

March 17, 2023

Vanessa Countryman  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-0609

**Re: File No. S7-03-22; Private Fund Advisers; Documentation of Registered  
Investment Adviser Compliance Reviews**

Dear Ms. Countryman,

We are law professors who study and teach topics related to the proposed rules regarding: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (the “Proposed Rules” or the “Release”).

We thank the Commission for the opportunity to comment on the Release, which coincides with our recently completed academic paper (attached as Exhibit A) that directly addresses one of the key issues covered by the Proposed Rules: GP led secondary transactions. We hope the Commission considers our suggestions for potential revisions in the proposed rule based on our findings.

We thank the Commission for considering our comments.

Respectfully,



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Kobi Kastiel  
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# Exhibit A

## High-Class Conflicts

Kobi Kastiel\* and Yaron Nili\*\*

### ABSTRACT

*The doors to America's most exclusive investment opportunities are closely guarded. Only the most wealthy and sophisticated investors are granted entry to the "Private Equity" club. With private equity investment long considered one of the most successful asset classes, investors often compete among themselves for the opportunity to obtain a slice of investment in a successful private equity fund. In fact, some of these investments turn out to be so profitable that the private equity managers decide to hold on to them, and instead of selling them to third parties, they sell them to their own newly established fund—a continuation fund.*

*Lauded by the private equity industry as providing "optionality" to investors, continuation funds have grown to represent a major segment of investment activity in the United States. Yet, puzzlingly, many of the existing investors in the original fund decline the option to roll over their stake into the continuation fund, even though it is run by the same private equity firm in which they have cultivated relationships for years and in which they have trusted their investments up to that point.*

*This Article addresses this puzzle and makes three contributions to the literature. First, utilizing original interviews with market participants from both sides of the aisle—investors and sponsors, we offer the first academic account of the continuation funds enigma. Second, utilizing both relational contracting theory and law and economics analysis, we highlight the labyrinth of concerns that cast a shadow on the growing prevalence of continuation funds. Specifically, we show why the "house always wins" is a major part of the private equity managers' incentives and why a web of conflicts of interests between the sponsors and investors, between investors themselves, and between investors and their underlying beneficiaries may explain the prevalence of continuation funds as well as the decision of many investors to not roll over their investment. Third, our findings have important implications for theory and practice. We explore the cautionary tale that continuation funds raise for relational contracting and law and economic theory. We then offer several policy recommendations that are particularly timely in light of the SEC's proposed rules addressing the issue.*

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### Introduction

In November 1988, the “barbarians” finally breached the gates of RJR Nabisco, the American manufacturing conglomerate.<sup>1</sup> The private equity firm Kohlberg Kravis and Company (KKR), notoriously dubbed as barbarians by the management of RJR Nabisco, succeeded in completing a leveraged buyout of RJR Nabisco after a nail-biting

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<sup>1</sup> BRYAN BURROUGH & JOHN HELYAR, *Barbarians at the Gate: The Fall of RJR Nabisco* (HarperCollins, 3d ed. 2008).

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Hollywood-style bidding war. The deal marked the largest leveraged buyout of all time and sparked the investment community's collective interest.<sup>2</sup> However, in the end, the deal serves as a cautionary tale, attesting to the dangers of putting too much money into one investment that must be exited at the end of the fund's term. By the late 1990s, with the value of its investment in RJR Nabisco declining and the end of the fund's term nearing, KKR traded its ownership stake in RJR Nabisco for ownership in Borden Inc., an over-leveraged public conglomerate. Between its investments in RJR Nabisco and Borden, KKR lost \$730 million.<sup>3</sup> In the aftermath, KKR agreed to never again put such a large portion of one fund into any single investment.<sup>4</sup>

At that time, KKR divested its investment in RJR Nabisco through a series of market sales; however, in today's landscape, it may have had an alternative route, potentially allowing it to hold on to RJR Nabisco a while longer—the creation of continuation funds. Indeed, as private equity continues to shift “towards a dizzying array of new tactics and new asset classes”<sup>5</sup> in response to increasing competitive pressures, innovation is constantly permeating the realm of private equity investments. The private equity business model has reinvented itself over the years in the form of leveraged buyout funds, credit funds, real estate funds, alternative investments funds, and hedge funds.<sup>6</sup> Continuation funds are its latest development.<sup>7</sup>

Continuation funds offer a creative solution for maneuvering around the original terms defined in the contract among investors. In the past, once the fund term lapsed, investors' capital was no longer “locked in” and assets had to be liquidated. However, with a continuation fund, instead of liquidating a losing asset, or selling a “crown jewel” that may yield even better returns in the future, the same fund sponsor (general partner) continues owning the asset in a newly established fund.<sup>8</sup> Limited partners typically have the option to either roll their existing interests into the continuation fund and strengthen their relationship with the sponsor or to simply exit the original fund.<sup>9</sup> For new investors, continuation funds offer the opportunity to invest in more “mature” and visible assets

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<sup>2</sup> Floyd Norris, *Fund Books Loss on RJR After 15 Years: A Long Chapter Ends for Kohlberg Kravis*, N.Y. TIMES (Jul. 9, 2004), <https://www.nytimes.com/2004/07/09/business/worldbusiness/fund-books-loss-on-rjr-after-15-years-a-long-chapter.html>.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> Elisabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095, 1095 (2019).

<sup>6</sup> *Id.* at 1100.

<sup>7</sup> Anthony Wong & Ilan Wong, *Continuation Funds Emerge as Attractive Options for PE Fund Managers and Investors*, WHITE & CASE (Dec. 7, 2022), <https://www.whitecase.com/insight-our-thinking/managing-volatility-considerations-taiwan-continuation-funds-emerge-attractive-options-pe>.

<sup>8</sup> Elizabeth Dylke, Jonathan McCullough & Mia Bacic, *Continuation Funds: A Growing Trend*, BENNETT JONES (May. 26, 2022), <https://www.bennettjones.com/Blogs-Section/Continuation-Funds-A-Growing-Trend>.

<sup>9</sup> *Id.*

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and to launch a new relationship with the sponsor.<sup>10</sup> For these reasons, supporters of the continuation funds often view them as a “win-win-win” for all parties involved.

In the past few years, continuation funds have grown increasingly popular within the private equity world and they are the most common type of secondary transaction led by private equity sponsors. In 2021, these transactions reached their highest volume in history, estimated at around \$63 billion dollars in deal value, representing an increase of 650% in a 5-year period.<sup>11</sup> A recent example is Morgan Stanley’s continuation fund, which closed in early February of this year with \$2.5 billion in total commitments, making it one of the largest continuation funds to date.<sup>12</sup> According to market participants, continuation funds are here to stay and grow, and the first quarter of 2023 will witness “more investments in continuation funds than during any quarter in history.”<sup>13</sup>

Yet, continuation funds are subject to unusual investor resistance.<sup>14</sup> Although investors seemingly enjoy a free choice of whether to participate in these funds, often presented to them as “crown jewel” funds, many of them (80–90%) elect to cash out<sup>15</sup> after being forced to make a decision within a tight time frame.<sup>16</sup> Furthermore, even if continuation funds could represent the best of all worlds,<sup>17</sup> they also embody one of the most concerning elements of private equity: the risk of self-dealing, as the sponsor stands on both sides of the deal, essentially selling the assets to itself.<sup>18</sup>

Crucially, many of the investors in these funds are pension funds that manage savings of working- and middle-class as well as everyday Americans. In fact, public pension plans are claimed to be the “single most important source of capital for private

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<sup>10</sup> Andreas Hinsen, *Private Equity’s New Trend: Selling to Themselves*, LOYENS LOEFF (Apr. 7, 2021), <https://www.loyensloeff.com/insights/news--events/news/private-equitys-new-trend-selling-to-themselves>.

<sup>11</sup> See *infra* Section II.B.

<sup>12</sup> Susan Barreto, *Morgan Stanley Attracts \$2.4bn for Single-Asset Continuation Vehicle*, ALTS.WATCH (Feb. 3, 2023), <https://www.alternativeswatch.com/2023/02/03/morgan-stanley-ashbridge-transformational-secondaries-fund-ii>.

<sup>13</sup> Kaye Wiggins, *Selling to Yourself: The Private Equity Groups That Buy Companies They Own*, FIN. TIMES (June 21, 2022), <https://www.ft.com/content/11549c33-b97d-468b-8990-e6fd64294f85>; Tjibbe Hoekstra, *Private Equity Continuation Funds to See ‘Record High’ in Q1 2023*, IPE (Nov. 18, 2022), <https://www.ipe.com/news/private-equity-continuation-funds-to-see-record-high-in-q1-2023/10063495.article>.

<sup>14</sup> See *infra* Section II.B.

<sup>15</sup> See *infra* note 166 and accompanying text.

<sup>16</sup> Alicia McElhaney, *Private Equity Firms Say These Funds Hold Their ‘Crown Jewels’ – But Most Investors Are Opting Out*, INSTITUTIONAL INVESTOR (Dec. 13, 2022), <https://www.institutionalinvestor.com/article/b1h6wg8el0wt8g/Private-Equity-Firms-Say-These-Funds-Hold-Their-Crown-Jewels-But-Most-Investors-Are-Opting-Out>.

<sup>17</sup> *Id.*

<sup>18</sup> Chris Witkowsky, *LPs Push Back Against ‘Pre-Clearance’ of GP-Led Deals*, BUYOUTS (Feb. 3, 2022), <https://www.buyoutsinsider.com/lps-push-back-against-pre-clearance-of-gp-led-deals/>.

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equity funds.”<sup>19</sup> Their involvement in private equity and, specifically, continuation funds, has raised eyebrows. The Chief Information Officer of Europe’s largest asset manager went so far as to claim that certain parts of private equity industry look like “Ponzi schemes” because of their circular structure, tossing assets back and forth.<sup>20</sup> Another leading pension fund executive has compared the sector to a pyramid scheme, warning that private equity groups are increasingly selling their companies to “themselves” on a scale that is not “good business for their business.”<sup>21</sup>

In a world where investors are often willing, and at times competing, to blindly put their trust in private equity managers—often committing hundreds of millions of dollars to newly established funds with little insight into how these funds will invest their money—it is puzzling, and possibly cause for serious concern, that most existing investors decide to not roll their investments into a continuation fund.<sup>22</sup>

Continuation funds challenge two key aspects of the private equity landscape. First, they challenge the notion that the sophistication of “high-class” investors in the private equity industry enables them to negotiate efficiently and address any concerns through contractual bargaining.<sup>23</sup> We demonstrate that continuation funds further undermine some of the key elements in the efficient bargaining dogma whose application has been long advocated in the private equity market. In this context, we show that some of these selling institutional investors often suffer from significant informational disadvantages, lack of expertise, lack of time, and agency costs that force them to sell their stakes under unfavorable conditions.

The second aspect of the private equity landscape that continuation funds challenge is the relational contracting paradigm that is so palpable in this arena.<sup>24</sup> Rather than focusing on what the parties *write*, relational contracting focuses on what the parties *do* as part of the exchange.<sup>25</sup> While classical and neoclassical contract theory largely focus on the legal enforceability of a contract under formal law, relational contracting looks to informal industry practices and relationships as also operating to enforce contractual commitments.<sup>26</sup> Investment in private equity has all the key attributes of relational contracting: investors and managers are repeat players that rely on reputational sanctions; contracts leave large discretion to the funds’ managers and lack narrowly tailored contractual provisions. Investors and managers are expected to work together throughout the life cycle of the fund, addressing issues as they arise. Yet most investors

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<sup>19</sup> William Clayton, *How Public Pension Plans Have Shaped Private Equity*, 81 MD. L. REV. 840, 851 (2022).

<sup>20</sup> See *infra* note 154 and accompanying text.

<sup>21</sup> *Id.*

<sup>22</sup> See *infra* note 166 and accompanying text.

<sup>23</sup> William Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703, 724 (2022).

<sup>24</sup> See *infra* Part I.B.

<sup>25</sup> Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 879 (2000).

<sup>26</sup> Robert C. Illig, *The Dog That Didn’t Bark: Private Investment Funds and Relational Contracts in the Wake of the Great Recession*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 49, 50–51 (2012).

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decline the invitation to roll their investment into a continuation fund, exhibiting what could be interpreted as a lack of trust in the sponsor's representations and motives. We provide a more nuanced understating of relational contracting in the private equity context and highlight the limits of this theory, especially with regard to small investors that have limited bargaining power and minimal interactions with the sponsor.

The Securities and Exchange Commission (SEC) has not remained indifferent to this important market development. On February 9, 2022, the SEC voted to propose new rules that, among other changes, aim to provide an “important check against an adviser’s conflicts of interest in structuring and leading a transaction.”<sup>27</sup> In its recently issued examination priorities for 2023, the agency noted that it would focus on continuation funds.<sup>28</sup> The SEC’s proposed rules have already triggered what is likely to be a very long battle with fund sponsors and their counsel.<sup>29</sup> Despite the growing importance of continuation funds and their impact on the U.S. capital market, no academic study to date has closely examined the topic. This Article fills this gap.

We make three key contributions to the existing literature. *First*, this Article is the first to shed light on the emerging phenomenon of continuation funds. Utilizing a law and economics framework, we provide a systematic analysis of the new and unique set of challenges that continuation funds present as well as the benefits they provide to market participants. We also explore how they challenge academic and practitioner preconceptions about high-class bargaining and relational contracting in the private equity space.

As we show, continuation funds guarantee the private equity managers substantial financial benefits, including additional management fees, partial liquidation of carried interest, an option to receive additional profits in the future, and an opportunity to improve their track record. Managers thus have a clear self-interest in using continuation funds, which may lead them to forgo alternative exit options, such as an IPO or a sale to a strategic or financial buyer.

In addition, our analysis shows that the intent to establish the continuation fund, the need to secure additional fundraising, and the close relationships between the managers and the new investors in the continuation fund (often sophisticated and repeat

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<sup>27</sup> Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 87 Fed. Reg. 16886 (proposed Feb. 9, 2022) (to be codified at 17 C.F.R. pt. 275); Gary Gensler, Chairman, U.S. Sec. & Exch. Comm’n, Statement on Private Fund Advisers Proposal (Feb. 9, 2022), <https://www.sec.gov/news/statement/gensler-statement-private-fund-advisers-proposal-020922>.

<sup>28</sup> 2023 Examination Priorities, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/files/2023-exam-priorities.pdf>.

<sup>29</sup> See Blass et. al, *Regulatory and Enforcement Alert: “Transparency Is Not Enough”—SEC Continues Steady March Towards More Intrusive Regulation of Private Funds*, SIMPSON THACHER & BARTLETT LLP (Feb. 9, 2022), [https://www.stblaw.com/docs/default-source/publications/regulatoryenforcementalert\\_02\\_09\\_22.pdf](https://www.stblaw.com/docs/default-source/publications/regulatoryenforcementalert_02_09_22.pdf) (critiquing the SEC’s new rules for private investment funds, from one of the top two U.S. counsel for private equity sponsors).

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players specializing in secondary transactions), might lead managers to favor the interests of potential new investors over those of the legacy fund investors who elected to cash out.<sup>30</sup> Recent evidence showing that the private equity industry has evolved along the years from being “mercenary” to being “a more collaborative clubbish culture now” further supports this view.<sup>31</sup>

*Second*, we utilize qualitative data from interviews with investor and manager participants to provide a more complete and rich analysis of continuation funds’ dynamics. There is a certain level of secrecy surrounding continuation funds: researchers do not have access to the original limited partnership agreements or valuations of these transactions, which are regarded as a “black box.” To overcome these informational limitations, we conducted semi-structured qualitative interviews with leading market participants, all with first-hand experience with continuation funds, and together, participated in over eighty-five sponsor-led continuation fund transactions totaling over \$60 billion in 2022. These interviews provide important insights on the realities of continuation funds.

*Finally*, we also provide a set of concrete policy recommendations regarding the future of this emerging practice, directly addressing the misalignment of incentives between sponsors and investors. These proposals are particularly important in light of the recent suggested SEC reform, which has focused on the mandatory use of fairness opinions in these transactions to protect the funds’ investors. We discuss the shortcomings of the SEC proposal as well as other mechanisms used by market players, such as subjecting the initiation of a continuation fund to the approval of a limited partnership advisory committee, requiring the sponsor to reinvest a significant fraction of its crystallized carried interest into the continuation vehicle, and using a competitive bid. Based on insights from our interviews, we then explain why these mechanisms are unlikely to cure the structural biases generated by continuation fund transactions and propose alternative avenues for dealing with continuation fund conflicts.

This Article proceeds as follows: Part I provides an overview of the private equity model. It also discusses the strengths and weaknesses of relational contracting and the reputation market as non-legal incentives for private equity funds to maximize value for investors, and the private equity bargaining conundrum wherein highly sophisticated investors routinely negotiate agreements that provide them with few contractual rights. Part II provides background on the genesis of continuation funds and outlines the reasons behind their soaring rise in popularity. It also discusses the legal challenges and potential conflicts that continuation funds present. Part III describes our findings from interviews with key market participants. Part IV concludes by discussing the future of continuation funds.

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<sup>30</sup> See *infra* Section II.C.4.

<sup>31</sup> See *infra* note 194 and accompanying text.



## I. Private Equity and High-Class Contracting

### A. *The Private Equity Model*

Private equity funds raise and pool money from investors to buy and sell entire companies, often while using a significant amount of debt to finance the acquisitions.<sup>32</sup> Virtually all private equity funds organize their funds as limited partnerships and invest the money in portfolio companies.<sup>33</sup> Investors in the limited partnership—usually institutional investors and wealthy individuals—are called limited partners (LPs), and the private equity firm, also referred to as the sponsor, serves as the general partner (GP).<sup>34</sup> The GP raises and manages the fund, owes fiduciary duties to the fund, and acts as an agent of the fund vis-a-vis third parties.<sup>35</sup> In contrast, the LPs have minimal rights to participate in day-to-day operations or challenge the GP’s decisions.<sup>36</sup> Nor do they owe any duties to the fund.<sup>37</sup> A limited partnership agreement (LPA), which is negotiated between the GP and the LPs, governs the relationship between the investors and the fund.<sup>38</sup> The LPA typically includes provisions on voting rights, access to information, and transfer restrictions.<sup>39</sup>

Private equity funds have long been heralded as a particularly successful asset class, with investors competing for the opportunity to invest in these funds.<sup>40</sup> The conventional wisdom concerning their success is that they have an advantage in running their acquired companies due to what is considered their superior governance structure, which includes several complementary mechanisms.<sup>41</sup> First, *better incentives*. Private equity funds incentivize portfolio company managers to improve performance metrics. Among other incentives, private equity funds compensate managers with large equity stakes in

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<sup>32</sup> See, e.g., Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121 (2009).

<sup>33</sup> *Id.*

<sup>34</sup> Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2009).

