Secondary Transactions: Tender Offers, Side Pocket Clearing and Residual Assets

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Jason centers his practice on the structuring, formation and negotiation of private equity and hedge funds. He has represented a wide variety of fund sponsors, asset managers and institutional investors in all stages of private equity funds, real estate funds, secondaries funds, funds of funds and other alternative asset classes, both domestically and internationally. He deals regularly with issues relating to the Securities Act, the Investment Company Act, the Investment Advisers Act, ERISA and tax. He also has significant private equity, venture capital and mergers and acquisitions transactional experience. In addition, he represents institutional investors in connection with their investment activities.

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Recognized by *The Legal 500 US* as a leading tax lawyer, David has spoken on tax issues related to running investment management firms and their funds, as well as hedge fund tax considerations and compensation structures. He contributed to “Hedge Fund Employee Compensation,” published by *Practical Law*, and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David has presented on the topic of “Hedge Funds” at PLI’s Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances Conference for numerous years. He is a member of the American Bar Association and the New York State Bar Association. David holds an LL.M. in taxation and a J.D., *magna cum laude*, from New York University School of Law, where he was a Florence Allen Scholar and Order of the Coif, and an A.B., *cum laude*, from Harvard University.

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Phyllis focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, credit funds, litigation financing funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management and employment arrangements, succession planning and the creation of internal investment and co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of investment funds. Phyllis also advises funds in connection with the acquisition and disposition of investments and the establishment of capital call credit lines.

Phyllis is listed in *The Legal 500 US*, *The Best Lawyers in America*, *New York Super Lawyers*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed compliance concerns for co-investments and issues related to fund restructuring and secondary transactions. Interviewed by *Private Funds Management* in the article "Ringing the Changes," Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject. In addition, she contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ), as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" in *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute). Phyllis received her J.D. from Columbia Law School and her A.B. from Smith College.

Secondary Transactions: Tender Offers, Side Pocket Clearing and Residual Assets

I. **Introduction**

A. Secondary transactions are seen as a means to achieve accelerated liquidity for investors prior to the disposition by a fund of its assets in the ordinary course of business, particularly for private equity funds, but also for hedge funds whose illiquid investments or "side pockets" do not afford withdrawal rights.

B. Secondary transactions involve one of two types of transactions: (1) sales by one or more investors of their partnership interest in a fund to one or more buyers or (2) the sale by a fund of all of its assets to one or more buyers in one or a series of transactions.

C. Secondary sales are associated with "zombie" funds. Zombie funds have been seen as the drivers of a broad network of other funds that are secondary buyers. Given the maturation of the secondary market, prices for secondary transactions and the number of potential secondary buyers have increased.

D. Secondary transactions raise an array of legal issues, including:

1. Compliance with partnership agreements;

2. Compliance with Delaware (or other jurisdictional) obligations, including compliance with fiduciary duties;

3. Tax issues;

4. Securities laws compliance – the transaction and the transferee must meet regulatory constraints; and

5. Tender offer rules – an offer to purchase interests owned by limited partners from multiple sellers may be deemed to be a tender offer; and, although the SEC has adopted extensive rules on how tender offers must be conducted, the SEC has never defined a tender offer.

II. **Limited Partner-Led Secondary Transactions**

A. To achieve liquidity, investors may negotiate and structure sales of their own interests in funds, whether a sale of a single fund interest or sales of multiple fund interests.

B. An LP would normally coordinate with the general partner of the fund whose interest is being transferred to address partnership agreement compliance, including:

1. Disclosure of confidential information – If the selling LP likely wishes to share confidential information with its prospective buyer, the GP's consent to such disclosure is required. This typically results in the drafting and negotiation of non-disclosure agreements.

2. The partnership agreement may provide for rights of first refusal. LPs have requested purchase rights in their side letters. GPs often resist such provisions.

C. The GP is not a party to LP-led transactions but must nevertheless consider the structure of the transaction and the identity of the buyer in light of the following:

1. For purposes of the Securities Act, the buyer should be an accredited investor.

2. For Investment Company Act purposes, the buyer may also need to be a qualified purchaser if the fund relies on Section 3(c)(7) of the Investment Company Act; or if the fund relies on Section 3(c)(1) of the Investment Company Act, then the transfer must not create a "slot" issue.

3. For purposes of the Investment Advisers Act, the buyer may need to be a "qualified client" if the manager is a registered investment adviser.

