NOVEMBER - DECEMBER 2019
VOL. 19-10

PRATT'S

ENERGY LAW REPORT

LexisNexis

Pratt's Energy Law Report

VOLUME 19 NUMBER 10 November/December 2019

LexisNexis®

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ISBN: 978-1-6328-0836-3 (print)
ISBN: 978-1-6328-0837-0 (ebook)
ISSN: 2374-3395 (print)
ISSN: 2374-3409 (online)

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S ENERGY LAW REPORT [page number] (LexisNexis A.S. Pratt);
Ian Coles, *Rare Earth Elements: Deep Sea Mining and the Law of the Sea*, 14 PRATT'S ENERGY LAW REPORT 4 (LexisNexis A.S. Pratt)

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MATTHEW BENDER

(2019–Pub.1898)

Editor-in-Chief, Editor & Board of Editors

Pratt's Energy Law Report is published 10 times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquiries and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway Suite 18R, Floral Park, New York 11005, smeyerowitz@meyerowitzcommunications.com, 646.539.8300. Material for publication is welcomed—articles, decisions, or other items of interest to lawyers and law firms, in-house energy counsel, government lawyers, senior business executives, and anyone interested in energy-related environmental preservation, the laws governing cutting-edge alternative energy technologies, and legal developments affecting traditional and new energy providers.

POSTMASTER: Send address changes to Pratt's Energy Law Report, LexisNexis Matthew Bender, 121 Chanlon Road, North Building, New Providence, NJ 07974.

Secondary Transactions Provide Welcome Flexibility to Both Fund Managers and Investors in Energy Sector Private Equity Funds, But They Must Be Structured and Timed to Avoid Tax Pitfalls

By Michael J. Blankenship, Heather M. Stone, Bill Swanstrom, and Louis B. Savage*

Secondary Transactions are transactions in which new investors buy interests in private equity funds from existing investors. The Secondary market has gone mainstream, and now both fund managers and fund investors are waking up to the huge array of possibilities presented by Secondary Transactions. This trend is expected to carry over into the energy sector. This article introduces readers to the two main categories of Secondary Transactions: investor-led Secondary Transactions and manager-led Secondary Transactions.

In April 2018, Coller Capital and Goldman Sachs Asset Management paid $2.9 billion to buy out existing limited partners in a fund raised by Nordic Capital in 2008. In the months following the Nordic Capital deal, it has been widely seen in the industry as a turning point for transactions in which new investors buy interests in private equity funds from existing investors (a "Secondary Transaction" or a "Secondary").

Previously, the Secondary Transaction market was dominated by distressed sellers and there were only a few investors interested in making acquisitions. But 2018 saw the Secondary market go mainstream, and now both fund managers and fund investors are waking up to the huge array of possibilities presented by Secondary Transactions.

This trend is expected to carry over into the energy sector, and for private equity funds in the sector to begin to experience a continuous and vibrant

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secondary market, which will lead to greater liquidity and better alignment of interests between fund managers and fund investors, going forward.

The new environment will require a savvy fund manager to be familiar and comfortable with structuring Secondary Transactions according to his or her own goals and the goals of his or her investors. A manager also should know that secondary interest transfers raise the specter of his fund being classified as a publicly traded partnership ("PTP"), and how to structure and time such transfers to take advantage of the safe harbors available, which allow a fund to avoid PTP classification. In practice, these considerations are extremely important to the success of a Secondary Transaction because a fund that becomes classified as a PTP may be separately taxable as a corporation, not a pass-through partnership.

This article on Secondary Transactions will introduce readers to the two main categories of Secondary Transactions: investor-led Secondary Transactions and manager-led Secondary Transactions.

INVESTOR-LED SECONDARY TRANSACTIONS

Seller and Intermediary Initiate

In an Investor-led Secondary Transaction, either the Seller will generally initiate the transaction through approaching an intermediary (such as a strategic advisor or an investment bank, the "Intermediary").

