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The Rise of Private Equity Continuation Funds

Law Working Paper N° 733/2023
November 2023

Kobi Kastiel
Tel Aviv University, Harvard Law School and ECGI
Yaron Nili
University of Wisconsin-Madison and ECGI

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This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-733-2023

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ECGI Working Paper Series in Law

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Abstract

This Article provides the first comprehensive examination of an emerging practice within the private equity sector—continuation funds. Continuation funds break from the traditional private equity model by allowing sponsors to hold on to assets beyond the typical fund term and, instead of selling the assets to third parties, sell them to their own newly established fund. Lauded by the private equity industry as providing "optionality" to investors, by allowing them to cash out or roll over, continuation funds have grown to represent a major segment of investment activity in the United States. Despite their surging popularity among private equity sponsors, they are subject to investor resistance, and, puzzlingly, most existing investors in the original funds decline the option to roll over their stakes into a continuation fund, even though it is run by the same private equity firm with which they have cultivated relationships for years. This Article addresses this puzzle and makes three contributions to the literature. First, 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 private equity managers' incentives and explore the web of conflicts of interest between sponsors and investors and among investors themselves. Second, employing in-depth interviews with market participants from both sides of the aisle—investors and sponsors—we examine the practical dynamics of continuation funds, exploring the cautionary tale they present to the conventional deference of law and economic theory to private contracting among sophisticated parties. Third, we present two alternative viewpoints regarding continuation funds: the market outcome view and the market failure view, and against this backdrop, we offer several policy recommendations that are particularly timely in light of the SEC's recently adopted rules addressing the issue.

Keywords: Private Equity, Continuation Funds, Corporate Governance, Corporate Law, Securities Law, Reputation, Related Party Transactions, SEC

JEL Classifications: K12, K22

Kobi Kastiel*
Associate Professor of Law
Tel Aviv University
Ramat Aviv
Tel Aviv 6997801, Israel e-
mail: kastiel@tauex.tau.ac.il

Yaron Nili
Professor of Law
University of Wisconsin-Madison
975 Bascom Mall
Madison, WI 53706, USA
phone: +1 (857) 222-9342
e-mail: nili@wisc.edu

*Corresponding Author

Draft November 2023

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[*] Professor of Law, Tel Aviv University; Visiting Associate Professor of Law, New York University School of Law; Senior Research Fellow, Harvard Law School Program on Corporate Governance; Research Member, the European Corporate Governance Institute (ECGI).

[**] Professor of Law and Smith-Rowe Faculty Fellow in Business Law, University of Wisconsin Law School; Research Member, the European Corporate Governance Institute (ECGI). We would like to thank [to update] as well as participants at the Harvard Law School Corporate Governance Seminar and the Corporate Lunch Seminar, the 2023 Annual Conference of Columbia Law School/Ono College, the 2023 ECGI Conference on the Law and Finance of Private Equity and Venture Capital at Oxford University, the 2023 Corporate Governance Conference at the London School of Economics, the 2023 Annual Penn-NYU Empirical Contracts Workshop, the University of Texas Law & Economics Workshop, the 2023 Corporate Law at a Crossroads Conference at Wisconsin University, Tel Aviv University Law & Economics Workshop, the Online Workshop of the Stigler Center's Affiliate Fellows Program at Chicago University, and the Fall 2023 ABA Business Law Section Annual Meeting (Private Equity) for extremely helpful comments and discussions.

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Introduction

In November 1988, the "barbarians" finally breached the gates of RJR Nabisco, the American manufacturing conglomerate.[1] The private equity firm Kohlberg Kravis Roberts 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 Hollywood-style bidding war. The deal marked the largest leveraged buyout of all time and sparked the investment community's collective interest.[2] However, in the end, the deal serves as a cautionary tale. By the late 1990s, with the value of its investment in RJR Nabisco declining and the end of the fund's term nearing, KKR had to sell its stake in RJR Nabisco, reportedly experiencing a loss of $730 million.[3]

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, the private equity business model has reinvented itself over the years in response to increasing competitive pressures,[4] with continuation funds now its latest development.[5]

Continuation funds offer a creative solution to circumvent the constraints of the traditional private equity model by enabling fund sponsors to retain assets beyond the customary 10-year fund term. In the past, funds' investments were expected to be liquidated once the fund term lapsed. With a continuation fund, instead of liquidating an asset that has not yet realized its full potential and selling it to third parties, the same fund sponsor sells this asset to its newly established fund.[6] Limited partners that invested

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

[2] 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; Brad Meikle, *August, 1989: RJR Investment Gets Underway*, BUYOUTS (Aug. 7, 2006), https://www.buyoutsinsider.com/august-1989-rjr-investment-gets-underway/.

[3] *Id.* It is difficult to calculate KKR's concrete loss, though, given the fees it has taken over the years.

[4] Elisabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095, 1095 (2019).

[5] 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.

[6] 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.

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in the legacy fund can either roll their interests into the continuation fund or exit.[7] For new investors, continuation funds offer the opportunity to invest in more "mature" and visible assets and to reinforce their relationship with the sponsor.[8] For these reasons, supporters of continuation funds view them as a "win-win-win" for all parties involved.

Continuation funds are not an esoteric phenomenon. In the past few years, they have grown increasingly popular within the private equity space, and are now the most common type of secondary transactions led by private equity sponsors. In 2021, these transactions reached their highest volume in history, estimated at around $68 billion in deal value, representing a 750% increase over five years.[9] According to market experts, these funds are here to stay and to grow.[10]

Despite their surging popularity among private equity sponsors, continuation funds face unusual investor resistance. The Chief Information Officer of Europe's largest asset manager went so far as to claim that certain parts of the private equity industry look like "Ponzi schemes" because of their "circular" structure, tossing assets back and forth.[11] Another leading pension fund executive warned that private equity groups are increasingly selling their companies to "themselves" on a scale that is not "good business for their business."[12] The Securities and Exchange Commission (SEC) has not remained indifferent to this important market development. In August 2023, it approved new rules that, among other changes, aim to provide a check against a sponsor's conflicts of interest in structuring continuation funds.[13]

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[7] *Id.*

[8] 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.

[9] *Id.*

[10] Kaye Wiggins, *Selling to Yourself: The Private Equity Groups That Buy Companies They Own*, FIN. TIMES (Jun. 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.

[11] 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.

[12] Kaye Wiggins, *Private Equity May Become a 'Pyramid Scheme,' Warns Danish Pension Fund*, FIN. TIMES (Sept. 20, 2022), https://www.ft.com/content/f480a99c-4c7b-4208-b9dd-ef20103254b9.

[13] 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); Documentation of Registered Investment Adviser Compliance Reviews IA-6383, 187 (Aug. 23, 2023), https://www.sec.gov/rules/2022/05/private-fund-advisers-documentation-registered-investment-adviser-compliance-reviews. The proposed reform includes other proposals aimed at improving the efficiency, competition, and transparency of the activities of private funds' advisers that are unrelated to continuation funds.

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These general concerns, however, leave some crucial questions open: What types of misalignments of interests might continuation funds cause? How severe are these conflicts? What are the economic interests of the sponsors? Why do most investors decline the option to roll over their stakes into the continuation fund, even though it is run by the same sponsor in which they have trusted their investments up to that point? Do these investors have the power to fend for themselves or is a regulatory intervention required? How effective are the existing regulatory and market mechanisms in addressing continuation fund conflicts? Despite the growing impact of continuation funds on the U.S. and European capital markets, no academic study has closely examined these questions. This Article fills that gap.

We make three key contributions to the existing literature. First, we provide a systematic analysis of the web of conflicts continuation funds generate. We show that continuation funds guarantee substantial benefits for sponsors, including additional lucrative management fees, crystallization of carried interest (taking some money off the table), an option to receive an additional carry in the future, and an opportunity to obscure their true performance for a longer period. The advisors to sponsors also have interests in initiating continuation funds, which offer the opportunity to collect fees twice for the same asset sale. This may motivate them to push the sponsors to use continuation funds more than is optimal for investors.

Further, in continuation funds, sponsors place themselves in a position where they are committed to two groups of investors whose interests are in direct conflict—the exiting investors interested in selling the fund's assets at the highest possible price and the incoming investors in the continuation fund interested in paying the lowest possible price for the assets. The tendency of the vast majority of existing investors (80–90%) to opt for cashing out instead of rolling over their investments intensifies the severity of this conflict.

Assessing how this conflict unfolds in practice is challenging due to data limitations. While in theory one group of investors (sellers or buyers) could sometimes have the upper hand—and sometimes the lower hand—our analysis suggests that the sponsor always wins. We also show that sponsors' incentives to establish the continuation fund and the close relationships between the sponsors and the new investors in continuation funds, often sophisticated and repeat players specializing in secondary transactions, might lead sponsors to favor new investors' interests over those of the legacy fund investors electing to cash out. Recent empirical evidence supports this view.[14] We further explain how investors in the legacy fund may face losses on two fronts: they can no longer rely on the sponsor as their faithful agent in the transaction's

[14] *See infra* notes 143–148 and accompanying text.

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negotiation, and they lose exposure to the assets if the continuation fund proves to be a successful investment.

This web of conflicts not only results in distributional effects but also imposes efficiency costs. Sponsors' financial interest in establishing continuation funds could lead them to forgo better exit options, resulting in suboptimal utilization of investors' capital. Continuation funds also exacerbate the information asymmetry problem in the private equity industry and enable portfolio companies to remain in "private equity darkness" for extended periods.

Second, we utilize qualitative data from interviews with market participants from both sides of the transaction—investors and sponsors—to provide a more comprehensive analysis of continuation funds' dynamics. There is a certain level of secrecy surrounding continuation funds: researchers often do not have access to the original limited partnership agreements or these funds' valuations, which are regarded as a "black box." To overcome these informational limitations, we conducted interviews with leading market participants, all with first-hand experience with continuation funds, and who together participated in over 85 continuation fund transactions totaling over $60 billion in 2022.

Using interviews and other publicly available resources, we explain how examining continuation funds can help clarify two key aspects of the private equity landscape. One is the notion that investors' sophistication enables them to protect their interests. We show how informational disadvantages, lack of expertise, lack of time, diversification and liquidity considerations, and internal agency problems of institutional investors often force investors to sell their stakes under unfavorable conditions. A recent survey supports this analysis, showing that only 6% of all investors express significant interest in continuation funds.[15] We also examine the convention that in an industry in which investors rarely use litigation to enforce their rights, non-legal incentives are sufficient to maximize value for all parties involved. We highlight the limitations of this theory, particularly regarding small investors with limited bargaining power.

We also discuss the shortcomings of the SEC's regulatory approach, which has focused on the mandatory use of fairness opinions, as well as other mechanisms used by market players to solve continuation fund conflicts (such as subjecting the initiation of these funds to the approval of a limited partnership advisory committee, requiring the sponsor to reinvest its profits into the continuation vehicle, and using a competitive bid). Based on insights from our interviews, we explain why these mechanisms are unlikely to cure the structural biases generated by continuation fund transactions.

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[15] *See* Madeleine Farman, *Private Fund Leaders Survey: LPs Get Comfortable With Continuation Funds*, PRIV. EQUITY INT'L (Aug. 23, 2023), https://www.privateequityinternational.com/private-fund-leaders-survey-lps-get-comfortable-with-continuation-funds/.

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Finally, we explore two alternative viewpoints regarding continuation funds: the market outcome view and the market failure view. The *market outcome* view holds that continuation funds are effective price discrimination mechanisms, that they reflect a trade-off between price and contractual protections, and that reputational forces can be relied upon to mitigate any opportunistic use of them. In contrast, the *market failure* view suggests that continuation funds impose significant efficiency costs, which reputational forces are unlikely to mitigate fully. Against this backdrop, we offer a set of policy recommendations directly addressing the misalignment of incentives between sponsors and investors. These proposals are particularly important in light of the recent SEC reform.

We view the study of continuation funds as an important setting for examining the power dynamics in the private equity industry, particularly the differences in sophistication and bargaining power between various players. This setting also sheds light on the institutional and agency problems many investors face, their limited power to mitigate sponsors' conflicts, and the limits of reputational markets in an industry lacking extensive disclosure and regulation, or any effective underlying threat of litigation.

The Article proceeds as follows: Part I gives an overview of the private equity model and the limitations of sophisticated players' bargaining within this sector. Part II provides background on the genesis of continuation funds and outlines their advantages. It then analyzes the web of conflicts that continuation funds generate. Part III describes our findings from interviews with key market participants and examines how continuation funds challenge the neoclassical deference given to sophisticated players' contracting. Part IV concludes by discussing two alternative viewpoints regarding continuation funds and explores potential avenues for addressing continuation fund conflicts.

I. Private Equity: Governance & Bargaining

A. The Private Equity Model

Private equity funds raise and pool money from investors to buy and sell companies, often financing the acquisitions with a significant amount of debt.[16] Virtually all private equity funds organize their funds as limited partnerships, in which investors—usually institutional investors and wealthy individuals—are limited partners (LPs),

[16] *See, e.g.,* Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 121 (2009).

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and the private equity firm, also referred to as the sponsor, serves as the general partner (GP).[17] The GP raises and manages the fund, owes fiduciary duties to the fund, and acts as an agent of the fund vis-à-vis third parties.[18] In contrast, the LPs have minimal rights to participate in day-to-day operations or challenge the GP's decisions.[19] Nor do LPs owe any duties to the fund.[20] The limited partnership agreement (LPA), negotiated between the GP and the LPs, governs the relationship between the investors and the fund.[21] The LPA typically includes provisions on voting rights, access to information, and transfer restrictions.[22] The limited partner advisory committee (LPAC) is the key avenue to address contractual questions as they arise. LPACs are typically comprised of a few LP representatives, whose primary function is reviewing conflicts of interest and waiving restrictions in the LPA.[23]

Private equity funds have long been heralded as a successful asset class.[24] This success is generally attributed to their superior governance structure, which includes several complementary mechanisms.[25] First, private equity sponsors provide strong financial incentives to managers of their portfolio companies to improve performance metrics.[26] Second, the sponsors closely monitor management behavior and use the large amount of debt placed on portfolio companies as a disciplinary mechanism.[27] Third, the sponsors possess financial, operational, and industry-specific expertise and benefit from

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[17] *Id.*

[18] UNIF. LTD. P'SHIP ACT § 305 (2001).

[19] Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 263–70 (2010); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1874–78 (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*, 37 YALE J. ON REG. 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, 328–29 (2009) ("The reason for choosing the limited partnership form is principally to limit the control rights that limited partners will have over the partnership…").

[20] UNIF. LTD. P'SHIP ACT § 302; REVISED UNIF. LTD. P'SHIP ACT §§ 302, 303(a).

[21] Harris, *supra* note 19, at 269.

[22] Magnuson, *supra* note 19, at 1857.

[23] *See* Section III.D.1.

