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Secondary Perspectives On The General Partner Relationship

An Overview Of General Partner Involvement In Secondary Transfers

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Current deal volume marks an evolution from the secondary market's humble beginnings. In the 1970s and 1980s, limited partners requiring liquidity for their private equity investments worked with the funds' general partners to find a solution. This often involved canvassing other existing limited partners for interest. Deal volume was relatively low.

However, in the early 1990s, following a market correction and an economic downturn, secondary specialist firms entered the scene and targeted limited partners directly through cold calls, advertising and missionary-marketing. Often, sellers brought assets to market as a result of financial distress or regulatory constraint. Large portfolios changed hands and the secondary market grew. New entrants and larger, dedicated funds cast a spotlight on the market, as higher transaction volumes raised awareness.

More recently, the market has evolved from being largely fueled by distress to being driven by strategic initiatives and the portfolio management goals of limited partners. Selling limited partners today are not only financial institutions, corporations and family offices, but pension funds, endowments and foundations.

Driven by the breadth of sellers, heavy deal volume and an increase in buyers, few general partners are left untouched by the transfer process and many regularly manage transfer issues. However, general partners are evolving as well, viewing the transfer process as a strategic opportunity, rather than a nuisance. Today, general partners are taking a more active role in the transfer of secondary interests, welcoming most transfers as a means by which they can manage the composition of a fund's limited partners. Equally, the activity of limited partners exercising active portfolio management amongst their private equity funds is respected and understood by general partners, as they use similar portfolio management tools for their own investments. Finding the right buyer for a secondary interest can create a win-win situation for seller, buyer and general partner.

The General Partner's Point Of View

In a secondary transfer process, both sellers and potentially numerous, competing groups of buyers are dependent upon the general partner to facilitate the transaction through information access and consent. Naturally, general partners differ in their view on how to approach the conflicts that arise. There are those general partners that believe their role is to be impartial to all prospective buyers. On the other hand, many general partners explicitly state their buyer preferences and supply information and consent accordingly. Further, general partners are increasingly willing to exert influence over the transfer process as they balance their firm's long-term objectives with their relationship to the seller and their relationship to prospective buyers.

What are the general partners' duties to the seller and prospective buyers in a secondary transaction? The governing document outlining the relationship between the general partner and the seller is the limited partnership agreement, or LPA. The relevant clauses in the LPA governing the general partners' activities in a secondary transaction lie within the transfer and substitution language. In all cases, a general partner must provide its consent to either a transfer or a substitution. Usually, the qualifying language in these LPAs is that general partners cannot unreasonably withhold their consent to a transfer, but most often can, at their own discretion, withhold consent to a substitution. As such, the contract binding general partner and seller often clearly states that the general partner can act in its sole discretion, and does not need to take into account other matters.

Regarding information access in a secondary transaction, the standard language is even more general partner-friendly. Under the terms of the vast majority of LPAs, the general partner has no requirement to provide any information to any prospective buyer, nor cooperate or assist in any way.

The other provision that shows up occasionally in LPAs is the right of first refusal, or ROFR, which allows the general partner and/or the existing limited partners in a fund an opportunity to acquire the selling interest under the terms and conditions offered by the prospective buyer. The motivation for the ROFR can be on the part of the general partner, to keep transfers within the family. Or it can be on the part of sophisticated limited partners that would like higher allocations in funds of their choice.

However, this provision often does not work as intended in portfolio sales, a commonly used form of sale. When acquiring a portfolio, buyers simply optimize purchase price allocations to circumvent ROFRs, placing artificially high prices on the ROFR interests and artificially low prices on the non-ROFR interests. Further, the existence of ROFRs in general may harm limited partners trying to execute sales, as they may face additional legal hurdles or even depressed prices in single interests (many buyers won't waste their time on a single interest with a ROFR).

The picture painted by strong general partner consent language and general partner information control supports the view that general partners have the upper hand in active management of secondary transfers within their funds. Indeed, Robin Painter, a partner with law firm Proskauer Rose LLP, describes the landscape as such. Robin states, "As a general matter, general partners are afforded considerable discretion with respect to their involvement in, and support of, the transfer process. There is a wide variation of transfer accommodation policies in the industry, which is reflective of the broad leeway afforded to the general partner, and the extensive confidentiality obligations imposed on the limited partner, in a typical fund agreement." Regardless of this, most general partners are very cooperative in the process, as they are thinking about the long-term interests of their firm and finding the best substitute limited partner.

Benefits Of The General Partner-Influenced Transfer Process

Despite the increasing availability of capital in the private equity markets, general partners have a vested interest in maintaining strong oversight of their investor base as it changes over time. The substitute limited partner in any given transfer may not have the same regard for the confidentiality of information, commitment to building long-term relationships, prospects for longevity and general reputation as the original limited partner.