<sup>35</sup> UNIF. LTD. P'SHIP ACT § 305 (2001).

<sup>36</sup> Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 263-270 (2010); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1874-1878 (2018) (“Investors in private equity funds have very little say in the way that their funds are run.”); William Clayton, *The Private Equity Negotiation Myth*, YALE J. ON REG. 37 67, 74 (2020) (“Managers typically have extremely broad discretion to select investments”); James Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 328-329 (2009) (“The reason for choosing the limited partnership form is principally to limit the control rights that limited partners will have over the partnership...”).

<sup>37</sup> UNIF. LTD. P'SHIP ACT § 302; REVISED UNIF. LTD. P'SHIP ACT §§ 302, 303(a).

<sup>38</sup> Harris, *supra* note 36, at 269.

<sup>39</sup> Magnuson, *supra* note 36, at 1857.

<sup>40</sup> Jonathan Shapiro, *Private Equity is the New Traditional Asset Class*, FIN. REV. (Jul. 4, 2022, 9:21 AM) <https://www.afr.com/markets/equity-markets/we-re-the-traditional-asset-class-says-partners-group-founder-20220629-p5axu5>.

<sup>41</sup> Magnuson, *supra* note 36, at 1848–65.

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their companies and frequently replace underperforming managers.<sup>42</sup> Second, *better monitoring*. Private equity funds closely monitor management behavior. Among other things, the large amount of debt placed on portfolio companies is an indirect monitor that encourages managers to pay attention to cash flow and firm value.<sup>43</sup> Third, *better expertise*. Private equity funds specialize in particular sectors and possess financial, operational, and industry-specific expertise and use their substantial experience from previous transactions to maximize the value of their portfolio companies.<sup>44</sup> Finally, by removing companies from the public markets, private equity funds are able to take aggressive actions that yield dividends in the *long term* even if they may lead to *short-term* turmoil.<sup>45</sup>

Two central characteristics of private equity funds differentiate them from other asset classes. The first is the GP's *compensation* structure, which has received extensive attention in the literature.<sup>46</sup> The second is the *limited duration* of private equity funds.<sup>47</sup> Both features are pivotal to the emergence of continuation funds, as we will further detail in Part II.

*GP compensation structure*: It is standard for the private equity firm to receive compensation in two forms (known as “Two and Twenty”): *management fees*, which are between 1.5% and 2% of the committed capital, and *carried interest*, typically equal to 20% of the profits from selling the portfolio companies.<sup>48</sup> It is also common for private equity firms to include a “hurdle rate” that prevents the GPs from earning any carried interest until LPs have realized a specified level of profits from their capital contributions.<sup>49</sup> The carried interest compensation system is considered effective at aligning the interests of the GP and the LPs. Since the GP's returns are proportional to those of the LPs, the GP is motivated to maximize value for other LPs.<sup>50</sup> However, unlike equity investors, managers with carried interest enjoy the upside of strong performance but do not face downside risks. If the private equity fund loses money, it will simply not trigger the carried interest.<sup>51</sup> GPs also charge a *management fee*, a fixed fee that is charged to cover the costs of managing the fund and does not depend on the underlying companies'

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<sup>42</sup> *Id.*

<sup>43</sup> See, e.g., Elisabeth De Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 129–134, 136–39 (2014).

<sup>44</sup> *Id.*; Clayton, *supra* note 36, at 73–107; Magnuson, *supra* note 36, at 1864–1903.

<sup>45</sup> *Id.* at 1861–62.

<sup>46</sup> See *infra* notes 48–54.

<sup>47</sup> See *infra* notes 55–62.

<sup>48</sup> Magnuson, *supra* note 36, at 1866–67; Clayton, *supra* note 36, at 76.

<sup>49</sup> Magnuson, *supra* note 36, at 1873.

<sup>50</sup> William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 292 (1990); Heather M. Field, *The Return-Reducing Ripple Effects of the “Carried Interest” Tax Proposals*, 13 FLA. TAX REV. 1, 35 (2012); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089–90 (2003).

<sup>51</sup> Harris, *supra* note 36, at 283; Magnuson, *supra* note 36, at 1870–1872.

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performance; instead, it is based on the total capital committed.<sup>52</sup> Finally, GPs often invest their own funds in what is termed as *capital contribution*, usually 1% of the total capital.<sup>53</sup> This investment is aimed at aligning the interests of the GP and LPs. After making this investment, the GP has some skin in the game and could face downside risks by making bad investments.<sup>54</sup>

*Limited duration.* Another significant feature of private equity funds, and central to this Article, is the limited duration of the funds. Private equity funds typically last ten years with an option to extend the fund for one or two years with specified approvals.<sup>55</sup> In most cases, investors commit capital to the fund that can be drawn upon and deployed during what is termed as the *commitment period*, usually lasting 3–6 years. During that time, the GP invests in companies that can be improved operationally, financially, or in other ways, using the LPs' investment and substantial debt.<sup>56</sup> After the commitment period has concluded, the GP may no longer embark on new acquisitions. Once the capital committed to the fund is invested, it cannot be withdrawn until the investment is liquidated and the proceeds are distributed to the LPs, either by selling it to another buyer (a strategic investor or another private equity fund) or by undertaking an initial public offering.<sup>57</sup>

The limited duration of private equity funds has several advantages. First, it provides a clear liquidity limit for LPs, whose capital is locked up during the fund's lifespan.<sup>58</sup> Furthermore, the limited exit options for LPs and the fixed duration of the fund complement and balance each other. On the one hand, investors' limited exit options reflect the importance of allowing the GP to invest with a long investment horizon.<sup>59</sup> On the other hand, the limited duration reflects the understanding that the GP's skills might not always be superior to other managers or investment strategies. If the GP's track record indicates that the GP is no longer the right choice to manage the fund, investors are not obligated to remain with that sponsor for an unlimited period of time.<sup>60</sup> However, a limited duration could also lead to an agency problem, as over time, managers may spend less time managing the current fund and more time with newer

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<sup>52</sup> Magnuson, *supra* note 36, at 1867–77.

<sup>53</sup> Harris, *supra* note 36, at 287 (“In the usual case, the fund manager contributes 1%”).

<sup>54</sup> Magnuson, *supra* note 36, at 1865–70.

<sup>55</sup> Harris, *supra* note 36, at 279.

<sup>56</sup> In this period, LPs contribute capital to the fund each time the fund's GP makes a “capital call” for the purpose of making an investment or paying the fund's fees. *High-End Bargaining Problems*, *supra* note 23, at 723.

<sup>57</sup> Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2009).

<sup>58</sup> *Id.*; Clayton, *supra* note 36, at 76–77.

<sup>59</sup> Magnuson, *supra* note 36, at 1880.

<sup>60</sup> Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 606–07, 610–11 (2017).

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funds, likely at the expense of existing LPs.<sup>61</sup> Additionally, managers may direct their more promising investment ideas to more recent funds at the expense of current funds nearing the end of their operating period, especially if the current fund is not likely to maximize their carried interest.<sup>62</sup>

Having now provided a broad overview of the private equity model, we turn to discuss two key aspects of the private equity landscape: relational contracting and the high-class sophistication of the investors in this industry. Both reflect the uniqueness of the private equity space. As we will show in the next two Parts, both are also challenged by the rise of continuation funds.

### B. *Relational Contracting in Private Equity*

Relational contracting, first proposed as an alternative contract theory in the 1960s, has gained popularity among academics and practitioners in recent years as a way to navigate complex and highly relational dealings.<sup>63</sup> Some have suggested that relational contracting might offer a more equitable and flexible alternative to traditional contracting, with the potential to solve problems in complex contractual relations where one party's success is dependent on the other party's performance.<sup>64</sup> Under relational contract theory, a contract is defined as the relations among the dealing parties and not the specific promises that constitute the contract.<sup>65</sup> Rather than focusing on what the parties *write*, relational contracting focuses on what the parties *do* as part of the exchange.<sup>66</sup>

While classical and neoclassical contract theory largely focus on the legal enforceability of a contract under formal law, relational contracting suggests that informal industry practices and relationships also operate to enforce contractual commitments.<sup>67</sup> Stewart Macauley's seminal work on relational contracting proposes that contracts are not fully protected by formal sanctions but rather by additional relational sanctions, such as reputational costs.<sup>68</sup> Parties engaged in relational contracting rely on informal enforcement: if a party breaches a contract, other actors in the industry are then unlikely to contract with them. Therefore, analyzing a contract through a

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<sup>61</sup> Harris, *supra* note 36, at 280.

<sup>62</sup> *Id.* at 279-82; Gilson, *supra* note 50, at 1090.

<sup>63</sup> See, e.g., David Frydlinger, Oliver Hart & Kate Vitasek, *A New Approach to Contracts*, HARVARD BUSINESS REVIEW (2019), <https://hbr.org/2019/09/a-new-approach-to-contracts>.

<sup>64</sup> *Id.*

<sup>65</sup> Macneil, *supra* note 25, at 879.

<sup>66</sup> *Id.*

<sup>67</sup> Illig, *supra* note 26, at 49, 50-51.

<sup>68</sup> Stewart Macauley, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

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relational lens requires understanding the context of the transaction and the relationships at play.<sup>69</sup>

Scholars have applied relational contract theory in a variety of contexts. Cathy Hwang has described how non-binding agreements, such as term sheets in the mergers and acquisitions context are used to build a “relational ecosystem” that facilitates future steps in the transaction.<sup>70</sup> Matthew Jennejohn, writing in the context of supply relationships, has proposed that relational contracting, or investing in “bilateral governance” might act as a “shock absorber for disruptions in the market.”<sup>71</sup> Others have examined relational contracting in the contexts of venture capital, bankruptcy, and financing transactions.<sup>72</sup>

Ian MacNeil has observed that the relationality of a given contract falls along a spectrum.<sup>73</sup> On one end are discrete or one-off contracts for the exchange of goods; on the other end are repeated dealings that occur within complex long-term relationships.<sup>74</sup> The contracts that govern private equity deals typically fall on the far end of this spectrum, with LPs commonly investing with the same firm multiple times. If these funds earn a reputation for acting unfavorably toward their investors, they will find it difficult to attract new investors.<sup>75</sup> Therefore, it can be argued that investors can rely on non-legal incentives to maximize their value even when there are no specific contractual restrictions in place to protect them.<sup>76</sup> Indeed, contract enforcement in private equity tends to be more relational than formal, relying heavily on reputational sanctions rather than the courts or other formal institutions.<sup>77</sup>

One of the major relational contracting avenues in the private equity context is the use of limited partner advisory committees (LPACs) to address conflicts.<sup>78</sup> The LPAC is an advisory committee consisting of representatives of LPs, and its

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<sup>69</sup> Macneil, *supra* note 25, at 877, 879.

<sup>70</sup> Cathy Hwang, *Fauxx Contracts*, 105 VA L. REV 1025, 1064 (2019).

<sup>71</sup> Matthew Jennejohn, *The Transactional Dynamics of Market Fragility*, 85 L. & CONTEMP. PROBLEMS, 281, 283 (2022).

<sup>72</sup> See, e.g., Illig, *supra* note 26; Jonathan C. Lipson, *Bargaining Bankrupt: A Relational Theory of Contract in Bankruptcy*, 6 HARV. BUS. L. REV. 239 (2016); Brian J. Brougham, *The Role of Relationships and Informal Norms in Entrepreneurial Finance*, THE CLS BLUE SKY BLOG (Aug. 14, 2018).

<sup>73</sup> Macneil, *supra* note 25, at 894 (“Probably the most recognized aspect of my work in contract is the use of a spectrum of contractual behavior and norms with poles, labeled relational and discrete, respectively.”).

<sup>74</sup> *Id.*

<sup>75</sup> See *infra* note 185 and accompanying text.

<sup>76</sup> Some scholars, however, argue that the market for reputation may not be as effective in private equity. See Magnuson, *supra* note 36, at 1881–84; Clayton, *supra* note 36, at 80–81.

<sup>77</sup> See *infra* Section III.F.

<sup>78</sup> Dylke, *supra* note 8.

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responsibilities and authority are defined in the LPA.<sup>79</sup> The most common functions of an LPAC includes reviewing and resolving in advance any conflict of interests or any non-arm's-length transactions, and waiving certain restrictions in the LPA.<sup>80</sup> The LPAC can also advise the GP on any other matters brought to it by the GP.<sup>81</sup> While regulators, such as the SEC, do not mandate the use of LPACs,<sup>82</sup> they have become fixtures of private equity funds, with 95% of funds having one.<sup>83</sup> The LPAC normally consists of a small number of representatives of LPs, chosen by the GP.<sup>84</sup> Most LPACs include the largest LPs in the fund<sup>85</sup> or the LPs with longstanding relationships with the GP.<sup>86</sup> LPACs epitomize the relational framework, with the ongoing relationship between the GP and the LPAC serving as a key avenue to addressing contractual questions as they arise.

Finally, while LPs do not typically negotiate specific terms into the LPA, large institutional investors engage in individualized negotiations through “side letters” containing individualized benefits, again reflecting the relational aspect of the private equity space, where each investor may be getting more tailored contractual terms.<sup>87</sup>

### C. *The Private Equity Bargaining Conundrum*

Private equity is known as an “elite contracting space.”<sup>88</sup> Players in this industry have long argued that investors in private equity funds are sophisticated and can use their bargaining power to negotiate for strong protections in the LPAs.<sup>89</sup> Therefore, there is no basis for outside observers to question these agreements. However, recently, scholars have begun to argue that LPAs—which are the result of a bargaining process

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<sup>79</sup> Robert Seber, *LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation*, PRIV. EQUITY LAW REP. (Feb. 25, 2020), [https://media.velaw.com/wp-content/uploads/2020/03/02120713/PELR\\_LPAC-by-Design-Six-Rec.pdf](https://media.velaw.com/wp-content/uploads/2020/03/02120713/PELR_LPAC-by-Design-Six-Rec.pdf).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> Claire Wilson, *The Power of the LPAC*, PRIV. FUNDS CFO (Nov. 16, 2017), <https://www.privatefundscfo.com/committed-capital/>.

<sup>83</sup> Seber, *supra* note 79.

<sup>84</sup> *LPAC Dos and Don'ts – How to Ensure Advisory Bodies Remain Effective*, PRIV. EQUITY INT'L (Feb. 20, 2020), <https://www.privateequityinternational.com/lpac-dos-and-donts-how-to-ensure-advisory-bodies-remain-effective/>.

<sup>85</sup> In a recent survey, most GPs admitted that they select LPs to the LPAC by the size of their allocation with more than 10% of the fund serving as a practical guarantee. *See Private Equity Fund Governance*, VISTRA (2017), <https://www.acg.org/sites/files/Vistra%20Private%20Equity%20Research.pdf>.

<sup>86</sup> Wilson, *supra* note 82.

<sup>87</sup> Elizabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. at 7 (forthcoming 2023) [hereinafter *Side Letter Governance*].

<sup>88</sup> *High-End Bargaining Problems*, *supra* note 23, at 722.

<sup>89</sup> *Id.* at 706.

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between large and sophisticated investors—do not respond satisfactorily to agency problems in the private equity industry.<sup>90</sup>

Despite private equity’s contracting advantages, conflicts of interest inevitably arise between the GP and LPs and among the LPs themselves. First, there is a risk that fund managers will engage in self-dealing transactions, as they are the ones who ultimately decide how to deploy their investors’ capital.<sup>91</sup> They may also be less careful about monitoring the fund’s activities and performance than they would be about managing their own money.<sup>92</sup> It is also possible that funds cannot secure their manager’s undivided attention, since private equity funds commonly launch sequentially, or even simultaneously.<sup>93</sup> These funds might also focus on diverse investment strategies, and investors may disagree with some or all of them.<sup>94</sup> The effectiveness of GPs’ compensation structure,<sup>95</sup> a waiver of fiduciary obligations, and the lack of strong rights to challenge the GP’s decisions also aggravate the issue.<sup>96</sup>

Thus, one central question scholars have focused on regarding private equity funds is why, in a world of freedom of contract and sophisticated parties with repeat exposure to the private equity industry, the governance structure of the LPAs does not provide LPs with some protections, such as the ability to challenge the GP’s decisions.<sup>97</sup> Our discussion of relational contracting may offer one reason for the absence of strong, specific, contractual rights. However, it should be noted that one of the main concerns raised in the literature is that the LPA does not provide a satisfactory response to agency problems in private equity because of *coordination problems*. Investor sophistication alone, the argument goes, is insufficient to overcome suboptimal contracting outcomes. As investors can negotiate individualized benefits in the side letters outside of fund agreements, they have weak incentives to negotiate collective protections in the fund agreements.<sup>98</sup> This gives them strong incentives to maximize their private benefits rather than seek fund-wide protections.

Indeed, a conflict of interest may arise among investors themselves, whereby some investors receive preferential treatment, often through unwritten “gentlemen’s agreements.”<sup>99</sup> For example, whether an investor is offered the option of participating

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<sup>90</sup> *The Private Equity Negotiation Myth*, *supra* note 36, at 78.

<sup>91</sup> *High-End Bargaining Problems*, *supra* note 23.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> See de Fontenay, *supra* note 5, at 1100 (“Large private equity firms now simultaneously run LBO funds, credit funds, real estate funds, alternative investments funds, and even hedge funds.”).

<sup>95</sup> See *supra* notes 48–54 and accompanying text.

<sup>96</sup> See *infra* note 36.

<sup>97</sup> *The Private Equity Negotiation Myth*, *supra* note 36, at 70–71.

<sup>98</sup> William W. Clayton, *High-End Securities Regulation* (forthcoming, 2023), at 30–31; *The Private Equity Negotiation Myth*, *supra* note 36, at 70–71; see also *Side Letter Governance*, *supra* note 87, at 47–48.

<sup>99</sup> *Id.*

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in co-investments opportunities may turn on an implicit agreement.<sup>100</sup> Through unwritten agreements and in side letters, managers may grant preferential treatment to investors who contribute more.<sup>101</sup> Side letters can create more problems of their own, imposing significant costs and creating delays in capital raising, and potentially impairing funds' operations and investments in unexpected or unpredictable ways.<sup>102</sup> Investors, too, are subject to the classic prisoner's dilemma.<sup>103</sup> Although they may benefit from collectively working together, each faces a competing incentive to defect from this equilibrium by negotiating its own rights.<sup>104</sup>

Even if investors were willing to coordinate, a *lack of information* about market terms can also lead to inefficient negotiations. The combination of private equity firms not being subject to disclosure requirements, as are public companies, together with the fact that private equity funds' contracts with LPs are frequently confidential, makes it difficult for investors to share information and improve the terms for LPs.<sup>105</sup>

Additionally, *unequal bargaining power* has been identified as a major cause of bargaining failure in the private equity context. In particular, Professor Will Clayton found that LPs do not seek better terms because they worry that they will be excluded from the GP's current or future funds if they bargain too aggressively.<sup>106</sup> Some institutional investors in private equity funds may also lack incentives to demand strong protections due to *internal agency problems*. For example, public pension plans—the largest private equity investors—might experience agency problems. It may be less likely that pension plan investment officers will push for strong protections for plan beneficiaries because of personal career concerns.<sup>107</sup> Investment officers may choose to negotiate price rather than investor protections, even if this is not in the beneficiaries' best interests. Given that the price is more likely to be noticed by the investment officer's regulators or superiors, negotiating for a lower price provides career benefits to the investment officer. In contrast, strong protections (through the use of restrictive covenants) are less likely to attract the scrutiny of an internal manager's superiors, thereby raising fewer career risk concerns if the manager does not ask for them.<sup>108</sup>

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<sup>100</sup> *Id.*

<sup>101</sup> *See de Fontenay, supra* note 5, at 28.

