Q&A

SAFEGUARDING GP-LED CONTINUATION FUND TRANSACTIONS

Theodore Cardos from Kirkland and Ellis and Andrew Johnson from Paragon discuss how best to safeguard continuation funds and the benefits of insuring a GP-led transaction.

By *Talya Misiri*

Why have GP-led continuation fund transactions increased in popularity in the last few years and particularly in the last 12 months?

Theodore Cardos: GP-led continuation fund transactions have now become a popular portfolio management tool for sponsors across a range of assets and sectors and this has been driven primarily by the following key drivers: generating liquidity for LPs where distributions have slowed or stalled; GPs retaining control of certain high performing 'trophy' assets to ensure a greater return in the long term; and creating new commitments for further capital to be made available to invest in portfolio companies.

How can warranty and indemnity ("W&I") insurance be used to create commercial advantages for the parties on a GP-led transaction?

Andrew Johnson: W&I insurance has become a widespread risk mitigation tool more generally in the private equity space and its benefits are widely acknowledged. Market data suggests that more than 5,000 transactions were insured globally in 2020 compared to c. 1,400 in 2015.

Despite W&I insurance's popular use, its application to GP-led transactions is still relatively new. We have, however, seen a number of recent successful GP-led processes take advantage of this solution. Whilst previously the W&I insurance market has found some of the subtleties of the secondaries strategy demanding, there are now a number of insurers with the appetite and requisite know how to support these processes. As GP-led deals continue to increase, the use of insurance has become an understandable area of focus for parties exploring alternative ways of addressing liability exposure.

Cardos: In GP-led transactions, it is usual to hold back a portion of the purchase price for a limited period (typically 18 months) to cover liabilities for a breach of warranty or indemnity obligations. The 'holdback' is typically structured by way of a retention of the purchase price by the continuation fund or through a third-party escrow arrangement. Without a holdback mechanic, it would fall to the remaining assets of the selling funds, the GP's ability to call unfunded commitments and/or LP clawback to meet any potential liabilities. The use of W&I insurance therefore affords the parties an alternative source of funds and is very helpful in, amongst other things: (i) significantly reducing the quantum of the holdback or avoiding the use of the 'holdback' mechanic and increasing the amount released to LPs at closing and (ii) allowing the GP to fix its carry entitlement that is needed for any roll-over into the continuation fund without having to consider the consequences of clawback or later adjustment.

Johnson: The steady growth of GP-led transactions has also led to certain GP-led transactions becoming more complex, sizeable and, in some instances, concentrated, making the use of W&I insurance more applicable for these deals. It is therefore unsurprising that we have witnessed a departure from a number of prior GP-led continuation fund transactions where only title and capacity warranties and knowledge qualified warranties were contemplated. Certain parties, particularly on single-asset and highly concentrated transactions, are now increasingly focused on obtaining coverage for a suite of additional warranties which, although still less comprehensive than a traditional M&A transaction, include a number of warranties which are more reflective of what one might typically expect to see in a standard M&A process, covering matters such as litigation, position since the accounts date and other business type warranties at the portfolio company level.

What is the best way to approach these transactions to ensure that coverage can be obtained?

Johnson: The two crucial factors in determining the extent of the warranty suite which can be insured on a GP-led continuation fund transaction are the scope of the due diligence and the disclosure process.

The usual position for a typical W&I insurance process is that insurers will expect to see robust written diligence which underpins the subject matter of the warranties being given in the transaction documents in order to provide a comprehensive coverage position. It is, however, rare for a GP-led transaction where buy-side diligence tends to be more light touch and, in some cases, there may be no formal written buyer diligence at all. How, therefore, can insurers be provided with the level of comfort they need to offer meaningful coverage of the warranties, in particular where there is a growing pressure to obtain coverage for a set of both fundamental and operational warranties?

