Single Asset Fund Recapitalizations: Key Considerations for Sponsors and Investors

A Practical Guidance® Practice Note by
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This practice note addresses the elements of a single asset fund recapitalization, a transaction in which a fund sells its interest in a portfolio investment to another entity controlled by the same sponsor. In recent years there has been a notable uptick in so-called single asset recapitalizations, as sponsors look for ways to provide liquidity to existing investors without fully divesting from a portfolio company they like. This practice note begins with a brief explanation of what these deals are, and why a sponsor and its fund investors may want to pursue a single asset recap. We'll next discuss typical structures for these deals and certain considerations sponsors will want to keep in mind, as well as strategies to reduce deal execution risk. Finally, we'll quickly cover certain key tax considerations in these transactions.

Sponsors and secondary buyers need to consider many factors in structuring a transaction that will be appealing and mutually beneficial to not only the sponsor and the secondary buyers, but also to the existing fund investors. Given the growth in these transactions over the last year, single asset recapitalizations are clearly meeting a need in the market; single asset recaps will likely prove to be a durable part of sponsors' toolkits as they look to increase their flexibility to effectively manage their investment portfolios in challenging economic conditions.

For additional context on exit strategies and secondary sales of fund interests and assets, see Exit Strategies in Private Equity Investments, Multi-Process Exit Transactions: Overview and Management and Stapled Secondary Private Equity Fund Restructurings.

What Is a Single Asset Recapitalization?

Very briefly, in a single asset recapitalization, a sponsor sells some or all of its investment in a current portfolio company to a continuation fund that is managed by the same sponsor but capitalized by a new investor base. Existing investors typically are given the option of either cashing out all or a part of their indirect interest in the portfolio company or continuing their investment through the new continuation fund. Other assets held by the existing fund, if any, are typically harvested in the ordinary course.

These transactions can be attractive for both sponsors and fund investors for a range of reasons. For example, a sponsor may have a firm conviction in a longer-term value creation thesis, but if the portfolio company has already performed well and appreciated in value, fund investors may want to take cash off the table. A single asset recap can allow the sponsor to retain the exposure to a portfolio company it likes while giving a nearer-term liquidity option to interested fund investors. This is particularly relevant under choppier market conditions such as those encountered during 2020, where sponsors may worry the market isn't acknowledging a portfolio company's value such that a full disposition would be desirable.

Alternatively, the sponsor may believe that a portfolio company requires more follow-on capital and/or a longer realization timeline than is available within the scope of the existing fund, either because of insufficient unfunded capital commitments or because further investment is restricted by concentration limits. A single asset recapitalization can provide a mechanism for the sponsor to access that additional capital and time.

Considerations for Sponsors

If a sponsor decides to pursue a single asset recapitalization, there are several key considerations to keep in mind. First, these transactions involve inherent conflicts of interest. As both the selling fund and the continuation fund are managed by the sponsor, a single asset recapitalization transaction constitutes a cross-trade. Because the transaction gives rise to an opportunity to favor one fund over another—for example, if the price at which the asset is sold to the continuation fund is too low, the transaction will benefit investors in the continuation fund at the expense of investors in the selling fund—a sponsor will want to get approval for the transaction from both of its clients (whether by limited partner or limited partner advisory committee (LPAC) approval).

Another conflict that arises in these transactions relates to the fact that the sponsor typically has an economic interest in the outcome of a fund or single asset recapitalization. The sponsor typically receives both management fees and carry from the continuation fund. It may also be crystallizing carry at the selling fund in connection with the recapitalization itself. The sponsor only receives these new economics if the transaction closes, however, resulting in a potential misalignment of interests with existing fund investors.

It is critically important for sponsors to carefully navigate these conflicts. Getting the necessary approval from the continuation fund is comparatively straightforward, as that fund has been established for the purpose of consummating the transaction. In contrast, and depending on the terms of the existing fund's partnership agreement, the sponsor may need to go to the full limited partner base for approval, but it's also very possible that the sponsor may be able to have the conflicts blessed by the LPAC of the relevant fund.