4. For tax, the GP must track whether the transaction increases the risk of the fund becoming a "publicly traded partnership" ("PTP") that is taxable as a corporation.

5. For purposes of ERISA, the GP must track whether the buyer is a "benefit plan investor" and therefore whether the transaction results in ownership by all "benefit plan investors" in the fund of more than 25 percent of a single class of interests, thus creating a plan asset fund under ERISA.

6. For purposes of money laundering regulations, the buyer must provide appropriate "anti-money laundering" representations.

While the seller and the buyer customarily enter into a purchase agreement, the above regulatory considerations will be addressed in a separate transfer agreement provided by the GP to the selling LP and its purchaser in which representations are made to the fund and the GP that covers the above issues. The GP's consent to the transaction is based on such representations.

D. Tender Offer Issues: Even if the GP is not involved in the LP-led transaction, where an LP-led transaction involves multiple offers to purchase by a buyer from several sellers, then tender offer rules might apply. Conversely, if there is only a single buyer negotiating with a single seller, the tender offer rules would not apply.

E. Tax Issues

1. "Publicly Traded Partnerships" – Transfers by investors in funds treated as partnerships for U.S. tax purposes raise PTP considerations. A PTP is a partnership (i) whose interests are traded in an established securities market (e.g., an MLP) or (ii) for which there exists a secondary market (or the substantial equivalent thereof) for the trading of interests. A PTP is taxed as a corporation unless it meets a 90-percent qualifying/passive income test set forth in Section 7704(c).[1]

   (a) Unless a partnership meets the income exception noted above, it will take great care to ensure that there is no "secondary market (or the substantial equivalent thereof)" for the trading of its interests. The most common exceptions to creating a secondary market (or the substantial equivalent thereof) are the following:

      (i) 100 partner safe harbor;

      (ii) "Block transfers" (i.e., a transfer by a partner of greater than 2 percent of partnership capital or profits);

      (iii) Transfers involving a carryover basis, family transfers, transfers at death and other "private transfers" described in Treasury Regulations Section 1.7704-1(e); and

[1] "Section" references are to the applicable sections of the Internal Revenue Code of 1986, as amended.

(iv) Facts and circumstances analysis to ensure that there is no secondary market or the substantial equivalent thereof. Unlike many affiliate or family transfers, a pure secondary transfer between unrelated parties will often be rejected by the fund if the fund cannot rely on any of the preceding exceptions. There may be more latitude for allowing transfers to an existing partner under a "redemption and repurchase" safe harbor than to a non-partner.

2. Possible Withholding of the Purchase Price – Withholding is required under Section 1446(f) by a buyer (or, secondarily, the fund) of 10 percent of the amount realized by the seller of an interest in an entity treated as a partnership for U.S. tax purposes unless an applicable certification can be made, including that the seller is a U.S. person or that the fund has little "effectively connected income" or assets generating such income. Also consider potential withholding of 15 percent of the amount realized under Section 1445 if the seller or the fund cannot make the applicable FIRPTA representation.

3. Other tax considerations raised by transfers of interests in funds include:

(a) Potential future recognition by purchasers of the fund's unrealized gains, even when the purchase is made at fair market value.

(b) Transfers often force a fund that is taxed as a partnership where either (i) the fund has a >$250K net unrealized loss in its positions or (ii) the transferor suffers a >$250K taxable loss on the transfer, to operate as if it had a Section 754 election in effect, which can be time-consuming and expensive for a hedge fund holding hundreds of positions, even if the buyer and seller cover the costs. Some private equity funds may operate under an "electing investment partnership" exception.

(c) Different tax status of the transferor and transferee.

(i) Is the transferee going into the "correct" fund — e.g., offshore vs. onshore fund or blocker vs. unblocked product.

(ii) Different tax compliance may be required by the fund for a non-U.S. partner than a U.S. partner.

(d) Obtain W-8/W-9 from new investors. If foreign, ensure FATCA-compliant.

(e) Income allocation between transferor and transferee.

(f) Look for disguised sale of partnership interests.

F. LP-led secondaries may involve sales by a single investor of an entire portfolio of fund interests (typically by strategy), and these transactions present greater challenges.

1. Sellers must coordinate with multiple GPs to obtain clearance of the transfer, to enter into confidentiality agreements and to enter into transfer agreements while separately negotiating a purchase agreement with a buyer.

