Making the Most of Continuation Funds

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In light of lingering effects of the pandemic on many funds and uncertain and volatile markets, sponsors are increasingly looking for alternative solutions to generate liquidity for their investors. One such solution offered by the private equity secondaries market is the continuation fund. We discuss below what a continuation fund is, benefits of using this type of transaction and potential concerns that sponsors and investors may have with these transactions, as well as common solutions.

What Are Continuation Funds?

Continuation funds are newly formed special purpose vehicles created for the sole purpose of buying one or more assets from an existing fund (which is often near the end of its term) managed by the same sponsor. Investors in the existing fund may either sell their interests in the existing fund and be paid out or roll their interests into the continuation fund in order to remain invested in the same assets. Interests in the continuation fund are offered to new investors for purchase, and investors who have rolled their interests into the continuation fund may increase their commitments. These commitments are then used to purchase the assets from the existing fund and pay out the selling investors.

Benefits of Continuation Funds

While continuation funds have historically been considered a tool to transfer poorly performing assets out of funds to give them more time to provide value, they are now increasingly being used by sponsors to retain well-performing assets to sell in a more optimal market at a later date for better returns while still providing an exit option for investors in need of liquidity. These transactions can be beneficial for all parties involved.

With respect to investors choosing to roll their interests into the continuation fund, they have the advantage of continued investment in an asset they know well for a longer term than is permitted under the existing fund organizational documents. Additionally, they often may retain their existing terms of investment if preferred or they have the opportunity to renegotiate for new terms along with the new investors. For investors who choose to sell their interests and be paid out, these transactions provide an opportunity to receive liquidity that would otherwise be locked up. New investors, often market participants in the secondaries market, find these investments attractive because they enable investors to invest in known assets, usually with shorter holding periods than primary funds.

Continuation funds provide sponsors with increased optionality, as sponsors are able to retain control over well-performing assets and assets with high potential rather than selling at inopportune times in the market as required by the terms of an existing fund's organizational documents. Additionally, sponsors may benefit from the crystallization of their carried interest upon the effectiveness of the rollover of the investment to the new fund. Often, sponsors will commit a significant portion of this carried interest to the continuation fund, aligning their interests with the success of the assets. Continuation funds also permit sponsors to raise new capital for follow-on investments.

Potential Concerns and Common Solutions

While there are many benefits to utilizing continuation funds, they also present certain issues that sponsors must navigate to successfully manage these transactions, including perceived conflicts of interest and short timelines that can hinder an investor's ability to determine whether to roll its interests into the continuation fund.

Conflicts of Interest

Continuation funds may be scrutinized by investors for perceived conflicts of interest, since the sponsor sits on both the sell and buy side of the transaction. Investors will look for the sponsor to provide a compelling business rationale for the transaction and to justify the transaction price as reasonable. Negotiation of ancillary economic terms, including management fees, can also raise questions from investors.

Sponsors must deftly balance profit and fiduciary duty to address these concerns. There are a number of common methods used by sponsors, including meeting with the fund's investment advisory committee to review the proposed transaction, disclosing fee details, explaining the rationale for the proposed transaction and obtaining the committee's approval. The Institutional Limited Partners Association (ILPA) has provided guidance on best practices for successful continuation fund transactions and recommends that sponsors involve the fund's investment advisory committee as early as possible to provide sufficient transparency and give enough time for the committee to make informed decisions. With respect to pricing concerns, a common approach is using an auction process to solicit competing offers. An additional measure that can be taken is requiring independent valuations of assets and related formal fairness opinions to show transparency and fairness in the valuation process. In regards to concerns about whether the transaction has a valid business purpose, requirements that should be met for creation of continuation funds are increasingly being hardwired into fund organizational documents to avoid this uncertainty.

Timing for Investors

Some investors have raised concerns about the amount of advance notice they receive to decide whether to sell their interests or roll them over into the continuation fund. Particularly for institutional investors, internal presentations and approval processes may take longer than the period given by the sponsor for a decision. If investors don't have time to complete those internal processes, they may be compelled to sell their interests rather than roll them into the continuation fund without regard to what their view of the continuation option is. To address such concerns, the ILPA has recommended that sponsors provide at least 20 to 30 days for investors to complete their diligence and conduct any necessary internal approval processes before requiring a decision on whether to sell or roll over their interests in the existing fund.

Conclusion

Continuation funds can provide helpful optionality for private equity fund sponsors and investors, and can be beneficial for all parties involved. However, these transactions require proactive steps from the sponsor to provide transparency and protect the interests of all participating parties.

FFF Sovereign Immunity Series – Part XI: Texas Toast

June 2, 2023

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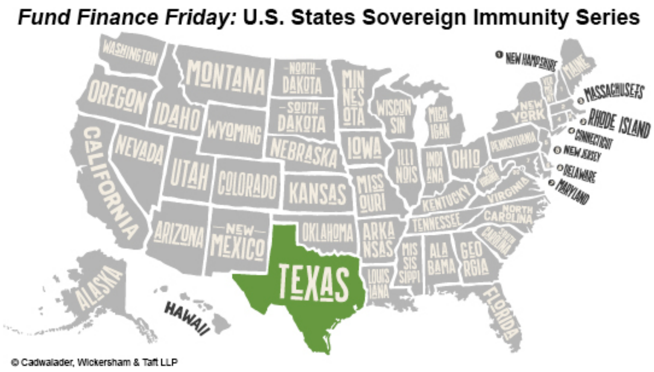

After leaving South Dakota and taking on a full tank of gas in Tennessee **last week**, today we have our biggest prize in our 50-state road trip of sovereign immunity: Texas. It's our luck to be your driver for this leg of the trip, and we will do our best in this article, which will just focus on Texas and no other state given its importance in fundraising and the complexity of its sovereign immunity problems.