[24] Jonathan Shapiro, *Private Equity Is the New Traditional Asset Class,* FIN. REV. (July 4, 2022, 9:21 AM) https://www.afr.com/markets/equity-markets/we-re-the-traditional-asset-class-says-partners-group-founder-20220629-p5axu5.

[25] Magnuson, *supra* note 19, at 1848–65.

[26] *Id.*

[27] *See, e.g.,* Elisabeth De Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 129–134, 136–39 (2014).

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their experience from previous transactions.[28] Finally, by removing companies from the public markets, private equity funds can take aggressive actions that yield dividends in the *long term* even if they may lead to *short-term* turmoil.[29]

Two governance characteristics of private equity funds are identified in the literature as essential to their success. The first is the *GP compensation structure*, which is heavily performance-based. The second is the *limited duration* of funds, which forces private equity firms to return to the market periodically in order to raise additional capital.[30] Both features are effective mechanisms to align the interests of private equity firms and their investors.[31] Both features are also pivotal to the emergence of continuation funds, as we will further detail in Part II.

GP compensation structure: It is standard for private equity firms to receive compensation in two forms (known as "Two and Twenty"): *management fees* of 2% of the committed capital, and *carried interest*, typically 20% of the profits from selling portfolio companies.[32] It is also common for private equity firms to include a "hurdle rate" that prevents the GP from earning any carried interest until the LPs have realized a specified level of profits from their capital contributions.[33] The carried interest compensation system is considered effective at aligning the interests of the GP and the LPs. Since large part of GP's returns are proportional to those of the LPs, the GP is motivated to maximize value for other LPs.[34]

The 2% management fee is charged to cover the costs of managing the fund and does not depend on the underlying companies' performance; instead, it is based on the total capital committed.[35] *Finally*, GPs often invest their own funds in what is termed as

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[28] *Id.*; Clayton, *The Private Equity Negotiation Myth, supra* note 19, at 73–107; Magnuson, *supra* note 19, at 1864–1903.

[29] Magnuson, *supra* note 19, at 1861–62.

[30] *See, e.g.,* Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN ECON. 3 (1999); Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2009).

[31] PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 95 (1999).

[32] Magnuson, *supra* note 19, at 1866–67; Clayton, *The Private Equity Negotiation Myth*, *supra* note 19, at 76.

[33] Magnuson, *supra* note 19, at 1873.

[34] 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).

[35] After the investment period ends, management fees are typically calculated based on the *actual invested capital* rather than the initial committed capital. The structure of management fees incentivizes firms to

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capital contribution, often 1% of the total capital.[36] 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.[37]

The GP compensation structure, however, is not without criticism. For example, it has been argued that this compensation structure might cause GPs to pursue investments with greater risk than LPs would prefer.[38]

Limited duration: Another significant feature of private equity funds, and central to this Article, is the limited duration of the funds.[39] Private equity funds typically last for ten years with an option to extend the fund for one or two years with specified approvals.[40] 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.[41] 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, generally either by selling it to another buyer (a strategic investor or another private equity fund) or by undertaking an IPO.[42]

The limited duration of private equity funds serves a few important purposes. *First*, it provides liquidity for LPs whose capital is locked up for a few years and creates incentives to refrain from opportunistic behavior.[43] In such funds, the GP has full

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raise and invest as much capital as possible, potentially leading to excessive risk-taking (Magnuson, *supra* note 19, at 1866–77).

[36] Harris, *supra* note 19, at 287 ("In the usual case, the fund manager contributes 1%.").

[37] Magnuson, *supra* note 19, at 1865–70.

[38] This is because sponsors with carried interest enjoy the upside of strong performance but do not face downside risks. If the private equity fund loses money, it will just not trigger the carried interest. *See, e.g.,* Harris, *supra* note 19, at 283; Magnuson, *supra* note 19, at 1870–72; Jarrod Shobe, *Misaligned Interests in Private Equity*, 5 BYU L. REV. 1437 (2016).

[39] GOMPERS & LERNER, *supra* note 31, at 3–5.

[40] Harris, *supra* note 19, at 279.

[41] 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. William W. Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703, 723 (2022).

[42] Metrick & Yasuda, *supra* note 30, at 2304.

[43] *See, e.g.,* GOMPERS & LERNER, *supra* note 31, at 19–20; Gilson, *supra* note 34, at 1089–90; David Rosenberg, *Venture Captial Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 379 (2002). The limited duration of the fund ensures the market will evaluate every few years whether

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control over the management of the fund's assets, but only for a finite period.[44] The limited duration forces the GP to raise new capital periodically.[45] This constant need to raise capital exposes private equity funds to frequent reputational pressures and to the disciplinary power of capital markets.[46] GPs that engage in opportunistic behavior or fail to establish a positive track record could face greater difficulty and increased costs in raising capital.[47]

Second, the limited duration imposes a market check on the GPs' valuations. GPs have significant control over investments' valuations during the fund's lifetime.[48] Therefore, when GPs delay the liquidation of their investments, they have more room to conceal or overstate performance metrics. The limited duration imposes a market check on GPs' valuations, ensuring unbiased valuations at the fund's end.[49]

Third, the limited duration of the funds also reflects the understanding that a 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.[50] *Finally*, the finite duration limits GPs' ability to maintain underperforming portfolio companies just to generate additional management fee income.

The limited duration, however, may give rise to an agency problem, as GPs may divert attention from existing investors to focus on raising new funds (though the need to maintain a strong track record in securing new investments may mitigate this concern).[51] Additionally, liquidating assets when the term of the fund ends may not always be optimal for investors. On some occasions, companies can generate higher

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the GP's investment decisions favored risk over expected returns and reward the GP accordingly. Gilson, *supra* note 34, at 1089–90.

[44] Metrick & Yasuda, *supra* note 30, at 2309 ("The typical fund has a lifetime of ten years.").

[45] *Id.* at 2304 ("Successful private equity firms stay in business by raising a new fund every three to five years."); John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L. J. 1228, 1254 (2014) ("Most private equity agreements therefore allow management companies to begin raising new funds as soon as all of the money in prior funds has been invested.").

[46] GOMPERS & LERNER, *supra* note 31, at 240.

[47] Sahlman, *supra* note 34, at 513.

[48] Harris, *supra* note 19, at 278.

[49] Andrew Metrick & Ayako Yasuda, *Venture Capital and Other Private Equity: A Survey*, 17 EUR. FIN. MGMT. 619, 622 (2011); Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 14 (2008).

[50] *Cf.* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 606–07, 610–11 (2017).

[51] Harris, *supra* note 19, at 280.

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value beyond the typical fund's lifespan if market conditions are unfavorable for exit or if the assets in the fund's portfolio have not reached their full potential. Against this background, continuation funds have evolved.[52]

Having provided a brief overview of the private equity model, we turn to discuss a key aspect of the private equity landscape: the sophistication of the investors in this industry.

B. The Private Equity Bargaining Conundrum

Conflicts of interest inevitably arise in the private equity context. First, there is a risk that the GPs will engage in self-dealing transactions. It is also possible that fund investors cannot secure their GP's undivided attention, since private equity funds commonly launch sequentially, or even simultaneously. The GP compensation structure (which might cause the GP to pursue investments with greater risk than LPs would prefer), the common waivers of GP fiduciary obligations, and the lack of strong rights to challenge the GP's decisions also aggravate the issue.[53]

The conventional wisdom has long been that investors in private equity funds are sophisticated and can use their bargaining power to mitigate these conflicts and negotiate for strong protections in the LPAs.[54] However, some scholars have recently criticized this view. They argued that private equity contracts do not respond satisfactorily to agency conflicts,[55] and contested the superiority of private equity returns over public market returns, emphasizing the complex nature of assessing the overall success of private equity.[56] One central question raised by this scholarship is why, in a world of contractual freedom and sophisticated parties with repeat exposure to private equity, LPAs do not provide LPs with solid protections against GPs' opportunistic behavior.[57]

The classic law and economics approach suggests that the absence of certain protections in LPAs is not necessarily inefficient for two reasons. First, certain governance terms that empower LPs might be suboptimal, as they overly interfere with the ability of the GP to successfully manage the fund. Second, LPs may have received a

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[52] See infra Section II.B.

[53] Clayton, *High-End Bargaining Problems*, *supra* note 41.

[54] *Id.*

[55] *See, e.g.,* Clayton, *The Private Equity Negotiation Myth*, *supra* note 19, at 78.

[56] *See, e.g.,* Ludovic Phalippou, *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory*, 30 J. INVESTING 11 (2020); JOHN COATES, THE PROBLEM OF 12: WHEN A FEW FINANCIAL INSTITUTIONS CONTROL EVERYTHING 73–93 (2023).

[57] Clayton, *The Private Equity Negotiation Myth*, *supra* note 19, at 70–71.

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discount in exchange for not including a term in the LPA.[58] Therefore, the absence of protections could result from a negotiation process in which LPs chose to forgo specific protections in exchange for a better price or other benefits.

However, scholars have recently proposed more nuanced explanations for the absence of governance protections. The main explanation raised in the literature is *coordination problems*. As investors can negotiate individualized benefits in the side letters outside of fund agreements, they have weak incentives to negotiate collective fund-wide protections and strong incentives to maximize their private benefits.[59] This conflict of interest among investors also arises when investors with significant bargaining power receive preferential benefits through co-investment opportunities,[60] access to alternative investment vehicles with better returns,[61] or unwritten "gentlemen's agreements."[62]

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 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 *all* LPs.[63] Many LPs also have *limited bargaining power* vis-à-vis the GP. In particular, Will Clayton found that the most common explanation for why LPs do not seek additional contractual protections is their fear of exclusion from the GP's funds if they bargain too aggressively.[64]

Finally, 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—may be less likely to push

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[58] *See, e.g.*, Alan Schwartz & Robert Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003); Clayton, *High-End Bargaining Problems*, *supra* note 41, at 714–15.

[59] 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. They can create more problems of their own, imposing significant costs, creating delays in capital raising, and potentially impairing funds' operations and investments. *See* William W. Clayton, *High-End Securities Regulation*, 13 HARV. BUS. L. REV. 30–31 (forthcoming 2023); Clayton, *The Private Equity Negotiation Myth*, *supra* note 19, at 70–71; *see also* Elizabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. 907, 959–60 (2023).

[60] Fontenay & Nili, *supra* note 59. In co-investment, investors invest directly in a portfolio company alongside the private equity fund rather than only through the fund. Co-investors pay lower compensation to the sponsor when they invest directly rather than through the fund.

[61] Josh Lerner, Jason Mao, Antoinette Schoar & Nan R. Zhang, *Investing Outside the Box: Evidence from Alternative Vehicles in Private Equity*, 143 J. FIN. ECON. 359, 359–61 (2022).

[62] *See supra* note 59.

[63] Magnuson, *supra* note 19, at 1849–50.

[64] Clayton, *High-End Securities Regulation*, *supra* note 59, at 41–42.

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for strong protections because of the personal career concerns of their investment officers. Given that strong governance protections (through the use of restrictive covenants) are less likely to be noticed by the investment officer's superiors, negotiating for such protections does not provide significant career benefits to the investment officer, even though it may be more beneficial to investors in the long term.[65]

As we will show, this heated debate about LPs' ability to defend themselves against GPs' opportunistic behavior is particularly relevant to continuation funds.

II. The Rise of Continuation Funds

A. The Structure of Continuation Funds

One of the characteristics of private equity funds is that they have finite durations.[66] However, selling private equity assets when the term of the fund ends, typically within 10 years, may not always be optimal.[67] In such cases, the GP can establish a continuation fund to acquire one or more portfolio companies from the legacy fund.[68]

Continuation funds are typically set to last up to 6–7 years.[69] In most cases, LPs of the legacy funds have the following options when a continuation fund is created: (i) selling their interest in the existing fund and receiving a pro-rata share of the purchase price; (ii) rolling over their interest into the continuation vehicle; or (iii) in some cases, both.[70] LPs may be offered to roll over their interest on either a reset or a status quo basis. On a *reset basis*, the LP participates in the continuation fund on updated economic terms, and the GP of the legacy fund locks in its profits and receives new terms for managing the acquired assets, including modified carried interest and management fees.[71]

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[65] *Id.* at 33–34.

[66] *See supra* notes 39–52 and accompanying text.

[67] *See infra* Section II.B.

[68] 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* (Sept. 2020), https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/09/decoding-the-secondary-market-part-IV-continuation-funds.pdf.

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

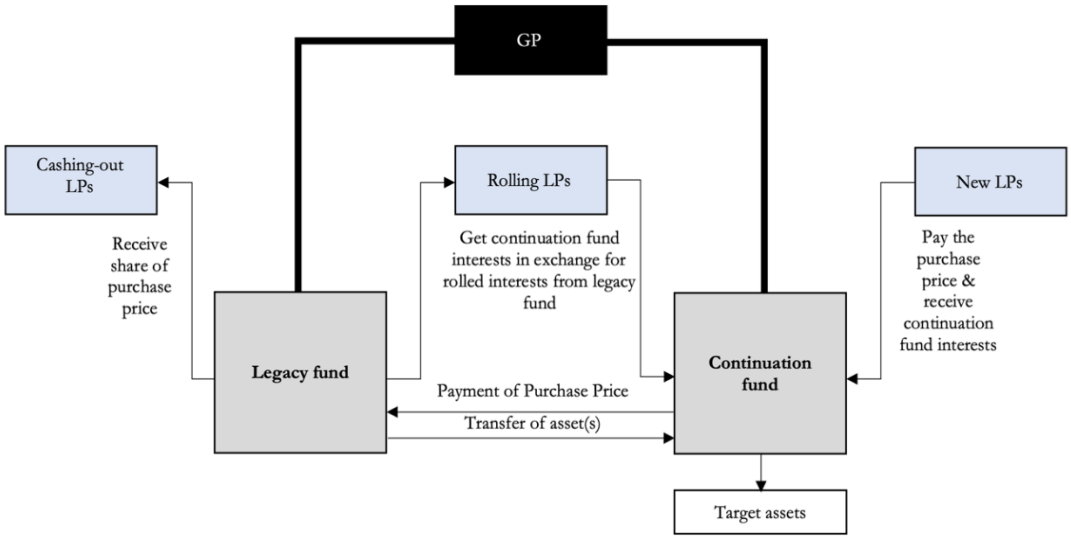
[70] *GP-Led Secondaries Reshaping the Landscape for Investors, Fund Managers, and Portfolio Companies* (May 2022), CAPITAL DYNAMICS, https://www.capdyn.com/Customer-Content/www/news/PDFs/Capital_Dynamics_-_GP-led_Secondaries.pdf [hereinafter CAPITAL DYNAMICS].