2. These sales do not all close on the same date given the difficulties in working with several GPs.

3. These transactions are very expensive. GP costs are borne by the seller and/or buyer.

4. If multiple buyers are involved, each may have different structuring, regulatory or tax needs driving its own transaction.

5. Existing investors in the fund may have rights to purchase other LP interests. Consider compliance with rights of first refusal resulting from the transaction.

6. A buyer may seek new side letter rights or assume the side letter of selling investors.

G. Even though an LP-led transaction involves the GP solely for its consent, we see more accommodations being requested from GPs in LP-led transactions, including:

1. Representations regarding underlying investments, both for tax reasons and for business diligence. As noted above, withholding obligations may arise given the nature of the fund's investments, and, therefore, the GP may be requested to provide a certification as to its fund's investments.

2. Requests to shift from "blocked" structures to "unblocked" structures — consider tax implications to the fund entity and the transferee resulting from the shift, including possible income recognition.

3. Requests for new side letters (or assignments of existing side letters).

4. Requests for GPs to find buyers. These requests raise fiduciary duties, as there may be an obligation to assist all LPs seeking liquidity even though the GP is being approached by a single LP.

III. **General Partner-Led Secondary Transactions**

A. Where multiple LPs request liquidity from a single fund, the GP of that fund is more likely to become involved in and structure the secondary transaction. These transactions are referred to as "GP-led secondary transactions." A GP-led secondary transaction may take the form of (i) the sale of multiple investor interests in a fund or (ii) the sale of all the assets of a fund in a single transaction. In private equity funds, the pressure from investors for GPs to lead secondary transactions has arisen after the term of the fund has been extended, thereby potentially delaying dispositions of investments.

B. GP-led secondaries usually involve an investment banker/broker who is retained to locate a buyer and to structure the transaction. Bankers can facilitate the sales process.

C. After the bankers assist in identifying a buyer, the GP will typically notify investors of the key terms of the potential transaction.

1. Arrangements with investment bankers must be disclosed, including fees payable to the agent.

2. The benefits afforded to the GP affiliate in the transaction must be carefully disclosed.

3. Investors should also understand the fees and expenses that will be charged to them as part of the transaction (such as bankers' fees) and that such fees will reduce the proceeds they will receive.

4. The GP seeks to ensure that the buyer does not have better access to material information than the fund's potential selling investors — the GP acts as a fiduciary and use efforts to protect its investors' interests. Both sellers and buyers are making an investment decision to sell (and implicitly whether to hold) and to buy.

(a) Although the specific tender rules that apply to unregistered funds are not particularly onerous, the SEC has broad authority to prohibit fraudulent, deceptive or manipulative practices and they have sometimes used that authority to bring enforcement actions against tender offers that the SEC deemed to be abusive even if they did not violate any specific rules.

(b) In a 2000 guidance, the SEC suggested including certain disclosures in tender offers for limited partnership units, including risk factors, a discussion of any conflicts of interest and a discussion of the market price for the units and how the offer price was determined, financial information about the partnership and a discussion of tax consequences of the offer.

(c) The SEC also expects the GP to state whether the GP takes a position on whether holders should participate in the tender offer (and the GP is permitted to state that it takes no position).

D. In addition to the disclosure referred to above, tender offer issues need to be generally addressed in GP-led transactions.

1. The GP considers whether a transaction in which the GP identifies a potential purchaser for the interests of its fund is in fact a tender offer.

   (a) The most widely used definition is an eight-factor test from *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), with the most important factors being the number of offerees and the percentage of securities sought to be purchased.

   (b) The number of LPs who actually accept an offer is not determinative of whether the transaction constitutes a tender offer.

2. So long as the fund is not an SEC-reporting company, complying with the U.S. tender offer requirements is less burdensome than most people expect.

3. The most significant requirement for non-reporting entities is that the offer remain open for a minimum of 20 U.S. business days. The offer may need to be extended if there are any changes to the terms of the offer. Realistically, changes to the terms of the transaction will change.

4. Following the expiration of the tender offer, the purchase price must be paid “promptly.” There is no clear definition of “promptly.” For traded securities, settlement is generally required in two to three business days. For non-traded fund interests, settlement will require more time.

5. There are also restrictions on making any purchases outside of the tender offer after it has been announced or announcing the tender offer without the ability and the expectation that it will be completed.

6. Tender offers may be subject to additional local law requirements in other jurisdictions where investors may be located.