Fund sponsors also will want to check whether any other approvals are required, for example, if there are any relevant restrictions in existing side letters. Fund sponsors also will want to check whether the approval of their subscription line lender is required and if there are change-in-control restrictions under the terms of the underlying portfolio company's shareholders' agreement or other governing documentation.

Another core question for a sponsor is whether to sell the asset outright as compared with pursuing a single asset recapitalization. The pool of potential buyers will be different for a single asset recap than for an outright exit, as typically these deals have been the domain of secondary buyers as compared with other sponsors and strategic purchasers. The deal size—whether too large or too small—may further limit interest even amongst secondary buyers. These deals are also inherently more concentrated than a typical secondary transaction, which can hinder interest due to the absence of diversification.

The Deal Process and Tips for Success

Having decided to pursue a single asset recapitalization, a sponsor typically will engage an agent for the transaction. The agent's role is twofold: Initially, the agent will solicit interest from a number of secondary buyers in the first instance, much as with the process for selling an asset to a third-party buyer, and assist the sponsor in establishing

a buyer selection process/auction to identify the best transaction terms for the parties, including the existing investors. Later, the agent will play a key role during the tender process when existing investors decide whether or not to sell in connection with the transaction.

During the diligence and bidding process, the pool of interested buyers will likely shrink. Having some level of communication with the selling fund's LPAC at each stage of the bidding process can also help make sure the direction of the deal structures and pricing being discussed are within the bounds that the LPAC supports, helping with deal certainty. These ongoing discussions with existing investors also can help ensure that there is sufficient interest by existing investors in selling on the proposed terms.

Sponsors and the secondary buyers who capitalize the continuation fund need to navigate pricing dynamics. If the sponsor (with the assistance of the agent) sets a price too low for a high-quality asset, a sponsor will attract more interest from secondary buyers, but too few of the existing limited partners may cash out their interests and the sponsor may not obtain the necessary approvals from its limited partner base or LPAC. To mitigate this risk, many secondary buyers will insist on minimum deal size condition—given the size of their funds, they have a targeted minimum check size. If too few existing investors elect to sell, the deal could fail. Conversely, if the price is set too high, a sponsor may deter potential buyer capital or may find itself without a deal or with a deal that is only partially underwritten, meaning that there isn't enough interested buyer capital to buy out all of the limited partners who want to sell. In that case, investors who have elected to sell may only be able to sell in part.

To avoid a partially underwritten deal (which, not surprisingly, tends to be less popular with the existing investors), a sponsor may solicit buyer dollars from a buyer syndicate and also may offer its existing investors the ability to invest in the continuation fund directly (versus only rolling their interest).

It is worth noting that secondary buyers also want comfort on their maximum exposure, so even if a buyer may be able to underwrite a full deal, it may prefer to maintain a lower overall exposure. Both to address buyers' desire to limit their overall concentration and to allow funds and buyers to line up sufficient capital, we often see parties agree to have a syndication window after investors have delivered their elections to sell or roll.

Communication and Cooperation

Key to navigating these issues from a sponsor's perspective is early and continuous communication with the LPAC of the fund and the limited partners. For example, it's often appropriate for the sponsor to get the LPAC to bless incurring expenses in pursuit of the transaction at a very early stage. We typically recommend that a sponsor keep the LPAC informed throughout the deal process, not only to explain the sponsor's decision to pursue the single asset recapitalization, but also to solicit feedback on the key terms of the transaction. Clear and frequent communication helps avoid a mismatch between the negotiated terms and what the LPAC views as acceptable, and also the basis on which the LPAC clears the conflicts. It also helps ensure that there is adequate sales volume at the proposed price and terms.

After the terms of the transaction are negotiated with the secondary buyer, the sponsor will typically want to adequately disclose the terms of the proposed transaction to investors, including giving existing investors access to comparable materials as were provided to the secondary buyers—a parity of information, if you will.