The Seller and Intermediary Find a Buyer

The Seller and Intermediary will identify a portfolio of marketable fund interests held by the Seller that it wishes to sell (the "Portfolio Interests") and prepare information and due diligence materials to allow potential Buyers to evaluate the Portfolio Interests as a whole and to adequately diligence each individual interest (although it is important to note that the Seller will likely only have the quarterly and annual reports provided to it by the managers of its Portfolio Interests).

Engage the Manager

Once the Buyer is identified and the price agreed, the Buyer and Seller will formally notify the fund manager (the "Manager" or the "GP") of the proposed transactions.

Transfer Procedures

Nearly all private equity fund partnership agreements (the "Partnership Agreement") require the Seller to obtain the prior written consent of the Manager prior to transferring its interest in the fund, and the Manager will have discretion to reject the transfer as well as require the Seller to fulfill conditions

precedent to making a transfer (such as causing the Buyer to undergo investment vetting by the Manager). Many Partnership Agreements also specify that interest transfers will only be deemed effective monthly, quarterly, or even annually. There are also many Partnership Agreements which give other investors in the fund a right-of-first refusal over any transfers (the "ROFR"). Therefore, when planning a Secondary Transaction, it is imperative to leave ample time for the procedures of the transfer.

Legal Documentation

A. The Buyer and the Seller will enter into a Purchase and Sale Agreement ("PSA"), which will provide for the commercial terms of the deal, including but not limited to price, Portfolio Interests, excluded obligations, reps and warranties, liability caps, deferred consideration (if any), publicly traded partnership risks and safe harbors, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), and other tax issues. The PSA is usually kept confidential from the Manager (Managers frequently do not know the price of a Secondary Transaction involving their own fund).

B. The Buyer, Seller, and the Manager will enter into a document that actually transfers or assigns each Portfolio Interest (the "Transfer Agreement" or "Assignment Agreement"). The Buyer will also complete a subscription booklet (the "Subscription Booklet") for each Portfolio Interest. And finally, the Manager may require other ancillary documentation, such as a legal opinion in respect of PTP risks and safe harbors.

The Energy Sector

The principal advantage of an Investor-led Secondary Transaction is that it can free up Investor capital for new investments. Energy investors have long been familiar with the concept that returns on an investment can be front-loaded. For instance, many natural gas wells can return up to 80 percent of lifetime revenues within the first five to seven years of a well's producing life.

An energy-focused fund can experience hyperbolic, and then exponential, decline in returns after the initial years, with the tail-end of the returns being a radically different investment proposition from the initial maximum production returns, potentially even harming overall returns. However, even with the lower returns, tail-end funds can be attractive to investors who think some of the assets held in the Portfolio Interests could turn a profit. A Secondary Transaction can be used here to transfer the tail-end to a new investor with a tailored investment strategy and allow the original, high-return, investor to free up capital for new investments.

MANAGER-LED SECONDARY TRANSACTIONS

This section of the article discusses the increasingly dynamic area of Manager-led Secondary Transactions.

Manager-led Secondary Transactions, the Investment Proposition

Just as in the broader Secondaries market as a whole, the Coller Capital and Goldman Sachs Asset Management joint restructuring of a Nordic Capital fund discussed above shows the new ascendance of Manager-led Secondary Transactions. The Nordic Capital deal was itself a Manager-led Secondary Transaction, and the deal really shows how Private Equity Fund Managers can utilize the Secondary Market to take a proactive role in offering liquidity options to fund investors.

A Secondary Transaction is no longer a sign of weakness in a fund, rather, a Fund Manager who knows the Secondaries market is now seen as a more capable Manager.

Beyond liquidity considerations, the Secondaries Market may in fact offer higher returns than primaries and even fund of funds investments. Secondary investments are not subject to the early effects of the J curve that hits normal private equity investments, which draw in money for years before reaching the value-creation stage. Secondary investors acquire stakes in mature companies closer to exit. This avoids the risky early-stages of investments and delivers higher returns.

