



Continuation Funds

Considerations for Limited Partners and General Partners

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ABOUT ILPA

The Institutional Limited Partners Association (ILPA) empowers and connects limited partners to maximize their performance on an individual, institutional and collective basis.

With nearly 600 member organizations representing more than \$2T USD of private equity assets under management, ILPA is the only global association dedicated exclusively to advancing the interests of LPs and their beneficiaries through best-in-class education, content, advocacy and events

Overview

Continuation fund transactions have been a prominent feature of the private equity industry over the last few years. More General Partners (GPs) have looked to move selected assets into a continuation vehicle, while giving Limited Partners (LP) the option to roll into the new vehicle, sell their interests and take liquidity or some combination of both options. With increased capital and sophistication in the secondary market, it is likely that these transactions will continue to be a tool for the industry moving forward.

While this transaction provides more optionality to private equity funds, their increased use has raised many questions for LPs. First, the highly complex nature of these transactions demands a substantial amount of attention from LPs, and requires LPs to make decisions about individual assets, as opposed to PE funds or managers. Additionally, LPs can struggle with the speed at which these transactions are run. LPs are forced to make roll or sell decisions within a period as short as 10 days, during which they must undergo a re-underwriting of the investment that can often force LPs into a position to take the liquidity option if the timeline doesn't align with institutional requirements, such as investment committee meetings. Lastly, these transactions are conflicted by nature, with the GP sitting on both sides of the transaction. ILPA was compelled to act and create this guidance in part because of growing LP frustrations around these transactions.

If the principles laid out in this document are followed, these transactions can be structured in a way that reduces strain on the alignment of interest between LPs and GPs.

Executive Summary

General Principles:

1. Continuation fund transactions should maximize value for existing LPs
2. Rolling LPs should be no worse off than if a transaction had not occurred

Rationale and Conflicts:

1. The GP should present the rationale for a continuation fund transaction to the Limited Partner Advisory Committee (LPAC), and should have explored alternative options for the selected asset
2. The LPAC should vote to waive conflicts of interest associated with the process of the transaction. GPs should bring all conflicts to the LPAC, whether or not conflicts are pre-cleared as per the LPA
3. A competitive process should be run to ensure a fair price was obtained; the process should include third party price validation
4. The GP should disclose the necessary information about the selected assets, the process, the rationale and the bids in a timely fashion to the LPAC when considering conflict waivers and to all existing LPs to facilitate roll or sell decisions

Process and Timing:

1. The continuation fund transaction process should conform with the relevant provisions of the existing fund LPA. GPs should avoid LPA terms that pre-clear conflicts of interest associated with these transactions
2. GPs should engage experienced advisors to facilitate the transaction. The GP should disclose any potential conflicts of interest with the advisor and the commercial arrangement. The advisor should be made accessible to the LPs
3. LPs should be afforded no less than 30 calendar days or 20 business days to make roll or sell decisions

Terms and Documentation:

1. Rolling LPs' side letters should apply to the continuation fund where relevant. At a minimum, all relevant risk and governance terms agreed to in the existing fund side letter should apply
2. There should be no increase to the management fee basis or percentage for rolling LPs
3. There should be no increase to the carried interest rate or decrease to the preferred return hurdle
4. There should be no crystallization of carried interest for rolling LPs
5. All carried interest accruing to the GP related to interests from selling LPs should be rolled into the new continuation vehicle

Recommendations for LPs:

1. LPs should establish internal protocols to respond to these transactions, such as approval processes, underwriting processes and understanding statutory requirements
2. When transactions arise, LPs should work with GPs to set timing expectations around reviews, negotiations and approvals
3. When transactions arise, LPs should request that GPs provide documentation, models and materials necessary to be fully informed; there should be a symmetry of information between existing LPs and prospective new buyers

Full Guidance

Given the highly unique nature of continuation fund transactions and broad range of deals they affect or encompass, the recommendations that follow may not be universally appropriate or applicable to every circumstance. Rather, they are intended to provide general parameters for well-run continuation fund transactions that will foster more informed decision-making by LPs and more aligned outcomes overall.