The sponsor will also want to ensure that its investors have adequate time to evaluate whether to sell, roll, or reinvest depending on how the deal is structured, and that evaluation period is typically at least 20 business days, although that could be extended under certain circumstances. In some instances we have seen sponsors proceed with shorter election windows where they conclude that such shorter period will still give investors an adequate opportunity to evaluate the sell/roll decision, but shorter election periods do entail possible risks for sponsors as investors have become accustomed to comparing a transaction's terms against the principles and guidance provided by the Institutional Limited Partners Association (ILPA), the industry association of institutional investors.

Depending on whether the lead buyer is fully underwriting the transaction or not, the sponsor also may need to cooperate with the lead buyer to syndicate additional buyer commitments to acquire the full amount of the interests that are tendered. Time also may be needed for the parties to obtain the necessary consents for closing, including relevant premerger approvals. All in, the timeline for one of these deals can range from just a few months to quite a bit longer, particularly if regulatory approvals are required.

Key Terms in Transaction Documentation

The agreements papering a single asset recapitalization are very bespoke and highly negotiated (and can run into the hundreds of pages). In the paragraphs that follow, we highlight some of the economic and other key business items that we often negotiate in these deals.

There typically are two key agreements in a single asset recapitalization transaction: The limited partnership agreement of the continuation fund, and a contribution, or purchase and sale agreement pursuant to which the asset is transferred from the existing fund to the continuation fund.

Within the partnership agreement, the parties negotiate the key economic provisions—management fees and the carry waterfall—as well as how to handle follow-on commitments and expenses, dilution if existing investors do not have the same proportion of follow-on capital as the secondary buyers, governance terms, and other investment matters.

The contribution agreement (or purchase and sale agreement) serves to transfer the asset from the existing fund to the continuation fund. It makes clear exactly what assets and obligations are being transferred (and which are not), contains a variety of representations regarding the transaction and the underlying asset, and sets forth the negotiated indemnity package for the deal. While the contribution agreement is formally between the continuation fund and the existing fund, the lead secondary buyers will be intimately involved in its negotiation, and the ultimate beneficiaries of any negotiated indemnity or representation and warranty insurance policy.

Tax Considerations

There are many tax considerations in these deals and the relative importance varies depending on the facts. These deals can be very tax-intensive, however.

On the sponsor side, among other things, if the sponsor is rolling any portion of its interest, the sponsor will want to preserve tax-free treatment. The sponsor often also tries to provide rolling investors with tax-free treatment and to segregate the rolling and selling investors to avoid accidental allocations of seller's gain to the rolling investors.

Sponsors must also consider how and whether to block effectively connected income (ECI) assets and whether to sell blockers or the underlying assets. These decisions will be driven both by the sponsor's desire to maximize returns for existing investors and by the buyers' preferences for tax structuring. The transaction steps involved with this structuring are often very involved.

Further, in such transactions a great deal of effort is invested in limiting withholding liabilities for ECI and Foreign Investment in Real Property Tax Act (FIRPTA). Due to the broad nature of the new ECI withholding rules, investors with no ECI at all can easily be subject to unnecessary withholding, buyers can be trapped with withholding obligations that they cannot practically comply with and the withholding can in some cases consume the entire purchase price. More specifically, under the new rules, buyers are required to withhold regardless of whether the underlying partnership has ECI if the parties do not comply with certain certification requirements. This can be very painful in the context of a "disguised sale" transaction where buyers can be treated as buying interests directly from a very large number of sellers without having material information with respect to the sellers or practical experience in withholding on a large number of parties. (The solution to this problem is to collect all foreign sellers in a newly created Delaware partnership). In terms of the amount of withholding, the 10% rate is deceptive. The relevant amount is not 10% of the purchase price, but 10% of the "amount realized," which includes the selling partner's share of partnership leverage. Due to the leverage adjustment, it is possible for a buyer to need to withhold 100% of the purchase price and for the parties to be unable to calculate the appropriate amount of withholding. See Effectively Connected Income (ECI) and Private Equity Funds for additional context on ECI, and Foreign Investment in Real Property Tax Act Fundamentals for background on FIRPTA.