<sup>102</sup> Side letters are confidential agreements between the fund manager and investor that give the investor special rights, beyond those that apply to other investors in the same fund *See Side Letter Governance, supra* note 87, at 20.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 54.

<sup>105</sup> Magnuson, *supra* note 36, at 1849–50.

<sup>106</sup> *High-End Securities Regulation, supra* note 98, at 41.

<sup>107</sup> *The Private Equity Negotiation Myth, supra* note 36, at 102–03.

<sup>108</sup> *High-End Securities Regulation, supra* note 98, at 33–34.



In this Part, we have provided an overview of the private equity landscape and the tension that relational contracting and high-class (lack of) bargaining may present in the private equity context. In the following Part, we review the emergence of continuation funds, and in Part III, we examine how these funds challenge both the relational contracting paradigm and the neoclassical deference to high-class contracting.

## II. The Rise of Continuation Funds

### A. *The Structure and Advantages of Continuation Funds*

One of the limitations of private equity funds is that they have finite durations.<sup>109</sup> However, selling private equity assets when the term of the fund ends may not always be optimal, since companies can often generate significantly higher value beyond the typical fund’s lifespan.<sup>110</sup> This can arise in two main situations: when the portfolio companies are underperforming in the short term but can create significant value for LPs in the long run, or when well-performing companies (also known as “trophy assets”) might be able to generate significant additional value in the future.<sup>111</sup> There is no doubt that market conditions significantly affect exit options as well, since traditional exit options may not be viable in challenging exit environments.<sup>112</sup>

In such cases, the GP can establish a continuation fund to acquire one or more portfolio companies from the legacy fund.<sup>113</sup> Continuation funds are typically set up for a shorter period than the 10-year typical life of a legacy fund—up to 6–7 years.<sup>114</sup> In most cases, LPs of the legacy funds have the following options when a continuation fund has been created: (i) selling their interests in the existing fund and receiving a pro rata share of the purchase price; or (ii) rolling their interest into the continuation vehicle; or (iii) in some cases, both.<sup>115</sup> The GP may also request that rolling investors provide

<sup>109</sup> See *supra* notes 57–62 and accompanying text.

<sup>110</sup> Miriam Partington, *HV Capital launches Germany’s first continuation fund of €430m*, SIFTED (Feb. 16, 2022), <https://sifted.eu/articles/hv-capital-continuation-fund/.16,2022>, <https://sifted.eu/articles/hv-capital-continuation-fund/>.

<sup>111</sup> Hinsen, *supra* note 10.

<sup>112</sup> *Id.*

<sup>113</sup> T.J. Hope, *Continuation Vehicles: Valuation and Fairness Considerations*, STOUT (Feb. 22, 2022), <https://www.stout.com/en/insights/article/continuation-vehicles-valuation-and-fairness-considerations>; Clifford Chance, “Decoding” the Secondaries Market, (Sep. 2020), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/09/decoding-the-secondary-market-part-IV-continuation-funds.pdf>.

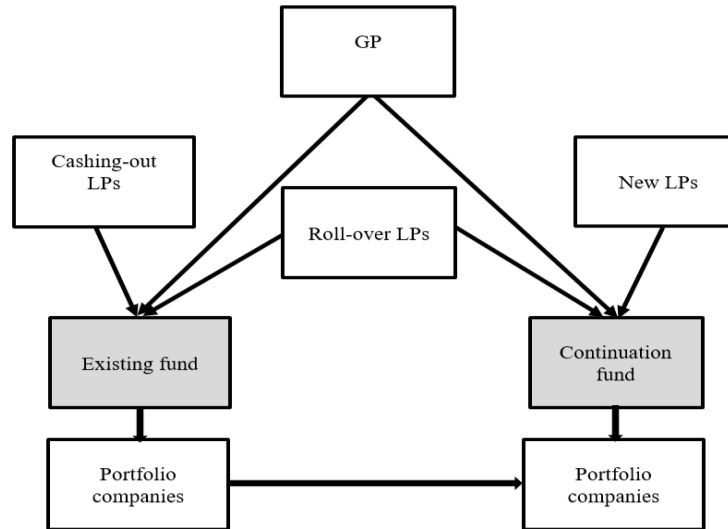
<sup>114</sup> Keith Button, *The Rise of Continuation Funds*, MERGERS & ACQUISITIONS (Mar. 7, 2022), <https://www.themiddlemarket.com/feature/the-rise-of-continuation-funds>.

<sup>115</sup> *GP-Led Secondaries Reshaping the Landscape for Investors, Fund Managers, and Portfolio Companies* (May 2022), CAPITAL DYNAMICS, [https://www.capdyn.com/Content/Content/www/news/PDFs/Capital\\_Dynamics\\_-\\_GP-led\\_Secondaries.pdf](https://www.capdyn.com/Content/Content/www/news/PDFs/Capital_Dynamics_-_GP-led_Secondaries.pdf) [hereinafter CAPITAL DYNAMICS].

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additional capital commitments to the continuation fund.<sup>116</sup> The continuation fund, which is typically managed by the GP of the legacy fund, offers new terms for managing the acquired assets and updated terms for the GP, including modified carried interest and management fees.<sup>117</sup> Figure 1 below illustrates a typical structure of a continuation fund.<sup>118</sup>

Figure 1: A Continuation Fund Structure



Supporters of the continuation funds view them as a “win-win-win” for all parties involved.

For *GPs*, continuation funds provide something that has been lacking in traditional limited partnership funds: optionality.<sup>119</sup> Using this structure, *GPs* have the option to continue holding high-performing assets for an extended period until these assets reach their full potential. At the same time, it eliminates the need to sell the assets to another private equity fund; thus, management need not adapt to a new board of

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<sup>116</sup> *Id.*

<sup>117</sup> *GP-led Secondary Fund Restructurings Considerations for Limited and General Partners*, ILPA (Apr. 2019), <https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-Restructurings-Apr-2019-FINAL.pdf> [hereinafter *GP-led Secondary Fund Restructurings*]; Sebastian McCarthy & Lina Saigol, *Private Equity Turns to Continuation Funds to Keep Hold of Trophy Assets*, FIN. NEWS (Nov. 24, 2021), <https://www.fnlonon.com/articles/private-equity-turns-to-continuation-funds-to-keep-hold-of-trophy-assets-2021112424>; Clifford Chance, *supra* note 113, at 4.

<sup>118</sup> See also Dylke, *supra* note 8; Ted Cominos & Cristina Audran-Proca, *‘Let the Good Times Roll’ – Continuation Funds and Their Appeal to GPs and LPs*, EVERSHEDES SUTHERLAND (Jun. 12, 2022).

<sup>119</sup> Debbie Reeve & Michelle McNaney, *The Rise of Continuation Funds*, AZTEC GROUP (July 14, 2022), <https://aztec.group/insights/the-rise-of-continuation-funds/>.

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directors.<sup>120</sup> Continuation funds solve other problems that GPs face towards the end of a fund's life: liquidity. At this stage, with most of the capital drawn, options for portfolio companies that need additional capital are limited. A continuation fund specifically addresses this issue, as the GPs can raise additional capital earmarked for that business.<sup>121</sup>

Continuation funds also offer benefits to the *legacy fund's LPs*. These investors are given the choice of either taking liquidity by realizing gains from the assets managed by the GP or rolling their investments into the continuation fund. Rolling LPs gain continued exposure to assets with which they are familiar (with potential that cannot be fulfilled during the original fund's lifetime) and reinforce their relationship with the GP.<sup>122</sup>

For *incoming LPs*, continuation funds offer the opportunity to invest in more "mature" assets for a shorter period than that of the portfolio company's lifecycle. They enjoy full visibility of the asset they are buying into, as well as the ability to develop a new GP relationship. Since an extension of the original fund cannot raise additional capital and requires the consent of all LPs (or at least a vast majority of them), with possibly different liquidity needs, it cannot serve the same purposes as a continuation fund.<sup>123</sup>

### B. *The Growing Prevalence of Continuation Funds and their Importance*

Continuation funds have been one of the most popular trends in the private equity world over the last few years.<sup>124</sup> As the data below show, the number of GPs that launch continuation funds and hold onto assets longer has increased significantly in recent years. Over the years, continuation funds have been utilized in different ways, with their history divisible into roughly two periods: the "*zombie funds*" period and the "*crown jewel*" period.

"*Zombie funds*": For a long time, continuation funds suffered from a bad reputation and were considered a means of restructuring underperforming assets.<sup>125</sup> Starting around 2010, continuation funds were used for distressed assets that

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<sup>120</sup> Madeline Shi, *Continuation funds drive GP-led Secondaries Wave*, PITCHBOOK (Feb. 1, 2022), <https://pitchbook.com/news/articles/continuation-funds-GPs-secondaries-private-equity>.

<sup>121</sup> Reeve & McNaney, *supra* note 119.

<sup>122</sup> Button, *supra* note 114; Hinsen, *supra* note 10.

<sup>123</sup> *Id.*

<sup>124</sup> Michael Forestner & Brad Young, *Continuation Funds: Gifts That Keep on Giving*, MERCER (2021) <https://www.mercer.com/our-thinking/wealth/yieldpoint-blog/continuation-funds-gifts-that-keep-on-giving.html>.

<sup>125</sup> McCarthy & Saigol, *supra* note 117, <https://www.fnlondon.com/articles/private-equity-turns-to-continuation-funds-to-keep-hold-of-trophy-assets-2021112424>; Madeleine Farman, *PE Zombie Funds Reinvented for 'Crown Jewel' Strategy* (Sept. 13, 2021), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/pe-zombie-funds-reinvented-for-crown-jewel-strategy-66278877>.

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were struggling in the aftermath of the global financial crisis.<sup>126</sup> Sponsors who could not raise a successor fund would use continuation funds to maintain fee generation.<sup>127</sup> The transfer of these assets into a new vehicle generated a liquidity event for the LPs, but they faced two “bad” choices: either accept new investment terms that were less favorable than they had before or sell their interests at a discount. For this reason, LPs did not view this phenomenon favorably.<sup>128</sup>

“*Crown jewel*” funds: The shift came around 2015 when sponsors and their advisors realized that continuation funds could be a useful tool, not necessarily just for distressed assets, but also for high-performing assets that they wanted to hold for longer periods due to unfavorable market conditions.<sup>129</sup> It also allowed for additional infusions of capital when the GP could no longer raise funding from the legacy fund investors.<sup>130</sup> This practice has accelerated due to COVID-19, which made scheduled exit windows for portfolio assets less viable.<sup>131</sup> As a result, continuation funds have gained more and more traction, quickly becoming entrenched in the private equity ecosystem.<sup>132</sup>

Data collected in the past six and half years indicate that secondary transactions led by GPs are witnessing continued and significant growth. For example, in 2016, the total deal value of these transactions was about \$11 billion. That number surged by over 650%(!) within a 5-year period. In 2021, GP-led secondary transactions reached their highest volume in history, estimated at around \$63 billion dollars in deal value.<sup>133</sup> Importantly, market participants accept that these transactions are here to stay and that they will continue to form a substantial part of the private equity market.<sup>134</sup> For example, most market participants recently estimated that the volume of GP-led transactions could surpass \$100 billion by 2025.<sup>135</sup>

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<sup>126</sup> See, e.g., Farman, *supra* note 125.

<sup>127</sup> Donald H. Lennard & Jeannette M. Anthony, *To be Continued: The Case for GP-Led Secondary Funds* (May 2021), <https://www.demarche.com/whitepaper/to-be-continued-the-case-for-gp-led-secondary-funds/>; James Kirk, *The Growth of General Partner Led Secondaries*, LONSEC (Dec. 6, 2021), <https://www.lonsec.com.au/2021/12/06/the-growth-of-gp-led-secondaries/>.

<sup>128</sup> See, e.g., Farman, *supra* note 125; Kirk, *supra* note 127.

<sup>129</sup> McCarthy & Saigol, *supra* note 117.

<sup>130</sup> Lennard & Anthony, *supra* note 127; Kirk, *supra* note 127.

<sup>131</sup> Clifford Chance, *supra* note 113. Also see Button, *supra* note 114.

<sup>132</sup> Reeve & McNaney, *supra* note 119; Cominos & Audran-Proca, *supra* note 118.

<sup>133</sup> John M. Caccia, Greg Norman & Anna Rips, *How Good Governance Frameworks Can Optimize Outcomes in Continuation Funds*, SKADDEN (Mar. 15, 2022), [https://www.skadden.com/-/media/files/publications/2022/03/how\\_good\\_governance\\_frameworks\\_can\\_optimize\\_outcomes\\_in\\_continuation\\_funds.pdf](https://www.skadden.com/-/media/files/publications/2022/03/how_good_governance_frameworks_can_optimize_outcomes_in_continuation_funds.pdf); Clifford Chance, *supra* note 113.

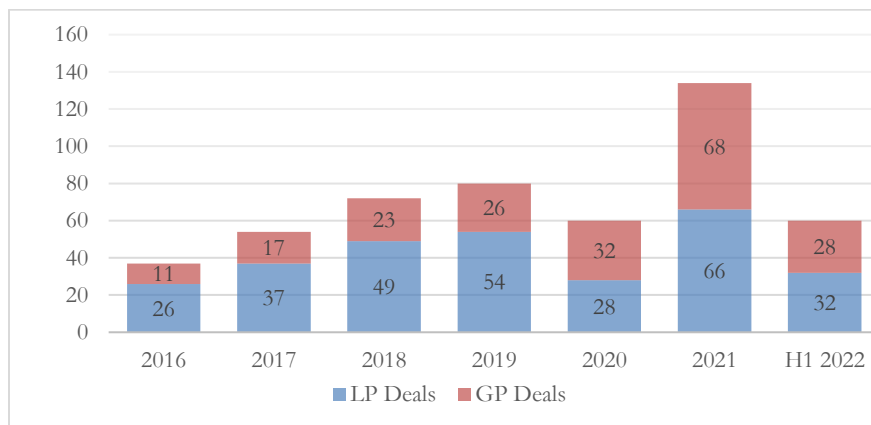
<sup>134</sup> Reeve & McNaney, *supra* note 119; Cominos & Audran-Proca, *supra* note 118.

<sup>135</sup> *Financial Sponsor Secondary Market Year-End Review – 2021*, LAZARD (Jan. 31, 2022), <https://www.lazard.com/media/451989/lazard-sponsor-led-secondary-market-report-2021.pdf> (hereinafter LAZARD 2021).

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Moreover, the data also show that in the past, LP-led transactions—one-off transactions led by an LP looking to sell one or more of its limited partnership interests at some point during the life of the fund—dominated the secondary market transactions. This is no longer the case. GP-led transactions, once a small percentage of the secondary market volume, now account for approximately 50% of the overall volume of the deals,<sup>136</sup> sometimes outpacing LP-led deals.<sup>137</sup>

Figure 2: Secondary Transaction volume by year (\$ bn)<sup>138</sup>



A continuation fund is only one type of secondary transaction conducted by GPs. Other types include tender offers,<sup>139</sup> portfolio strip sales,<sup>140</sup> and stapled transactions.<sup>141</sup> However, continuation funds are by far the most common type of GP-led secondary transaction.<sup>142</sup> In 2021 and 2022, continuation funds represented 83% and 76% of these

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<sup>136</sup> CAPITAL DYNAMICS, *supra* note 115, at 2.

<sup>137</sup> Cari Lodge, *LP-Led Secondaries: The Core of the Secondaries Market*, COMMON FUND (Sept. 26, 2022), <https://www.commonfund.org/cf-private-equity/lp-led-secondaries-the-core-of-the-market>.

<sup>138</sup> *Id.*

<sup>139</sup> A GP-led tender offer is “a coordinated option for LPs to obtain liquidity through a market-priced tender offer for fund interests [and] typically triggered by a group of LPs having indicated an interest in liquidity.” CAPITAL DYNAMICS, *supra* note 115, at 4.

<sup>140</sup> A portfolio strip sale involves “a sale of a specified selection or percentage (sometimes referred to as a ‘strip’) of direct interests in assets held by a fund, typically to an SPV managed by the same GP at a valuation determined by secondary buyers.” *Id.*

<sup>141</sup> In a staple transaction, the GP organizes the sale of secondary interests in a fund to a buyer and, simultaneously, the buyer agrees to make a primary commitment to a new (or other existing) fund managed by the same GP. *Id.*

<sup>142</sup> Shi, *supra* note 120.

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transactions, respectively.<sup>143</sup> In addition, some continuation funds are beginning to be created earlier in a fund's lifecycle,<sup>144</sup> a practice that also raises some investor concerns.

A GP that forms a continuation fund can move a single asset or a small group of assets into a continuation fund. Single-asset funds, which are less diversified and thus riskier for investors, constitute the largest segment of all GP-led transactions in the past few years.<sup>145</sup> For example, in 2021, single-asset continuation funds accounted for 52% of all transactions led by GPs, compared to 38% in 2020.<sup>146</sup> Multi-asset continuation funds accounted for 31% and 34% of all GP-led transactions in 2021 and 2020, respectively.<sup>147</sup>

Finally, while the use of continuation funds is a global development, the North American market is, by far, the most active region,<sup>148</sup> with 71% of total GP-led transactions that closed in 2021 (249 out of 350 transactions) from this area.<sup>149</sup> The majority of this volume stemmed from large continuation fund transactions.<sup>150</sup>

Combining all these factors, the empirical evidence shows that continuation funds are no longer an esoteric phenomenon. Their use has soared in recent years, hitting a new record in 2021, and they are particularly prevalent in North America. They are also here to stay. As recently observed: "Don't expect the interest in continuation vehicles to fade even if COVID continues to abate. Sponsors have become increasingly comfortable with continuation funds as another tool in their toolboxes, along with IPOs and sales to strategic or financial buyers."<sup>151</sup>

Not surprisingly, the growth of continuation funds, as well as the acknowledgement that they are here to stay, have also caught the attention of large institutional investors and regulators. Some investors have expressed concern about this rising trend and its rationale. For example, a leading executive from Denmark's largest pension fund has compared private equity to a pyramid scheme, warning that buyout

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<sup>143</sup> LAZARD PRIVATE CAPITAL ADVISORY, SPONSOR-LED SECONDARY MARKET REPORT H1'22 (Aug. 2022), [https://www.lazard.com/media/452215/lazard-sponsor-led-secondary-market-report-h1-2022\\_vf.pdf](https://www.lazard.com/media/452215/lazard-sponsor-led-secondary-market-report-h1-2022_vf.pdf); Shi, *supra* note 120; LAZARD 2021, *supra* note 135.