[71] ILPA, *GP-led Secondary Fund Restructurings Considerations for Limited and General Partners* (Apr. 2019), https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-

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The GP may also request that rolling investors provide additional capital commitments to the continuation fund.[72] On a *status quo basis*, the LP participates in the continuation fund on substantially the same economic terms, and the GP's carried interest is not crystallized.[73] Figure 1 below illustrates a typical structure of a continuation fund.[74]

Figure 1: A Continuation Fund Structure



Restructurings-Apr-2019-FINAL.pdf [hereinafter *ILPA, GP-led Secondary Fund Restructurings 2019*]; Sebastian McCarthy & Lina Saigol, *Private Equity Turns to Continuation Funds to Keep Hold of Trophy Assets,* FIN. NEWS (Nov. 24, 2021), https://www.fnlondon.com/articles/private-equity-turns-to-continuation-funds-to-keep-hold-of-trophy-assets-2021112424; Clifford Chance, *supra* note 68, at 4.

[72] Clifford Chance, *supra* note 68, at 4.

[73] The "Pure" status quo option involves transferring assets from a legacy fund to a new fund without changing the fund terms. However, if rolling LPs neither commit new capital nor face dilution, there is no opportunity for the GP to raise additional capital. Since the need for more time and capital often drives the establishment of a continuation fund, LPs requesting the status quo option typically mean an option closest to the "pure" status quo with specific criteria, including no increase in the management fee and the carried interest rate, no decrease in the preferred return hurdle or other GP-favorable changes to the distribution waterfall, no crystallization of carried interest for rolling LPs, and rolling LPs' side letters to apply where relevant. *See* ILPA, *Continuation Funds – Considerations for Limited Partners and General Partners*, 4, 11 (May 2023), https://ilpa.org/wp-content/uploads/2023/05/Continuation-Funds-Considerations-for-Limited-Partners-and-General-Partners.pdf [hereinafter *ILPA, Continuation Funds 2023*].

[74] *See also* Dylke et al., *supra* note 6; Ted Cominos & Cristina Audran-Proca, *'Let the Good Times Roll' – Continuation Funds and Their Appeal to GPs and LPs*, EVERSHEDS SUTHERLAND (Jun. 12, 2022).

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B. The Advantages of Continuation Funds

The increasing use of continuation funds is often motivated by the conviction that companies can generate higher value beyond the typical fund's lifespan.[75] This can happen 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 beyond the fund's lifespan.[76] Market conditions could also significantly affect exit decisions, as traditional exit options may not be viable in challenging markets.[77] Therefore, supporters of continuation funds emphasize their ability to provide *more time* for assets to realize their full potential.

Continuation funds also offer another advantage: the opportunity for *capital infusion*. This advantage applies both toward the end of a fund's life when most of the capital is withdrawn, and options for portfolio companies in need of additional funding are limited, as well as early in the fund's lifecycle when assets experience rapid and substantial growth and require additional funding to support their expansion.[78] Since an extension of the original fund does not include raising additional capital and requires the consent of all LPs (or at least a vast majority of them) with possibly differing liquidity needs, it cannot serve the same purposes as a continuation fund.[79]

Thus, supporters of 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 funds: optionality.[80] Using this structure, GPs can continue holding 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 directors.[81]

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 sold assets or

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[75] Miriam Partington, *HV Capital launches Germany's First Continuation Fund of €430m,* SIFTED (Feb. 16, 2022), https://sifted.eu/articles/hv-capital-continuation-fund/.

[76] Hinsen, *supra* note 8.

[77] *Id.*

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

[79] *Id.*

[80] *Id.*

[81] Madeline Shi, *Continuation Funds Drive GP-led Secondaries Wave*, PITCHBOOK (Feb. 1, 2022), https://pitchbook.com/news/articles/continuation-funds-GPs-secondaries-private-equity.

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rolling their investments into the continuation fund.[82] *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.[83]

For *incoming LPs*, continuation funds offer an opportunity to invest in more "mature" assets for a shorter period than the portfolio company's lifecycle. They enjoy full visibility of the asset they are buying into and the ability to develop a GP relationship.

C. 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.[84] As the data below shows, 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.[85] Starting around 2010, continuation funds were used for distressed assets that were struggling in the aftermath of the global financial crisis.[86] Sponsors who could not raise a successor fund would use continuation funds to maintain fee generation.[87] 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.[88]

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[82] Interview with Participant 12 (June 28, 2023) (stating that one of the original rationales for continuation funds was to resolve a disagreement among LPs at the end of a fund's term, where some LPs were content to stay invested while others wanted an immediate exit).

[83] Button, *supra* note 69; Hinsen, *supra* note 8.

[84] Michael Forestner & Brad Young, *Continuation Funds: Gifts That Keep on Giving*, MERCER (Feb. 26, 2022) https://www.mercer.com/our-thinking/wealth/yieldpoint-blog/continuation-funds-gifts-that-keep-on-giving.html.

[85] 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.

[86] *See, e.g.,* Farman, *supra* note 85.

[87] 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/.

[88] *See, e.g.,* Farman, *supra* note 85.

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"Crown jewel" funds: The shift occurred 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.[89] It also allowed for additional infusions of capital when the GP could no longer raise funding from the legacy fund investors.[90] This practice has accelerated due to COVID-19, which made scheduled exit windows for portfolio assets less viable.[91] As a result, continuation funds have gained more and more traction, quickly becoming entrenched in the private equity ecosystem.[92]

Data collected in the past seven years indicates that continuation funds, which are the most common type of secondary transactions led by GPs, are witnessing continued and significant growth. As Figure 2 demonstrates, the total deal value of GP-led secondary transactions was about $9 billion in 2016. That number surged by over 750% within a 5-year period. In 2021, these transactions reached their largest volume in history, estimated at around $68 billion in deal value.[93] Importantly, market participants estimate that these transactions will continue to form a substantial part of the private equity market.[94] For example, most market participants recently estimated that the volume of GP-led transactions could surpass $100 billion by 2025.[95]

Moreover, the data also shows that in the past, LP-led transactions—one-off transactions led by LPs looking to sell one or more of their limited partnership interests at some point during the life of the fund—dominated the secondary transaction market. This is no longer the case. GP-led transactions, once a small percentage of the secondary

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[89] Pitchbook, *U.S. PE Breakdown 2021* 40 (2022) ("Unlike in the past, though, the vast majority of these GP-led transactions are about continuing to profit off and/or providing additional funding to high-performing companies.").

[90] Lennard & Anthony, *supra* note 87.

[91] Clifford Chance, *supra* note 68. *See also* Button, *supra* note 69.

[92] Reeve & McNaney, *supra* note 78; Cominos & Audran-Proca, *supra* note 74.

[93] JEFFERIES, GLOBAL SECONDARY MARKET REVIEW 7 (Jan. 2023), https://www.jefferies.com/CMSFiles/Jefferies.com/files/IBBlast/Jefferies-Global_Secondary_Market_Review-January_2023.pdf; 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; Clifford Chance, *supra* note 68.

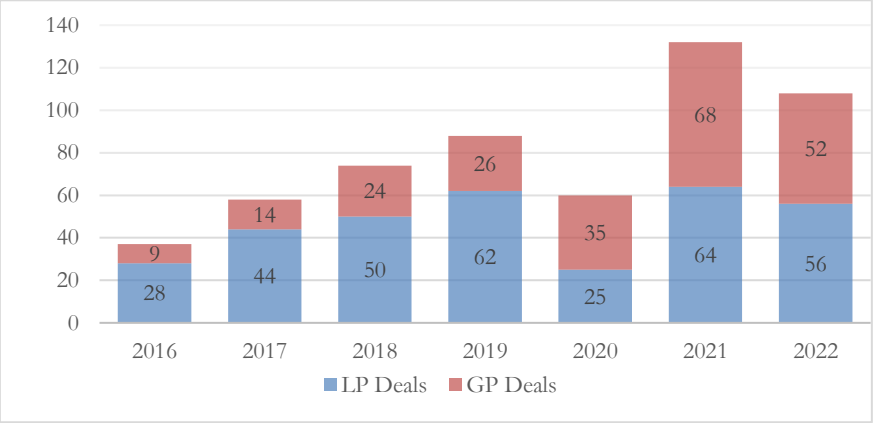
[94] Reeve & McNaney, *supra* note 78; Cominos & Audran-Proca, *supra* note 74.

[95] *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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market volume, now account for approximately 50% of the overall volume of secondary deals,[96] sometimes outpacing LP-led deals.[97]

Figure 2: Secondary Transaction volume by year ($ bn)[98]



A continuation fund is only one type of secondary transaction conducted by GPs. Other types include tender offers,[99] portfolio strip sales,[100] and stapled transactions.[101] However, continuation funds are by far the most common type of GP-led secondary transaction.[102] In 2021 and 2022, continuation funds represented 83% and

[96] CAPITAL DYNAMICS, *supra* note 70, at 2.

[97] 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.

[98] JEFFERIES, GLOBAL SECONDARY MARKET REVIEW, *supra* note 93, at 7.

[99] 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 70, at 4.

[100] A portfolio strip sale involves "a partial sale of a fund's investment (strip) in all/some underlying assets to provide LPs with liquidity. This allows the fund to partially 'lock-in' any increase in asset values at the time of the sale, while still allowing the LPs to benefit from further upside via the fund's retained stake in the asset(s). The GP typically has discretion to determine the strip percentage and/or asset selection." Clifford Chance, *"Decoding" the Secondaries Market* 3 (Oct. 2019), https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2019/10/decoding-the-secondary-market.pdf.

[101] 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.*

[102] Shi, *supra* note 81.

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85% of these transactions, respectively.[103] In addition, some continuation funds are beginning to be created earlier in a fund's lifecycle,[104] a practice that also raises some investor concerns. In 2022, 60% of GP-led transactions involved funds aged between 1–6 years old, with 20% of those falling within the 1–3 year age range.[105]

A GP that forms a continuation fund can move a single asset or a small group of assets into that 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.[106] For example, in 2021, single-asset continuation funds accounted for 52% of all transactions led by GPs, compared to 38% in 2020.[107] Multi-asset continuation funds accounted for 31% and 34% of all GP-led transactions in 2021 and 2020, respectively.[108]

Finally, while the use of continuation funds is a global development, the North American market is, by far, the most active region, [109] with 71% of total GP-led transactions that closed in 2021 (249 out of 350 transactions) coming from this area.[110] The majority of this volume stemmed from large continuation fund transactions.[111]

Combining all these factors, the empirical evidence shows that continuation funds are no longer an esoteric phenomenon and are here to stay. As recently observed:

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[103] JEFFERIES, GLOBAL SECONDARY MARKET REVIEW, *supra* note 93, at 7; Shi, *supra* note 81; LAZARD 2021, *supra* note 95.

[104] 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.

[105] EVERCORE PRIVATE CAPITAL ADVISORY, 2022 SECONDARY MARKET SURVEY RESULTS 8 (Feb. 2023), https://indd.adobe.com/view/b50985c1-3819-4a23-849b-7d66e545df09; LAZARD PRIVATE CAPITAL ADVISORY, 2022 SECONDARY MARKET REPORT 7 (Feb. 14, 2023), https://www.lazard.com/research-insights/lazard-2022-secondary-market-report/; (hereinafter LAZARD 2022) ("Only a minority of transactions in today's market are taking place on fund vehicles that require the additional time to liquidate their portfolios").

[106] *Id.*

[107] Shi, *supra* note 81.

[108] *Id.* Similar distributions were observed in 2022. *See* JEFFERIES, GLOBAL SECONDARY MARKET REVIEW, *supra* note 93, at 7.

[109] LAZARD 2021, *supra* note 95, at 4.

[110] *Id.*

[111] *Id.*

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"[s]ponsors have become increasingly comfortable with continuation funds as another tool in their toolboxes, along with IPOs and sales to strategic or financial buyers."[112]

D. Continuation Funds' Web of Conflicts

The continued growth of continuation funds has also drawn the attention of large institutional investors and regulators.[113] While some investors and the SEC have expressed concerns about this rising trend and its reasons,[114] some crucial questions remain open: What types of misalignments of interests do continuation funds cause? How severe are these conflicts? What are the economic interests of the GPs? Are they more aligned with the interests of the buying or the selling LPs? We now turn to examine these questions.

1. GPs' Private Interests

From the perspective of the GPs, the mere initiation of a continuation fund is almost always a "win," providing the following substantial benefits:

Additional fees. Establishing a continuation fund enables GPs to earn *additional* management fees for an extended period. True, the management fee in continuation funds may be lower than in regular funds (for example, 1.5% in continuation funds versus 2% in regular funds).[115] However, the management fee in continuation funds is calculated as a percentage of the assets under management; thus the basis for calculating it is high from day one.[116] Since the value of the assets transferred to the continuation fund is likely to be higher than the value of the same assets in the legacy fund, the management fee of a continuation fund will increase accordingly and will likely offset any discount (in percentage) given to the investors in the continuation fund.

To illustrate this point, consider a fund with an asset initially valued at $500 million and subsequently sold to a continuation fund for $1 billion. Before the sale, the

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[112] Justin Johnson, *SEC Could Take Fairness Opinions From 'Nice to Have' to 'Must Have' for Continuation Funds*, SECONDARIES INV. (Apr. 19, 2022) https://www.secondariesinvestor.com/sec-could-take-fairness-opinions-from-nice-to-have-to-must-have-for-continuation-funds/.

[113] *See, e.g.,* Zak Bentley, *LPs Wonder If They Stand to Lose from 'Win-Win-Win' Continuation Funds*, SECONDARIES INV. (Dec. 12, 2022), https://www.secondariesinvestor.com/lps-wonder-if-they-stand-to-lose-from-win-win-win-continuation-funds/.

[114] *See supra* notes 11–13 and accompanying text.

[115] CAPITAL DYNAMICS, *supra* note 70, at 9 ("Management fees [in continuation funds] typically range from 0.50% to 1.25%.").

[116] Continuation funds generally charge management fees based on *invested* capital (not committed capital) from the outset, since most of the capital is invested in acquiring the target assets. Interview with Participant 12 (June 28, 2023).

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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 asset value, it remained the same at $10 million per year. Moreover, management fees are typically reduced as the fund nears its end.[117] By transferring the asset to a new fund, the GP receives fees for an extended period on the same asset, 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 most of the meaningful investment work. The GP has already chosen the companies to invest in and worked on improving them for several years. In a continuation fund, the GP's main task is to continue managing the assets, without necessarily making any new or time-consuming investment decisions.[118] Therefore, a continuation fund might enable the GP to do less but get paid more.

Crystallization 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, taking 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, the LPs that rolled over their investment did not obtain any liquidity, and the GP continues to run and benefit from the same assets. Moreover, the ability to take some money off the table also provides the GP with liquidity, enabling the GP to diversify some of the risk associated with the investment in the continuation fund. At that point, the carry is also no longer subject to a clawback provision that would require the GP to pay back the amounts of carried interest if some of the GP's successful investments are followed by losses.[119]

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

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[117] *See* CAPITAL DYNAMICS, *supra* note 70, at 9; Amy Carroll, *The Complex World of Management Fees*, PRIVATE FUNDS CFO (Oct. 3, 2022), https://www.privatefundscfo.com/the-complex-world-of-management-fees/.