General partners would almost always prefer that an existing limited partner enjoy the opportunity to purchase a secondary interest, although they often err in thinking that ROFRs provide this opportunity. However, to the extent a new limited partner is contemplated, early general partner interaction can smooth the transfer process. Indeed, Stephen Holmes, CFO of InterWest Partners, struggled with a recent transfer to a substitute limited partner, having had no interaction prior to the closing. On general partner involvement in the transfer process as a whole, Holmes' main concern revolved around "having the appropriate amount of time to vet a new limited partner and the ability to verify that InterWest's interests are protected in the process." While many general partners are perfectly happy to entertain a wide variety of substitute limited partners, they do not enjoy being the last to learn of a transaction.

Beyond smoothing the transfer process and reducing transfer risk, early and coordinated general partner involvement in a secondary transfer can provide prospective buyers with better information, and, correspondingly, better pricing. Buyers more knowledgeable of the general partner and the assets can be more aggressive in their pricing. The unknown always requires a discount.

The corollary to supplying more information is supplying that information with care. A substitute limited partner must take a view on the strength and stability of the general partner and the value of the underlying assets. To properly make these assessments requires a certain amount of highly confidential information about the inner workings of the partnership and portfolio company details. General partners are often shocked to learn that confidential and sensitive information about their portfolio companies was disseminated without their knowledge to vast numbers of prospective buyers.

Although the seller may be maximizing the number of prospective bidders, by doing this, they are not maximizing the flow of critical information, nor are they maximizing general partner cooperation, and are therefore jeopardizing their ability to maximize price. Thus, heightened general partner control of such information can yield benefits.

The Seller's Perspective

Often the seller is not exiting the asset class entirely, but merely using the secondary market as a portfolio management tool to selectively prune a portfolio. As such, seller reputation in the marketplace is a concern. The publicity of a transaction, the sensitivity to confidential information, and how the seller partners with the general partner to find the best substitute limited partner will shape that seller's reputation and its subsequent ability to continue to access the right funds.

Limited partners have a range of motivations for selling an interest, such as diversification, administrative burden, over-allocation, the Freedom of Information Act, financial distress and general partner underperformance. Similarly, buyers have different motivations, from simple, short-term internal rate of return objectives to long-term relationship development and the potential for follow-on primary capital commitments. The most successful transactions have sellers working closely with general partners to identify appropriate substitute limited partners before a sales process even begins. Involving the general partner early in a transfer process can help maintain the seller's relationship with the general partner and their overall reputation in the marketplace. In summary, the earlier the general partner is informed and the more involved the general partner is in the transfer process, the better equipped it is to help facilitate a smooth, price maximizing process.

The Buyer-General Partner Relationship

From the buyer's perspective, an engaged general partner during the transfer process is essential, particularly for firms with the goal of building long-term relationships. For investors with primary and secondary capital, fostering an ongoing relationship with the general partner is a goal in itself. For existing general partner relationships, this emphasis yields better insight into the portfolio, thus better asset pricing for secondary purchases, and also communicates a long-term investor status to the general partner. For non-existing general partner relationships, the diligence process to evaluate the blind pool or general partner risk serves to set expectations post-transaction.

By engaging the general partner early in the process, the buyer can effectively articulate the goals for the transaction, whether they are merely near-term financially oriented or motivated by long-term relationship expectations. Finally, early and ongoing interaction identifies the situations where a transfer is not the best fit, thus reducing transaction risk and limiting wasted resources.

Potential Legal Improvements

If the goal is to foster a more meaningful relationship between general and limited partners in secondary transfers, stronger confidentiality provisions would work much better than, for instance, ROFRs. A clause specifying that no information will be provided to prospective buyers of a limited partner's interest in a fund without first notifying and seeking approval from the general partner would ensure that sensitive and confidential information is handled correctly and that there is clear communication between the seller, approved buyers and the general partner.

General partners are very sensitive about the confidential nature of the information that they share with limited partners; therefore, a conversation prior to any sales process would support a more beneficial environment for all involved. Again, as many general partners do not appreciate learning of a transfer late in the process, and as such are surprisingly much more accommodating than many limited partners realize, a contractual improvement in limited and general partner communication on this front may be in order.

We've Come Full Circle

To some extent, general partner involvement in the secondary transfer process has come full circle. Just as in the infancy of the secondary market, general partners find themselves today spending more time and resources managing transfers.

However, the motivations for this involvement

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have certainly changed. No longer is the role to infrequently facilitate liquidity in an illiquid market. Today, general partner direction in the secondary transfer process holds meaningful financial and marketing benefits and, depending on the general partner, the activity is much more frequent than in the past.

As general partners allocate more time to this function in the future, and perhaps even dictate the behavior of the secondary market more directly (stronger general partner consent language, early-warning requirements, etc.), participants in the market can benefit from stronger, more meaningful relationships.

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