While no two deals are exactly alike, achieving greater consistency around disclosures and the structure of the process will ensure that investors are better equipped to evaluate such deals and the processes will be more transparent. Considerations and specific recommendations are detailed below:

STAGES OF A CONTINUATION FUND

1. GP presents rationale for selling the selected assets to a continuation vehicle to the LPAC. The GP shares the rationale with all LPs
2. Selection/engagement of an advisor by the GP to structure the process, initiate the solicitation of bids and guide the transfer of fund assets
3. LPAC review of the structure of the process and any conflicts related to the proposed transaction
4. LPAC vote on whether or not to waive the conflicts associated with the transaction, inclusive of the structure of the process. LPAC should have 10 business days to review the transaction and the opportunity for an in camera session prior to the vote
5. Solicitation and due diligence, including the notification to LPs, portfolio company disclosures provided to acquirers and accessible to LPs, e.g., data room, including the outlook for the underlying investments
6. Confidential disclosure document circulated to all LPs outlining the final proposed terms and conditions of the transaction, indication of new terms that differ from the original LPA, amendments to governing documents and framework for allocating transaction-related expenses
7. Election by LPs to: (a) roll their interests on a pro-rata basis into the new entity, (b) sell their interests to the acquirer on the terms offered, (c) roll their LP interests into a continuation vehicle and purchase more interests or (d) some combination thereof

The following guidance does not necessarily follow the order of a continuation fund transaction process. The guidance should be read and considered in whole.

LP Engagement and the Role of the LPAC

Role of the LPAC

The specific mandate of the LPAC in a continuation fund transaction is defined by the LPA but is generally understood to include the review of any conflicts associated with the transaction and to provide guidance to the GP throughout to ensure the process is transparent and fair. Engaging the LPAC at the earliest opportunity around the objectives and logic for the transaction, process, terms and framing of the deal is critical to ensure that the proposal ultimately presented to LPs will be met with full consideration. The GP should provide the LPAC an opportunity to convene with an in camera session to discuss the proposed transaction and rationale behind it and ensure the LPAC has access to the advisor if requested, which

should be treated as a fund expense. Additionally, the GP should ensure that all LPAC members receive access to the same level of information. For example, when a question is asked by an individual LPAC member, the GP should share the response with the entire LPAC. If amendments to the existing LPA are necessary to affect the transaction, the LPAC should not be asked to recommend that LPs approve the amendments or otherwise recommend the transaction.

Individuals serving on the LPAC act in their own interests and do not hold a fiduciary duty to the fund or other LPs, and LPAC members should be appropriately indemnified in relation to any decisions made on the transaction. However, the LPAC's consideration of the process and the terms of the proposal should support maximizing value for existing LPs. In this context, LPACs may choose to seek independent advice, which should be treated as a fund expense.

Timing of LP Engagement with Rationale of the Transaction

The GP should be as transparent as possible preceding and throughout a continuation fund transaction. The rationale for the continuation fund should be shared and tested with the LPAC, and in some cases a broader subset of all LPs, as early as possible and prior to a formal proposal to run a transaction process or hiring an advisor. The GP should proactively initiate discussions with the LPAC ahead of presenting a formal rationale.

Business Rationale behind the Proposed Transaction

The GP should provide the LPAC and LPs with a clear articulation for why the transaction is taking place via a continuation fund rather than an alternative option before initiating the transaction.

The primary rationale for a continuation fund transaction should be to maximize the value for existing investors. In presenting the rationale, the GP should provide information on i) reasoning for a continuation fund transaction rather than another alternative (e.g., a fund extension, a traditional exit, additional co-investment), ii) the quality and outlook for the selected portfolio company(s), iii) the amount of (new) capital required, iv) the projected time to realization and v) an exit plan for the new vehicle. The rationale should be heavily scrutinized in circumstances where the existing fund has remaining unfunded capital or is within the first five years of the inception of a fund.

Managing Conflicts Related to the Transaction

Any conflicts related to the process of the transaction should be identified, mitigated by the GP and approved by the LPAC. The review of conflicts associated with the transaction should be aimed at ensuring that the process is transparent and fair to existing investors in the fund—the overriding goal of the transaction.

Any conflicts related to the final economics of the transaction where the GP may receive a benefit that does not accrue to the LPs should also be identified, mitigated where possible and approved by the LPAC. Potential conflicts to review can include, but are not limited to, the crystallization of carried interest, the method of soliciting bids on the selected assets and any economic incentive accruing to the GP such as stapled financing, changes to the preferred return, etc.

Early and fulsome disclosure enhances the likelihood of obtaining any required waiver of conflicts and a more favorable reception of the proposal by all LPs in the fund. When considering the terms of a potential fund investment, GPs and LPs should avoid LPA terms that seek to 'pre-clear' conflicts associated with continuation fund transactions at the onset of the fund. All conflicts should be mitigated and cleared when they arise.

Disclosures

Disclosures to the LPAC on the Solicitation Process and Bids Received

LPAC members should be provided enough information to assess whether the continuation fund transaction process was structured appropriately to ensure a fair price was obtained in relation to conflicts of interest waivers. A fairness opinion from an independent financial adviser, a partial disposition to a third-party or an arms-length transaction through a minority stake may be helpful in this context.