<sup>144</sup> Global Fund Performance Report, PITCHBOOK (Nov. 2022), 31, <https://pitchbook.com/news/reports/2022-global-fund-performance-report-as-of-q1-2022-with-preliminary-q2-2022-data>.

<sup>145</sup> *Id.*

<sup>146</sup> Shi, *supra* note 120.

<sup>147</sup> *Id.*

<sup>148</sup> LAZARD 2021, *supra* note 135, at 4.

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> Justin Johnson, *SEC could take fairness opinions from 'nice to have' to 'must have' for continuation funds*, SECONDARIES INVESTOR (Apr. 19, 2022) <https://www.secondariesinvestor.com/sec-could-take-fairness-opinions-from-nice-to-have-to-must-have-for-continuation-funds/>.

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groups are increasingly selling their companies to “themselves” on a scale that is not “‘good business’ for their business.”<sup>152</sup>

Similarly, the chief investment officer of ATP (another large pension fund) expressed concern about the fact that over 80% of the portfolio companies sold by the private equity funds that ATP invested in 2021 were either sold to another buyout group or were “continuation fund” deals.<sup>153</sup> The Chief Information Officer of Europe’s largest asset manager (Amundi), made a similar claim. He stated that certain parts of private equity look like Ponzi schemes: “When you know you can exit your stake to another private equity house for multiple of, let’s say, 20, 25 or 30 times earnings, of course, you won’t mark down your book... I’m talking about a Ponzi because it’s a circular thing.”<sup>154</sup>

Additionally, the Securities and Exchange Commission (SEC) recently published proposed rules regarding private equity funds that, among other changes, aim to provide an “important check against an adviser’s conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors” and that “would help ensure that private fund investors are offered a fair price for their private fund interest.”<sup>155</sup>

### C. Continuation Funds’ Web of Conflicts

As we have just shown, continuation funds generate significant concerns among investors and regulators who are worried about the potential conflicts of interest and unique challenges that continuation funds present.<sup>156</sup> Such concerns, however, seem to be general and ambiguous, leaving open some crucial questions: What types of misalignments of interests do continuation funds cause? How severe are these conflicts? What are the economic interests of the GP? Are they more aligned with the interests of the buying or the selling LPs? We now turn to examine these important questions.

#### 1. GP’s Private Interests

From the perspective of the GP, the mere initiation of a continuation fund is almost always automatically a “win,” providing the following unique and substantial benefits:

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<sup>152</sup> Kaye Wiggins, *Private Equity May Become a ‘Pyramid Scheme,’ Warns Danish Pension Fund*, FIN. TIMES (Sep. 20, 2022), <https://www.ft.com/content/f480a99c-4c7b-4208-b9dd-ef20103254b9>.

<sup>153</sup> *Id.*

<sup>154</sup> Sebastian McCarthy & Mark Latham, *Amundi CIO: Parts of PE Are Like a Ponzi Scheme*, PRIV. EQUITY NEWS (Jun. 1, 2022), <https://www.penews.com/articles/elements-of-private-equity-resemble-a-ponzi-scheme-amundi-cio-warns-20220601?mod=topStories>.

<sup>155</sup> See *supra* note 27, at 122.

<sup>156</sup> See, e.g., Zak Bentley, *LPs Wonder If They Stand to Lose from ‘Win-Win-Win’ Continuation Funds*, SECONDARIES INVESTOR (Dec. 12, 2022), <https://www.secondariesinvestor.com/lps-wonder-if-they-stand-to-lose-from-win-win-win-continuation-funds/>.

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*Additional management fees.* Establishing a continuation fund enables the GP to earn *new* management fees for an extended period. As the SEC explained in its proposed rule, the opportunity to earn economic benefits, which are *conditioned* upon the closing of the secondary transaction, such as additional management fees and carried interests, generates the GP's conflict of interest in setting and negotiating the transaction terms. True, the management fee in continuation funds may be lower than in regular funds (for example, 1% in continuation funds versus 1.5–2% in regular funds).<sup>157</sup> However, the management fee is calculated as a percentage of the assets under management, and in a continuation fund, the basis for calculating the management fee is high from day one. Since the value of the assets transferred to the continuation fund is likely to be higher compared to the value of the assets when the legacy fund was created, the management fee of a continuation fund will increase accordingly and thus will offset any discount (in percentage) given to the new investors.<sup>158</sup>

To illustrate this point, consider a fund with an asset that initially equaled \$500 million and was subsequently sold to a continuation fund for \$1 billion. Before the sale, the management fee of the initial fund was 2%, or \$10 million per year. After the sale, the management fee was reduced to 1% per year, but due to the increase in the asset value, it remains the same \$10 million per year. Moreover, management fees are often eliminated or reduced at the end of the commitment period when investments are no longer being made. Therefore, management fees are phased out by the time the fund nears its end. By transferring the asset to a new fund, the GP *double-dips* on the fees, now collecting them anew from the new LPs.

Importantly, management fees are justified by the need to pay for the management services of the GP. When a continuation fund is established, the GP has already completed the majority of the meaningful investment work. It has already chosen the companies to invest in and has already worked on improving them for several years. In a continuation fund, the GP's main task is to manage the assets, without necessarily making any new or time-consuming investment decisions.<sup>159</sup> Therefore, a continuation fund might enable the GP to do less but get paid more.

*Partial Liquidation of the Carried Interest.* Another important benefit of a continuation fund from the perspective of the GP is that immediately upon closing the deal, the GP crystallizes its carried interest and takes some money off the table. To be clear, the GP receives that carried interest, even though the portfolio company was not sold to another investor or to public investors through an IPO, and the LPs who rolled over their investment did not obtain any liquidity. That is, from the perspective of the

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<sup>157</sup> CAPITAL DYNAMICS, *supra* note 115, at 9 (“Management fees [in continuation funds] typically range from 0.50% to 1.25%.”).

<sup>158</sup> See *id.*

<sup>159</sup> Tim Jenkinson, Hyeik Kim & Michael S. Weisbach, *Buyouts: A Primer*, (Working Paper, 2021), at 21-22, 105.



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rolling-over LPs, although not having accomplished the legacy fund's main mission, the GP continues to run and benefit from the same assets and the GP locks in its carried interest. Moreover, the ability to take some money off the table also provides the GP with liquidity, enabling the GP to diversify away some of the risk associated with the investment in the continuation fund.

*An option to receive additional carry.* Furthermore, the GP can receive additional carried interest when the portfolio company is sold at the end of the continuation fund's lifespan if the continuation fund sells its asset at a profit.<sup>160</sup> And while the carried interest in continuation funds may be lower than in regular funds (10–15% versus 20%),<sup>161</sup> it is still a substantial benefit. The continuation fund, thus, provides the GP with an *option* to generate additional value from exactly the same assets a few years later.

As classic asset pricing theory suggests, time also influences the value of the option. The longer until expiration of the option contract, the more valuable the option will be, as the holder of the option has more time for the stock to move above or below the strike price.<sup>162</sup> Therefore, moving assets to the continuation funds provide the GP an additional important benefit: more time to increase the value of the assets and to receive additional carried interest.

*Improving the GP Track Record.* By creating an “artificial” sale transaction through the sale of assets to itself, the GP also improves its track record and signals to the market that a particular GP knows how to manage assets better than other sponsors. Such a transaction could be included in the GP's past performance statistics, creating a reputation and signaling an ability or a specialty that the GP does not necessarily have. Furthermore, the artificial extension of the fund's limited duration through continuation funds undermines investors' ability to accurately measure the GP's performance when deciding whether to reinvest.<sup>163</sup> While the ten-year timeframe gives investors a yardstick

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<sup>160</sup> José Gabriel Palma, *Financialization as a (it's-not-meant-to-make-sense) gigantic global joke*, CAMBRIDGE WORKING PAPERS IN ECONOMICS 15 (2022), <https://aspace.repository.cam.ac.uk/bitstream/handle/1810/334496/cwpe2211.pdf?sequence=1&isAllowed=y/>.

<sup>161</sup> The carried interest in continuation funds can also be higher than in regular funds. Wong & Wong, *supra* note 7 (“Managers will frequently push for a super carry”).

<sup>162</sup> Merrill, *Options Pricing*, <https://www.merrilledge.com/investment-products/options/options-pricing-valuation#:~:text=Time%20will%20also%20influence%20the,or%20below%20the%20strike%20price.> (last visited 02/14/23).

<sup>163</sup> See, e.g., David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, COLUM. BUS. L. REV. 363, 395 (2002) (“[T]he short life of limited partnerships virtually guarantees...a 'periodic performance review' at the hands of their current investors”); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003); Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

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for measuring fund managers' performance when deciding whether to reinvest,<sup>164</sup> the GP may be able to obscure its true performance by segregating successful or underperforming assets.

The conclusion of this analysis is clear: GPs have a strong interest in establishing a continuation fund because it will provide the GP with a number of benefits: earning management fees for an extended period; diversifying away some of its risk by crystalizing its carried interest and taking some money off the table; enjoying an option to receive additional carried interest when the portfolio company is sold at the end of the continuation fund's lifespan (if sold at profit); and improving its track record. But what about the LPs?

### 2. GP's Dual Loyalties

In a typical continuation fund transaction, the GP is on both sides of the transaction, as the GP offers existing LPs the option to sell their interests in the legacy fund or roll it over into a continuation vehicle managed by the same GP. This transaction also involves some new investors that will infuse new capital to the continuation fund and will buy the interests of the legacy investors who elected to sell their interest.<sup>165</sup>

In a scenario where all or an overwhelming majority of LPs elect to roll over their shares, the LPs' conflicts of interest generated by the continuation funds are not severe, as almost all LPs sit on both sides of the transaction. For example, if the value of the LPs' interests in the legacy fund assets is overestimated and the buyer (i.e., the continuation fund) overpays, then the very same LPs benefiting from inflating the sale price will bear the same cost on the buy side. This transaction is essentially a transfer from their left pocket to their right one. Therefore, to assess the severity of the conflicts of interest, the turnover rate in the body of the LPs following a continuation fund transaction must be examined.

Interestingly, data from recent years shows that 80–90% of LPs in the legacy fund elect to cash out rather than to roll over their investments into the continuation fund.<sup>166</sup> There are various reasons for the original LPs' proclivity to sell their interests, and not all of them are related to the consideration offered to them in the continuation fund transaction. We will discuss those reasons in greater details in Part III.<sup>167</sup> Regardless

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<sup>164</sup> See Harris, *supra* note 36, at 280–81.

<sup>165</sup> See *supra* Section II.A.

<sup>166</sup> In the first half of 2022 90% of LPs chose to sell rather than roll over their investments. Adam Le, *LPs Are Missing the Boat When it Comes to Continuation Funds*, PRIV. EQUITY INT'L (Oct. 17, 2022), <https://www.privateequityinternational.com/lps-are-missing-the-boat-when-it-comes-to-continuation-funds-research>. According to ILPA standards and best practice director, Neal Prunier "as many as 80 per cent of LPs not rolling." Fiona McNally, *Frustrated LPs await new guidance on GP-led secondaries*, PRIV. EQUITY WIRE (Apr. 29, 2022), <https://www.privateequitywire.co.uk/2022/04/29/314174/frustrated-lps-await-new-guidance-gp-led-secondaries>.

<sup>167</sup> See *infra* Section III.B.

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of the reasons, it is clear that the mere initiation of the continuation fund creates a significant turnover in the body of LPs.

In these situations, the GP puts itself in a position where it is committed to two groups of investors whose interests are in a direct conflict—the *existing LPs* that are interested in selling the fund’s assets at the highest possible price, and the *new LPs* investing in the continuation fund that acquires one or more assets of the legacy fund and who are interested in paying the lowest price possible for the assets.<sup>168</sup> The GP controls both the legacy fund and the continuation fund and is financially invested in both funds.<sup>169</sup> The GP also represents LP investors in the negotiation process and conducts the valuation of the relevant assets. Thus, the GP must maneuver in the context of this complex and conflicting dual loyalties.

GPs’ legal fiduciary duties are outlined in the federal Investment Advisers Act of 1940 and in the states’ limited partnership laws.<sup>170</sup> As a fiduciary to both the legacy fund and the continuation fund, the GP must act in the best interest of each group of LPs.<sup>171</sup> There are legal mechanisms for resolving this conflict. For example, in Delaware, where most private equity funds are formed, fiduciary duties can be modified or even waived entirely by an LPA’s terms.<sup>172</sup> Under the Investment Advisers Act, the requirements of fiduciary duties can largely be met by a disclosure of conflicts and by receiving a conflict waiver.<sup>173</sup> We will analyze the effectiveness of these mechanisms in the next Part. As we will show, the GP often receives a waiver from representatives of the legacy fund LPs that approves solely the establishment of a continuation fund.<sup>174</sup> In such a case, the GP is in an *inherent* conflict of interests regarding the transaction price, which raises two opposing concerns.<sup>175</sup>

The *first* is that the GP could maximize the profit for the LPs in the legacy fund at the expense of the new LPs. As explained in Part I, the success of the private equity model has been attributed to the alignment of interests between investors and sponsors.

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<sup>168</sup> Gregg Gethard, *LP/GP alignment at risk from proliferation of continuation funds, subscription lines: report BUYOUTS* (Oct. 31, 2022), <https://www.buyoutsinsider.com/lp-gp-alignment-at-risk-from-proliferation-of-continuation-funds-subscription-lines-report/>; Reeve & McNaney, *supra* note 119.

<sup>169</sup> Ryan Clements, *Misaligned Incentives In Markets: Envisioning Finance That Benefits All of Society*, 19 DEPAUL BUS. & COM. L.J. 1 (2022) (characterizing continuation funds deals as GPs selling assets to themselves).

<sup>170</sup> These duties include, among other things, a duty of loyalty that requires the GP to refrain from dealing with the partnership on behalf of a party with an adverse interest. *See* Clayton, *supra* note 36, at 77–78, 82; Harris, *supra* note 36, at 273.

<sup>171</sup> Sonia Gioseffi, Yasho Lahiri & Aaron Russ, *Breaking Up Is Hard to Do, So Let’s Stay Together: An Analysis of Issues in Continuation Funds*, THE INVESTMENT LAWYER 28, 4 (Nov. 2021), [https://marketingstorageragrs.blob.core.windows.net/webfiles/IL\\_Gioseffi-Lahiri-Russ\\_1121.pdf](https://marketingstorageragrs.blob.core.windows.net/webfiles/IL_Gioseffi-Lahiri-Russ_1121.pdf).

<sup>172</sup> Clayton, *supra* note 36, at 77.

<sup>173</sup> *Id.*

<sup>174</sup> *See infra* Section IV.C.

<sup>175</sup> Hope, *supra* note 113.

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In particular, the carried interest compensation system discussed above is considered effective at aligning the interests of the GP and the LPs. The GP typically earns 20% of the fund's profits as carried interest;<sup>176</sup> consequently, the GP's returns are proportional to those of the LPs, generally making the GP motivated to maximize value for other LPs.<sup>177</sup>

Since the GP may receive a carried interest when liquidating the asset through a sale to the continuation fund,<sup>178</sup> it may seem reasonable that it would have an interest in overvaluing the assets to receive a higher carried interest. The SEC also raised this concern in its proposed rule, noting that a continuation fund transaction that involves illiquid assets are likely to involve unfair prices and thus to generate “a higher risk of investor harm from potential conflicts of interest or fraud.” In particular, the SEC raised the concern that “advisers may use a high level of discretion and subjectivity in valuing a private fund's illiquid investments, and the adviser further may have incentives to bias the fair value estimates of the investment *upwards* in order to generate larger fees.”<sup>179</sup> In light of this analysis, the new LP's interests may be at risk since they might be overpaying for assets.

The analysis does not stop here. The *second*, converse, concern is that the GP will act to maximize the interests of the continuation fund LPs at the expense of the legacy fund LPs. To prevent conflicts of interest arising from the GP deciding on a value at which carried interest will be calculated, LPs investing in the continuation fund expect the GP to reinvest a substantial portion of its carried interest in the continuation fund. Data show that the GP often meets this expectation, rolling over a significant portion of its carried interest into the continuation vehicle.<sup>180</sup> Consequently, the GP's interests are also aligned, to a significant extent, with those of the new LPs, thus minimizing the agency problem with them. At the same time, the reinvestment of the carried interest in the continuation fund causes the GP's interests to be less aligned with those of the legacy fund LPs, thereby magnifying the agency problem with them.

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<sup>176</sup> Sahlman, *supra* note 50, at 494. Heather Field, *The Return-Reducing Ripple Effects of the “Carried Interest” Tax Proposals*, 13 FLA. TAX REV. 1, 35 (2012).

<sup>177</sup> Some scholars, however, argue that the GP incentive model are far from operating perfectly and suffers from their own weaknesses. *See, e.g.*, Jarrod Shobe, *Misaligned Interests in Private Equity*, 5 BYU L. REV. 1437 (2016).

<sup>178</sup> Simon Witney, *Carried Interest and Continuation Funds* (Oct. 7, 2022), TRAVERS SMITH, <https://www.traverssmith.com/knowledge/knowledge-container/travers-smiths-alternative-insights-carried-interest-and-continuation-funds/>.

<sup>179</sup> *See supra* note 27, at 254.

<sup>180</sup> Reeve & McNaney, *supra* note 119 (“In more than two-thirds of continuation funds a leading advisory firm worked on since 2021, GPs rolled 100% of their carry and in more than 85% of vehicles at least half of the GPs’ carried interest was rolled”); CAPITAL DYNAMICS, *supra* note 114, at 8 (“In a GP-led fund restructuring, GPs can roll 100% of any crystallized carry...and also often invest very significant additional commitments; in our experience, it is not unusual for a GP to increase their commitments by 3–5% of the purchase price”).

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Therefore, the question whether the GP is likely to use its discretion to bias the fair value estimates of the sold assets *upwards* (in favor of the selling LPs) or *downwards* (in favor of the continuation fund LPs) is not an easy one to answer, at least on the face of it. Furthermore, the lack of publicly available data regarding the valuations of the assets sold to the continuation funds prevents researchers from empirically examining this question.