E. GP-led secondaries involving the sale of partnership interests involve the purchase of limited partnership interests from up to all the limited partners of a fund by a single buyer identified to selling limited partners.

1. Not all limited partners will agree to buyer’s price or terms. As a result, the buyer may only purchase a portion of the interests in a fund. Typically, a buyer requires a minimum amount of sellers to be compelled to close the transaction.

2. A buyer may agree in advance to consent to an amendment to the fund’s partnership agreement or other terms (such as a new waterfall, management fees, term and possibly additional capital commitments).

   (a) The GP should evaluate whether existing LPs may veto such amendments.

(b) The buyer will be required to assume unfunded capital commitments of the sellers, but the buyer is unlikely to provide new commitments. Occasionally, the buyer's purchase of interests in an existing fund is "stapled" to an investment in a successor fund.

3. Usually, the GP does not sell its partnership interest in secondary transactions. Rather, the GP seeks to "reset" the waterfall so as to be able to receive a carried interest on a lower cost basis (i.e., the cost that the new investors paid for the LP interests, as opposed to the fund's actual cost of investments) per the amendments referred to above.

F. Tax issues relating to transfers of interests in funds by investors in GP-led transactions raise the same tax issues discussed above for LP-led transactions. Carry should be allocated from profits earned by the fund that are allocable to the underlying LP interest even if calculated on a waterfall that has been "reset" at the time of the secondary transaction.

G. GP-led secondary transactions may involve the sale of fund assets instead of fund interests.

1. If assets of the fund are being sold, a new vehicle managed by the GP or its affiliate would typically be set up to acquire such assets. The buyer would become an investor in the new vehicle; the new vehicle would purchase assets from the fund; and the proceeds from the sale would be distributed to the existing investors (to the extent such investors have elected to cash out of the fund).

2. The transfer of the assets to an entity controlled by, and which will make payments to, a GP affiliate requires a conflict approval. Even if LPAC approval is technically the only requirement for a sale of fund assets to a new vehicle that will be managed by the GP or its affiliates, typically LPAC members will want all LPs to have a chance to approve the transaction and may want such LPs to be fully informed and consulted on (and not formally consent to) with respect to the transaction. The buyer may also condition its offer on obtaining a minimum level of consent from investors (separately from the minimum number of LPs electing to participate in the transaction).

3. Transferring assets may require third-party approvals under portfolio company documents, such as lender consents, stockholder and portfolio company consents. Consider whether there are rights of first refusal.

4. Pricing of the secondaries transaction will be subject to scrutiny, and therefore GPs typically seek to (a) demonstrate that an auction for the sale was held, and/or (b) obtain a valuation from an independent valuation agent. Certain offers are not necessarily credible. Comparisons of offers may not be as simple as the relative pricing. For instance, a buyer may need to finance the purchase price or may need its own approvals to proceed with the purchase.

5. In light of pricing issues, a GP may offer LPs a "rollover" option, where the LPs, individually, have the right to receive cash or to invest their proceeds from the transaction in the new vehicle.

(a) The offer of interests in the new vehicle would need to comply with the same securities laws restrictions as an offering of interests in an entirely new fund and, depending on the structure of the transaction, offering interests in a new vehicle in exchange for the interests in the existing vehicle could be an exchange offer, which could then be subject to the tender offer rules.

(b) The buyer may expect a minimum amount of "rollover" investors in order to plan for its own financing of the transaction. Therefore, it is important to provide organizational documents of the new vehicle to "rollover" investors promptly.

(c) A “cashless” transaction may require additional tax compliance, including tracking the basis of assets contributed, or deemed contributed, to the new vehicle.

H. Proceeds from the sale of assets will be distributed by the fund to its partners, including a carried interest to the GP.

1. At this time, the GP may owe a clawback, which is unlikely to be waived.

2. The fund may have indemnification obligations to its buyer and may not be permitted to distribute the sales proceeds immediately. Accordingly, the desired liquidity for investors may be delayed. The GP must also consider escrows, potential claims against the partnership, purchase price adjustments/earn-outs, etc.

IV. Conclusion

A. Secondary transactions have become a regular and larger part of the investment management business in creating exit strategies.

B. The growth of this market has increased the pool and types of purchasers: (i) existing LPs in funds; (ii) GPs; and (iii) secondary funds.

C. Participants in the investment management industry should be familiar with structures and processes utilized to effect these transactions.

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