The LPAC should also review and approve any break-up or termination fees payable in the event the transaction is not completed.

● RECOMMENDED DISCLOSURES: INFORMATION ABOUT BIDS/PROCESS

1. Description of the process for soliciting bids from potential acquirers
2. Overview of the bids received including the number of bids and pricing
3. Discounted pricing or more favorable economics for any potential acquirers relative to rolling LPs, including any special terms such as stapled financing
4. New capital provided by existing LPs, if any
5. The participation by any LPAC members as acquirers, if any
6. Any factors that would have excluded certain acquirers
7. Management fee (both the percentage paid and actual dollars) and carried interest percentage for LPs in the continuation fund
8. Management fee and carried interest for LPs allocating primary capital (i.e., staple), if any
9. The percentage of crystallized carry being rolled into the continuation vehicle, and the rationale behind that number
10. Any other meaningful changes in terms versus the original fund, e.g., approvals, key person, related to either the continuation vehicle or the stapled primary capital

Disclosures to LPs beyond LPAC and Parity of Information Provided

As early as possible, the GP should provide LPs beyond the LPAC the disclosures and transparency required to allow sufficient time to review the continuation fund transaction. GPs should endeavor to achieve parity in the information provided to the acquirer and to the LPs in the fund. Data room access should be provided to all LPs at the earliest opportunity as determined by the LPAC and the GP. Such protocols for providing parity of information should respect any confidential or commercially sensitive information related to the transaction.

At the close of the process and once the final terms of the proposed transaction have been set, LPs should have access to the same level of information about the process as LPAC members, i.e., the number, range and content of bids considered, whether any LPAC members participated and were considered as finalists in the bidding process and the justification as to why the “winning bid” was selected.

The GP should provide LPs with the necessary asset-specific information to carry out diligence on the assets included in the continuation fund.

● RECOMMENDED DISCLOSURES: INFORMATION ABOUT SELECTED ASSETS

1. The GP's investment memo and the returns to date on each selected asset
2. Asset-specific information required for due diligence related to material risks
3. Detailed information on the basis for the assumed price and multiple of the assets, including details on valuations and modeling assumptions used
4. The GP's view on potential returns at exit for each selected asset
5. The performance of any continuation fund the GP currently manages or has managed in the past

Additional Disclosures Related to Conflicts, Complex Deals

In the case of more complex transactions such as stapled secondaries, the GP should disclose to LPs whether discounted pricing or highly favorable economics for new investor commitments to the continuation vehicle were linked to the acquirers also providing stapled primary capital in a new fund. LPs should receive detailed information on the basis for the assumed price and multiple of the assets, including detail on valuations and modeling assumptions used. The GP should disclose the existence of any LPAC members who are participating in the process as bidders. LPAC members should consider their own conflicts of interest and recuse themselves where appropriate.

Access to the Transaction Advisor or the GP

To ensure that LPs can make a fully informed decision on whether to roll or sell their interests, the GP should consider making itself—the deal team, advisor and portfolio company management (where feasible)—available to all LPs at the appropriate time to address questions about the process, such as through a conference call.

Changed Fund Terms for Acquirers and Rolling LPs

All LPs should be apprised of the terms for new LPs investing in the new entity. To the extent there are differences in terms relative to the existing fund, those terms and the basis for the differences between existing and rolling LPs should be fully disclosed. Where new economic terms are being proposed for LPs participating in the new structure, a clear rationale should be presented.

Key Person Provisions

To the extent that the continuation fund impacts the key person provisions of the existing fund, the GP should disclose an agreed retention and incentive plan for key investment professionals involved in the management of the assets in the continuation fund.

Time and Attention Clauses

To the extent that the continuation fund impacts the time and attention of the deal team of the existing fund, the GP should disclose how individual members of the GP will split their time between the continuation fund and the existing fund.

Structure of the Process - Timing and Legal Considerations

Timeline for LPs to Review Proposal

LPs should be afforded sufficient time—no less than 30 calendar days/20 business days—to thoroughly evaluate the GP proposal and return their respective election forms. The timeline for LP consideration of the proposal should account for bank holidays that fall within the election period.

Some LPs may have institutional legal requirements, such as ERISA or other statutes, mandating additional layers of review. Longer review timelines that accommodate these requirements should be considered if the execution risk is not substantial. LPs should have symmetrical information with the buyer throughout this time.

