund and that there are no liens on the interest. It is becoming common for investors to borrow against the value of interests in a fund, so it is important to confirm that the interest you might be buying has no liens and has not been pledged before closing.
- **Distributions and contributions.** A representation to the buyer that a list of distributions and capital contributions (usually set forth in an exhibit) made from or to the seller are true.
- **Brokers.** If no brokers are involved, a representation to that fact is customary.
- **Material agreements.** PSAs will typically contain a representation that the seller has provided the buyer with all agreements relating to the interest. A list of documents is often included in an exhibit.
- **Litigation.** A representation that the seller is not subject to litigation that may impact the secondary transaction.

- **ERISA.** Assuming the seller is not subject to ERISA, a representation to this fact is customary.

Indemnification

Typically, the buyer will want to be indemnified for any obligations arising before the transfer including a clawback obligation. The seller will want the opposite. Thus, indemnification provisions are highly negotiated in a PSA. Typically, the buyer will indemnify the seller for any liabilities or obligations except for the excluded obligations described above. Limits on indemnifications are often added to a PSA including buckets or carve-outs for immaterial indemnification obligations. Indemnification is also sometimes capped at the purchase price.

Confidentiality

The PSA will typically contain information about what can be disclosed about the transaction to third parties. Generally, secondary transactions are private and press releases or other disclosure is not usually made after closing.

Conclusion

In conclusion, secondary transactions are becoming very popular in the private equity world and the agreements used in their purchase and sale can be complicated. Becoming aware of the issues one should initially diligence when participating in a secondary transaction and learning about the common provisions contained in a PSA will help you move efficiently to a closing and avoid surprises after closing.

Related Content

For additional information on secondary transactions and private equity investments, see the following practice notes and form:

- *Restructuring Your Way to a New Tomorrow: The Emerging Trend of "Stapled Secondary" Private Equity Fund Restructurings*

- *Limited Partner Transfers and Secondary Sales*

- *Domestic Transfer Agreement and PSA*

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