Even without resolving this difficult empirical question, the incentives analysis we provide in this Article leads to two clear insights. *First*, the GP has a strong financial interest in the *very establishment* of continuation funds, regardless of whether there are upwards or downwards biases in the price estimation of the assets being sold to the continuation fund. *Second*, the GP's desire to establish the continuation fund might cause the GP to prefer the interests of the new LPs over those of the legacy fund LPs.

### 3. The House (GP) Always Wins

As Subsection II.C.1 demonstrated, the GP has a strong financial interest in the very establishment of continuation funds, as this enables the GP to earn additional management fees, diversify some of its risk by crystalizing its carried interest, enjoy an option to get additional carry in the future, and improve its track record.

While in theory one group of LPs (sellers or buyers) could sometimes have the upper hand—and sometimes the lower hand—in a continuation fund transaction, the GP, like the house in a casino, always wins. The reason for this is that any amount the GP loses on the carried interest it receives from the legacy fund by undervaluing the price of the assets sold the continuation fund will be recovered (in full or in part) through the additional carry and return on investment it received from the continuation fund. At the same time, the GP will *always* receive the additional private benefits outlined in the previous paragraph, and thus will always win.

To illustrate this point, consider a fund with an asset that was initially valued at \$500 million and was subsequently sold to a continuation fund for \$1 billion. The GP manages the continuation fund for additional 5 years, receiving management fees of 1% per year (\$10 million), and a total of \$50 million for the entire period. Let us further assume an extreme scenario, where the GP makes no additional profits from the continuation fund (e.g., there is no additional carry or a positive return on its investment in the continuation funds) other than its management fees. Even in that extreme case, the assets sold to the continuation fund must be significantly undervalued by at least \$250 million for the losses the GP suffers from a significantly reduced carry to equal its benefits from additional management fees of \$50 million (20% of \$250 million). The fact that the GP receives significant private benefits from a continuation fund transaction but bears only a fraction of the costs (say, by receiving a reduced carry) generates clear incentives for the GP to turn to continuation funds instead of pursuing other exit alternatives that could be more beneficial to the LPs, such as IPOs or sales to strategic or financial buyers.

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### 4. The GP's (Potential) Bias Towards the New LPs

In this Section, we show that the intention to establish the continuation fund might cause the GP to prefer the interests of the new LPs over those of the legacy fund LPs that elected to cash out for various reasons.

*First*, the new LPs, especially the lead investors, are the group of investors that the GP must convince to “come on board” in order to even begin executing the transaction. The LPs that invested in the legacy fund are “locked in” and their capital is already committed. However, to initiate the continuation fund, the GP needs to attract new investors by providing them with a “sweetener,” such as preferential price terms. This conflict of interests might lead to a low-price transaction where the new LPs benefit at the expense of the legacy fund LPs.<sup>181</sup>

*Second*, as noted earlier, many GP-led transactions also include commitments by some of the new LPs to support ongoing fundraising and commitments to generate follow-on capital for portfolio companies (also known as “staple commitment”).<sup>182</sup> This practice could also contribute to a conflict of interest regarding the pricing of the continuation fund deal. Due to the willingness to establish a long-term relationship with some of the new LPs, the GP might promote its own interests over those of the legacy fund's LPs, especially if some of the legacy fund LPs no longer have an active ongoing investment relationship with the GP. For example, a GP might prefer a low bid on assets that come with an offer of a stapled commitment by some new LPs.<sup>183</sup>

*Third*, reputational considerations could also enhance the bias of the GP towards the new LPs, especially the most sophisticated ones. As classic literature on the private equity model suggests, reputational forces can temper GPs' opportunistic behavior.<sup>184</sup> If the GP earns a reputation for mistreating investors, the GP will have difficulties in finding new investors willing to commit their capital to them. As Professor Steve Kaplan has noted, if GPs “behave badly in one deal, they will be treated differently in the next

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<sup>181</sup> *Sale of Portfolio Companies Between Affiliated Funds: The (Legal) Road Less Traveled*, KRAMER LEVIN (Jan. 27, 2021), <https://www.kramerlevin.com/en/perspectives-search/Sale-of-Portfolio-Companies-Between-Affiliated-Funds-The-Legal-Road-Less-Traveled.html>.

<sup>182</sup> LAZARD 2021, *supra* note 135, at 9.

<sup>183</sup> Sophie Gioanni, *What are Continuation Funds in Private Equity?*, LINCHPIN (Sep. 16, 2021), <https://www.linchpin-advisory.com/post/what-are-continuation-funds-in-private-equity>; Button, *supra* note 114 (“For example, an anchor LP who has promised to invest in the next fund raised by the PE firm creating the continuation fund may be offered favorable terms in the continuation fund as part of a package deal [...] This kind of package deal for favorable terms, also known as stapled commitment, can introduce another potential conflict that could hurt the GP's case that the continuation fund has been established with strictly arms-length transactions”).

<sup>184</sup> Matthew D. Cain et al., *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default*, 40 J. CORP. L. 565, 565 (2015).

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deal.”<sup>185</sup> By contrast, a positive reputation can increase future funding from existing investors and perhaps convince new investors to shift resources. Thus, GPs should value their reputations highly and seek to avoid actions that could damage those reputations. In this view, reputation is a matter of economic interest.<sup>186</sup>

In the context of continuation funds, the GP wants to maintain a positive reputation among two groups of investors with opposing interests: the selling legacy fund LPs and the new LPs. Therefore, if the GP promotes a deal that benefits one group of investors at the expense of the other group, its reputation will be improved among the first group, but will be damaged among the second group.<sup>187</sup> In light of the foregoing, does the GP value its reputation more among the selling LPs or among the new ones?

To evaluate the reputation of a GP, LPs must obtain and be able to analyze relevant information. The efficiency of reputation markets depends on the quality of the information on which they are based.<sup>188</sup> Investing in a continuation fund requires expertise in carrying out due diligence on *particular assets* (rather than a *particular private equity fund*).<sup>189</sup> As a result, many continuation fund investors are sophisticated investors specializing in secondary transactions.<sup>190</sup> In contrast, LPs in legacy funds may have small investment teams that are not necessarily experts in secondary investments and rely on the GP to conduct this kind of analysis.<sup>191</sup> As we will explain further, this may be one of the reasons why many LPs decide to sell their investments rather than roll them over.<sup>192</sup> Therefore, a GP seeking to enhance its reputation in the market may benefit from acting more favorably towards new, sophisticated investors since these investors are better able to analyze information regarding continuation fund performance and react accordingly (by, for example, sanctioning the GP if it acts opportunistically).

*Finally*, GPs could be biased towards the lead investors of the continuation fund due to their on-going interactions and the close relationships between them. As noted earlier, the lead investors in continuation funds are often repeat players, including other private equity funds that specialize in secondary transactions.<sup>193</sup> Recent evidence shows that the private equity industry has evolved over the years from being “mercenary” to

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<sup>185</sup> Antoine Gara, *The Private Equity Club: How Corporate Raiders Became Teams of Rivals*, FIN. TIMES (Aug. 9, 2022) <https://www.ft.com/content/aec70aab-7215-4fa7-9ee3-1224d967dc28>.

<sup>186</sup> Clayton, *supra* note 36, at 81; Harris, *supra* note 36, at 288.

<sup>187</sup> See Gara, *supra* note 185.

<sup>188</sup> Magnuson, *supra* note 36, at 1900.

<sup>189</sup> Button, *supra* note 114.

<sup>190</sup> LAZARD 2021, *supra* note 135, at 15. We examined the identities of investors in ten prominent continuation funds. Those cases illustrate that sophisticated investor (other private equity funds and large institutional investors, who differ from traditional institutional investors who invest in private equity funds) usually lead investments in continuation funds. Information on these transactions is on file with the authors.

<sup>191</sup> McNally, *supra* note 166.

<sup>192</sup> See *supra* notes 210–213 and accompanying text.

<sup>193</sup> See *supra* note 190.

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being “a more collaborative clubbish culture now.”<sup>194</sup> In an environment where many buyout firms have large amounts of funds at their disposal, the fastest way to deploy capital is to buy companies directly from other private equity firms. Indeed, a record 442 of such deals worth a total of \$62 billion were completed in 2021.<sup>195</sup> As Harvard professor Josh Lerner explained, “[w]hen you have repeated relationships, you are just not going to go to war with the same ferocity.”<sup>196</sup>

As noted, some institutional investors have gone further, expressing strong concerns that “certain parts of private equity look like Ponzi schemes.” Here, again, they point out that many private equity shops exit their stake through a sale to another private equity house instead of marking down their book, and that could be a “circular thing,” which can distort market operation or cause price bubble.<sup>197</sup>

Indeed, this new web of relationships among private equity competitors, which is cozier than ever, is a fascinating development meriting a close examination that extends well beyond the scope of this Article. For our present purpose, however, it is sufficient to note how this evidence on the increased cooperation, coziness, and repeat interactions among private equity sponsors further support our hypothesis that the GP’s incentive structure will very likely lead to a bias towards seasoned secondary buyers, which are often also private equity funds. An analysis by Upwelling Capital Group supports this view, showing that “[f]or every year an LP forgoes rolling into a [continuation vehicle], they give up an extra 15 percent-plus gain over the long run.”<sup>198</sup>

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In this Part, we explored the rise of continuation funds—one of the most popular trends in the U.S. capital market—and analyzed in length the web of unique or heightened conflicts of interest they raise. Regulators and market players, however, have not remained indifferent to this phenomenon.

Two major approaches address these complex conflicts. The first involves several *market-based solutions*, which include the following: (i) ensuring that the legacy fund LPs have an independent choice about whether to sell their interests or roll them over into the continuation fund, thereby potentially giving them the power to protect their interests; (ii) subjecting the initiation of a continuation fund to the approval of the LPAC; (iii) increasing the GP’s skin in the game by requiring the GP to reinvest a significant fraction of its crystallized carried interest into the continuation vehicle and thereby enhancing its commitment to the new LPs; and (iv) conducting a competitive bid or

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<sup>194</sup> Gara, *supra* note 185.

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> McCarthy & Mark Latham, *supra* note 154.

<sup>198</sup> Le, *supra* note 166; *Are LPs Missing the Boat? Examining GP-Led Secondaries in the Private Equity Market*, UPWELLING CAPITAL GROUP (Q4 2022), 5, <https://upwellingcapital.com/wp-content/uploads/2022/10/Continuation-Vehicles-Research-Report-2022-Upwelling-Capital-Group.pdf>.



soliciting an offer from a lead investor that could negotiate an arms-length price with the GP.

The second approach to addressing continuation funds conflicts of interest is through *regulatory interventions*. The SEC has recently published new proposed rules that would regulate private equity funds.<sup>199</sup> Among other things, the SEC proposed requiring GPs to obtain and share a fairness opinion from an independent opinion provider for LPs of the legacy fund with interested parties.

But, to the extent these various mechanisms are *effective* in addressing continuation, funds conflicts remains unanswered. To shed new light on this key question, we conducted interviews and cross-referenced the results against publicly available sources on continuation funds. The next Part will present the key insights from this analysis.

### III. Continuation Funds: When Theory Meets Reality

#### A. Methodology

Continuation funds are, to some extent, a “black box.” Neither the original limited partnership agreements of these funds, nor the valuations of these transactions are directly accessible to researchers. To overcome these informational limitations, we conducted semi-structured qualitative interviews with senior investment officers at LPs and leading legal counsels for GPs. All interview participants have first-hand experience with continuation funds. The interviews thus provide important insights as to how market participants perceive continuation funds and shed light on the theoretical analysis presented in the previous Parts. A table describing the interviews is set out in Appendix A.

To identify interview subjects on the sponsor side, we reviewed law firm memorandums published on the topic by law firms that are considered market leaders in the field. We contacted senior partners who were involved in advising sponsors that conducted GP-led secondary transactions, such as continuation funds. On the investor side, we contacted senior officers of large asset managers that tend to invest as LPs. This allowed us to access market participants who might have otherwise been disinclined to participate. All interview subjects had at least 10 years of experience, and often significantly more. To encourage candid and detailed responses, the interview participants were promised anonymity.<sup>200</sup>

The major shortcoming of the interview technique used is that it introduces bias into the sample selection. One could also argue that participants’ experiences are not

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<sup>199</sup> See *supra* note 27.

<sup>200</sup> The authors retained copies of each interview transcript and/or detailed notes, with personal information removed.

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necessarily representative of the continuation fund industry. To mitigate potential biases in our sample, we ensured adequate representation for interview subjects who work on the investment side and those who advise private equity sponsors to obtain the perspectives of those who sit on different sides of the table. We also ensured that interview subjects are market leaders. Altogether, the partners we interviewed were involved in over eighty-five GP-led transactions during 2022 (with the aggregate transaction volume exceeding \$60 billion).

Finally, it is important to stress that we did not rely on the interviews as our sole source of data. Rather, we supplemented the findings of the interviews with an extensive review of publicly available sources on continuation funds (such as law firm memorandums and reports prepared by financial advisors and other professionals who regularly advised clients or closely follow the continuation fund market, like Lazard Private Capital Advisory and Pitchbook). We also reviewed and closely analyzed all comment letters related to continuation funds that were submitted to the SEC by various market players. Altogether, this mixed-method strategy enabled us to shed new light on the realities of private equity continuation funds.

### *B. Testing the Prior that Sophisticated LPs Can Protect Themselves*

As we noted in Part II, supporters of continuation funds often view it as a triple “win” for all parties involved. In particular, they emphasized that legacy fund LPs maintain the *independent choice* whether to sell their interests or roll them over into the continuation fund.<sup>201</sup> This possibility purportedly may give legacy fund LPs, who are sophisticated investors, the power to fend for themselves.

According to this view, we might have expected LPs to invest in continuation funds if they believed they would gain further economic gains and to sell out if not. The reality, as our interviews show, is more complex. The LPs of the legacy funds may face significant challenges that could cause them to sell their interests in the legacy funds under unfavorable terms or forgo profitable investment opportunities in the continuation funds.<sup>202</sup> We discuss these major challenges below.

*Lack of sufficient information.* LP investors often suffer from significant informational disadvantages when they are faced with the difficult dilemma of whether to opt for a liquidity opportunity or to invest in continuation funds.<sup>203</sup> As scholars have pointed out, the GP exercises substantial control over the information flow about the

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<sup>201</sup> See *supra* Section II.A.

<sup>202</sup> See, e.g., Le, *supra* note 166 showing that “[f]or every year an LP forgoes rolling into a [continuation vehicle], they give up an extra 15 percent-plus gain over the long run.”

<sup>203</sup> Private Funds Spotlight, *GP-Led Secondary Transactions: A “New-Fashioned” Way of Achieving Liquidity*, PAUL WEISS (Oct. 2017), <https://www.paulweiss.com/media/3977412/2oct17-pfs.pdf> (2017), <https://www.paulweiss.com/media/3977412/2oct17-pfs.pdf>; Interview with Participant 6 (January 18, 2023).

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performance of the fund’s investments and the process of valuing the portfolio. LPs, and especially LPs who are not members of the small LPAC group, have limited access to this information.<sup>204</sup> In such a situation, there is a concern that the GP may use its informational advantage strategically.<sup>205</sup>

This asymmetry of information between the GP and LPs also makes it challenging for LPs to verify the fairness of the price in continuation fund transactions. LPs might not know in advance if the transferred asset is a well-performing “trophy” asset that has not reached its full potential (thus justifying rolling it over) or an underperforming “hard-to-sell” asset (thus making it more reasonable to cash out). They may also lack some information that is provided, informally or formally, to the LPAC or the new lead investor.<sup>206</sup> As a director at Institutional Limited Partners Association (“ILPA”) summarized it, “transparency and having access to the necessary information are also current big concerns” in continuation fund transactions.<sup>207</sup> And as our participants indicated, when LPs are not well informed about the value of the transferred assets, they may choose the less risky option and exit the investment<sup>208</sup> rather than conduct asset-level due diligence that they are not accustomed to perform.<sup>209</sup>

*Lack of expertise.* Legacy funds LPs do not necessarily have the skills and capacity required to make complex investment decisions in continuation funds. Some LPs have small investment teams lacking any experts in GP-led secondary transactions.<sup>210</sup> As explained in our interviews, the lack of expertise is one reason why these investors elect to invest in private equity in the first place (and pay lucrative compensation to the GP), so that the GP will make these complex buy, hold, or sell decisions for them.<sup>211</sup> However, in the continuation fund context, this liability shifts once again from the GP to the LPs.<sup>212</sup> One senior investment manager explains that many LPs opt to sell because in

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<sup>204</sup> Harris, *supra* note 36, at 277–78; Magnuson, *supra* note 36, at 1881–82.

<sup>205</sup> Douglas Cumming, Andrej Gill & Uwe Walz, *International Private Equity Valuation and Disclosure*, 29 NW. J. INT’L L. & BUS. 617 (2009) (discussing strategic non-disclosure of performance information related to investments that have not yet been exited by private equity firms).

<sup>206</sup> Interview with Participant 9 (January 30, 2023) & Participant 6 (January 18, 2023).

<sup>207</sup> McNally, *supra* note 166.

<sup>208</sup> Interview with Participant 6 (January 18, 2023); Interview with Participant 5 (February 6, 2023) (“Sponsors now effectively flip the decision when the optimal time to sell over to the LPs, who have less perfect information and are paying sponsors a management fee to make that decision...most LPs would take the sure gain over the risk-adjusted one, even if the risk-adjusted return is similar or better”).

<sup>209</sup> Gisèle Rosselle, Cédric Devroey & Marie-Elisabeth Dubois,  *Holding On To Diamonds Longer - Continuation Funds*, LEXOLOGY (OCT. 27, 2022) <https://www.lexology.com/library/detail.aspx?g=55c6efa7-a24e-46e7-99ff-7cd5ee246632>.

<sup>210</sup> Interview with Participant 3 (January 26, 2023) (“The typical LPAC member understands continuation fund assets very well. However, many other LPs do not and the easiest option is to sell”); Interview with Participant 5, *supra* note 208.

<sup>211</sup> *Id.*

<sup>212</sup> Le, *supra* note 166.