[118] Tim Jenkinson, Hyeik Kim & Michael S. Weisbach, *Buyouts: A Primer* 21–22, 105 (Working Paper, 2021).

[119] Interview with Participant 3 (Jan. 26, 2023). 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. Shobe, *supra* note 38, at 1454–55.

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lifespan if the continuation fund sells its asset at a profit.[120] And while the carried interest in continuation funds may be lower than in regular funds (10–15% versus 20%),[121] 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 the expiration of the option contract, the more valuable the option will be, as the option holder has more time for the stock to move above the strike price.[122] Therefore, moving assets to a continuation fund provides the GP with an important benefit: more time to increase the value of the assets and to receive additional carry.

Obscuring true performance for a longer period. Continuation funds also undermine investors' ability to accurately measure the GP's performance when deciding whether to reinvest.[123] While the 10-year timeframe gives investors a yardstick for measuring fund managers' performance when deciding whether to reinvest, with continuation funds, the GP may be able to obscure its true performance for a longer period.[124]

The conclusion of this analysis is clear: GPs have a strong interest in establishing a continuation fund because it will provide them with multiple economic benefits. But what about the LPs?

2. GPs' Dual Loyalties

In a continuation fund transaction, the GP puts itself in a position where it is committed to two groups of investors whose interests are in direct conflict—*the exiting 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 are interested in paying the lowest price possible for the assets.[125] Thus, the GP, as a fiduciary to both the legacy fund and the

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[120] José Gabriel Palma, *Financialization as a (it's-not-meant-to-make-sense) Gigantic Global Joke,* CAMBRIDGE WORKING PAPERS IN ECONOMICS 15 (2022), https://api.repository.cam.ac.uk/server/api/core/bitstreams/8abfa04d-b1df-4870-97fc-79bf7f337d31/content.

[121] The carried interest in continuation funds can also be higher than in regular funds. Wong & Wong, *supra* note 5 ("Managers will frequently push for a super carry.").

[122] Merrill, *Options Pricing*, https://www.merrilledge.com/investment-products/options/options-pricingvaluation#:~:text=Time%20will%20also%20influence%20the,or%20below%20the%20strike%20price (last visited 02/14/23).

[123] *See, e.g.,* Rosenberg, *supra* note 43, at 395 ("[T]he short life of limited partnerships virtually guarantees…a 'periodic performance review' at the hands of their current investors.").

[124] *See* Harris, *supra* note 19, at 280–81.

[125] 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-

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continuation fund, must act in the best interest of each group of LPs and maneuver within a web of complex and conflicting loyalties.[126] These conflicts are further aggravated due to the GP's significant involvement in the negotiation, valuation, and pricing process, and the limited disclosure available to investors in private equity.[127]

There are legal mechanisms for addressing GPs' conflicts. Under the Investment Advisers Act of 1940, the requirements of fiduciary duties can largely be met by disclosure of conflicts and by receiving a conflict waiver.[128] In Delaware, where most private equity firms are formed, fiduciary duties can be modified or even waived entirely by an LPA's terms.[129] As we will show, the GP often receives a waiver from the LPAC approving the establishment of a continuation fund.[130] In such a case, the GP is in an *inherent* conflict of interest regarding the transaction price.

In a scenario where all or an overwhelming majority of LPs elect to roll over their shares, the conflict of interest generated by the continuation fund is not severe, as the same LPs sit on both sides of the transaction. Therefore, to assess the severity of the conflict 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 legacy funds elect to cash out rather than roll over their investments into continuation funds.[131] LPs tend to sell their interests for various reasons, which will be

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proliferation-of-continuation-funds-subscription-lines-report/. However, according to the ILPA, as a general principle, continuation fund transactions should maximize value only for *existing* LPs. *ILPA, Continuation Funds 2023, supra* note 73, at 4.

[126] GPs' legal fiduciary duties are outlined in the federal Investment Advisers Act of 1940 and states' limited partnership laws. 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, *The Private Equity Negotiation Myth*, *supra* note 19, at 77–78, 82.

[127] Interview with Participant 5 (Feb. 6, 2023).

[128] Clayton, *The Private Equity Negotiation Myth*, *supra* note 19, at 77.

[129] *Id.*

[130] *See infra* Section III.D.1.

[131] 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 RAYMOND JAMES, "LPs' selling participation in [continuation funds] remains well above historical levels, expected to continue to reach 80%+ volumes seen recently." RAYMOND JAMES, 2023 SECONDARIES OUTLOOK SURVEY 13 (Feb. 6, 2023), https://www.raymondjames.com/-/media/rj/dotcom/files/corporations-and-institutions/investment-banking/industry-insight/rjpca_2023_secondaries_outlook_survey_report.pdf. Another expert estimates that "[s]omewhere between 80 to 90 percent of limited partners are selling when they have the option to." Alicia McElhaney, *As Continuation Funds Plague LPs, Investors Search for a Solution*, INST. INV. (June 13, 2023),

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discussed in Part III.B. Regardless of the reasons, it is clear that the mere initiation of the continuation fund creates a significant turnover in the body of LPs, which exacerbates the severity of conflicts.

The GP's conflicted loyalties raise two opposing concerns.[132] The *first* is that the GP could maximize the profit for the LPs in the legacy fund at the expense of the new LPs. Since the GP earns 20% of the fund's profits as carried interest when liquidating the assets through a sale to the continuation fund,[133] it may seem reasonable that the GP would have an interest in overvaluing the assets in order to receive a higher carried interest.[134] The SEC raised this concern, noting that the adviser "may have incentives to bias the fair value estimates of the investment *upwards* in order to generate larger fees."[135]

However, the *second*, converse, concern is that the GP will act to maximize the interests of the new LPs at the expense of the legacy fund LPs. To prevent conflicts of interest arising from the GP deciding on the price 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 shows that the GP often meets this expectation.[136] Consequently, the GP's interests become aligned, to a significant extent, with those of the new LPs. At the same time, the reinvestment of the carried interest causes the GP's interests to be less aligned with those of the legacy fund LPs, thereby amplifying the agency problem with them.

Whether GPs are likely to use their discretion to bias the fair value estimates of the sold assets *upwards* (in favor of the selling LPs) or *downwards* (in favor of the new LPs) is not an easy question to answer. The lack of publicly available data regarding the valuations of the assets sold to the continuation funds makes it difficult to examine this question empirically. However, even without resolving this difficult question, it is clear that by making the GP a servant of two masters, continuation funds distort the high

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https://www.institutionalinvestor.com/article/b8z2xx0fp7ywh6/As-Continuation-Funds-Plague-LPs-Investors-Search-for-a-Solution.

[132] Hope, *supra* note 68.

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

[134] *See* The Healthy Markets Association Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 10–11 (Apr. 15, 2022) ("the greater the valuations of the securities, the greater the potential fees for the adviser.").

[135] *See* Documentation of Registered Investment Adviser Compliance Reviews, *supra* note 13, at 522.

[136] Reeve & McNaney, *supra* note 78 ("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 69, 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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incentives the GP had in the original private equity model to act as a faithful agent of a single group of investors—the legacy fund LPs—and get the best deal for them.

3. The House (GP) Always Wins

Our analysis leads to another clear insight: the GP has a strong financial interest in the *very establishment* of continuation funds regardless of the specific pricing of the transaction. 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 to the continuation fund) will be recovered (in full or in part) through the additional carry and return on investment it receives from the continuation fund. At the same time, the GP will *always* receive the additional private benefits outlined in Section II.D.1 (including additional management fees, the benefits of diversifying some of its risk by crystallizing its carried interest, and the benefit of reduced accountability), 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 an 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).[137]

The fact that the GP receives significant private benefits from a continuation fund transaction but bears only a fraction of the costs (by receiving a reduced carry when selling assets to a continuation fund) generates clear incentives for the GP to turn to continuation funds instead of pursuing other exit alternatives that could be more beneficial to investors.

[137] This example assumes that the sponsor establishes a continuation fund *in addition* to its regular ongoing fundraising activities, which is likely to be the case in reality.

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

In this Section, we show that the incentive 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 are the group of investors the GP must convince to "come on board" to even begin executing the transaction. Therefore, the GP is incentivized to provide the new LPs with a "sweetener," such as preferential price terms. This conflict might lead to an underpriced transaction where the new LPs benefit at the expense of legacy fund LPs.[138]

Second, many continuation funds include commitments by some of the new LPs to support ongoing fundraising (also known as "staple commitments") and commitments to generate follow-on capital for portfolio companies.[139] In recent years (2020–2022), more than 75% of GP-led transactions included LPs offering follow-on capital, and more than 24% included a staple commitment.[140] This practice could also contribute to a conflict of interest regarding the pricing of the continuation fund deal. For example, a GP might prefer a low bid on assets that come with an offer of a stapled commitment by some new LPs.[141]

Third, GPs could be biased towards the lead investors of the continuation fund due to their ongoing interactions and close relationships. The lead investors in continuation funds are often repeat players, including other private equity funds specializing in secondary transactions.[142] Evidence shows that the private equity industry

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[138] Eitan Tabak & Abbe L. Dienstag, *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.

[139] LAZARD 2021, *supra* note 95, at 9.

[140] EVERCORE PRIVATE CAPITAL ADVISORY, 2022 SECONDARY MARKET SURVEY RESULTS 8 (Feb. 2023), https://indd.adobe.com/view/b50985c1-3819-4a23-849b-7d66e545df09.

[141] Sophie Gioanni, *What Are Continuation Funds in Private Equity?*, LINCHPIN (Sept. 16, 2021), https://www.linchpin-advisory.com/post/what-are-continuation-funds-in-private-equity; Button, *supra* note 69 ("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.").

[142] Pitchbook, *U.S. PE Breakdown 2021* 41 (2022) ("Some firms prefer to bring in another sponsor to provide capital, expertise, and price discovery."); JEFFERIES, GLOBAL SECONDARY MARKET REVIEW, *supra* note 93, at 8 ("Many investors chose not to evaluate transactions involving sponsors they did not already have a meaningful relationship with."); LAZARD 2021, *supra* note 95, at 15. We examined the identities of investors in ten prominent continuation funds. Those cases illustrate that sophisticated

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has evolved over the years from being "mercenary" to being "a more collaborative clubbish culture."[143] Indeed, a record of 442 deals among private equity firms worth a total of $62 billion were completed in 2021.[144] 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."[145] This new web of relationships among private equity competitors, which is cozier than ever, supports our hypothesis that the GP's incentive structure will likely lead to a bias towards seasoned secondary buyers.

New empirical insights further support our analysis, showing that preferred investors with superior sophistication and bargaining power will be offered higher returns by GPs. Josh Lerner and colleagues found that GPs do not treat all LPs equally. LPs with better past performance are more likely to have access to alternative investment vehicles with above-average market returns than those with lower past performance.[146] Our hypothesis on GPs' bias towards new LPs, possibly leading to the underpricing of assets, also gains some support from data on sale prices collected in investor surveys. For example, in 2022, over 90% of continuation fund transactions were traded at some level of discount.[147] Furthermore, an analysis by Upwelling Capital Group shows 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."[148]

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investors (other private equity funds and large institutional investors, that differ from traditional institutional investors that invest in private equity funds) usually lead investments in continuation funds. Information on these transactions is on file with the authors.

[143] 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.

[144] *Id.*

[145] *Id. See also* COATES, *supra* note 56, at 92 ("[T]hrough club deals, secondary buyouts, and lobbying through trade groups, [private equity firms] function less like rivals than allies.").

[146] Lerner et al., *supra* note 61, at 359–61. According to the authors, when providing access to alternative investment vehicles (including continuation funds), GPs do not treat all limited partners equally, but instead differentiate between them based on their outside options.

[147] RAYMOND JAMES, *supra* note 131, at 2, 12. According to William Blair's survey report, most closed deals (72%) were priced between 90-100% of NAV, 12% between 80-90% of NAV, 10% under 80% of NAV, and only 6% above NAV. WILLIAM BLAIR PRIVATE CAPITAL ADVISORY, INAUGURAL SECONDARY MARKET SURVEY REPORT 5 (Feb. 24, 2023), https://www.williamblair.com/Insights/William-Blair-Private-Capital-Advisory-Inaugural-Secondary-Market-Survey-Report; JEFFERIES, GLOBAL SECONDARY MARKET REVIEW, *supra* note 93, at 8 ("GP-led secondary pricing saw a notable decrease in 2022 vs. prior years with ~40% of transactions trading at a discount in excess of 5% to GPs' latest holding values.").

[148] Le, *supra* note 131; *Are LPs Missing the Boat? Examining GP-Led Secondaries in the Private Equity Market*, UPWELLING CAPITAL GROUP 5 (Q4 2022), https://upwellingcapital.com/wp-content/uploads/2022/10/Continuation-Vehicles-Research-Report-2022-Upwelling-Capital-Group.pdf.

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5. The Efficiency Costs of Continuation Funds

As discussed in Section I.A., the efficiency of the private equity model is essentially based on a compensation structure that motivates the GP to maximize value for other LPs and the pre-defined limited duration of funds. By their very nature, continuation funds distort these features, breaking the incentive-compatible structure of a limited term. This deviation not only results in distributional effects (e.g., transferring benefits between LPs and GPs or among different groups of LPs), but also imposes efficiency costs.

First, continuation funds may lead to suboptimal utilization of LPs' capital by GPs. The 10-year limited duration restricts GPs' power to maintain underperforming portfolios just to generate an additional fee income, while continuation funds provide them with an extended timeframe to do so. Furthermore, in a standard exit, GPs' desire to receive a high carried interest motivates them to act as faithful agents of LPs and get the best deal for them. However, due to GPs' potential private benefit from establishing a continuation fund, they might sacrifice exit options that may result in better returns and higher value creation, such as IPOs or sales to strategic buyers.[149] Those potentially inefficient decisions result in suboptimal capital allocations: assets are not transferred to and managed by the buyer best able to maximize their value.[150] Also, without active bargaining by the GP for better exit options, these alternatives, in most cases, are simply not known to legacy fund LPs.

Second, continuation funds exacerbate the information asymmetry problem in the private equity industry. During the funds' lifetimes, GPs' valuations are highly subjective and susceptible to manipulation due to the absence of public information and asset illiquidity. Unlike LPs, GPs have inside information, but conflicting interests may hinder them from providing accurate information to LPs. This information gap closes when

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[149] *See* Section II.D.3.

[150] Blue Yonder's case may illustrate this concern. Blue Yonder was intended to be the largest asset of New Mountain's multi-asset continuation fund. However, following months of planning the transaction and well into the process, it turned out that Panasonic, one of Blue Yonder's shareholders, was eager to acquire it, as it ultimately did. This suggests that New Mountain Capital might not have fully explored alternative exit options before commencing the construction of the continuation fund. Chris Witkowsky, *Ardian and New Mountain end $2bn-plus GP-led after Blue Yonder acquisition*, BUYOUTS (Apr. 23, 2021), https://www.buyoutsinsider.com/ardian-and-new-mountain-end-2bn-plus-gp-led-after-blue-yonder-acquisition/.

