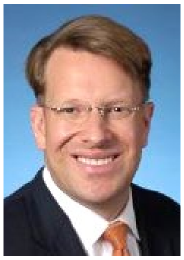

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Restructuring Your Way to a New Tomorrow: The Emerging Trend of "Stapled Secondary" Private Equity Fund Restructurings

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As funds raised in the 2006–2008 heyday of private equity reach the ends of their 10-year terms, there has been a surge of restructurings of those funds utilizing a "stapled secondary" structure. The widely publicized $1.2 billion restructuring in March 2016 of a 2008 vintage buyout fund managed by private equity pioneer Thomas H. Lee is the latest example of this trend, showing that private equity fund restructurings have become mainstream.

In the Lee Equity Partners restructuring, an investment group led by prominent secondaries investor AlpInvest Partners that included Harbourvest Partners, Pantheon Ventures, and the Canadian Pension Plan Investment Board purchased the LP interests of existing fund investors for approximately $900 million and committed approximately $300 million in capital to a new fund. Because sponsors face actual or perceived conflicts of interest when restructuring their funds, private equity fund restructurings have attracted the attention of the U.S. Securities and Exchange Commission (SEC). This article describes the process of private equity fund restructurings, discusses the key considerations involved in restructurings, and provides some action items for sponsors to use to reduce the risk of SEC enforcement action when restructuring their funds.

What Are "Stapled Secondary" Restructurings?

Stapled secondary private equity fund restructurings enable existing fund LP investors to sell their stakes to new LP investors that also agree to provide fresh capital to make additional portfolio company investments. The restructurings are referred to as "stapled secondaries" because the new investors purchase the LP interests of existing fund investors in "secondary" private equity fund transactions and also "staple on" an obligation to make capital contributions into the new fund.

Restructurings can be an effective solution for private equity sponsors with funds that are reaching the end of their fund terms and have portfolio company investments that are not yet ready to be sold, particularly where the sponsor is experiencing difficulty with fundraising for a new fund. They can be beneficial for existing LP investors that are unhappy with the fund's performance and are seeking liquidity and/or a way out of their obligation to make additional capital contributions. As a result, these existing LP investors may be willing to accept a price for their fund interests that represents a discount to the fund's Net Asset Value (NAV).

Participating in private equity fund restructurings can be attractive to new investors due to their potential acquisition of the LP interests of existing fund investors at a discount to NAV, which can substantially enhance new investors' overall return from their investment. However, not all private equity fund restructurings entail acquisition of existing investors' LP interests at a discount to NAV. The strong secondary market for LP interests in the private equity funds of sought-after sponsors has resulted in those LP interests trading at little or no discount to NAV. Secondary transactions involving those LP interests, including stapled secondary private equity fund restructurings, are often viewed by investors as an opportunity to invest in funds to which they might not otherwise have access.

Considerations for Fund Sponsors

A key factor for private equity sponsors considering restructuring their funds is often restoring the incentive effect of the carried interest for the members of their investment team. Sometimes, a few poorly performing portfolio company investments make it unlikely that the sponsor will meet the hurdles for payment of carried interest, resulting in the sponsor being disincentivized to expend the effort to maximize the value of the fund's remaining portfolio company investments. Those bad investments may be attributable to what the sponsor views as extraordinary events, like the drying up of the capital markets after the 2008 financial crisis, which the sponsor does not believe to be an accurate reflection of its investment abilities. As a result, private equity fund restructurings typically include a "reset" of the fund's economics (i.e., the carried interest and management fees).

The carried interest of restructured private equity funds is typically calculated based on profits realized over the new fund's acquisition price for its portfolio companies, rather than over the existing fund's historical cost basis for those portfolio companies. This revised calculation increases the likelihood of profits upon sale of the portfolio companies, in which the sponsor will share through the carried interest. Unlike typical buyout fund waterfalls, the carried interest provisions in restructured private equity funds may have multiple tiers, in which the sponsor receives successively higher percentages of profits as the fund's investments generate higher internal rates of return.