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order to make an informed decision, it would be necessary to perform *specific asset-level due diligence* (rather than *fund-level due diligence*) with which these investors are unfamiliar.<sup>213</sup>

*Lack of time.* LPs often have a short timeframe, only 15–20 days, to make the important election of whether to cash out or roll over their stake to continuation funds. For many of them, it is difficult (or even unrealistic) to make a well-informed choice in such a narrow timeframe.<sup>214</sup> This problem is further aggravated as continuation funds gain popularity. LPs are now required to make this type of election at least two or three times a month, and to review and analyze long and complex documents within a narrow timeframe.<sup>215</sup> Additionally, some legacy fund LPs, such as state pension funds, need to comply with Employee Retirement Income Security Act of 1974 (ERISA) rules or with their internal governance rules, which require additional layers of approvals, including by their board of trustees, before making additional investments.<sup>216</sup> Receiving the appropriate approvals could take time, especially if the board of trustees does not meet often, and without securing them, the LP is prevented from investing in the continuation funds.<sup>217</sup>

*Capital allocation, diversification, and liquidity.* Some LPs may choose to cash out due to some “external” considerations that are unrelated to the deal terms, such as liquidity preferences, the need to re-balance their investment allocation, or to maintain the

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<sup>213</sup> Victoria Rakitin & Andrea Villa, *Why PE and VC Firms Want to Hold: Continuation Funds*, BSPE club (May. 18, 2022), <https://bspeclub.com/why-pe-and-vc-firms-want-to-hold-on-continuation-funds/> “many of them opt to sell: to make an informed decision, it would be necessary to perform specific asset-level due diligence that these investors need to be used to”; Le, *supra* note 166; McNally, *supra* note 166; McElhaney, *supra* note 16 (“The deals also eat up allocators’ time, particularly because the due diligence required to vet a portfolio company is far different than what’s needed to dig into a fund or a manager”); Jessica Hamlin, *GP-Led Secondaries Are Having a Moment — But Don’t Discount the Traditional Market*, INSTITUTIONAL INVESTOR (Oct. 4, 2022), <https://www.institutionalinvestor.com/article/b2022zq08nfrzz/GP-Led-Secondaries-Are-Having-a-Moment-But-Don-t-Discount-the-Traditional-Market>.

<sup>214</sup> Gioseffi, Lahiri & Russ, *supra* note 171 (“The 30-day window is much shorter than the typical time period in which an institutional investor reviews a new investment, which often takes several months”); McElhaney, *supra* note 16.

<sup>215</sup> Interview with Participant 5 (February 6, 2023) (noting that “you [LP] get a 200-page disclosure document, and you’re told you have 20 business days, which is the market standard, to make a decision [...] LPs don’t want to have to plug through all that information. While they might be willing to do so on a single basis, what happened in 2021 and 2022 was there were so many of these transactions going on that many LPs, especially large LPs, were getting these election packages for 2-4 funds in a month”).

<sup>216</sup> Interview with Participant 5 (February 6, 2023) (“Under your state laws, you may need to call an investment committee meeting which may require you to publish notice of that in advance”); UPWELLING CAPITAL GROUP, *supra* note 198, at 5 (“LPs do not have a process for executing CV transactions, mostly amongst those institutions with more structured investment policies and processes that require a consultant engagement and board of trustees’ approval.”).

<sup>217</sup> McNally, *supra* note 166.

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appropriate level of portfolio diversification.<sup>218</sup> For example, if institutional investors' private equity investments have appreciated considerably in recent years compared to other investments in their portfolios, they may seek liquidity to rebalance their portfolios.<sup>219</sup> Similarly, investments in continuation funds, especially single-asset funds that are increasingly common, are less diversified and could increase their portfolio risk or contravene their guidelines.<sup>220</sup>

If we accept that certain LPs must sell due to the above-mentioned reasons, there is a concern that once the GP establishes a continuation fund, it no longer acts as a faithful agent that *solely* represents the LPs' interests. For example, the GP may have limited incentives to seek out an outside investor as there is already an "easy-to-find" buyer in the continuation fund that has some prior ongoing relationships with the GP. The GP could also opt for a transaction on a favorable term for the buying investors due to broader interactions with the investor that extend beyond the continuation fund transaction, such as a commitment to invest in other funds of the GP.

Altogether, our analysis and insights from the interviews may explain why some sophisticated investors may be "forced" to sell their stakes under unfavorable conditions. Contrary to the theory that celebrates contractual freedom in the context of high-end bargaining, continuation funds provide additional evidence that even sophisticated investors with an "election option" may face difficulties in protecting their interests.<sup>221</sup> As a senior director at ILPA observed, "[j]ust because LPs are accepting a liquidity route doesn't mean they want to sell."<sup>222</sup>

### C. Testing the Relational Contracting Priors

As discussed in Part I, the private equity ecosystem is a prime example of relational contracting. The parties in an investment fund enter into a contract that spans ten or more years, with a blind pool of investment and a dependency on the sponsor and an advisory LPAC to navigate the fund throughout its life cycle. The repeat nature of investment, strong reputational incentives, and "relational" provisions in the LPA all eschew specific and narrow contractual obligations in favor of looser language and a focus on alignment of interests.

Continuation funds are usually not explicitly negotiated by *ex ante* contracting, either because the parties have not thought about it (old contract) or because it is difficult

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<sup>218</sup> See also interview with Participant 5 (February 6, 2023), stating that investment professionals at institutional investors, for example at a public pension plan, are compensated on a cash basis and may prefer, given the fact that they are not planning to stay in the plan in three or four years, to take the short-term liquidity event.

<sup>219</sup> Hope, *supra* note 113; Interview with Participant 6 (January 18, 2023).

<sup>220</sup> Hamlin, *supra* note 213 ("GP-led deals also don't offer the same level of diversification that LP-led deals do. In fact, GP-led deals are highly concentrated"); LAZARD 2021, *supra* note 135, at 14.

<sup>221</sup> *High-End Bargaining Problems*, *supra* note 23; Clayton, *supra* note 36.

<sup>222</sup> McElhaneey, *supra* note 16.

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to agree *ex ante* on the course of action of an event that will take place six to ten years in the future and is subject to many contingencies.<sup>223</sup> Indeed, several of our interviewees noted that current LPAs have not contemplated a continuation fund,<sup>224</sup> and that efforts by GPs to include language regarding continuation funds in prospective fundraising have mostly been unsuccessful.<sup>225</sup> Therefore, relational contracting theory predicts that parities who have long-term relationship will find a way to resolve these issues mid-stream.

Our interviews reaffirmed the relational contracting narrative we anticipated to find in the private equity context, but at the same time exposed the stress points that potentially explain why relational contracting may not be sufficient in the context of continuation funds. When the LPs commit their investments to a fund, they do so without knowing the specific investments to be made or their subsequent success. When the opportunity to hold to an asset longer than originally anticipated arises, relational contracting provides a sound basis for the establishment of a continuation fund.

Yet, as discussed above, many LPs choose not to roll their investment into the new fund but to sell their stake and cash out. Why would an LP suddenly make a choice that reflects either lack of trust in the GP or a preference for exiting the well-established relationship?

Our interviews revealed two distinct narratives. On the one hand, some LPs have expressed concerns with the GP's motives in moving the asset from the legacy fund, sometime very early, and explained that these concerns, along with time, knowledge and liquidity considerations, may lead them to opt out.<sup>226</sup> They also specifically highlighted that if the GP establishes a continuation fund to provide liquidity for themselves (for example, in order to cash out departing partners) or enabling the sponsor to double dip on the management fees and carried interest, their trust in the relationship would be challenged to the point that they may not invest with the GP at all.<sup>227</sup> One interviewee also blamed outside advisors for convincing GPs that continuation funds are desirable, with GPs facing LP anger only when the fund is established.<sup>228</sup>

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<sup>223</sup> See *infra* note 239.

<sup>224</sup> Interview with Participant 7 (January 27, 2023); Interview with Participant 8 (January 27, 2023).

<sup>225</sup> *Id.*; Interview with Participant 6 (January 18, 2023).

<sup>226</sup> Interview with Participant 6 (January 18, 2023); Interview with Participant 7 (January 27, 2023) (Stating that if LPs are over-allocated in private equity, they will try to reduce this allocation and cash out); Interview with Participant 8 (January 27, 2023); Interview with Participant 9 (January 30, 2023) (Stating that if they need more time for the investment, then why don't they extend the life of the fund); Interview with Participant 5 (February 6, 2023) ("I think in many cases, LPs have assumed a certain velocity of distributions from their portfolio, and they are motivated to take the cash").

<sup>227</sup> Interview with Participant 9 (January 30, 2023).

<sup>228</sup> *Id.*

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On the other hand, interviewees on the GP side stressed the value of “optionality” that continuation funds provide to their investors who want to liquidate their position.<sup>229</sup> These interviewees also emphasized that the GP often keeps skin in the game in the new fund and thereby signals its commitment to other investors.<sup>230</sup> Indeed, several LPs have underscored that their decision to roll their investment would be swayed by their relationship with the GP, either because they are invested with the GPs in subsequent funds and because of the way the GP is invested and incentivized in the continuation fund.<sup>231</sup>

How can we reconcile these two narratives? The answer, in our view, is related to the heterogeneity in the body of LPs. Large and sophisticated LPs, who often sit on LPACs, tend to develop closer relationships with the GP. The multiple interactions between the parties increase the level of mutual trust and encourage them to roll over their stake. For these investors, relational contracting works exactly as the theory predicts. In contrast, smaller LPs have limited interactions with the GP. They are more likely to exhibit lower levels of trust and to have less faith in the GP’s motives. Their ability to retaliate if the GP misbehaves is also limited. As result, they are more likely to cash out.

Interestingly, some interviewees acknowledged that the relational contracting aspect is present not only in the GP-LP negotiations, but also between investors themselves, as the LP body often delegates the authority to approve conflict-of-interest transactions to a few large investors sitting on the LPAC. But even in this context, trust issues and misalignment of interests between the smaller and larger investors in the fund have been mentioned in the interviews as a point of concern.<sup>232</sup>

Finally, despite anger or frustration often expressed by LPs in connection with the use of continuation funds, our interviews show that all private equity investors—those that engage in high-class bargaining—avoid using litigation to enforce their rights. Our interviewees—both on the sponsor and on the LP side—all emphatically reiterated that LPs rarely sue the GP. Absent extreme circumstance of fraud, LPs avoid taking this route.<sup>233</sup> First and foremost, interviewees explain that LPs are unlikely to sue a GP due to reputational concerns and due to the relational aspect of contracting in private

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<sup>229</sup> Interview with Participant 2 (January 25, 2023); Interview with Participant 3 (January 26, 2023); Interview with Participant 4 (January 27, 2023); Interview with Participant 5 (February 6, 2023).

<sup>230</sup> Interview with Participant 3 (January 26, 2023) (Stating that to close the deal, the GP usually transfers part of his carried interest into the continuation fund, sometimes all of his carried interest).

<sup>231</sup> Interview with Participant 7 (January 27, 2023) (Stating that if the LPs are not going to invest with the GP in the future the LPs is going to cash out and if LPs are have faith with the GP they will be inclined to participate); Interview with Participant 8 (January 27, 2023) (Stating that the less likely they are to invest with the GP next time, they prefer to take cash of the table); Interview with Participant 9.

<sup>232</sup> For elaboration, see *infra* Section III.D.1. See also Interview with Participant 7 (January 27, 2023); Interview with Participant 8 (January 27, 2023) Interview with Participant 9 (January 30, 2023).

<sup>233</sup> Interview with Participant 2 (January 25, 2023); Interview with Participant 3 (January 26, 2023); Interview with Participant 8 (January 27, 2023).

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equity—especially if they want to continue investing in private equity in the future.<sup>234</sup> No market player wants to be the investor that has a bad reputation among GPs as one who takes them to court.<sup>235</sup>

Indeed, the only example of a litigation against a GP that one of the interviewees raised was the Kentucky Blackstone litigation, but this case involves extreme circumstances; in any event, the lawsuit was filed not by an LP, but rather by a public official who had other interests in initiating this proceeding.<sup>236</sup>

To be clear, the lack of a litigation threat does not necessarily mean that LPs are completely powerless. They could express their discomfort with how the continuation fund process was run and threaten to vote with their feet and not to invest with the same GP in the future.<sup>237</sup> But if the GP is a well-performing one, such a threat could be less credible, especially for small LPs that compete for attractive investment opportunities and that will bear some costs due to the decision to avoid investing with that GP. Here again, the effect of relational contracting and reputational markets seems to be weaker when the parties do not have equal bargaining power.<sup>238</sup>

### *D. Resolving High-Class Conflicts*

GP-led secondary transactions, such as continuation funds, in which the sponsor is effectively on both sides, serve as an interesting case study for examining how sophisticated parties—GP and LPs—handle conflicts of interest. This examination is not merely theoretical. If sophisticated parties can devise efficient solutions to address conflicts, then these solutions could also be used in the context of public companies (with some modifications).

#### 1. Approval by LPAC

A formation of a continuation fund clearly presents conflicts of interest between a sponsor and the fund that requires LPAC approval according to the typical fund agreement.<sup>239</sup> In a well-run process, the LPAC receives detailed disclosure regarding the rationale behind the transaction terms, framing of the deal, its timeline, and most

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<sup>234</sup> Interview with Participant 7 (January 27, 2023); Interview with Participant 8 (January 27, 2023).

<sup>235</sup> Interview with Participant 7 (January 27, 2023); Interview with Participant 8 (January 27, 2023).

<sup>236</sup> Interview with Participant 3 (January 26, 2023); Mark Vandeveld & Billy Nauman, *Kentucky sues Blackstone and KKR over fund performance*, FINANCIAL TIMES (July 23, 2020), <https://www.ft.com/content/dcc74348-07a4-4757-a94b-77b9ea5ad23a>.

<sup>237</sup> Interview with Participant 8 (January 27, 2023).

<sup>238</sup> See also *supra* notes 185-191, and accompanying text.

<sup>239</sup> It is also possible to codify new terms in the LPA that would provide a pre-clearance of conflict of interests associated with these deals, and therefore would enable the GP to skip the review and consent process of the LPAC. LPs, however, almost universally push back against these terms, claiming that it is impossible to predict in advance all the details of complex transactions that would occur five to ten years down the road. As a result, pre-clearance provisions are still rare in the marketplace. See “Witkowsky, *supra* note 18.



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importantly, any conflicts related to the transaction.<sup>240</sup> This information also includes a description of the solicitation process and overview of bids received, the identities of prospective acquirers, and a detailed overview of the economics of the deal.<sup>241</sup> Such information enables the LPAC members to assess whether the process is appropriate, transparent, and efficient, and to ensure that a fair price is obtained.<sup>242</sup>

In theory, nominating the largest investors to the LPAC should maximize the value of the fund's assets. As LPAC members are often the most sophisticated investors with the highest stakes in the fund, it is presumed that they have high-powered incentives to achieve the most optimal results to the benefit of all other LPs. It is also easier and quicker to negotiate with a small body of LPs, which is more agile in its decision-making, than the full investor base.<sup>243</sup> The GP would also be comfortable sharing sensitive and confidential information with the LPAC, which it may otherwise be reluctant to disclose to a large body of LPs.<sup>244</sup>

Our interviewees confirmed that when a GP initiates a continuation fund, the standard practice is to turn to the LPAC.<sup>245</sup> One interview participant also emphasized that it is easier for the GP to talk to four or five LPs and get the deal done.<sup>246</sup> Therefore, at least on the face of it, the use of LPAC seems a creative solution devised by sophisticated parties to handle conflicts in an efficient manner and streamline the process. However, interviewees on the LP side questioned whether LPACs are actually effective and suggested that they are often a means for rubber-stamping a GP's desired course of action.<sup>247</sup>

More specifically, one interviewee explained that the LPAC tends to approve almost every conflict-of-interest transaction that the GP brings before them, and that this body has a lot of confidence in the GP.<sup>248</sup> They also explained that those who sit on the LPAC are hand-picked by the GP, which often has the full discretion over the composition of the LPAC.<sup>249</sup> Investors who are selected to the LPAC also have some

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<sup>240</sup> *GP-led Secondary Fund Restructurings*, *supra* note 117 at 7.

<sup>241</sup> *Id.*

<sup>242</sup> *GP-led Secondary Fund Restructurings*, *supra* note 117.

<sup>243</sup> Gabriel Boghssian, *LPAC dos and don'ts – how to ensure advisory bodies remain effective*, PRIVATE EQUITY INTERNATIONAL (Feb. 20, 2020), <https://www.privateequityinternational.com/lpac-dos-and-donts-how-to-ensure-advisory-bodies-remain-effective/>.

<sup>244</sup> *GP-led Secondary Fund Restructurings*, *supra* note 117.

<sup>245</sup> Interview with Participant 2 (January 25, 2023) (noting that “[y]ou will never catch a sponsor try to do one of these transactions [GP-led transactions] without LPAC consent. It is just not done”); Interview with Participant 3 (January 26, 2023) (noting that “when a manager decides they want to do a continuation fund, they usually turn, if they can, to the LPAC. But if they can't, sometimes they turn to a full LP base.”); Interview with Participant 6 (January 18, 2023).

<sup>246</sup> Interview with Participant 9 (January 30, 2023).

<sup>247</sup> See *supra* note 238.

<sup>248</sup> Interview with Participant 8 (January 27, 2023); Interview with Participant 7 (January 27, 2023).

<sup>249</sup> *Id.*

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ongoing relationship with the GP, have already committed a lot of money to the GP's funds, and are probably looking for future investments with the GP. When a GP is a successful one, the goal for any individual LP is maintaining or increasing the pro rata share in the GP's future fund. Alienating the GP by asking hard questions or derailing the deal will jeopardize this goal.<sup>250</sup>

LPAC members that approve the deal might also be some of the few investors that elect to reinvest in the continuation fund either because of their ongoing relationship with the GP or because analyzing these transactions requires some sophistication. This may put the LPAC members that elect to reinvest in a direct conflict, as they are still required to vet the transaction on behalf of the selling LPs that elected to cash out and have opposing interests.<sup>251</sup> Conversely, some LPAC members may decide not to roll over their stake due to the availability of better investment opportunities through co-investments (which usually are without any fees);<sup>252</sup> again leaving them with little interest in alienating the GP who doles out such opportunities.

Relatedly, the fund's LPA typically reiterates that each LPAC member is entitled to consider *only* the interests of the LP that such member represents, and it has no duties to other investors in the fund.<sup>253</sup> In that sense, "the LPAC is not the equivalent of a board of directors."<sup>254</sup> While the rationale behind this limitation is to reduce the legal exposure of the LPAC members and increase their incentives to serve on the committee, it could also exacerbate the conflict of interests between the LPAC members and other LPs.

Those conflicts and the GP power over the nomination of the LPAC led one interviewee on the LP side to summarize that LPACs are not independent and are unsuited for this role.<sup>255</sup> Therefore, for a transaction of such significance, other interviewee claimed that "an LP vote will be fairer."<sup>256</sup> More broadly, it was argued that there is a fundamental flaw with the governance of most of these funds. This view is further corroborated by a recent survey that shows that many LPs are dissatisfied with

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<sup>250</sup> *Id.*; One of the interviewees, who advise GPs noted that he has seen a few scenarios where LPACs do not consent to the transaction immediately, typically when the sponsor does not roll his carried interest at all or rolls just a small percentage of it. Then, to close the deal, the GP usually agreed to transfer a greater percentage of its carried interest into the continuation fund (Interview with Participant 2 (January 25, 2023)).