Additionally, many LPs are required by policy/statute to consider each continuation fund transaction as a new investment. Therefore, they are required to undergo a full investment and legal due diligence and review process, which may involve re-underwriting of the opportunity, reviewing and negotiating applicable governing documents and seeking investment committee approval. GPs should consider their relationship with LPs and understand which timing decisions will directly prevent LPs from being able to consider investing. Where possible, GPs should strive to provide more than 30 calendar days/20 business days.

Timeline for LPAC Review of Proposed Deal Terms

In advance of finalizing the acquisition agreement, but no less than 10 business days before finalizing the terms of the transaction for LP election, the GP should convene an LPAC meeting to review the proposed acquisition agreement and discuss the principal terms of the transaction. The GP should meet with the LPAC as a group, as opposed to meeting with LPAC members individually, to facilitate the discussion around the deal.

Compliance with the Existing Fund LPA

The continuation fund formation and offering process should conform with the LPA of the existing fund. Some LPAs may include high-level anticipatory language around the process, such as notice periods, disclosures, conflict approval protocols, voting processes and expense allocations including broken deal expenses and procedures for third-party valuation of interests. It is recommended that such provisions provide sufficient clarity for all parties without unduly restricting or prescribing either the rationale or the exact means or parameters of the continuation fund formation or offering. Conflict approvals should guide the process but should not include a presumptive waiver of conflicts.

In respect of existing fund LPAs that do not specifically address continuation funds, conflicts of interest should be identified, mitigated and cleared. In these scenarios, the principles outlined here should serve as a roadmap for the transaction.

Compliance with Side Letters

The continuation fund formation and offering process should conform with any side letter agreements entered into between the GP and LP. Additionally, for any LP electing to roll their interests into the

continuation vehicle, the terms within the LP's negotiated side letter for the existing fund should carry over to the continuation fund, either by way of a new side letter specific to the continuation fund or express language in the continuation fund LPA. Certain side letter provisions may not be applicable, and these may be negotiated as they occur. At a minimum, all relevant risk and governance terms should apply.

LP Failure to Elect

In cases where the LP does not respond to the election in a timely fashion (30 calendar days/20 business days), the election for such LPs should be treated as liquidating their interests rather than rolling into the new vehicle. LPs should never be forced to roll their interests into a new vehicle.

Structure of the Process - Economic

Allocation of Fees and Expenses

The allocation methodology for transaction fees and expenses between the acquirer, selling LPs, rolling LPs and the GP should be clearly disclosed to all LPs and allocated according to which parties benefit from the transaction. In cases where the GP clearly benefits from either additional fee revenue or through a stapled commitment, the GP should share a portion of transaction costs.

Costs associated with the formation of the new vehicle should be borne by the rolling LPs and the acquirer. It is recommended that transaction-related expenses allocable to either the acquirer or to the LPs rolling their interests into the new entity be capped, or subject to monitoring by the LPAC to ensure reasonableness. Selling LPs should bear their proportionate share of sale transaction costs.

If the transaction does not progress, the allocation of broken deal fees and expenses should conform to the relevant provisions within the LPA. In cases where the transaction does not ultimately proceed, costs incurred by the GP to solicit offers after the LPAC has approved a process should be considered a fund expense.

Any management fees charged to LPs participating in the new entity should be proportionate to the operational requirements of managing those specific transacted assets.

Follow-on Capital and Dilution of LP Interests

Any resulting dilution of existing LPs should be done on a fair and reasonable basis. If rolling LPs are diluted, the GP should provide a commercial rationale as to why diluting rolling LPs will be accredited to the return on the transacted assets. This dilution can be calculated at i) the same entry valuation as the original transaction, ii) at a market value to be determined by independent advisors at the time the capital goes in or, iii) mitigated via an alternative instrument that does not dilute the equity interests of the rolling LPs.

“Status Quo” Option

LPs must be provided the option to participate in the new structure with no change in economic terms i.e., a “status quo” option. Status quo should be defined as:

- i. no increase in the management fee rate,
- ii. no change in the management fee base, i.e., for rolling LPs, the same management fee base as the management fee base for the existing fund as of the time of the transaction,
- iii. no increase to the carried interest rate, decrease to the preferred return hurdle or other GP-favorable changes to the distribution waterfall, and
- iv. no crystallization of carried interest for rolling investors.

Rolling LPs should not be disadvantaged relative to their status prior to or absent the transaction. In addition, there should be no minimum threshold roll participation to offer the status quo option.

Treatment of Carried Interest

In almost all cases, the GP should roll 100% of the carried interest accrued into the continuation vehicle to ensure an alignment of interest. In scenarios where the GP does not roll all of their carried interest into the new vehicle, the GP should provide a detailed explanation as to why they didn’t roll all the accrued carried interest (e.g., the retirement of deal team professionals) and the alignment incentives for the new vehicle.