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portfolio companies are sold in an arms-length transaction.[151] However, continuation funds allow GPs to *delay* this crucial "market check" on their valuations.

While continuation fund transactions often involve new buyers, these transactions do not impose the same market check as traditional exits. In a conventional exit, the GPs' interest in selling at the highest price possible creates bargaining that reveals the assets' actual value. In contrast, in continuation funds, the GPs' dual role gives them substantial control over the negotiation process, including valuation and pricing, and their incentive may not be achieving the highest price for the assets.[152] As a result, continuation fund transaction prices are less reliable in reflecting investments' actual value. Furthermore, the absence of systematic performance data collected by major data vendors makes the assessment of sponsors' performance even more challenging for LPs.[153] This situation also gives GPs more time to conceal or overstate performance metrics, impairing investors' ability to evaluate their competence.

Finally, private equity investments shield portfolio companies from mandatory disclosures and public scrutiny. With continuation funds, companies remain in "private equity darkness" for extended periods.[154] During this duration, potential social harms remain hidden, competition within the portfolio companies' industries could be suppressed, and the ingress of new competitors might be hindered.[155]

6. The Advisors' Incentives

Until now, the discussion has solely focused on the parties whose direct economic interests are at stake—the sponsors and investors. However, they both 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 tends to be drawn from a very small set of elite law firms specializing in private equity practice, and most tend to focus primarily on sponsor-side or investor-side work.[156] This also applies to financial advisors.[157] As a result, these advisors are the purest

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[151] *See supra* notes 48–49, and accompanying text.

[152] *See* Section II.D.4.

[153] Lerner et al., *supra* note 61, at 360–61.

[154] COATES, *supra* note 56, at 74.

[155] *Id.* at 74, 88.

[156] *See* Fontenay & Nili, *supra* note 59.

[157] See, e.g., Lucian Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair are They and What Can be Done About it?*, 1989 DUKE L. J. 27, 37–42 (1989).

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repeat players in the private equity industry:[158] they set market standards and derive significant economic benefits from developing the continuation fund practice.[159]

Legal and financial advisors may also have financial interests in developing the continuation fund phenomenon. For sponsor-side lawyers and advisors, and for advisors that represent rolling-over LPs, continuation funds present an opportunity to provide advisory services twice for the sale of the same asset(s) when: (i) the assets are sold to the continuation fund, and (ii) the continuation fund conducts its exit via a sale to a third party or an IPO. With these transactions reaching their highest volume in history,[160] there is much more paid work for advisors.

We do not suggest that legal and financial advisors are the sole drivers behind the rise in continuation funds. However, the financial interests of these advisors in the initiation of continuation funds could push them towards advising their clients to use the continuation fund structure more than is optimal for the LPs.

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This Part explored the rise of continuation funds—one of the most popular trends in the private equity market—and analyzed their advantages as well as the web of unique conflicts of interest that they raise. Our theoretical analysis of continuation funds suggests several insights challenging the "win-win-win" perspective. *First*, GPs' financial incentives and personal benefits might cause them to establish a continuation fund even if it is suboptimal for investors. *Second*, continuation funds often benefit one group of LPs over another, likely new LPs (that are sophisticated investors or funds specializing in secondary transactions) over legacy fund LPs. For the latter, the GP is no longer their faithful agent in the transaction negotiation, potentially leading to underpriced transactions or a loss of better exit opportunities.

Continuation funds also subject rolling LPs to prolonged fee periods and defer their expected liquidity, while the GPs have already received their profits. Indeed, some LPs we interviewed explained that once the carry is crystallized, the GP does not have

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[158] 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).

[159] 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.

[160] *See supra* note 93.

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to re-earn it, and it is no longer subject to a clawback provision that enhances the alignment of interests.[161] According to them, it is better if the GP is required to re-earn the carried interest, and the GP should not collect carried interest from the rolling LPs before these investors see profits on their investment.[162] Our interviews and recent data support this analysis, painting a picture of substantial skepticism towards continuation funds among the overwhelming majority of LPs,[163] with survey results revealing a mere 6% of LPs expressing significant interest in such funds.[164]

Regulators and market players have not remained indifferent to continuation fund conflicts. But, the extent to which the various mechanisms adopted by them are *effective* in addressing continuation fund 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 legacy funds LPAs 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 continuation fund transactions. On the investor side, we contacted senior officers of asset managers who tend to invest as LPs. All interview subjects had at least

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[161] *See supra* note 119.

[162] Interview with Participant 9 (Jan. 30, 2023); Interview with Participant 7 (Jan. 27, 2023).

[163] Chris Witkowsky, C*ontinuation Funds, NAV Loans Potentially Disruptive of LP/GP Relationship: Goldman Survey,* BUYOUTS (Sept. 28, 2023), https://www.buyoutsinsider.com/continuation-funds-nav-loans-potentially-disruptive-of-lp-gp-relationship-goldman-survey/ ("A large swath of LP respondents believe continuation funds […] negatively impact their alignment of their relationships with GPs.").

[164] *See* Farman, *supra* note 15.

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10 years of experience, and often significantly more. To encourage candid and detailed responses, the interview participants were promised anonymity.[165] This allowed us to access market participants who might have otherwise been disinclined to participate.

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 necessarily representative of the continuation fund industry. To mitigate potential biases in our sample, we ensured a representation of interview subjects who work on the investment side and who advise private equity sponsors to obtain the perspectives of those sitting on different sides of the table. We also ensured that interview subjects are market leaders. Altogether, the partners we interviewed were involved in over 85 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 data source. Rather, we supplemented the findings of the interviews with an extensive review of publicly available sources on continuation funds (such as reports prepared by financial advisors and other professionals who closely follow the continuation fund market). We also reviewed and analyzed all comment letters related to continuation funds that were submitted to the SEC by various market players.[166] Altogether, this mixed-method strategy enabled us to shed new light on the realities of private equity continuation funds.

B. Testing the Assumption that Sophisticated LPs Can Protect Themselves

Supporters of continuation funds often emphasize that legacy fund LPs maintain the *independent choice* of whether to sell their interests or roll them over into the continuation fund.[167] This possibility purportedly gives legacy fund LPs the power to fend for themselves. 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.[168] We discuss these major challenges below.

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[165] The authors retained copies of each interview transcript and/or detailed notes, with personal information removed.

[166] We reviewed and analyzed 18 comment letters submitted to the SEC that referred in detail to the rules regarding continuation funds. The commentators included various institutions: institutions affiliated with private equity firms, institutions affiliated with limited partners, and independent constituencies.

[167] *See supra* Section II.B.

[168] *See, e.g.,* Le, *supra* note 131 (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").

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Lack of sufficient information. LP investors often suffer from significant informational disadvantages when faced with the dilemma of whether to opt for a liquidity opportunity or invest in continuation funds.[169] The GP exercises substantial control over the information flow about the assets' performance, while the LPs, especially those that are not members of the small LPAC group, have limited access to this information.[170] In such a situation, there is a concern that the GP may use its informational advantage strategically.[171] 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.[172] As our interviewees 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.[173] In addition, LPs lack information regarding continuation funds' *returns*. Major data vendors do not collect systematic information about their performance, and focus instead on traditional funds.[174] This information gap may cause investors to hesitate to roll their interests into continuation funds.

Lack of expertise. Legacy fund LPs do not necessarily have the skills and capacity to make complex investment decisions in continuation funds. Some LPs have small investment teams lacking any experts in GP-led secondary transactions.[175] As explained

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[169] 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.; Interview with Participant 6 (Jan. 18, 2023).

[170] Harris, *supra* note 19, at 277–78; Magnuson, *supra* note 19, at 1881–82.

[171] 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).

[172] Interview with Participant 9 (Jan. 30, 2023); Interview with Participant 6 (Jan. 18, 2023).

[173] Interview with Participant 6 (Jan. 18, 2023); Interview with Participant 5 (Feb. 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.").

[174] Lerner et al., *supra* note 61, at 360–61.

[175] Interview with Participant 3 (Jan. 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 173; 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-

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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.[176] However, in the continuation fund context, this responsibility shifts once again from the GP to the LPs.[177] One senior investment manager explains that many LPs opt to sell because in 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.[178]

One can contend that while legacy fund LPs may not possess sufficient information and expertise to make an informed decision about rolling over their investments, there is one crucial piece of data they can rely on: the transaction price. The willingness of new LPs, typically specializing in secondary transactions, to pay the transaction price indicates the expected profitability of the transaction and allows legacy fund LPs to follow their lead. However, new LPs, typically more sophisticated investors with prior relationships with GPs, may engage in specific investments as part of their broader relationship with the GP, unbeknownst to legacy fund LPs. These new LPs may receive future compensation, such as access to alternative investment opportunities, in exchange for investing in a continuation fund.[179] Hence, the price new LPs are willing to pay for a particular transaction cannot be considered a sufficient indicator. Additional factors contribute to legacy LPs' hesitation to follow buyers' lead, such as time constraints due to institutional requirements and different risk tolerances.

Lack of time. LPs often have a short timeframe, only 10–20 days, to decide 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.[180] This problem is further aggravated as continuation funds gain popularity.

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lps-await-new-guidance-gp-led-secondaries. (explaining that pension plans which manage significant amounts of capital often have small teams).

[176] Interview with Participant 3 (Jan. 26, 2023); Interview with Participant 5 (Feb. 6, 2023).

[177] Le, *supra* note 131; *supra* note 173.

[178] 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."); McElhaney, *supra* note 131 ("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."); *ILPA, Continuation Funds 2023*, *supra* note 73, at 3.

[179] Lerner et al., *supra* note 61, at 360–61.

[180] *ILPA, Continuation Funds 2023*, *supra* note 73, at 3; Sonia Gioseffi, Yasho Lahiri & Aaron Russ, *Breaking Up Is Hard to Do, So Let's Stay Together: An Analysis of Issues in Continuation Funds*, 28 THE

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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.[181] Additionally, some legacy fund LPs, such as state pension funds, need to comply with the 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.[182] 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.[183]

Lack of status quo option. LPs may also avoid rolling over their investments due to the lack of a status quo option.[184] When LPs are given only an option of rolling over their investments if they contribute new capital or accept revised economic terms, some LPs perceive it as coercive,[185] especially when the continuation fund is established early in the life of the legacy fund.[186] Although the reset terms may sometimes appear

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INVESTMENT LAWYER 4 (Nov. 2021), https://marketingstorageragrs.blob.core.windows.net/webfiles/IL_Gioseffi-Lahiri-Russ_1121.pdf; ("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.").

[181] Interview with Participant 5 (Feb. 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").

[182] Interview with Participant 5 (Feb. 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."); *Are LPs Missing the Boat? Examining GP-Led Secondaries in the Private Equity Market*, UPWELLING CAPITAL GROUP 5 (Q4 2022), https://upwellingcapital.com/wp-content/uploads/2022/10/Continuation-Vehicles-Research-Report-2022-Upwelling-Capital-Group.pdf ("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."); *ILPA, Continuation Funds 2023, supra* note 73, at 9.

[183] McNally, supra note 175.

[184] Adam Le, *GPs Are Strengthening Their Skin in Game with Continuation Funds*, SECONDARIES INVESTOR (Feb. 21, 2023), https://www.secondariesinvestor.com/gps-are-strengthening-their-skin-in-game-with-continuation-funds-william-blair/.

[185] Chris Witkowsky, *Why Some GPs See No Need to Offer a Status Quo Option*, SECONDARIES INV. (Dec. 21, 2020), https://www.secondariesinvestor.com/why-some-gps-see-no-need-to-offer-a-status-quo-option/.

[186] Some continuation funds are beginning to be created earlier in a fund's lifecycle, a practice that also raises some investor concerns. *Global Fund Performance Report*, PITCHBOOK 31 (Nov. 2022), https://pitchbook.com/news/reports/2022-global-fund-performance-report-as-of-q1-2022-with-preliminary-q2-2022-data. In 2022, 60% of GP-led transactions involved funds aged between 1–6 years

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advantageous at first glance, rolling LPs may lose benefits they successfully negotiated in the legacy fund, such as preferred returns or hurdle rates. Additionally, when LPs are required to commit new capital to maintain their investments, it can trigger institutional requirements that pose challenges, such as the need to present the plan to their investment committees.[187]

Capital allocation, diversification, and liquidity. Some LPs may choose to cash out due to "external" considerations unrelated to the deal terms, such as liquidity preferences, the need to rebalance their investment allocation, or the need to maintain an appropriate level of portfolio diversification.[188] 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.[189] Similarly, investments in continuation funds, especially single-asset funds that are increasingly common, are less diversified and could increase investors' portfolio risk or contravene their guidelines.[190]

Internal Agency Problems. Agency problems of investment professionals may also incentivize LPs to cash out. As one interviewee explained, the compensation structure of investment professionals at public pension funds may incentivize them to opt for a short-term liquidity event, given that some of them have no plans to remain in the same workplace three or four years down the road.[191]

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old, with 20% of those falling within the 1–3 year age range. *See* EVERCORE PRIVATE CAPITAL ADVISORY, 2022 SECONDARY MARKET SURVEY RESULTS 8 (Feb. 2023), https://indd.adobe.com/view/b50985c1-3819-4a23-849b-7d66e545df09; LAZARD PRIVATE CAPITAL ADVISORY, 2022 SECONDARY MARKET REPORT 7 (Feb. 14, 2023), https://www.lazard.com/research-insights/lazard-2022-secondary-market-report/ [hereinafter LAZARD 2022] ("Only a minority of transactions in today's market are taking place on fund vehicles that require the additional time to liquidate their portfolios.").

[187] Witkowsky, *supra* note 185.

[188] *See* interview with Participant 5 (Feb. 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.").

[189] Hope, *supra* note 68; Interview with Participant 6 (Jan. 18, 2023); Interview with Participant 7 (Jan. 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 (Jan. 27, 2023).

[190] 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 ("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 95, at 14.

[191] Interview with Participant 5 (Feb. 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

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Altogether, our analysis and insights from the interviews may explain why sophisticated investors may be "forced" to sell their stakes under unfavorable conditions. Contrary to the theory that celebrates contractual freedom in the private equity context, continuation funds provide additional evidence that even sophisticated investors with an "election option" may face difficulties in protecting their interests.[192] As a senior director at the Institutional Limited Partners Association (ILPA), observed, "[j]ust because LPs are accepting a liquidity route doesn't mean they want to sell."[193]

C. Testing the Role of Reputation and Ongoing Relationships

Parties in long-term ongoing relationships rely often on non-legal sanctions to maintain cooperation and deter misbehavior.[194] The private equity ecosystem shares similar characteristics.[195] The parties in an investment fund enter into a long-term contract that spans ten or more years, with a blind pool of investments, and strong dependency on the sponsor to navigate the fund throughout its life cycle. The long-term relationships and repeat interactions among GPs and LPs are expected to encourage strong reliance on reputational forces rather than courts to align the parties' interests. It should also encourage the parties to find a way to negotiate disputes related to continuation funds in a way that will create value for all parties and will ensure the continuation of their relationship.