Most people in the market know to be careful with sovereign immunity when it comes to a Texas investor that is an arm of the state. Most bankers and funds also know that inclusion of such investors in the borrowing base is limited to exceptional circumstances or only with a hurdle concept if at all. Today, our goal is to understand the problems facing our market when it comes to sovereign immunity in Texas so that all market participants can see the risks with clear eyes and assess them candidly.

First, a general recap of sovereign immunity issues when it comes to investors that are an arm or agency of the state. (For a more in-depth overview of sovereign immunity as a concept, see our first installment of the series **here**.) Since the United States is a federal system, each state has sovereign status within that system as codified by the Eleventh Amendment. (Texas is in fact a great example of this sovereign status, since it was an independent republic before admission to the United States.) As a result of its sovereign constitutional status, a state may raise a defense that it may not be sued under the long-standing doctrine of sovereign immunity.

Over time, as states have engaged in more commercial activity, most states have recognized that sovereign immunity should not apply in a commercial context, such as a breach of contract when the state is a party to such contract. As a result, most states have statutes or case law that have adopted or recognized waivers to the doctrine of sovereign immunity in a commercial context. Texas is *not* one of those states.

The rule in Texas is that the state and arms of the state retain sovereign immunity absent a specific waiver provided by the Texas legislature. A statutory waiver of immunity must be "effected by clear and unambiguous language." Tex. Gov't Code Ann. § 311.034. In addition, the Texas Supreme Court has stood by this principle time and again – it is up to the state legislature to grant waivers, not the courts, when it comes to the state's immunity from suit. See *Wichita Falls State Hosp. v. Taylor*, 106 S.W.3d 692, 695 (Tex. 2003). In that respect, the problem in Texas is not at all complex: we know we don't have a waiver of sovereign immunity unless the Texas legislature has enacted one into law. If this is your only takeaway from the article, you are probably halfway there in understanding the risk.

However, there are two issues that can cause confusion. One is that there is a certain type of immunity that Texas courts have found is waived in certain circumstances. If you hear or read somewhere that says Texas courts have recognized a waiver to sovereign immunity in a contractual context, this would refer to immunity from *judgments*, not immunity from *suits*. Sovereign immunity has two concepts: immunity from suit (there is no waiver in Texas absent a specific law from the legislature) and immunity from judgment (an arm of the state can waive immunity from judgment by engaging in a proprietary action – that is, under Texas case law, non-governmental function – in certain circumstances). The question of when a Texas sovereign entity waives immunity from judgment is a complex question of Texas case law, but we actually can ignore that for our purposes: it's the immunity from suit that would bar any recovery in the first place.

The second confusion is that the Texas legislature has in fact provided a limited waiver from suit back in 2005, but the confusion comes in understanding the scope of this waiver. This waiver covers qualifying local government entities' immunity for breaches of contract and can be found at Texas Local Government Code Section 271. However, the qualifying local government entity definition is pretty narrow: either a municipality, public school district or special-purpose district. Texas Local Government Code Sec. 271.152. It does not, per statute, include a county or a unit of state government. Texas law helpfully defines what a unit of state government is (that is, not covered by the legislature's waiver): "the state or an agency, department, commission, bureau, board, office, council, court, or other entity that is in any branch of state government and that is created by the constitution or a statute of this state, including a university system or institution of higher education." Tex. Gov't Code Ann. § 2260.001(4). In sum, with respect to this limited waiver, it is a very short list of investors that qualify for such waiver and a very long list of investors who cannot.

We hope you have enjoyed this installment of our series, which was a bit unusual as we only focused on one state. However, given its prominence in fundraising and the problems sovereign immunity presents in Texas, we thought it was worth a stand-alone feature. In our next and penultimate installment, we will discuss Utah, Vermont, Virginia and Washington as we come toward the end of our 50-state survey.

Fund Finance Chapter Published

June 2, 2023

The International Comparative Legal Guide – Lending and Secured Finance 2023 was recently published by Global Legal Group and features a chapter on Fund Finance by Cadwalader partners Wes Misson and Sam Hutchinson. The chapter, titled "Fund Finance: Past, Present and Future," surveys the ascendency of the fund finance market to 2021, the state of play as the financial conditions tightened, and how the market is likely to develop going forward.

You can access the chapter **here**.

You can read the full guide **here**.

Full Details Coming on FFA University 2023

June 2, 2023

The FFA has provided some sneak-preview information on FFA University 2023. Training session 1.0 will once again take place virtually on September 21, and training session 2.0 will be in person in New York on October 5. These intensive full-day training sessions are designed for both bankers and lawyers transacting under U.S. law who are either relatively new to Fund Finance or seeking an in-depth training course.

The beginner course, 1.0, will cover everything from understanding fund formation and structures to subscription facility credit documentation and investor issues. You can find more information **here**. The virtual session will be followed by a live reception in New York hosted by Reed Smith.

The more advanced session, 2.0, is designed for mid-level bankers and lawyers and will cover advanced issues in subscription facilities, NAV loan structures, Collateralized Fund Obligations and the PE business model. A complimentary networking reception sponsored by Sidley Austin LLP and KBRA will follow. A detailed curriculum will be announced shortly.

Stay tuned for additional details.

Fund Finance Hiring

June 2, 2023

Fund Finance Hiring

Moody's Investors Services is hiring for a Relationship Management role with a focus on the Alternative Asset Management space to assist the U.S. FIG Commercial team. For more information, visit **here**.