It is accepted that no carry will be crystallized in cases where the existing fund utilizes a European waterfall and is not yet in carry. In such cases, the acquirer and the rolling LPs will need to gain comfort on alignment based on the GP’s commitment to the new vehicle.

Advisors to the Transaction

Engaging Third Party Advisors

The GP should engage an experienced advisor to solicit bids for the portfolio of assets. Any potential conflicts of interest and/or the advisor’s past dealings with the GP should be disclosed to all LPs. The GP should establish in the engagement letter that the advisor should represent the interests of the fund and not solely the GP in the solicitation process.

LPAC Review of Advisor Selection Process

The LPAC should review the GP’s selection of the advisor, including the advisor’s role, scope of services and the fee arrangement, including fee level, fee components, and how the fee is allocated among LPs, the GP and the acquirer. The GP is encouraged to disclose to the LPAC all commercial terms agreed to with the advisor and a summary of the engagement letter. The LPAC is encouraged to review the advisor’s engagement to ensure that the compensation is fair and customary and structured in a way that maximizes value for existing investors. LPs should be aware that in cases where the advisor’s compensation is based on a fixed fee rather than linked to the value of the transaction, should the transaction go forward at lower than anticipated volume, selling LPs could bear a disproportionate amount of associated costs. The LPAC should have access to the advisor throughout the solicitation process to allow for questions on the relative merits of the respective bids.

Independent Counsel and Specialist Advisor to the LPAC

The LPAC should have the right to avail itself of an experienced independent legal and specialist advisor, separate from the GP-selected advisor, to offer counsel on the structure of the process, the transaction terms and valuation and, in particular, the waiver of any conflicts. Independent counsel and a specialized advisor working on behalf of the LPAC (or in some circumstances, by extension on behalf of all LPs of the fund), may be particularly valuable in certain situations. These scenarios include highly complex transactions that may overburden the LPAC, or when the GP failed to consult with the LPAC on the advisor selection and compensation. Additionally, the use of independent advisors may be recommended in transactions that present greater potential conflicts of interest, such as when the transaction offers significant future financial benefits for the GP that may not align with the interests of LPs seeking to maximize the value of the underlying assets. The LPA should provide for the LPAC to engage such independent counsel, which, should be considered a fund expense.

Independent Fairness Opinion Provider

In certain instances, selling LPs may benefit from an independent assessment of the value of the underlying assets, together with a formal opinion stating that the cash price offered is fair from a financial point of view. This is relevant as the NAV is determined by the GP, and typically, a trailing number will be used for discussion purposes during the solicitation process, which may or may not be relevant to the current valuation. LPs as a group may request the GP to commission a fairness opinion for the fund, conducted by an advisor independent of the party selected as the GP's advisor, with regards to the price being offered for the assets in the continuation fund transaction.

● ANTICIPATING A CONTINUATION FUND PROCESS: RECOMMENDATIONS FOR LPS

1. In anticipation of a continuation fund process, LPs should consider initiating an internal discussion within their own organizations to establish a protocol for addressing such transactions when they arise, to include approvals, underwriting process, understanding legal requirements and any steps that are statutorily defined
2. LPs should engage existing GPs and potential new GPs early to set expectations around timing, disclosures and if appropriate, terms
3. LPs should review the full scope of documentation around any such transaction, including reviewing representation and warranties in election and legal documents, it is critical to understand what will change as a result of the transaction
4. LPs should review existing fund documents, including side letters, especially in cases where the transaction will result in new economics; LPs should be cognizant of the opportunity to update the side letter
5. LPs should work with GPs to set timing expectations early around reviews and approvals, particularly where the transaction entails new documentation that will require the LP to conduct legal negotiations and secure internal approval and sign-off
6. In conducting due diligence on the specific deal being offered to inform their election, LPs should request that GPs provide documentation, models and materials that inform the rationale behind the transaction and its structure
7. LPs should incorporate questions related to continuation funds in their due diligence process regarding new managers/funds and re-ups with existing managers. LPs should inquire about past use of continuation funds and view on the potential uses of continuation funds moving forward
8. LPs should consider the potential for continuation fund transactions when reviewing and negotiating LPAs and fund documents. LPs should scrutinize and push back on any terms that pre-clear conflicts of interest related to these transactions

Conclusion

As continuation fund transactions increase in prevalence, greater transparency and consistency in these deals will be critical to their efficiency and quality of execution. As such, GPs should pursue processes and deal structures that maximize alignment and LP engagement. For LPs, by anticipating how to successfully engage in the process and requesting adequate disclosures, they can transact in a manner that serves the best interest of their beneficiaries.



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