Interestingly, our interviews revealed two distinct attitudes toward the GP's behavior and motivations. On the one hand, some LPs have expressed concerns with the GP's motives in moving assets from the legacy fund, sometimes very early.[196] They were worried about GPs establishing continuation funds just to provide liquidity for themselves (for example, in order to cash out departing partners) or to enable them to

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the fact that they are not planning to stay in the plan for three or four years, to take the short-term liquidity event).

[192] Clayton, *High-End Bargaining Problems, supra* note 41; Clayton, *The Private Equity Negotiation Myth*, *supra* note 19.

[193] McElhaney, *supra* note 131.

[194] *See, e.g.,* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study,* 28 AM. SOC. REV. 55 (1963); Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 879 (2000); For a review, *see* 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.

[195] *See, e.g.,* 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).

[196] See *supra* note 105, and accompanying text.

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receive additional management fees and carried interest.[197] They explained that these concerns, along with time, knowledge, and liquidity considerations, may lead them to cash out.[198] On the other hand, 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 GP in subsequent funds or because of the way the GP is invested and incentivized in the continuation fund.[199]

How can we reconcile these two narratives? Our interviews, aligned with the theoretical analysis presented in the previous part, suggest that the answer lies in the heterogeneity of LPs. LPs do not constitute a single entity. LPs' differences, especially in terms of sophistication and bargaining power, significantly impact their relationships with the GP, including the degree to which the GP wishes to maintain a relationship with them.[200]

As described in Section II.D.4, large LPs are often sophisticated repeat players specializing in secondary transactions, and the GP may have ongoing interactions and close relationships with them. The multiple interactions increase LPs' trust in GPs, encouraging them to roll over their stake or invest in continuation funds on the secondary market.[201] In contrast, smaller LPs have limited interactions with the GP,[202]

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[197] Interview with Participant 9 (Jan. 30, 2023) (stating that if GPs need more time for the investment, then why don't they extend the life of the fund).

[198] *See supra* Section III.B. Agency problems may also incentivize LPs to cash out (interview with Participant 5 (Feb. 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 to take the short-term liquidity event).

[199] Interview with Participant 7 (Jan. 27, 2023) (stating that if an LP decides not to invest with the general partner GP in the future, they will cash out. Conversely, if an LP has faith in the GP, they will be inclined to participate); Interview with Participant 8 (Jan. 27, 2023) (stating that the less likely LPs are to invest with the GP next time, they prefer to take cash off the table); Interview with Participant 9.

[200] A recent survey supports this view, showing that the majority of investors are skeptical about continutation funds, with only 6% expressing a great level of interest in these funds and 24% expressing a moderate level of interest. *See* Farman, *supra* note 15.

[201] Large LPs with long-term relationships with GPs also seek specific protections through side letters aimed at ensuring that their often no-fee, no-carry co-investments will not be dragged into a continuation fund that would charge them new fees. Some also want the right to greenlight the continuation fund deal. (Chris Witkowsky, *LPs want protections from continuation funds for their 'no fee' co-investments*, Buyouts (Sept. 6, 2023), https://www.buyoutsinsider.com/lps-want-protections-from-continuation-funds-for-their-no-fee-co-investments/.

[202] McNally, *supra* note 183 (explaining that pension plans which manage significant amounts of capital often have small teams).

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and their ability to retaliate if the GP misbehaves is also limited. As a result, sponsors care less about maintaining relationships with them, and they are more likely to cash out.

Additionally, despite the anger or frustration often expressed by LPs in connection with the use of continuation funds, our interviews show that private equity investors generally avoid using litigation to enforce their rights. Absent extreme circumstances of fraud, LPs rarely sue the GP.[203] Our interviewees explain that LPs are unlikely to sue a GP due to reputational concerns, especially if they want to continue investing in private equity in the future.[204] No market player wants to be the investor that has a bad reputation among GPs as one that takes them to court.[205] LPs could still express their discomfort by threatening not to invest with the same GP in the future,[206] but if the GP is well-preforming, such a threat could be less credible for small LPs competing for attractive investment opportunities.

Therefore, the effectiveness of non-legal sanctions and reputation in ongoing repeat relationships seems stronger for large and sophisticated investors and weaker when it comes to investors with little bargaining power.

D. Resolving Continuation Funds' Conflicts: Market Practices

Continuation funds also serve as an interesting case study for examining how sophisticated parties–GPs and LPs—handle conflicts of interest. This Section explores these mechanisms, which include (i) subjecting the initiation of these funds to the approval of the LPAC, (ii) requiring the sponsor to reinvest its profits into the continuation vehicle, and (iii) using a competitive bid. It also assesses their effectiveness in addressing continuation fund conflicts.

1. Approval by LPAC

The LPAC is an advisory committee consisting of representatives of LPs chosen by the GP.[207] Most LPACs include the largest LPs in the fund[208] or LPs with

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[203] Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 3 (Jan. 26, 2023); Interview with Participant 8 (Jan. 27, 2023).

[204] Interview with Participant 7 (Jan. 27, 2023); Interview with Participant 8 (Jan. 27, 2023).

[205] *Id.*

[206] Interview with Participant 8 (Jan. 27, 2023).

[207] Gabriel Boghossian & Sarah de Ste Croix, *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/.

[208] 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*

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longstanding relationships with the GP.[209] The most common functions of an LPAC include reviewing and resolving any conflict of interest in advance and waiving certain restrictions in the LPA.[210] While regulators do not mandate the use of LPACs,[211] they have become fixtures of private equity funds, with 95% of funds having one.[212] The formation of a continuation fund clearly presents conflicts of interest between a sponsor and the LPs requiring LPAC approval according to the typical fund agreement.[213] Indeed, our interviewees confirmed that when a GP initiates a continuation fund, the standard practice is to turn to the LPAC.[214]

As LPAC members are often the most sophisticated investors with the highest stakes in the fund, it is presumed that they have powerful incentives to achieve the optimal result for all LPs. It is also easier and quicker to negotiate with a small body of

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Governance, VISTRA (2017), https://www.acg.org/sites/files/Vistra%20Private%20Equity%20Research.pdf.

[209] Claire Wilson, *The Power of the LPAC*, PRIV. FUNDS CFO (Nov. 16, 2017), https://www.privatefundscfo.com/committed-capital/.

[210] 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; Dylke, *supra* note 6.

[211] Wilson, *supra* note 209.

[212] *See* Seber, *supra* note 210.

[213] While it is possible to include pre-clearance provisions in LPAs, allowing GPs to skip LPAC review and consent, such provisions are uncommon in the marketplace. Chris Witkowsky, *LPs Push Back Against 'Pre-clearance' of GP-led Deals*, BUYOUTS (Feb. 3, 2023), https://www.buyoutsinsider.com/lps-push-back-against-pre-clearance-of-gp-led-deals/.

[214] Interview with Participant 2 (Jan. 25, 2023) (noting that "[y]ou will never catch a sponsor try to do one of these [continuation fund] transactions without LPAC consent. It is just not done"); Interview with Participant 3 (Jan. 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 (Jan. 18, 2023); Interview with Participant 5 (Feb. 6, 2023) (noting that "[o]ur advice [to GPs] is to pick up the phone and preview [the continuation fund deal] with the two or three largest LPs as well as LPAC members individually before they go spending any money on it"). In a well-run process, the LPAC receives disclosure regarding the rationale behind the transaction, its timeline, the solicitation process, an overview of the economics of the deal terms, and most importantly, any conflicts related to the transaction. These potential conflicts include the crystallization of carried interest and any economic incentive accruing to the GP, such as stapled financing and changes to the preferred return. 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. *See ILPA, Continuation Funds 2023, supra* note 73, at 6–8.

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LPs, which is more agile in its decision-making, than the full investor base.[215] Additionally, the GP would be comfortable sharing sensitive information with the LPAC, which it may otherwise be reluctant to disclose to a larger body of LPs.[216] Therefore, at least on its face, the use of an LPAC seems a creative solution devised by sophisticated parties to handle conflicts efficiently. 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.

More specifically, one interviewee explained that the LPAC tends to approve almost every conflicted transaction that the GP brings before them, and that this body has a lot of confidence in the GP.[217] They also explained that those who sit on the LPAC are hand-picked by the GP, which often has full discretion over the composition of the LPAC.[218] Investors who are selected to the LPAC also have some ongoing relationship with the GP, have already committed considerable 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.[219]

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 LPs that elected to cash out and have opposing interests.[220]

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[215] Gabriel Boghssian, *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/.

[216] *ILPA, GP-led Secondary Fund Restructurings 2019*, *supra* note 71.

[217] Interview with Participant 8 (Jan. 27, 2023); Interview with Participant 7 (Jan. 27, 2023).

[218] *Id.*

[219] *Id.* One of the interviewees, who advises GPs, noted that he had seen a few scenarios where LPACs do not consent to the transaction immediately, typically when the sponsor does not roll its 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 (Jan. 25, 2023).

[220] Claire Wilson, *The Power of the LPAC,* PRIVATE FUNDS CFO (2017) https://www.privatefundscfo.com/committed-capital/.

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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 has no duties to other investors in the fund.[221] In that sense, "the LPAC is not the equivalent of a board of directors."[222] 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 conflicts of interest between the LPAC members and other LPs.

Those conflicts and the GPs' power over the nomination of the LPAC led one interviewee on the LP side to conclude that LPACs are not independent and are unsuited for this role.[223] Therefore, for a transaction of such significance, another interviewee claimed that "an LP vote will be fairer."[224] This view is further corroborated by a recent survey that shows many LPs are dissatisfied with this governance model, which relies mostly on LPACs to resolve conflicts.[225] 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.[226] For this reason, the survey mentions that there are certain key matters, such as those related to the 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 LPAC mechanism has great potential to streamline the process of reviewing a GP's conflicts, in reality, many LPs question its effectiveness.

2. Increasing GPs' Skin in the Game

LPs buying in often want the GP to make significant commitments to the continuation fund, thereby increasing the alignment between these LPs and the GP, particularly if the GP is expected to realize significant carry in connection with the

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[221] Clayton, *The Private Equity Negotiation Myth, supra* note 19, at 105; Interview with Participant 5 (Feb. 6, 2023).

[222] Seber, *supra* note 210.

[223] Interview with Participant 8 (Jan. 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).

[224] Interview with Participant 9 (Jan. 30, 2023).

[225] *Private Equity Fund Governance*, VISTRA (2017) https://www.acg.org/sites/files/Vistra%20Private%20Equity%20Research.pdf.

[226] *Should LP's Be Worried About LPACs?, Private Equity Merger*, MORGAN LEWIS (Aug. 2014) https://www.morganlewis.com/pubs/2014/08/pem_shouldlpsworryaboutlpacs_august2014.

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continuation fund transaction.[227] One interviewee noted that typically, when the GP does not roll over its carried interest to the continuation fund, or rolls over just 50% or less of it, there could be some investor pushback to the deal.[228] Indeed, in the past few years, many GPs have signaled their confidence in their continuation fund deals by increasing their skin in the game,[229] either by rolling a significant fraction of their carried interest or by providing up to 10% of the investor commitment to the continuation fund.[230]

GPs' decision to increase their commitments in continuation funds certainly improves the alignment of interests with LPs rolling over their stakes to the continuation fund and with the new LPs investing in the continuation fund. However, such commitments do not align with and aggravate the conflicts of interest between the GP and a large group of LPs—those cashing out.[231] When the GP has a significant financial interest in the new fund, this financial interest and the additional considerations detailed

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[227] *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. According to the ILPA, the GP should roll 100% of the carried interest into the continuation fund. If not, they must explain why and provide alignment incentives for the new vehicle. *ILPA, Continuation Funds 2023, supra* note 73, at 4, 11.

[228] Interview with Participant 3 (Jan. 26, 2023).

[229] Jennifer Banzaca, *How Managers Can Strike the Right Balance with Continuation Funds*, SECONDARIES INV. (Apr. 5, 2022), https://www.secondariesinvestor.com/how-managers-can-strike-the-right-balance-with-continuation-funds/.

[230] For example, one 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. It also shows that when GPs do not provide a new direct commitment to the continuation fund, they invest a large fraction of crystallized carry from existing funds in the continuation fund. *See 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. 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. Reeve & McNaney, *supra* note 78. GPs could also invest alongside their continuation funds with their flagship funds, or contribute additional new capital through their flagship funds. Increasingly, these two practices are becoming more prevalent, with 56% of continuation fund transactions in 2022 involving at least one of them. RAYMOND JAMES, *supra* note 131, at 8; JEFFERIES, GLOBAL SECONDARY MARKET REVIEW, *supra* note 93, at 7 ("Continuation vehicle transactions featuring parallel cross-fund investments from a sponsor's current flagship fund […] comprised ~25% of single-asset transactions in 2022."); LAZARD 2022, *supra* note 105, at 8.

[231] As data shows, this group is quite substantial: at least in the most recent deals, between 80%-90% of LPs chose to sell rather than roll over their investments to the continuation fund. See *supra* note 131.

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in Section II.D.4 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.

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.[232] 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. The GP will also hire an agent to determine if investors are willing to bid and at what price. Through that process, the GP will reveal the market estimation of the asset's value.[233] If the GP considers none of the proposals good enough, it would suggest to the LPs to keep the asset in a continuation fund and ensure that the transaction price matches the highest bid it received.[234] Depending on the portfolio, the GP may invite one or more third parties to be lead investors. Those lead investors, mostly funds specializing in valuing specific assets in the secondary market, are responsible for negotiating the purchase terms with the GP.[235]

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 hired by the GP.[236] Ostensibly, a market-process solution, which involves a sophisticated player on the buy side and is intended to mimic an arms-length transaction, enables the LPs to rely on that third party to validate the fairness of the transaction. However, LP interviewees believe that even market-based solutions might not fully resolve continuation fund conflicts. For example, one interviewee expressed concern regarding 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.[237] LP interviewees also complained that

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[232] *ILPA, Continuation Funds 2023, supra* note 73, at 11–12.

[233] Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 4 (Jan. 27, 2023); Interview with Participant 7 (Jan. 27, 2023).

[234] Interview with Participant 7 (Jan. 27, 2023).

[235] Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 6 (Jan. 18, 2023). *See also supra* note 142 and accompanying text.

[236] Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 4 (Jan. 27, 2023); Interview with Participant 3 (Jan. 26, 2023); Interview with Participant 6 (Jan. 18, 2023).