The management fees of restructured private equity funds are typically calculated using the traditional formulation of a specified percentage (usually 1%–2%) of capital commitments during the investment period, dropping down to a percentage of invested capital during the remainder of the fund's term. However, because fund restructurings result in the investment period being restarted while the new fund's capital is deployed, they typically result in the sponsor receiving management fees in larger amounts than it was receiving from the existing fund.

Investor Options upon Fund Restructuring

Typically, the investors in the fund being restructured are offered the choice of either selling their LP interests to the new investors (sometimes at a discount to NAV) or rolling their investment into the new fund, subject to the reset fund economics discussed above and what is usually a longer fund term. Sometimes, there is also a "status quo" option, in which the investors in the existing fund who do not choose either of the options described above simply retain their LP interest in the existing fund, albeit usually with an extended fund term. Status quo investors do not participate in investments made by the new fund and need to wait until the existing fund's portfolio company investments are sold to receive a return on their invested capital.

Although private equity funds' limited partnership agreements typically give the general partner broad latitude to approve secondary transfers of LP interests in the fund and to effect purchases and sales of portfolio companies, fund restructurings often require the approval of a majority or supermajority in interest of the fund's existing LP investors. However, depending on the fund documents, restructurings may sometimes be effected with only the approval of the fund's LP advisory committee.

Regulatory Review and Conflicts of Interest

Private equity fund restructurings have attracted the attention of the SEC due to what it views as the inherent conflict of interest between the sponsor's duties to the LP investors of the existing fund, on the one hand, and the sponsor's desire to help ensure the success of the restructuring process by striking the best possible bargain for the new investors, on the other. This conflict manifests itself in the new investors seeking to acquire the LP interests of the existing fund's LP investors at the largest possible discount to NAV, as well as them benefiting from lower valuations assigned to the portfolio companies transferred from the existing fund to the new fund in connection with the restructuring, which conversely has an adverse impact on the existing fund's LP investors. This situation may be exacerbated by the inherent informational advantage that the sponsor, as manager of the existing fund, has over the existing fund's LP investors regarding the valuation of its portfolio companies and the resulting NAV of the fund. At a May 2015 industry conference, Igor Rozenblit, co-head of the SEC's Office of Compliance Inspections and Examinations, identified private equity fund restructurings as a focus of SEC attention, stating that "[y]ou have to wonder if the manager is fulfilling its fiduciary duty when the options offered to [the fund's existing LP] investors are often two bad options," consisting of either being bought out at a discount to NAV or rolling into the new fund and becoming subject to reset fund economics and a longer fund term. More recently, in April 2016, Mr. Rozenblit placed some of the blame for the Park Hill Group / Andrew Caspersen fraud on the lack of transparency in private equity fund restructurings. In some cases, transfer of the portfolio companies from the existing fund to the new fund results in transaction fees being payable to the sponsor, which could be perceived as furthering the conflict of interest inherent in private equity fund restructurings.

In light of the SEC's focus on private equity fund restructurings and the concerns discussed above, sponsors should use great care when restructuring their funds to avoid a possible enforcement action under the Investment Advisers Act of 1940's prohibition on "fraudulent, deceptive or manipulative" practices, as well as possible breach of contract actions under the fund partnership agreement and other adverse consequences. Sponsors considering a private equity fund restructuring should consider employing the following "best practices":

- Work with advisors to create robust disclosure documents to supply to existing fund LP investors and new LP investors that describe in detail the potential conflicts of interest that the sponsor may have resulting from the transaction

- Engage an independent valuation firm to provide the valuations of the portfolio companies being transferred from the existing fund to the new fund

- Have the new fund engage different legal counsel from existing fund counsel to negotiate the acquisition by the new fund of the portfolio companies from the existing fund
- Consider foregoing receipt of transaction fees on the transfer of portfolio companies from the existing fund to the new fund

For the reasons discussed above, private equity fund restructurings can be mutually beneficial to sponsors, existing LP investors and new LP investors. With care and forethought, they can also be structured to address SEC concerns and to protect sponsors from enforcement actions and other adverse consequences.

Related Content

For more information on secondary transactions, including an overview and form of transfer; and purchase and sale agreements, see the following forms / practice notes:

- Domestic Transfer Agreement and PSA