The new environment will require a savvy Fund Manager to be familiar and comfortable with structuring Secondary Transactions according to the Fund Manager's own goals and the goals of his investors. A Manager should also know that secondary interest transfers raise the specter of his fund being classified as a publicly traded partnership ("PTP"), and how to structure and time such transfers to take advantage of the safe harbors available, which allow a fund to avoid PTP classification. In practice, these considerations are extremely important to the success of a Secondary Transaction because a fund that becomes classified as a PTP may be separately taxable as a corporation, not a pass-through partnership.

Manager-led Secondary Transactions, Deal Structures

There are three primary deal structures available to a Fund Manager contemplating a Manager-led Secondary Transaction, the "Tender Offer," the "Fund Restructuring," and the "Stapled Secondary." "GP Spin-outs" can also include a Secondary component.

A. *Tender Offer Transactions*

Tender Offer Transactions are the simplest, and most similar to

traditional LP-led transactions, of the Manager-led Secondary Transaction variants. In a Tender Offer Transaction, the Manager solicits offers from buyers (or a large buyer or buyer-group) to tender for all (or a significant portion) of the LP interests in the Manager's fund.

The key features of the Tender Offer Transaction are:

- The Manager plays a significant role in coordinating the process among the existing LP investors and the new buyer or buyers.
- Existing LP investors who do not wish to exit the fund, can simply remain in place by opting not to participate in the transfer.
- The Tender Offer Transaction is fast and simple to execute, compared to the Fund Restructuring discussed below.
- Tender Offers usually do not involve completely re-setting the economics of the fund, rather, the only change is usually to extend the term of the fund. Once the transaction is complete, the Manager will hold a vote to extend the term of the fund.
- Federal tender offer rules will typically apply and can impose timing and procedural restrictions on the transaction.

It is also possible to structure a transaction as a hybrid between the Tender Offer and the Fund Restructuring Transaction, through the utilization of side letters and/or feeder vehicles.

B. *Fund Restructuring Transactions*

In a Fund Restructuring Transaction, the Manager will transfer some or all of the assets of an existing fund (the "Existing Fund") to a new fund (the "Continuing Fund"). The Continuing Fund will be financed with capital from new investors (or new capital from existing investors), but it will continue to be managed by the same Manager.

Some of the key features of the Fund Restructuring Transaction are:

- *Re-mix Investors.* Existing Investors are given the option to "cash out" of the existing fund structure, or "roll-over" in the Continuing Fund on the basis of either the Existing Fund terms or the Continuing Fund terms. Existing Investors may also be given the option to commit additional capital to the Continuing Fund.
- *Re-set Economics.* The Fund Manager has the opportunity to reset the economics of the fund, either through extension of the fee stream associated with managing the assets going forward, or

through re-setting the performance metrics and/or claw-back escrow reserves to free up money for the Manager's employees or other personnel.

- *Flexibility.* Fund Restructurings are extremely flexible and can be limited to one or only a subset of the assets in the Existing Fund.

C. *Stapled Secondary Transactions*

In conjunction with either a Tender Offer Secondary or a Fund Restructuring Secondary, an existing LP who is electing to stay put (in a Tender Offer) or roll-over to the continuing fund (in a Fund Restructuring) may be requested, or in extreme cases, required to make additional capital commitments.

The additional capital commitments can be utilized by the Fund Manager to either fund new investments in the Continuing Fund, or form the basis of an entirely new successor fund. Stapled Secondaries mean more capital for the Fund Manager to invest, which could be critical to executing on the investment thesis associated with the existing investments, or it could simply mean renewed life for the Fund Manager to launch a new fund.

D. *Applications in the Energy Sector*

Manager-Led Secondary Transactions are set to grow in importance in the energy sector. As Energy Fund Manager's begin to understand the permutations and appreciate the flexibility of these transactions, their benefits will become self-evident.

Physical assets that fluctuate significantly in value are a defining characteristic of the energy sector. Instead of passively allowing these price fluctuations to wreck entire funds, Fund Managers can utilize Secondary Transactions to roll-over investors, re-set economics, and even create a launch pad for their next fund.