[237] Interview with Participant 7 (Jan. 27, 2023).

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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.[238]

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,[239] which could extend 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).[240] In that case, a GP might prefer a low bid on assets that come with an offer of a stapled commitment, and refrain from seeking a higher bid.[241] In line with the analysis provided in Section II.D.4, one interviewee explained that in situations that generate conflicts of interest between different LPs, the GP may favor the new large investors (often repeat and seasoned players) at the expense of other investors.[242]

Finally, it should be remembered that the new lead investors represent only the interests of the buying LPs, which are 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.

4. The Road Not Taken

In addition to examining the main practices employed by market players to navigate continuation fund conflicts, it is also essential to consider alternative routes that were *not* followed by them. For example, market players could incorporate new terms into the LPA that provide pre-clearance of conflicts of interest related to these deals, allowing the GP to bypass the LPAC review and consent process. However, LPs generally push back against such terms, arguing that it is challenging to predict the complexities of transactions that may occur several years down the line.[243] Consequently, pre-clearance provisions are rare in the marketplace.[244] Conversely, there is also no pre-ban on the formation of continuation funds, and LPAs do not include terms to protect LPs' interests in continuation fund transactions.[245]

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[238] Interview with Participant 6 (Jan. 18, 2023).

[239] *See supra* note 201; Interview with Participant 8 (Jan. 27, 2023) (stating that sometimes investors that do not have the relationship with the GP to do co-investment will use a continuation fund to establish a relationship).

[240] Interview with Participant 7 (Jan. 27, 2023).

[241] Gioanni, *supra* note 141.

[242] Interview with Participant 7 (Jan. 27, 2023).

[243] *See* Witkowsky, *supra* note 185. *See, e.g., ILPA, Continuation Funds 2023, supra* note 73, at 4, 6, 12; Interview with Participant 6 (Jan. 18, 2023); Interview with Participant 7 (Jan. 27, 2023).

[244] *Id.*

[245] ILPA, *Continuation Funds 2023, supra* note 73.

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Moreover, contractual mechanisms aimed at facilitating the ability of LPs to roll over or make an informed selling decision, such as extended election periods, or a status quo option, are not commonly observed. Similarly, provisions aimed at empowering LPs in the continuation fund process or implementing cost-sharing mechanisms are also uncommon. Part IV sheds light on the reasons behind the lack of variation in governance terms governing the use of continuation funds.

E. A Critique of the SEC's Reform

The SEC recently adopted new rules regarding private equity funds that, among other things, require GPs to obtain and share with LPs a fairness or a valuation opinion from an independent opinion provider, as well as a summary of any material business relationships between them and the opinion provider. According to the SEC, the new rules aim to provide an "important check against an advisor's conflicts of interest in structuring and leading a [continuation fund transaction] from which it may stand to profit at the expense of private fund investors" and ensure that "the private fund and investors that participate in the secondary transaction are offered a fair price."[246]

Interviewees on both sides—advisors to GPs and LPs—as well as commenters on the SEC proposal strongly criticized this approach. On the sponsor side, interviewees claim that the rule would entail substantial costs and would force sponsors to invite a fairness opinion even when such an opinion is not required, such as where there are clear market indications of the value of the assets sold to the continuation fund.[247] One interviewee explained that fairness opinions are usually reserved for assets sold below the Net Asset Value ("NAV") when their valuation is uncertain.[248] However, the SEC mandates a fairness opinion for *all* continuation fund transactions, even with complete

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[246] *See* Documentation of Registered Investment Adviser Compliance Reviews, *supra* note 13, at 39, 187; The SEC has also recently adopted a law requiring sponsors to report advisor-led secondary transactions quarterly, stating the closing date and a transaction description. *See* Gary Gensler, Chairman, U.S. Sec. & Exch. Comm'n, Statement on Form PE (May 3, 2023), https://www.sec.gov/news/statement/gensler-statement-form-pf-050323).

[247] Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 5 (Feb. 6, 2023); Interview with Participant 4 (Jan. 27, 2023).

[248] Interview with Participant 2 (Jan. 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."). *See also* Cravath, Swaine & Moore Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 4 (Apr. 11, 2022) (stating that "an opinion should only be required in the absence of any other external, independent and reliable indicator of value"). *See also* Interview with Participant 3 (Jan. 26, 2023) ("I have not done a deal without a fairness opinion.").

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bid processes or prices at or above the NAV. In those situations, fairness opinions do not add much value to investors. Essentially, sponsors and their advisors believe that market participants know better than regulators when a fairness opinion is required, and forcing a blank check rule will increase costs without adding much value.

Interviewees on the LP side and commenters on the SEC proposal were also skeptical of the mandatory use of fairness opinions, but for other reasons.[249] They explain that a fairness opinion does not give them a lot of confidence, as the sponsor is charged with selecting the financial advisor that provides the opinion, while the fund incurs the costs.[250] In such a situation, the financial advisor has strong incentives to provide an opinion that would please the sponsor. Otherwise, that advisor may 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 are a handful of repeat financial advisors who specialize in providing fairness opinions to sponsors.[251] Securing future opinions may require these repeat players to please their clientele at the expense of LPs.[252] Therefore, they argue that fairness opinions cannot be considered as truly objective.[253]

This dynamic is not unique to the private equity context, and concerns regarding the objectivity of fairness opinions have been raised in other contexts.[254] However, in

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[249] The Healthy Markets Association Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 10–11 (Apr. 15, 2022); ILPA Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 13–14 (Apr. 25, 2022) ("LPs generally deem fairness opinions to offer procedural comfort but not true assurance of fair pricing of the transacted assets."); Apevue Inc. Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 3 (Apr. 25, 2022).

[250] Interview with Participant 8 (Jan. 27, 2023).

[251] Interview with Participant 6 (Jan. 18, 2023); Interview with Participant 7 (Jan. 27, 2023); Interview with Participant 9 (Jan. 30, 2023); Interview with Participant 8 (Jan. 27, 2023) (stating that no fairness opinion provider wants to give the "wrong" fairness opinion as they would lose future business).

[252] *Cf.* Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CALIF. L. REV. 1 (2022).

[253] *See infra* note 257; ILPA does not endorse the use of fairness opinions as a standard policy but acknowledges their potential benefits for selling LPs in certain instances, such as when the NAV is determined by the GP. *ILPA, Continuation Funds 2023, supra* note 73, at 12.

[254] Lucian Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About it?*, 1989 DUKE L. J. 27, 53 (1989) ("Investment banks face conflicts of interest that lead them to use their discretion to render pro-management fairness opinions."); *See also* Andrew Tuch, *Fairness Opinions and SPAC Reform* (Working Paper, Apr. 2023), https://ssrn.com/abstract=4419151 (examining the use of fairness opinions in mergers of special purpose acquisition companies (SPACs), showing that they suffer from profound methodological problems and fail to achieve their intended purpose: ensuring fairness to

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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 seldom initiate legal proceedings against sponsors.[255] 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 that invite them is unlikely to severely affect the reputation of the financial advisors.

Finally, in some situations, the decision to initiate a continuation fund is driven by external considerations of the GP that are distinct from the fairness opinions. For example, the fund could be used to receive management fees for an extended period or to help the GP to meet a specific carry hurdle rate and therefore collect the 20% carried interest following the completion of that specific transaction. As one LP interviewee noted, he does not see how a fairness opinion would help the other LPs in these situations.[256]

Therefore, while the SEC places trust in fairness and valuation opinions, market participants (especially on the LP side) remain more skeptical. In their view, these opinions are of little value, worth only the paper they are written on.[257]

IV. The Continuation Funds Debate

After examining the emergence of continuation funds, the conflicts of interest they generate, and the insights obtained from interviews with market participants, we now shift our focus to a broader market perspective. Specifically, this Part explores two alternative viewpoints regarding continuation funds: the market outcome view and the

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public shareholders). But *see also* Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG LAW REV 1, 23 (2015) (suggesting that although fairness opinions may have limited direct benefit for shareholder voting, they can be helpful if they include relevant information such as management's cash flow projections and the adviser's assumptions and methods).

[255] *See supra* Part III.B.

[256] Interview with Participant 8 (Jan. 27, 2023).

[257] Interview with Participant 7 (Jan. 27, 2023) (stating that a market process is preferred to having the GP pay $200,000 to a third-party firm to have them write a fairness opinion; these firms are also repeat players; according to Participant 7, fairness opinions are "worth just the paper written on"); Interview with Participant 9 (Jan. 30, 2023) (stating that the person that gets paid for a fairness opinion cannot be considered truly independent). *See also supra* note 236.

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market failure view. It also highlights the limitations of the market outcome view and proposes several systemic solutions to the unique challenges of continuation funds.

A. Continuation Funds as an Efficient Market Outcome

Those who support the market outcome perspective put forth three key arguments concerning continuation funds. First, continuation funds are effective price discrimination mechanisms. Second, continuation funds reflect a trade-off between price and contractual protections. Third, reputational forces can mitigate sponsors' opportunistic behavior. In the following paragraphs, we examine each of these arguments.

Continuation Funds as a Price Discrimination Mechanism. Price discrimination is a selling strategy that charges customers different prices for the same product or service according to their willingness to pay. Economic theory suggests that under specific circumstances, price discrimination increases the overall social welfare by eliminating monopoly deadweight loss.[258] As one of us has shown elsewhere, private equity price discrimination results in the powerful and largest LPs receiving access to better deals than smaller, less sophisticated LPs.[259] This is because sponsors prefer large investors that contribute more funds to achieve the desired fund size. Consequently, these large investors possess favorable outside options, leading to a lower willingness to pay.[260] Therefore, the efficient price discrimination perspective holds that to achieve optimal fund composition, sponsors must offer better deals to large and sophisticated LPs, and continuation funds are one potential way to do it.

Continuation Funds Reflect a Price-Protections Trade-off. The absence of contractual protections against the unilateral use of continuation funds can also be viewed as a trade-off between contractual protections and price. LPs that considered such contractual protections to be of significant importance could have actively negotiated for them. They could also pay a higher fee in exchange for including these protective terms in LPAs.[261] Additionally, if top GPs are unwilling to agree to those terms, LPs can invest in lower-performing GPs that should be more willing to adjust. Finally, it could be argued that investors lacking the sophistication to negotiate effectively with sponsors are not

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[258] In brief, this is because setting prices in close alignment with consumers' willingness to pay causes consumers who *should* buy a product, but would have *refrained* from purchasing it under uniform pricing conditions, to make the purchase. *See*, *e.g.*, Oren Bar-Gill, *Algorithmic Price Discrimination When Demand Is a Function of Both Preferences and (Mis)perceptions*, 86 U. CHI. L. REV. 217, 233–36 (2019).

[259] Fontenay & Nili, *supra* note 59, at 933–35.

[260] *Id.*

[261] *See supra* note 58 and accompanying text.

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compelled to invest in private equity and are free to direct their resources to other asset classes. Therefore, according to this view, the prevailing lack of LP protections should be considered an efficient market outcome, reflecting LPs' preferences.

Reputational Forces. Supporters of the market view would also argue that even if the formation of continuation funds is motivated by GPs' opportunistic behavior, reputational forces can temper GPs' opportunism.[262] A GP that earns a reputation for mistreating investors will have difficulties in finding new investors. As Professor Steve Kaplan has noted, if GPs "behave badly in one deal, they will be treated differently in the next deal."[263] In contrast, a positive reputation can increase future funding from existing investors and perhaps convince new investors to shift resources.[264] According to this view, private equity firms that use continuation funds to the detriment of many investors may face a loss of investors' trust and ultimately struggle to raise additional capital. Furthermore, private equity firms also face competition from other asset classes. If LPs perceive private equity investments as less favorable, they can allocate more capital to alternative investments, such as public markets. This ability to reallocate their capital gives LPs leverage to influence the private equity market and encourages GPs to meet their demands.

B. Continuation Funds as a Market Failure

Against the market view stands the approach that highlights the market failures associated with continuation funds. In particular, this view suggests that continuation funds impose significant efficiency costs (as outlined in Section II.D.5), that they are a costly form of price discrimination, and that reputational forces and the possibility of

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[262] *Cf.,* 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).

[263] Gara, *supra* note 143. *See also* Gregory W. Brown, Oleg R. Gredil & Steven N. Kaplan, *Do Private Equity Funds Manipulate Reported Returns*?, 132 J. FIN. ECON. 267, 289 (2019) (finding that managers manipulating net asset values raised fewer funds); Feng Jiang, Paul Mason, Yiming Qian & Steven Utke, *Misconduct and Fundraising in Private Equity* (working paper, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4271808 (finding that the disclosure of misconduct reduces firms' ability to raise capital).

[264] For studies indicating that top-performing funds are more likely to raise follow-on funds, *see* Paul A. Gompers & Josh Lerner, *What Drives Venture Capital Fundraising?*, BROOKINGS PAPERS: MICROECONOMICS 149 (1998) (explaining the ability to raise new capital is also positively affected by age and size); Steve Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows,* 60 J. FIN. 1791, 1791 (2005); Ji-Woong Chung, Berk A. Sensoy, Léa Stern & Michael S. Weisbach, *Pay for Performance from Future Fund Flows: The Case of Private Equity*, 25(11) REV. FIN. STUD. 3259 (2012).

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exiting private equity investments are unlikely to fully mitigate these market failures. Below we explore each of these arguments.

Continuation Funds as a Costly Form of Price Discrimination. As explained earlier, there are potential efficiency advantages behind the sponsors' decisions to offer better deals to large and sophisticated LPs. However, when such differential treatment is conducted in an opaque and non-transparent manner, using alternative investment vehicles such as continuation funds could generate significant efficiency costs associated with forming the continuation funds as outlined in detail in Section II.D. In this regard, we note that explicit discrimination between investors, by providing large and sophisticated LPs with better investment terms, offers similar efficiency advantages, and could be employed by sponsors without incurring the overall costs associated with continuation funds.

The Limits of the Reputation Market. It is well known that the efficiency of reputation markets depends heavily on the quality of the information that LPs can obtain and analyze before making investment decisions.[265] Since private equity investments are not liquid and have a long lifespan, it may take a while until investors accumulate all relevant information to assess the performance of the sponsor.[266] Empirical studies also highlight investor difficulties in collecting reliable information on previous fund performance due to the tendency of underperforming sponsors to inflate reported returns during fundraising.[267]

Moreover, as explained above, many investors face challenges in conducting due diligence on *specific assets*, particularly due to their lack of expertise and small investment teams. Coupled with the absence of systematic performance data on continuation funds and the lack of an arms-length transaction as a "market check" for the GP's valuation, it becomes even more challenging to determine the fairness of continuation fund deals.[268] This information gap explains why less sophisticated LPs face challenges in identifying opportunistic behavior by GPs and punishing the untrustworthy ones.[269]

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[265] Magnuson, *supra* note 19, at 1900.

