ILPA Publishes New Guidance on Continuation Funds

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INTRODUCTION

The Institutional Limited Partners Association ("ILPA") recently published a paper setting out its suggested guidance and best practices for continuation funds (the "Guidance")[1]. The Guidance acknowledges the increasing prominence of continuation funds in the private equity industry, describing the most common LP frustrations and offering a few principles and recommendations—some but not all of which reflect existing market practice. We summarize below a few of the key takeaways.

KEY RECOMMENDATIONS

- Continuation fund transactions should maximize value for existing LPs and rolling LPs should be no worse off as a result of the transaction.
- Since continuation fund transactions can be highly complex and may demand a substantial amount of time from LPs (to analyze and fully understand the implications of any particular transaction), GPs should involve a fund's LP advisory committee (the "LPAC") and LPs as soon as practicable at each of the key stages of the transaction to provide them with sufficient time to make key decisions. ILPA recommends at least 30 calendar days / 20 business days to make roll or sell decisions.
- GPs should identify, manage and mitigate potential conflicts that may arise at the outset of the transaction, engage and consult experienced advisors, and provide and maintain clear communication and documentation with and to LPs throughout the process.

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1 *See* https://ilpa.org/continuation-funds/

PROCESS

The Guidance provides a roadmap for what ILPA considers a well-run continuation fund process. Key steps should include the following:

- GP presents the business rationale for the proposed transaction to the LPAC and LPs;
- GP selects an experienced advisor to structure the auction process, solicit bids and guide the transaction process;
- The LPAC reviews the transaction terms and decides whether to waive any conflicts associated with the transaction;
  - The LPAC should be given at least 10 business days to approve conflicts and also given an opportunity for an *in-camera* session prior to doing so;
  - GP is encouraged to engage with the LPAC as a whole and avoid one-on-one communications with LPAC members.
- GP notifies the broader LP base of the transaction and provides transaction and asset-level disclosures to buyers; the LPs should be provided with the same information made accessible to the LPAC;
- GP circulates disclosure memorandum to all LPs and presents the final the transaction terms; and
- LPs are given at least 30 calendar days/20 business days to elect whether to sell or roll over their interests to the continuation fund.

CONFLICTS

As the sponsor is generally on both sides of the transaction, various forms of conflicts can arise, including around valuation of the assets, the method of soliciting bids, economics accruing to the GP, stapled financing and additional capital for follow-on investments, etc. The Guidance proposes a number of potential mitigants to manage these conflicts, including:

Extensive LPAC Involvement

GPs are discouraged from relying on existing LPA provisions that preclear conflicts and are encouraged to bring all conflicts to the LPAC and to keep the LPAC apprised throughout the key stages of the transaction. The Guidance suggests that the LPAC should have the option to engage independent advisors to evaluate the transaction, at the expense of the fund (particularly in the context of distressed restructurings where GP may not be aligned with LPs' interests in seeking to maximize the asset value).

Transparency

GPs should provide the LPAC and LPs with extensive information regarding the transaction, with the goal of achieving parity of information among the LPAC, the LPs and the buyer(s). Recommended disclosures include:

- Business rationale behind the proposed transaction, including why an alternative (e.g., a traditional exit, fund extension, additional follow-on or co-investment) was not selected;
- Asset-level information to facilitate diligence on the assets, including GP's investment memo, GP's diligence on material risks of the assets, details on valuations and modeling assumptions used, GP's view on exit plans and potential return at exit, and performance of any existing continuation funds managed by GP; GPs are also encouraged to make the transaction advisor, their deal teams and portfolio company management (where feasible) available to address potential LP and/or LPAC concerns;
- Description of the auction process and evaluation of the bids, including the number of bids received and pricing;
- Any discounted pricing or favorable economics offered to buyers relative to rolling LPs, including terms offered in connection with stapled financing;
- Any material changes in terms compared to the existing fund related to either the continuation fund or any stapled primary capital;
- Any dilution of existing LPs' interests in the assets as a result of the transaction and commercial rationale therefore;
- Allocation of transaction fees and expenses between buyers, selling LPs, rolling LPs and the GP; and
- The percentage of crystalized carried interest being rolled into the continuation fund and the rationale.

Other Mitigants

The Guidance recommends that 100% of crystalized carry be rolled into the continuation fund (to help align interests) and, when requested by LPs, for pricing to be tested by a fairness opinion from an independent appraiser. A partial disposition to a third-party or an arm's-length transaction for a minority stake may also help to confirm the fairness of valuation.

KEY TERMS / ECONOMICS

The Guidance states that existing LPs "must" be provided an option to participate in the continuation fund with no change to existing economic terms (i.e., the "status quo" option). Additional recommendations include:

- No crystallization of carried interest for rolling LPs;
- 100% of crystallized carried interest should be rolled into the continuation fund;
- Side letters for existing LPs should generally be carried over;
- Expenses should be allocated based on which parties benefit from the transaction;
- No minimum threshold for rolling LP participation; and
- LPs that do not make elections in connection with a continuation fund election process should always be treated as electing to sell.

As the Guidance notes, continuation fund transactions are typically bespoke, and there may not be a "one size fits all" approach to the broad range of deals that market participants will encounter. It remains to be seen how the recommendations set out in the Guidance will be implemented in practice.

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Please do not hesitate to contact us with any questions.

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