In practice, parties are now taking a combined approach to diligence led by the vendor seller. This commonly involves a diligence exercise tailored to the suite of warranties. The vendor diligence exercise can either be a standalone process or serve as a top-up exercise to the process carried out when the selling fund acquired the asset(s).

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Where there is no written buyer diligence, insurers will seek to rely on the transaction Q&A (and investment committee papers to the extent that these can be shared) and will expect the selling GP, lead investor(s) and warrantors to be involved in the underwriting process. We would often expect the sponsor deal team to contribute to the Q&A process, as well as sometimes senior management of the assets, assuming that has been agreed with the secondaries' investors. Their involvement will include contributing to the underwriting questions and taking part in the underwriting call itself. In circumstances where there is no memorialised buy-side due diligence, underwriters may require the incoming investor to give a declaration confirming that it has "read and understood" the underwriting responses. This is designed to ensure the investor is deemed to have sufficient knowledge of the asset(s) being acquired given that matters of which the investor is actually aware are excluded under W&I insurance policies.

Cardos: Structuring W&I insurance on GP-led transactions will generally increase the amount of due diligence required from the sellers and buyers to get the insurer comfortable with the risks. This may not only impact the overall timing but will also increase the overall costs of the transaction due to the premium and enhanced due diligence exercise. The GP will need to factor these considerations into the deal timeframe and structure as early on in the process as possible.

With regards to disclosure, data room population for a GP-led secondaries transaction would normally be fairly limited and tied to a more focused scope of diligence compared with a typical M&A transaction (although a more extensive set of warranties and therefore more enhanced diligence are often sought for single-asset and more concentrated transactions). Whilst it is accepted that the data room will not be populated to the same extent that one would expect to see on a traditional M&A process again, a hybrid approach will need to be agreed between the parties to tailor the scope of information provided to the coverage being sought.

Overall, why should stakeholders in a continuation fund prioritise W&I insurance?

Cardos: Enabling exiting investors to cap their liability and reduce the holdback amount whilst also providing the buyer with a more extensive recourse package are obvious benefits of using W&I insurance on GP-led secondary deals - offering significant value to not only the reinvesting sellers, but also the buyers and in turn the underlying asset(s).

Johnson: As with insuring any transaction, there is no one size fits all; each one is carefully tailored to the underlying asset(s), LPs and the GP's ultimate long-term goals for the asset(s). There is no easy roll-out formula for these types of transactions which, by their very nature, are complex and relatively bespoke. Early engagement on the insurance process is critical to help shape the disclosure and due diligence exercises and tailor the recourse profile for the transaction. Using advisers who understand GP-led continuation fund transactions in depth and the nuance of adopting W&I insurance for these types of deals is also crucial to managing the marketing, negotiations and underwriting process.

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Commercial advantages of insuring a GP-led continuation fund transaction:

EXITING LPS / SELLING FUND	NEW INVESTORS / CONTINUATION FUND
– 'Cleaner exit' for the selling fund and its LPs – meaning: – immediate release of proceeds from sale to LPs and GP ("carry") with no re-adjustment as between the LPs and GPs – no (or less) liability going forward enabling the selling fund to be liquidated earlier and avoid resorting to clawback from LPs. – Reduces the amount of the holdback or eliminates the need for a holdback mechanism or escrow accounts. – Bridging the gap between buyer and seller expectations by potentially improving terms and simplifying negotiations.	– Potentially higher protection / recourse in terms of financial liability and survival periods. – Avoids post-closing adversarial issues with sellers/GP/manager enabling secondaries investors (through the continuation funds) to claim against an A+ rated insurer paid to assume the risk instead of the GP / manager or parties that are potentially also investors in the continuation fund and/or repeating players in the market place. – Potential bid differentiator - strengthens a prospective buyer's bid as a seller/GP will prefer a bidder taking insurance over a bidder requiring the seller/GP to provide a full indemnity. – It can potentially aid in obtaining a broader set of representations and warranties.