THE
NATIONAL LAW REVIEW

Fund Restructurings: How to Navigate a Conflict-Rich Environment

Article By
Timothy W. Mungovan
Michael R. Hackett
Proskauer Rose LLP
The Capital Commitment

- Financial Institutions & Banking
- Securities & SEC

- All Federal

Wednesday, October 19, 2016

The number of private equity fund restructurings is likely to rise in the coming years. The current economic expansion will inevitably come to an end (at 87 months and counting, this expansion is already the third longest post-WWII) making exits more challenging, just as the terms expire on funds raised during the "golden era" (2003-2007). At the same time, some managers will seek to continue managing certain portfolio assets, by extending the terms of the funds and/or restructuring the funds to bring in new capital and provide liquidity to existing limited partners.

On a simplified basis, a restructuring often involves the manager forming a new fund (with a combination of new LPs and continuing or "rolling" LPs) and the new fund merging with or otherwise acquiring the remaining assets of the existing fund. The influx of new cash from a secondary buyer creates liquidity for some existing LPs to cash out. The purpose of the transaction structure is to give the manager additional time to maximize the value of the portfolio, while providing liquidity to those investors who prefer an immediate exit.

While a completed restructuring, when done correctly, has the unique ability to re-align the incentives and objectives of managers and LPs to create long-term value, the SEC has signaled that it has concerns that certain aspects of some restructurings may be abusive. In particular, the restructuring process can be highly complex and fraught with conflicts of interest. As such, restructurings require extraordinary prudence in planning and execution.

Fund restructurings almost always occur when things have not gone according to plan. The fund may be at or past its term, portfolio assets may be illiquid in whole or in part, the sponsor may be facing a clawback or not receiving management fees, or the prospect of carry may be unrealistic. Despite these circumstances, the manager believes not only that certain assets in the fund have substantial upside, but also that the manager is in the best position to achieve that upside. Meanwhile, some LPs may desire liquidity or a cessation of management fees. Other LPs may see value in the portfolio on a longer-term basis and would be willing to forgo liquidity and maintain (or even increase) their commitment for additional follow-on financing.

Restructurings often are rife with actual and potential conflicts of interest. Most – if not all – of those conflicts involve the manager. Given that the manager owes a fiduciary obligation to the existing fund and the new fund, and the manager owes duties and obligations to the LPs (both current and new), prudent managers should work to identify all of the potential conflicts and address them head-on.

There are at least six relationships that could involve a conflict of interest in a restructuring:

- **Within the Sponsor/Management Company:** The sponsor should be mindful of a restructuring’s impact on alumni (of the sponsor), particularly where sponsors owe continuing duties to alumni or alumni owe continuing duties to the sponsor (*g.*, clawback obligations).   A restructuring that involves a “roll” to a new fund may strip alumni of future economics, or a restructuring may delay liquidity for certain alumni. Depending on obligations and expectations, alumni may object and even attempt to block a restructuring. Alumni may also object to clawback payments that may be required as a condition to restructuring.

- **Sponsor and Fund:** The sponsor’s ultimate duty is to the fund as a whole. As such, for each existing LP, the sponsor must ensure that the process is transparent (*e.*, full disclosure), honest (*i.e.*, accurate disclosure), and, where possible, equal (*i.e.*, equal opportunity to roll or cash out). In addition, the sponsor must ensure that the price at which the fund is selling the assets (to the new fund) is fair. There are various methods to establish a fair price, but engaging a third party to run a sale process is often a prudent course – whether before or as part of the restructuring.

- **Sponsor and Cashing-out LPs:** To effectively restructure the fund, the sponsor and/or secondary buyer may need or want a certain percentage of the existing LPs to cash out (to make room for new investors and/or reach a certain minimum threshold for the secondary buyer to engage in the transaction). Nevertheless, the sponsor should ensure that cashing-out LPs understand that they will not participate in any potential “upside” in the portfolio.

- **Sponsor and Rolling LPs:** The sponsor and/or secondary buyer may need or want a certain percentage of existing LPs to “roll” into the new fund. The sponsor should generally treat existing LPs as “new” investors – even if they are familiar with the portfolio and the risks and opportunities. As such, the sponsor must disclose all of the “risks” of the transaction, including unique risks applicable to the new fund. In addition, sponsors must be careful about imposing additional obligations on LPs who want to roll, such as an additional financial commitment to the new fund. Such “stapled financing” – where it is obligatory to “rolling” with the asset – could be viewed as coercive and a conflict of interest.

- **Sponsor and New LPs:** Similar to rolling LPs, the sponsor must disclose the “risks” to new LPs. In addition, the sponsor should maintain an arms-length relationship with new LPs, especially where the sponsor is viewed as needing the new LPs to restructure the fund and re-set the sponsor’s economics. The disclosures to the new LPs should be the same as to the existing LPs.
- **Sponsor and Portfolio Company:** Where the sponsor has designee(s) serving on the board of directors of portfolio companies, the sponsor must be cognizant of the fiduciary duties that its designees owe to the shareholders of the portfolio company. Depending on the percentage of the company that the fund owns, and the stock restrictions in place, the company and its stockholders may be better off pursuing a different transaction. In addition, the sponsor must comply with the restrictions and limitations set forth in the stockholders agreement, such as a ROFR. Finally, where the portfolio company is publicly traded, the sponsor must be mindful of reporting obligations and liability risk for short-swing trading under Section 16 of the ’34 Act.

Surmounting this multiplicity of conflicts requires careful planning and execution, along with close coordination with experienced legal counsel.

In closing, the key for sponsors to limit their risk is to ensure that all parties are provided the full and fair disclosure necessary to make an informed decision of whether and how to participate in the restructuring.