<sup>251</sup> Claire Wilson, *The Power of the LPAC*, Private Funds CFO (2017) <https://www.privatefundscfo.com/committed-capital/>.

<sup>252</sup> Interview with Participant 6 (January 18, 2023).

<sup>253</sup> Clayton, *The Private Equity Negotiation Myth*, *supra* note 170, at 105.

<sup>254</sup> Robert Seber, *LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation*, PRIVATE EQUITY LAW REPORT (February 25, 2020) [https://media.velaw.com/wp-content/uploads/2020/03/02120713/PELR\\_LPAC-by-Design-Six-Rec.pdf](https://media.velaw.com/wp-content/uploads/2020/03/02120713/PELR_LPAC-by-Design-Six-Rec.pdf).

<sup>255</sup> Interview with Participant 8 (January 27, 2023) (Also stating that in some calls it was strongly alluded by the GP that they will remember who raised issues and how they voted).

<sup>256</sup> Interview with Participant 9 (January 30, 2023).

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the overall governance structures employed by the private equity industry, which relies mostly on LPAC to resolve conflicts.<sup>257</sup> Along those lines, another survey shows that LPs are becoming increasingly concerned when the LPAC is stacked with GP allies, as LPAC members are submitting to the GP's desired course of action too easily.<sup>258</sup> For this reason, the survey mentions that there are certain key matters, such as those related to investment period and term, which some LPs would like for all LPs to vote on rather than just the LPAC.

All of the above suggests that while in theory, the mechanism of LPAC has great potential to streamline the process of reviewing GP's conflicts, in reality, many LPs (including those we interviewed) question its effectiveness. This is mostly because members of the LPAC are determined by the GP, have a close ongoing relationship with the GP, and particularly in the case of continuation funds, could have different incentives from those LPs that elect to cash out.

### 2. Increasing GP's Skin in the Game

Another main concern associated with continuation funds, which was also raised in our interviews, is that the GP "crystallizes" the carried interest and takes some money off the table, despite the fact that "it's not a real exit," but rather a sale of asset(s) to another fund that the GP sponsors. Prior to the use of continuation funds, a GP had to choose between keeping an asset under its management and receiving a management fee or selling it and crystallizing a carried interest but losing the assets under its management. As explained in the previous Part, by establishing a continuation fund, the GP enjoys both worlds: it crystallizes the carry and simultaneously maintains the assets under management, or even increases it by raising new capital that will entitle the GP to additional management fee for a few more years.

Due to this concern, buying LPs often want the GP to commit significantly to the continuation fund in order to increase their alignment with the GP, particularly if the GP is expected to realize significant carry in connection with the continuation fund transaction.<sup>259</sup> In the past couple of years, GPs have signaled their confidence in the deals by increasing their skin in the game and rolling a significant fraction of the carried interest into the continuation vehicle.<sup>260</sup> Indeed, one interviewee also noted that typically

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<sup>257</sup> *Private Equity Fund Governance*, VISTRA (2017) <https://www.acg.org/sites/files/Vistra%20Private%20Equity%20Research.pdf>.

<sup>258</sup> *Should LP's be Worried About LPACs?, Private Equity Merger*, MORGAN LEWIS (August 2014) [https://www.morganlewis.com/pubs/2014/08/pem\\_shouldlpworryaboutlpacs\\_august2014](https://www.morganlewis.com/pubs/2014/08/pem_shouldlpworryaboutlpacs_august2014).

<sup>259</sup> *Navigating the Nuances of Continuation Funds*, DEBEVOISE & PLIMPTON (Dec. 2020), <https://www.debevoise.com/insights/publications/2020/12/navigating-the-nuances-of-continuation-fundshttps://www.debevoise.com/insights/publications/2020/12/navigating-the-nuances-of-continuation-funds>.

<sup>260</sup> Jennifer Banzaca, *How Managers Can Strike the Right Balance with Continuation Funds*, SECONDARIES INVESTOR (5 April 2022), <https://www.secondariesinvestor.com/how-managers-can-strike-the-right-balance-with-continuation-funds/>.

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when the GP does not roll its carried interest or rolls over just 50% or less of its carried interest, there could be some investor push back to the deal.<sup>261</sup>

Recent studies of existing market practices support this view. For example, one research study focusing on the last quarter of 2021 and the first quarter of 2022 found that almost a third (29%) of deals during this period involved GPs providing 10% of the investor commitment to the continuation fund.<sup>262</sup> It also shows that when the GP does not provide a new direct commitment to the continuation fund, it rolls over 100% of its commitment from existing funds or invests 100% of crystallized carry from existing funds in the continuation fund.<sup>263</sup> Another research, conducted by the Aztec Group, found that in two-thirds of continuation funds in their database since 2021, GPs rolled 100% of their carry, and in more than 85% of vehicles, at least half of the GPs' carried interest was rolled.<sup>264</sup>

GPs' decision to reinvest their carry in the continuation funds certainly increases the alignment of interests with LPs who roll over their stake to continuation fund or with the new LPs that invest in the continuation fund. However, such commitments do not align, and could even aggravate, the conflict of interests between the GP and a large group of LPs—those that cash out and do not reinvest in the continuation fund.<sup>265</sup> In practice, the GP is charged with leading the negotiations of the terms of the asset sale to the continuation fund on behalf of the cashing out LPs. When such GP has significant financial interest in the new fund and its future success, this financial interest and the additional considerations detailed in Section II.C could cause the GP to sell the legacy fund assets in terms that are favorable to the new investors and at the expense of the old ones.

Moreover, as we noted earlier, many continuation fund transactions include commitments by the new investors to support ongoing fundraising of the GP and to generate follow-on capital for other portfolio companies of the GP.<sup>266</sup> This practice could also further aggravate the conflict of interests regarding the pricing of the continuation fund deal. A GP that is willing to establish a long-term relationship with the new investors, who are often repeat and seasoned players that specialize in the secondary market, might promote their interests over those of the selling LPs.<sup>267</sup> All of

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<sup>261</sup> Interview with Participant 3 (January 26, 2023).

<sup>262</sup> *Continuation Vehicles – Six Month Snapshot of the Key Terms of Continuation Vehicles*, PAUL HASTINGS SECONDARIES PRACTICE RESEARCH (May 13, 2022), <https://www.paulhastings.com/insights/attorney-authored/continuation-vehicles>.

<sup>263</sup> *Id.*

<sup>264</sup> Reeve & McNaney, *supra* note 119.

<sup>265</sup> As data show, this group is quite substantial at least in the most recent deals, as between 80%-90% of LPs chose to sell rather than roll over their investments to the continuation fund. *See supra* note 166.

<sup>266</sup> LAZARD 2021, *supra* note 135, at 9.

<sup>267</sup> Sophie Gioanni, *What are Continuation Funds in Private Equity*, Linchpin (Sep. 16, 2021), <https://www.linchpin-advisory.com/post/what-are-continuation-funds-in-private-equity>.

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the above suggest that rolling over the GP's carried interest to the new fund is unlikely to mitigate the concerns of selling LPs from having the GP sitting on both sides of the transactions.

Moreover, even though most GPs try to increase the economic alignment by making significant equity investment in the continuation fund, some LPs we interviewed were still displeased with the existing structure of continuation funds, even when they analyzed it from the perspective of the rolling-over LPs. For example, one of them explained that by establishing a continuation fund, the GP enjoys both worlds: it crystallizes the carried interest and at the same time maintains (or increases) the assets under management.<sup>268</sup> And once the carried interest is crystalized, the GP does not have to re-earn it and it is no longer subject to a clawback provision, requiring the sponsor to pay back amounts of carried interest that exceed what it should have received under the intended economic arrangement.<sup>269</sup> According to that investor, it is better if the GP is required to re-earn the carried interest, and it should not collect a carried interest from the rolling-over LPs before these investors enjoy an exit and see profits on their investment.<sup>270</sup>

### 3. Competitive Process

Another major avenue for addressing continuation fund conflicts is by employing additional market-based solutions, such as competitive bids and the involvement of a third party in the continuation fund transaction that could negotiate an arms-length price with the GP. Some of our interviewees shed light on how this competitive process works. As they explained, early in the process of a sale to a continuation fund, the GP will make a bid for the asset. It will also hire an agent to determine if investors are willing to bid and at what price, and through that process, the GP will reveal market estimation as to the value of the asset.<sup>271</sup> If the GP is of the opinion that none of the proposals is good enough, it would suggest to the LPs to keep the asset through the of continuation fund and ensure that the transaction price matches the highest bid.<sup>272</sup> Depending on the portfolio, the GP may invite one or more third parties to be lead investors. Those lead investors are responsible for negotiating the purchase terms and deal documents with the GP.<sup>273</sup> As we explained earlier, the lead investors are

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<sup>268</sup> Interview with Participant 3 (January 26, 2023); *See supra* note 158 and accompanying text.

<sup>269</sup> A clawback obligation generally arises where the sponsor receives amounts of carried interest that are attributable to early successful investments, and these successful investments are followed by losses or subpar gains. *See Shobe, supra* note 177, at 1454-55.

<sup>270</sup> Interview with Participant 9 (January 30, 2023).

<sup>271</sup> Interview with Participant 2 (January 25, 2023); Interview with Participant 4 (January 27, 2023); Interview with Participant 7 (January 27, 2023).

<sup>272</sup> Interview with Participant 7 (January 27, 2023).

<sup>273</sup> Interview with Participant 2 (January 25, 2023); Interview with Participant 6 (January 18, 2023).

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mostly funds that specialize in valuing and buying specific assets in the secondary private market.<sup>274</sup>

The interview participants expressed a clear preference for a market-based process over other alternatives, such as having an independent valuation by a financial advisor that is hired by the GP.<sup>275</sup> Ostensibly, a market-process solution, which involves a sophisticated player on the buy side and is aimed to mimic an arms-length transaction, enables the LPs to rely on that third party to validate the fairness of the transaction.

However, according to LP interview participants, even the market-based solution is unlikely to resolve all of continuation fund conflicts. For example, one interviewee expressed concern regarding the price fairness, even when the GP initiates a bid process, if the GP ultimately decides to keep the asset under its management rather than selling it to a third party. According to that investor, in such a situation, it is difficult to rely on the GP to act in the best interests of the legacy fund investors.<sup>276</sup> LP interviewees also complained that the information provided by the GP in those situations is limited, and they are asked to decide whether to cash out or roll over without knowing what other legacy fund LPs are doing.<sup>277</sup>

Interviewees on the LP side have also emphasized that the process with a third-party lead investor must be examined in light of the broader interactions between the GP and that lead investor,<sup>278</sup> which extends well beyond the investment in the specific continuation fund (and could include promises by the lead investor to spread out a large investment across different funds or portfolio companies of the GP).<sup>279</sup> In that case, a GP might prefer a low bid on assets that come with an offer of a stapled commitment.<sup>280</sup> Lead investors are often repeat and seasoned players with some prior relationship with the GP. Alternatively, they could use a continuation fund as a means of establishing a relationship with the GP.<sup>281</sup> In line with the analysis provided in Subsection II.C.3, one interviewee explained that in situations that generate conflicts of interests between

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<sup>274</sup> See *supra* notes 188-193 and accompanying text.

<sup>275</sup> Interview with Participant 2 (January 25, 2023); Interview with Participant 4 (January 27, 2023); Interview with Participant 3 (January 26, 2023); Interview with Participant 6 (January 18, 2023); Interview with Participant 7 (January 27, 2023) (Stating that a market process (such as a bid) is preferred to having the GP pay to a third-party firm 200K to have them write a fairness opinion; these firms are also repeat players; according to Participant 7, fairness opinions “worth just the paper written on”); Interview with Participant 9 (January 30, 2023) (Stating that the person that gets paid for fairness opinion cannot be considered as truly independent); See also McElhaney, *supra* note 16.

<sup>276</sup> Interview with Participant 7 (January 27, 2023).

<sup>277</sup> Interview with Participant 6 (January 18, 2023).

<sup>278</sup> Interview with Participant 8 (January 27, 2023) (Stating that sometimes investors that don’t have the relationship with the GP to do co-investment will use a continuation fund to establish a relationship).

<sup>279</sup> Interview with Participant 7 (January 27, 2023).

<sup>280</sup> Gioanni, *supra* note 183.

<sup>281</sup> Interviews, *supra* note 278.

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different LPs, the GP may favor the new large investor at the expense of other investors.<sup>282</sup>

Finally, even if we assume that the negotiation between the lead investor and the GP truly mimics an arms-length process, it should be remembered that the new lead investors represent only the interests of the buying LPs, which are quite contrary to those of the selling LPs. Therefore, ensuring that that process will include a third-party lead buyer does not necessarily protect all investors in the legacy funds.<sup>283</sup>

### *E. The Advisors' Incentives*

Until now, the discussion has solely focused on the parties whose direct economic interests are at stake—the sponsor and investors (both in the legacy and continuation fund). However, both sponsors and investors rely heavily on their respective counsels and financial advisors for negotiations and drafting. One of us has shown elsewhere that outside counsel for private equity sponsors and investors tend to be drawn from a very small set of elite law firms that specialize in private equity practice, and most of them tend to focus primarily on either sponsor-side or investor-side work.<sup>284</sup> This also applies to financial advisors.<sup>285</sup> As a result, these advisors are the purest repeat players in the industry:<sup>286</sup> they set market standards and derive significant economic benefits from developing the continuation fund practice.<sup>287</sup>

Legal and financial advisors in this market could have very particular incentives that may depart from the interests of their principals. For example, advisors may have strong financial interests to develop the continuation fund phenomenon even if the vast majority of LPs who invested in the legacy funds tend not to invest in the continuation

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<sup>282</sup> Interview with Participant 7 (January 27, 2023).

<sup>283</sup> See *supra* note 171 and accompanying text.

<sup>284</sup> See *Side Letter Governance*, *supra* note 87.

<sup>285</sup> See, e.g., Lucian Bebchuk & Marel Kahan, *Fairness Opinions: How Fair are They and What Can be Done About it?*, 1989 DUKE L. J. 27, 37–42 (1989).

<sup>286</sup> Casey Sullivan, *Private Equity Firms are Locked in a Power Struggle with their Investors, and Lawyers are Raking in Cash no Matter What*, INSIDER (Sept. 20, 2021), <https://www.businessinsider.com/private-equity-lawyers-investors-legal-war-2021-9> (citing an anonymous source claiming that Kirkland & Ellis is “accruing somewhat of an unfair advantage” by advising so many private-equity-fund formations that it has effectively monopolized the market).

<sup>287</sup> For example, private equity takes prominence among the largest law firms in the U.S. See Victor Goldfeld & Mark Stagliano, *Mergers and Acquisitions: 2022*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 27, 2022), <https://corpgov.law.harvard.edu/2022/01/27/mergers-and-acquisitions-2022>. See also Patrick Smith, *Even With M&A Down, Funds Work Is Up. Law Firms Are Taking Notice*, AMERICAN LAWYER (Aug. 15, 2022), <https://www.law.com/americanlawyer/2022/08/15/even-with-ma-down-investment-funds-work-is-up-law-firms-are-taking-notice> (“Debevoise & Plimpton, Kirkland & Ellis, and Simpson Thacher & Bartlett—have all said they see hours increasing, an active lateral market ...[and] high interest from rising talent, with Kirkland seeing a record number of summer associates wanting to focus on investment funds.”)

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funds.<sup>288</sup> For sponsor-side lawyers and advisors, and for advisors that represent rolling-over LPs, continuation funds present an opportunity to provide advisory services for the sale of the same asset(s) twice: (i) when the assets are sold from the original fund to the continuation fund, and (ii) when the continuation fund conducts its exit via a sale to a third party or an IPO. And with GP-led secondary transactions reaching their highest volume in history in 2021, estimated at around \$63 billion dollars in deal value,<sup>289</sup> there is much more paid work for advisors as well.

Moreover, another recent suggestion for coping with the conflicts of interest generated by continuation funds is to engage two separate legal advisers: one to represent the selling LPs and another one for the buying LPs, to mimic the normal legal diligence process and adversarial negotiation between two different parties. Each counsel would report to a fund committee comprised of independent investor representatives of that fund, free to make its own decisions and to consult (or not consult) with the sponsor at its discretion.<sup>290</sup> While this route could mitigate conflict-of-interest concerns and dispel the appearance of a tilted playing field, it would further increase costs associated with these transactions. Investors who eventually bear the costs might object to duplicating legal expenses.

Indeed, LP investors we interviewed expressed concerns about the fact that all fees and expenses related to the legal and financial advice with regard to continuation fund transactions, which are complex and require that the cost of time-consuming preparation of documents are borne by the fund and not the sponsor.<sup>291</sup> One interviewee even noted that GPs are often surprised to hear negative reactions of investors to continuation funds, because they are surrounded by advisors who have strong interests that these transactions will take place, and therefore keep focusing them one side of the story, the upsides, while downplaying the downsides.<sup>292</sup>

We do not suggest that legal and financial advisors are the sole drivers behind the rise in continuation funds. However, the clear financial interests of these advisors in the initiation of continuation funds, including their ability to collect fees twice for the sale of the same asset(s), could push them towards advising their clients to use the continuation fund structure more than is optimal for the LPs. Moreover, since the GP does not bear the financial and legal costs associated with these transactions, but do derive significant benefits from these transactions (including additional management fees and carried interest), they could be more receptive to their advisors' hearty recommendation to pursue a continuation fund transaction. If the GP had to bear those

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<sup>288</sup> See *supra* note 265.

<sup>289</sup> See *supra* note 133.

<sup>290</sup> KRAMER LEVIN, *supra* note 181.

<sup>291</sup> Interview with Participant 7 (January 27, 2023); Interview with Participant 9 (January 30, 2023).

<sup>292</sup> Interview with Participant 9 (January 30, 2023).



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expenses themselves, it is questionable whether they would remain as enthusiastic about those transactions.

### *F. A Critique of the SEC's Suggested Reform*

As noted earlier, the SEC recently published proposed new rules regarding private equity funds that, among other things, require GPs to obtain and share a fairness opinion from an independent opinion provider with interested parties.<sup>293</sup> According to the SEC, “[t]his would provide an important check against an adviser’s conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors.”<sup>294</sup>

Interviewees on both sides—advisors to GP and LPs—strongly criticized this proposal. On the sponsor side, interviewees claim that the proposal would entail substantial costs and would force sponsors to invite a fairness opinion even when such opinion is not required, such as where there are clear market indications as to the value of the assets sold to the continuation fund.<sup>295</sup> One interviewee explained that fairness opinions are usually reserved for assets selling for a discount of the Net Asset Value (“NAV”), where there is uncertainty regarding their valuation. In those situations, sponsors will proactively acquire a fairness opinion to support these transactions and to obtain LPAC consent.<sup>296</sup> However, the proposed SEC rule has pushed some sponsors to obtain a fairness opinion in every continuation fund transaction, even when the sponsor runs a complete process to get bids from all big secondary buyers, or when the price is at NAV or a premium to NAV. In those situations, the interviewee argues, fairness opinions, which are costly, do not add much value to investors, and thus market practice has been to avoid them.<sup>297</sup> In other words, sponsors and their advisors believe that market participants know better than regulators when a fairness opinion is required and forcing a blank-check rule that makes fairness opinion mandatory, even where the sponsor conducts a competitive sale process, will increase costs without adding much value to investors.