Among other items, buyers will focus on avoiding any assumption of seller liabilities (including partnership audit liabilities and the ECI withholding liabilities). In certain cases, a new partnership can be treated as a continuation of an older partnership and thus inherit the earlier partnership's liabilities. Buyers will also consider Code Sections 26 U.S.C. § 754 and 26 U.S.C. § 6226 elections to step up acquired basis and push out historic audit liabilities.

As potential tax liabilities may not arise for many years given the comparatively slow time frame of IRS audits, parties will want to pay attention to how long the tax covenants survive and may want to negotiate longer survival periods for these covenants than for many of the other covenants.

There are many other tax considerations, and notwithstanding the phrase "single asset recap," these deals often involve many, many steps, but the foregoing considerations appear in many deals.

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Asset management partner Isabel K.R. Dische co-leads Ropes & Gray's institutional investors team. Ranked nationwide by *Chambers USA* for investment funds, she primarily focuses on advising asset managers and institutional investors on matters that span alternative asset classes. Among the clients she counsels are seven of the top 15 secondary buyers and sovereign wealth funds across the globe, including Australia, Canada, China, Japan, the Netherlands, Nigeria, Singapore, and South Korea.

Isabel is especially skilled at structuring legally complex transactions and is known for "thinking creatively," being "commercially smart," and providing "incredibly thoughtful" advice, as clients have told *Chambers*. With experience as both a funds lawyer and a deal lawyer, Isabel is able to offer a unique perspective when advising clients.

Isabel's keen sense of the market is grounded in her representation of both fund sponsors and investors, and in the sheer volume of her practice. Her team was named the number one legal adviser by global secondaries deal count in 2019, according to *Secondaries Investor*. In 2019, the team closed more than 150 secondaries transactions worth over $17.5 billion and over 200 co-investment transactions.

In addition to her work with institutional investors, Isabel advises hedge funds and other private funds and their sponsors on fund formation, legal and risk management questions, and firm ownership and operations. She started her career as an associate at Atlas Venture, which one client notes "adds to her insight of how [funds] operate." She also counsels investment advisers and institutional investors on environmental, social and governance (ESG) and responsible investing.

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Adam is a partner in the asset management group. He advises hedge funds, private funds and investment funds in regulatory, transactional and compliance matters. Adam specializes in counseling hedge fund clients on Section 12 and Section 16 reporting compliance and proxy contests. Prior to joining the firm, Adam was an assistant attorney general in the Environmental Protection Bureau of the New York Attorney General's Office.

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Daniel C. Kolb is a partner in Ropes & Gray's New York office. His practice focuses on transactional tax matters, including matters relating to private equity, real estate, and hedge funds; joint ventures; REITs; inbound and outbound investments; and REMICs, collateralized bond obligations, and other structured finance transactions. Dan also regularly represents a number of large investors with respect to their private equity, hedge, timber and real estate fund investments and in connection with secondary and co-investment transactions. *Chambers USA* ranks Dan in its Band 1 nationwide for Investment Funds: Investor Representation, and calls him a "very, very talented lawyer."

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Peter Laybourn is a partner in Ropes & Gray's asset management group and co-leader of the firm's buyout and growth equity funds team. Focusing on fundraising for private equity and other private funds, Peter has helped steer clients through complex fundraisings and transactions ranging in size from a hundred million to many billion dollars.

Drawing on his extensive experience in the formation of growth and buyout funds, credit funds, funds of funds, co-investment funds, energy funds and secondary funds for both emerging and well-established firms, Peter brings deep insight and creativity to the fundraising process. Peter regularly helps clients navigate critical operational and governance matters as well as complex fund level transactions. Moreover, Peter also works with private fund sponsors as well as other institutional clients in the negotiation and execution of domestic and international transactions, GP-led fund restructurings, "spinoffs," succession planning, joint ventures and general investment management matters.

Some of Peter's clients include Antares Capital, Audax Group, Bain Capital, Baupost Group, Breakthrough Energy Ventures, Constitution Capital Partners, Hamilton Lane, Neuberger Berman, Shoreline Equity Partners and Thomas H. Lee Partners.

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