Interviewees on the LP side also expressed preference for a market-based process and were skeptical of a mandatory use of fairness opinions, but for other reasons. They explain that a fairness opinion does not give them a lot of confidence, as the

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<sup>293</sup> See *supra* note 27.

<sup>294</sup> *Id.* at 122.

<sup>295</sup> Interview with Participant 2 (January 25, 2023); Interview with Participant 5 (February 6, 2023); Interview with Participant 4 (January 27, 2023).

<sup>296</sup> Interview with Participant 2 (January 25, 2023) (“A fairness opinion is a valuable tool when there is uncertainty concerning the pricing, or the price is at a discount. If the price is at par, close, or above par, and when the sponsor runs a complete bidding process from all big secondary buyers, the fairness opinion does not add much value”).

<sup>297</sup> Interview with Participant 3 (January 26, 2023) (“I have not done a deal without a fairness opinion”); Interview with Participant 2 (January 25, 2023) (“The proposed SEC rule has pushed some sponsors to get a fairness opinion”).

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sponsor is charged with selecting the financial advisor that provides the fairness opinion, while the fund is incurring the costs.<sup>298</sup> In such a situation, the financial advisor has strong incentives to provide an opinion that would please the sponsor. Otherwise, that advisor would not be selected to give the next opinion. According to the LP interviewees, this concern is further aggravated in the private equity context, as there is a handful of repeat financial advisors who specialize in providing fairness opinions to private equity sponsors.<sup>299</sup> Securing future opinions may require these repeat players to please their clientele at the expense of LPs.<sup>300</sup> Therefore, they argue that fairness opinions cannot be considered as truly objective.<sup>301</sup>

This dynamic is not unique to the private equity context, and concerns regarding the objectivity of fairness opinions have been raised in other contexts, such as the buyout of public companies.<sup>302</sup> However, in the other transactional contexts, where lawsuits are common, the objectivity of the fairness opinion is subject to a court examination. In that case, any negative judicial determination on the validity of the fairness opinion could affect the reputation of the financial advisors in the marketplace. Such *ex post* examination is unlikely to happen in the context of continuation funds, because as a matter of fact, LPs almost never initiate legal proceedings against sponsors.<sup>303</sup> And in the absence of opposing opinions or cross-examination that could involve the financial advisors and question their analysis, providing opinions that may please sponsors who invite them is unlikely to severely affect the reputation of the financial advisors.

Another LP interviewee also explained that in some situations, the decision to initiate a continuation fund is driven by external considerations of the GP. For example, it could be used to receive management fees for an extended period.<sup>304</sup> It could also be driven by carry distribution considerations. For example, even if the asset being transferred to the continuation fund is by itself not a big carry driver, selling it can help the GP to meet a specific carry hurdle rate and therefore collect the 20% carried interest following the completion of that specific transaction. The decision to initiate a continuation in those cases is driven by structural issues that are distinct from the

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<sup>298</sup> Interview with Participant 8 (January 27, 2023).

<sup>299</sup> Interview with Participant 6 (January 18, 2023); Interview with Participant 7 (January 27, 2023); Interview with Participant 9 (January 30, 2023); Interview with Participant 8 (January 27, 2023) (Stating that no fairness opinion provider wants to give the “wrong” fairness opinion as they would lose future business).

<sup>300</sup> Cf. Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CALIF. L. REV. 1 (2022).

<sup>301</sup> See *supra* note 275.

<sup>302</sup> See *supra* note 285.

<sup>303</sup> See *supra* Part III.F.

<sup>304</sup> Interview with Participant 8 (January 27, 2023); See Section II.C.1.

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fairness opinions, and as one LP interviewee noted, he does not see how a fairness opinion would help the other LPs in these situations.<sup>305</sup>

While the SEC has put a lot of faith in the fairness opinion, market participants (especially on the LP side) are more skeptical about making them mandatory.<sup>306</sup> In their view, these opinions are of little value, worth just the paper they are written on it.<sup>307</sup> As we will discuss below, if the SEC intends to continue relying on fairness opinion as a major avenue for dealing with continuation fund conflicts, it shall provide the selling LP more say on the nomination of those financial advisors, and thereby reducing their dependency on the sponsors who initiate the transaction.

More broadly, our analysis shows that it is impossible to treat all LPs the same. Some of them are less sophisticated or have limited resources to invest in vetting continuation funds transactions. Therefore, some oversight by the SEC is required, and we will present some suggestions as to how this could be done in the next Part.

### **IV. The Future of Continuation Funds**

Continuation funds are not merely a fad. Market players estimate that they are here to stay and will continue to play an important role in the private equity industry. Their prevalence and importance underscore the need to find systemic solutions to the unique challenges they raise, and to re-envision their future. This Part undertakes this task.

Of course, one possible regulatory solution would be to prohibit continuation funds altogether. However, such a measure would also prevent overall value-enhancing transactions that could benefit all parties involved. Indeed, all market participants we interviewed, without exception, believed that continuation funds should not be prohibited. Similarly, ILPA, an organization dedicated exclusively to advancing the interests of LPs, did not call for an outright prohibition of these funds, but instead lists several parameters for a well-run process.<sup>308</sup> The SEC's recent proposed rules also do not suggest prohibiting continuation funds altogether.<sup>309</sup>

Below we explore several potential avenues for addressing these conflicts. Section A begins by presenting existing proposals to enhance disclosure, such as the one suggested by ILPA. We discuss the advantages and shortcomings of this proposal and explain why disclosure alone is unlikely to cure the structural biases generated by continuation fund transactions. Sections B–D explore solutions that directly address the imbalance of incentives between GP and LPs. We highlight the advantages and potential

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<sup>305</sup> Interview with Participant 8 (January 27, 2023).

<sup>306</sup> See *supra* note 275.

<sup>307</sup> *Id.*

<sup>308</sup> *GP Led Secondary Fund Restructurings*, *supra* note 117.

<sup>309</sup> See *supra* Part III.F.

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costs of each of those solutions. While this is not an exhaustive list, these solutions are aimed at sparking a much-needed discussion on this hot topic.

### A. *Enhanced Disclosure (and its Limitations)*

One of the concerns raised in the interviews is that legacy fund LPs suffer from serious informational gaps and that these investors do not receive enough time to make an informed decision. To address this concern, the ILPA suggests that that LPAC members receive a detailed description of the transaction rationale, the solicitation process, and the bids received; once the final terms of the proposed transaction have been set, the legacy fund LPs should have access, upon request, to the same level of information about the process as LPAC members.<sup>310</sup> In addition, the ILPA called for parity in the information provided to the new investors and the legacy fund LPs (including, financial information about the projected value of remaining assets in the fund) and for a disclosure of any conflicts of interests, including highly favorable economics for new investors arising from the provision of stapled primary capital in a new fund.<sup>311</sup>

We support those proposals for enhanced disclosure, which could reduce the LPs' informational gap, by giving the existing LPs access to the same data that the new investors have and enabling them to make informed decisions. However, leaving disclosure to the discretion of the GP, without clear guidance from regulators, could lead to a lack of standardization and predictability and to information overload.

Moreover, interviewees explained that disclosure documents distributed to LPs prior to their election decisions are already very detailed and often contain around 200 pages or even more (without attachments).<sup>312</sup> Since the resources and attention of many LPs are limited, they are likely to have difficulties with reviewing and digesting lengthy disclosure statements and forming an investment recommendation in a timely manner. Additionally, due to the rise of continuation funds, many LPs receive multiple disclosure documents each month, which could further contribute to their information overload.

We therefore suggest that the SEC provide detailed guidance on the information that must be disclosed to LPs before they decide whether to invest in continuation funds to further ensure standardization and predictability. This information should be summarized so that LPs with tight time constraints will still be able to review the main terms of the transaction in a timely manner. Disclosure alone, however, is no substitute for additional LP protections that could better align the interests of the GP and the legacy funds investors. We turn to discuss those protections now.

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<sup>310</sup> *GP-led Secondary Fund Restructurings*, *supra* note 117, at 6.

<sup>311</sup> *Id.*

<sup>312</sup> Interview with Participant 5 (February 6, 2023).

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### B. *Back to the Status Quo Option?*

One possible avenue, strongly supported by some LPs we interviewed and the ILPA, is to provide the legacy fund LPs with a *status-quo option* that enables them to reinvest on the same economic terms (assuming they are better than the new terms), if they do not like the price offered to them.<sup>313</sup> An important advantage of the status quo option is that it eliminates the objection of LPs that they are being squeezed by the GP, thus opening up a problematic choice for them: rolling over to a continuation fund on new, and often inferior, terms or cashing out on a price that could be unfavorable to them.

Under a typical status-quo option, the LPs keep their stake in the legacy fund, and the GP cannot crystallize the carry of the rolling-over LPs nor increase their management fee. In addition, the carried interest that the LPs pay to GP will continue to be burdened by any accrued preferred return terms if they were initially granted to the LPs. The GP will also have to honor side letters and keep in place all other benefits that were initially afforded to the rolling-over LPs.<sup>314</sup>

The ILPA also suggested that if an existing LP does not respond to the election in a timely fashion, its election should be treated as a decision to participate in the continuation fund, with no change in economic terms, rather than treated as an election to sell.<sup>315</sup> The rationale behind such a suggestion is that LPs should not be forced out if they do not respond.

This proposal has three major advantages. *First*, it calls for a very minimal intervention in the marketplace (even less interventionist than the SEC proposed rule calling for a mandatory fairness opinion) and it is relatively easy to implement. All it does is to ensure that the existing LPs are no longer squeezed by the GP, which could not force them to either roll over or cash out, in both cases on terms that are unfavorable to them. *Second*, this proposal also puts pressure on the GP to ensure that the pricing was at an appropriate level so that enough existing LPs elect to sell their stake to new investors, especially under a default that treats every investor that does not respond to the election as electing to roll over. This proposal, however, will reduce the number of continuation fund transactions, as new investors will have to offer a higher price to induce the existing ones to sell and to cover the costs of a higher management fee. To make the continuation fund transaction work for everybody, it must generate enough cash flow. This will ensure that only the most profitable transactions succeed.

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<sup>313</sup> *GP-led Secondary Fund Restructurings*, *supra* note 117, at 7.

<sup>314</sup> In the case of a single investment fund, there could be some necessary adjustments to side letters, as some provisions were contemplating a multi asset blind pool investment.

<sup>315</sup> *GP-led Secondary Fund Restructurings*, *supra* note 117, at 7.

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### C. *Relational Contracting & Empowering Legacy Fund LPs*

Addressing continuation funds concerns through a relational contracting prism should promote a solution that allows the parties to lean in on their existing contractual relationships rather than attempt to narrowly address continuation funds in a void. Therefore, it is vital to strengthen the ways through which LPs and GPs must work together when considering continuation funds. Below we explore several avenues that could reinvigorate the effectiveness of the relational framework.

*Approving the Transaction.* Many LPs question the effectiveness of LPAC approval because its members are selected by the GP and often have close ongoing relationships with the GP.<sup>316</sup> LPAC members could also have different incentives from the LPs that elect to cash out.<sup>317</sup> Bringing the decision regarding the initiation of a continuation fund to the LP base (and not just to the LPAC) should be a foundational aspect of relational contracting. In cases where the LPAC may not be best suited to represent all LPs, engaging all parties should be viewed as a fundamental element of the contractual relationship. This solution will ensure that a proposal to establish a continuation fund will move forward only if a majority of the LP base perceives it as value-enhancing. This will mitigate the concern that the GP would use the continuation fund vehicle for inappropriate purposes, such as providing liquidity to a retiring partner or enabling the sponsor to double dip on the management fees and carried interests of “hard-to-sell” asset.

As one interviewee explained, there are different types of continuation funds: some are “zombie” funds with hard-to-sell assets that investors generally dislike, and others are “crown jewel” funds with “trophy” assets that could appreciate in the future and investors could see potential in holding onto these assets.<sup>318</sup> So far, most LPs could simply elect whether to roll over their shares (but they did not have a “say” on the mere formation of the fund). This proposal would provide all LPs (not just LPAC members) with the ability to oppose the formation of funds that are perceived as value-reducing.

One clear objection to this proposal is that it may be too costly. The GP will have to compile lengthy disclosure documents and distribute them to investors. It also typically takes months, sometimes even a year, to execute a continuation fund transaction from the initial concept to closing. Such a process often involves solicitation of bids from third parties. Therefore, a late-stage LP vote could generate a risk that the LPs reject the proposal at the last minute (and after the GP invested significant time and efforts in the process). Such risk further increases, as most funds do not have negative consent, which means that the GP will need to secure a majority of LPs’ commitment to affirmatively approve the transaction. One of our interviewees explained that there is

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<sup>316</sup> See *Supra* notes 249-250 and accompanying text.

<sup>317</sup> See *supra* Section III.D.1.

<sup>318</sup> Interview with Participant 5 (February 6, 2023).

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always a certain percentage of LPs that are non-responders, and their vote would count as a “no-vote.”<sup>319</sup> Late-stage LP approval, therefore, generates a huge risk that could lead the GP to avoid establishing continuation funds in the first place, even when doing so could enhance value to all parties involved.

While this is a valid concern, there are several ways to mitigate it. *First*, the LP approval could be sought at a relatively early stage of the process before the GP invests significant time and effort. At that early stage, disclosure documents could be very short and just present the initial proposal to establish the fund, the rationale behind it, and any conflict of interest involved (including those related to the GP). *Second*, the voting default in the LPA could be amended to specifically allow the GP to exclude the votes of non-responders, rather than treating them as a “no-vote.” *Finally*, the voting threshold for preventing the formation of the fund could be increased from a simple majority to a super-majority. Altogether, we believe that these measures could reduce the risks or costs associated with a vote of the LP base.

*Selection of Financial Advisors.* When LPs approve a continuation fund transaction, they could simultaneously select the financial advisor. As we explained earlier, typically the financial advisors that provide fairness opinions are hand-picked by the GP. The control over their selection creates a structural bias and raises the concern that the advisors would seek to please their clientele at the expense of LPs. This concern could be mitigated if the LPs that elect not to approve the continuation fund transaction were the ones that elect the financial advisor (out of several options presented to them by the GP). If combined with the early-stage approval of the formation of continuation fund, this vote would entail no additional costs.

*Enchaining the Representation of the Selling LPs in the LPAC.* Interviewees on the LP side criticized the LPAC composition and raised concerns that members of the LPAC do not represent the interests of other LPs, especially the small ones or those that elect to cash out.<sup>320</sup> To address this concern, after the early-stage approval of the continuation fund, the GP could review the list of LPs that objected the fund’s formation and invite the largest LPs listed on it to serve on the LPAC that oversees and approves the transaction. This will empower the selling LPs and assure them a seat at the LPAC table.

### D. *Transaction Costs*

As we explained earlier, while the GP derives significant benefits from continuation fund transactions, including an extended period of management fees and the ability to increase the total carried interest, the GP usually does not incur any of the

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<sup>319</sup> *Id.*

<sup>320</sup> See *supra* notes 247–259 and accompanying text.

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costs associated with it.<sup>321</sup> Usually, the financial and legal costs of the transaction are considered fund expenses and are borne by the LPs.

To address this problem, the ILPA suggested that in cases where the GP clearly benefits from either additional fee revenue or through a stapled commitment, it should share some portion of transaction costs.<sup>322</sup> In addition, LPs electing not to participate should incur no cost. We support this recommendation. In our view, it has two major advantages. *First*, it will lead to more equitable allocation of the transaction expenses, ensuring that all parties that benefit from the transaction (including the GP) will bear their own share of the expenses. *Second*, and most importantly, the proposal could positively affect the GP decision-making. When the GP does not incur any costs of the transaction, its tendency to initiate continuation fund transactions increases, and there is an enhanced risk that the GP will initiate these transactions even when they do not serve the interests of all LPs.<sup>323</sup> The proposal will mitigate this tendency (at least partially) by causing the GP to internalize some of the transaction costs.

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In this Part, we discussed the shortcomings of existing proposals to address continuation funds conflicts and explored several alternative avenues that the SEC could consider, ensuring well-run GP-led processes. These proposals are very timely, as the SEC is currently in the process of regulating continuation fund transactions, and we hope that they will spark a much-needed dialogue regarding the future of these transactions.

### Conclusion

Continuation funds are becoming a mainstream option in the private equity world. Their popularity among private equity sponsors stands in stark contrast to the frustration of many of their investors. But continuation funds provide us with important lessons not only regarding the question of whether they are efficient or whether they should be regulated. They also allow us to glean further key insights into the relational contracting theory, the deference to investor sophistication, and to the role of lawyers and other advisors in mitigating or aggravating market frictions. This Article opens the door for a more robust discussion of these important questions. We hope that regulators, market participants, and academics will take up the challenge.

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<sup>321</sup> See *supra* note 291 and accompanying text; See *supra* Section II.C.1.

<sup>322</sup> *GP-led Secondary Fund Restructurings*, *supra* note 117, at 7.

<sup>323</sup> See *supra* Section II.C.3.



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### Appendix A

<b>Interview List</b>		
<b><u>Participant Number</u></b>	<b><u>Date Interviewed</u></b>	<b><u>Background</u></b>
1	January 9, 2023	A partner at a leading law firm, specializing in representing GP in continuation fund transactions
2	January 25, 2023	A partner at a leading law firm, specializing in representing GP in continuation fund transactions
3	January 26, 2023	A partner at a leading law firm, specializing in representing GP in continuation fund transactions
4	January 27, 2023	A partner at a leading law firm, specializing in representing GP in continuation fund transactions
5	February 6, 2023	A partner at a leading law firm, specializing in representing GP and LPs in continuation fund transactions
6	January 18, 2023	A director in an investment management company that invests in continuation funds as LP
7	January 27, 2023	An officer in an investment management company that invests in continuation funds as LP
8	January 27, 2023	An officer in an investment management company that invests in continuation funds as LP
9	January 30, 2023	An officer in an investment management company that invests in continuation funds as LP
10	January 30, 2023	A partner at a mid-size law firm, specializing in representing LPs in continuation fund transactions.