[266] James C. Spindler, *How Private Is Private Equity, and at What Cost?,* 76 U. CHI. L. REV. 311, 332–33 (2009). For recent empirical support, *see*, *e.g.*, Robert S. Harris, Tim Jenkinson, Steven N. Kaplan & Ruediger Stucke, *Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds* (Working Paper, Mar. 2022), https://ssrn.com/abstract=2304808.

[267] Brad M. Barber & Ayako Yasuda, *Interim Fund Performance and Fundraising in Private Equity* 124(1) J. FIN. ECON. 172, 193–94 (2017); Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACADEMY OF MANAGEMENT PERSPECTIVES 45 (2021).

[268] *See supra* Section III.B.

[269] For empirical support, *see* Blake Jackson, David Ling & Andy Naranjo, *Catering and Return Manipulation in Private Equity* 5–7 (Dec. 15, 2022), https://ssrn.com/abstract=4244467 (finding that LPs

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Additionally, the argument for the disciplinary effect of the reputation market assumes that private equity firms engage in fierce competition for investors' capital. This assumption, however, overlooks the power dynamics at stake.[270] Recent empirical evidence shows that many investors experience difficulty gaining access to top-tier firms' alternative investment vehicles,[271] and top GPs involved in misconduct still find it relatively easy to attract new investors.[272] Given the competition for accessing top-tier firms' investments, some LPs may reinvest in subsequent funds with the same GP, even if they are displeased with the GP's decision to establish a continuation fund.

Finally, even if the GP suffers reputational harm from initiating a continuation fund, such damage must be offset against the private benefits they derive from such a transaction (including additional management fees and carried interest). When the expected loss from reputational harm is lower than the expected value from private benefits, the GP may choose to act in its own interests, even if it comes at the expense of other investors.[273]

Limited Exit Options and Internal Agency Problems. The notion that LPs can easily stop investing in private equity if continuation funds have substantial adverse effects on them overlooks several considerations. As fiduciaries, institutional investors must act in their beneficiaries' best interests. This includes maintaining a diversified investment portfolio to manage risks effectively. Private equity investments allow institutional investors to diversify their portfolios and mitigate public market risks. This need for diversification gives GPs significant room to benefit themselves at the expense of LPs

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do not punish GPs for manipulating IRRs by refusing to commit capital to subsequent funds); Vladimir Atanasov, Christopher Newport & Katherine Litvak, *The Impact of Public Pension Funds and Other Limited Partners on the Governance of Venture Capital Funds* 3, 19–20 (Working Paper, 2018), https://ssrn.com/abstract=3088998 (finding that public pension funds are actually more likely to invest in VCs that were defendants in lawsuits, possibly due to internal agency problems).

[270] Clayton, *The Private Equity Negotiation Myth*, *supra* note 19, at 97–98, 109–10.

[271] Lerner et al., *supra* note 61, at 359–61.

[272] Yina Yang, *Private Equity Limited Partner Responses to Advisory Misconduct by General Partners* (2022), https://ssrn.com/abstract=4223588 (showing that reputational costs for GPs are relatively low: although reports of GP misconduct, such as hidden charges or unequal treatment of LPs, are leading to increased LP departures, GPs easily find substitutes, especially GPs with more resources and GPs that engage in minor misconduct); Sharjil Haque & Anya Kleymenova, *Private Equity and Debt Contract Enforcement: Evidence from Covenant Violations* (2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4361582 (showing that private equity firms violate loan covenants more often than non-PE firms, but experience smaller reductions in credit commitments due to lender leniency, influenced by repeated deals, sponsor reputation, and sponsor bargaining power).

[273] Shobe, *supra* note 38, at 1485–86.

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before LPs consider reducing their allocations to private equity. However, the persistent investments in private equity cannot be solely attributed to diversification benefits.[274]

Institutional investors, as agents of beneficial investors, also face agency problems,[275] with studies showing how internal agency problems lead to suboptimal behavior in private equity investments, particularly among public pension plans.[276] The investment industry encourages institutional investors to invest in private equity, while incomplete and missing data can lead institutional investors to make false conclusions regarding the desirability of such investments.[277] In this regard, individuals working in LPs' private equity divisions may possess information about the private equity industry's flaws, but are incentivized to continue investing in private equity to secure their jobs.[278]

Considering these factors, LPs have limited leverage to prevent opportunistic behavior by GPs, as the threat of exiting private equity investments can only partially serve as a disciplinary force. This power dynamic could also explain the lack of a pre-ban on the formation of continuation funds as well as the absence of other governance terms aimed at protecting LPs' interests (as observed in Section III.D.4). Given that institutional investors are expected to continue investing public savings in private equity, some safeguards may be needed.

C. Mapping Out Alternative Pathways

In light of the significant role of continuation funds in the private equity industry and their potential costs, seeking systemic solutions to the unique challenges they raise becomes important. This Part undertakes this task.

Of course, one possible solution would be to prohibit continuation funds altogether. However, such a measure would also prevent overall value-enhancing

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[274] Francesco Franzoni, Eric Nowak & Ludovic Phalippou, *Private Equity Performance and Liquidity Risk* 67 J. FIN. 2341 (2012) (suggesting that diversification benefits may be lower than anticipated as private equity suffers from significant exposure to the same liquidity risk factor as public equity and other alternative asset classes).

[275] Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017).

[276] Clayton, *High-End Securities Regulation*, *supra* note 59, at 35 (describing studies identifying internal agency problems resulting in suboptimal behavior within institutions investing in private equity funds).

[277] Phalippou, *supra* note 56, at 12–13 (Phalippou asserts that the notion that private equity consistently outperforms public markets is perpetuated by industry professionals, including investment teams, external managers, and consultants. According to him, the use of misleading performance metrics, like the internal rate of return (IRR), selective benchmarking, and incomplete public data, all further contribute to the illusion of superior private equity performance); Rosemary & Appelbaum*, supra* note 267.

[278] Phalippou, *supra* note 56, at 12–13.

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transactions that could benefit all parties involved. Indeed, all the market participants we interviewed, the ILPA (an organization dedicated exclusively to advancing the interests of LPs), and the SEC believe that continuation funds should not be prohibited. Instead, they offer different views regarding their structure and regulation.[279]

Below, we explore several potential avenues for addressing these conflicts. We begin by presenting existing proposals to enhance disclosure. We discuss the advantages of this proposal but also explain why disclosure alone is unlikely to cure the structural biases generated by continuation funds. We then explore solutions that directly address the imbalance of incentives between GPs and LPs. We highlight the advantages and potential costs of each of those solutions.

1. Enhanced Disclosure with Extended Election Period

One of the concerns raised in the interviews is that legacy fund LPs suffer from information gaps and do not receive enough time to make an informed election decision. To address this concern, the ILPA suggests providing legacy fund LPs with access to the same level of information as LPAC members or new LPs, including with respect to conflicts of interest (such as highly favorable financial conditions for new LPs).[280] The ILPA also recommends that LPs be given at least 30 calendar days to decide whether to roll or sell their interests, while emphasizing that GPs should consider institutional legal requirements that may require longer review timelines, where possible.[281]

We expressed support for these proposals, as they directly address fundamental challenges associated with continuation funds. The requirement to disclose the rationale for establishing a continuation fund addresses concerns that GPs may prioritize their benefits over maximizing value for LPs. Moreover, providing legacy fund LPs with information regarding any favorable economics for new LPs, participation of LPAC members as finalists in the bidding process, and the justification for selecting the "winning bid," addresses conflicts between existing LPs and new LPs, as well as conflicts between existing LPs and LPAC members.

However, without clear guidance from regulators, enhanced disclosure could lead to a lack of standardization and information overload. Interviewees explained that disclosure documents distributed to LPs prior to their election decisions are already very long and often contain around 200 pages or even more.[282] 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

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[279] *ILPA, Continuation Funds 2023, supra* note 73; *supra* Part III.E.
[280] *Id.* at 6–8.
[281] *Id.* at 4–9.
[282] Interview with Participant 5 (Feb. 6, 2023).

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multiple disclosure documents each month, further contributing to their information overload.

Therefore, we suggest that the SEC provide detailed guidance on the disclosure provided to LPs before deciding whether to invest in continuation funds. This information should be summarized so that LPs with tight time constraints can still review the main terms of the transaction in a timely manner. In addition, we suggest that the SEC provide guidance regarding the minimum period given to LPs to decide whether to roll over their investments. These steps alone, however, are no substitute for additional LP protections that could better align the interests of the GP and the legacy fund investors. We turn to discuss these protections now.

2. Back to the Status Quo Option?

The status quo option, which enables legacy fund LPs to reinvest in the continuation fund on the same economic terms (assuming they are better than the new terms), is rarely offered in continuation fund transactions.[283] One possible avenue, strongly supported by some LPs we interviewed, is to provide the legacy fund LPs with a *status quo option*.

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 LPs nor increase their management fee or carried interest.[284] 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 maintain all other benefits that were initially afforded to the rolling LPs.[285]

An important advantage of the status quo option is that it eliminates LPs' concerns that they are being squeezed by the GP, thus opening a problematic choice for them: rolling over to a continuation fund on new, and often inferior, terms or cashing out at a price that could be unfavorable to them. Another advantage of this proposal is that it improves the incentive structure of sponsors. A status quo option puts pressure on the GP to ensure that the pricing is at an appropriate level so that enough existing LPs elect to sell their stake to new investors, especially under a default that treats every

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[283] According to a recent survey, only 19% of transactions include the status quo option for LPs. *See* Le, *supra* note 184; *ILPA, Continuation Funds 2023, supra* note 73 at 10–11.

[284] Interview with Participant 12 (June 28, 2023) (stating that there are instances where there is a carry crystallization for rolling LPs, but no additional carry is charged from them in the continuation fund).

[285] In the case of a single investment fund, there could be some necessary adjustments to side letters, as some provisions contemplated a multi-asset blind pool investment.

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investor that does not respond to the election as electing not to roll over. This proposal will reduce the number of continuation fund transactions, as new investors will have to offer a higher price to induce enough existing ones to sell and to cover the costs of a higher management fee, ensuring that only the most profitable transactions succeed.

However, there are certain situations where practical considerations may limit the use of a status quo option. One such scenario is observed in continuation funds that involve the transfer of numerous assets from multiple older funds to a single continuation pool. Offering the status quo option to all LPs in these cases would create an imbalance in economic terms among the LPs involved.[286] Additionally, if a significant number of LPs choose to roll over, the absence of carry crystallization for rolling LPs could pose challenges when compensating retiring partners of the GP. Furthermore, in some cases, the infusion of new capital is crucial, and potential buyers may require a minimum exposure size as a condition for participating in the transaction. Consequently, rolling LPs must be diluted.[287] It is therefore essential to recognize that the status quo option cannot be applied uniformly as a one-size-fits-all solution. In cases that deviate from the scenarios above, such as continuation funds that are established at an early stage of the legacy fund[288] or that involve the transfer of only a single asset and do not necessitate the dilution of LPs due to available capital, the status quo option becomes particularly relevant.

3. Empowering Legacy Fund LPs

While legacy fund LPs are adversely affected by conflicts of interest in continuation fund transactions, their participation in the approval process is minimal. Below we explore several avenues for addressing continuation fund concerns by empowering legacy fund LPs.

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.[289] LPAC members could also have different incentives from the LPs that elect to cash out.[290] Bringing the proposal to establish a continuation fund to the LP base ensures that such a proposal will move forward only if a majority of the LP base

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[286] Amy Caroll, *Will LPs Always Have a Status Quo Option in a G-Led Secondaries Process?,* PRIV. EQUITY INT'L (Mar. 6, 2023), https://www.privateequityinternational.com/will-lps-always-have-a-status-quo-option-in-a-gp-led-secondaries-process/.

[287] *Id. See also ILPA, Continuation Funds 2023, supra* note 73 at 10 (stating that any dilution of existing LPs must take place fairly and reasonably and that GPs should provide a commercial rationale as to why diluting rolling LPs will be accredited to the return on the transacted assets).

[288] *See supra* note 186.

[289] *See supra* notes 217–219 and accompanying text.

[290] *See supra* Section III.D.1.

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perceives it as value-enhancing. This will mitigate the concern that the GP would use the continuation fund vehicle for opportunistic purposes.

For early-stage approval, disclosure documents could be concise and present the initial proposal to establish the fund, its rationale, and any conflict of interest involved (including those related to the GP). However, while the early-stage vote on the continuation fund initiation represents a step towards mitigating conflicts of interest, at this stage, LPs lack sufficient information to safeguard their interests concerning valuations, rolling over terms, and pricing. Therefore, implementing a *late-stage LP vote* during the closing stage would provide LPs with an extra layer of protection.

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 may involve the solicitation of bids from third parties. Therefore, a late-stage LP vote could generate a risk of LPs rejecting the proposal at the last minute (and after the GP has invested significant time and effort into the process). This risk further increases given that most funds do not have negative consent, which means that the GP will need to secure a majority of the LPs' commitments to affirmatively approve the transaction. One of our interviewees explained that there is always a certain percentage of non-responding LPs, and their vote would count as a "no-vote."[291] Late-stage LP approval, therefore, generates a risk that could lead the GP to avoid establishing continuation funds in the first place, even when doing so would enhance value to all parties involved.

While this is a valid concern, there are several ways to mitigate it. First, the early-stage LP approval could be sought before the GP invests significant time and effort, giving an indication of LPs' preferences. 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 fund formation could be increased to a supermajority. Altogether, we believe these measures could reduce the risks or costs associated with a vote of the LP base.

Another concern is that some LPs, particularly smaller ones, may lack the necessary resources to analyze the information presented and effectively make informed voting decisions. In this context, drawing inspiration from the public market, where shareholders utilize proxy advisors to address similar challenges, could offer a potential

[291] Interview with Participant 5 (Feb. 6, 2023).

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solution.[292] LPs can engage an independent advisory body, which can assist them in assessing both the merits of a continuation fund compared to other exit options, and the specific terms offered in the continuation fund transaction. Furthermore, this challenge mirrors LPs' difficulty in deciding whether to sell or roll over their investments.[293]

Finally, the vote should be confidential, so that LPs will not be reluctant to vote against the formation of a continuation fund out of fear of losing future allocations from sponsors. A confidential ballot may help ensure this concern does not unduly influence the vote.

Selection of Financial Advisors. When LPs approve a continuation fund transaction, they can simultaneously select the financial advisor. As we explained earlier, typically, the financial advisors who provide fairness opinions are hand-picked by the GP. Their control over their selection creates a structural bias and raises concern that the advisors would seek to please their clientele at the expense of LPs.[294] This concern could be mitigated if the LPs that elect not to approve the continuation fund transaction were also the ones that elect the financial advisor (out of several options presented to them by the GP). This vote would not entail additional costs if combined with the early-stage approval of the continuation fund.

Enhancing 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.[295] To address this concern, we suggest that after the early-stage approval of the continuation fund, the GP could review the list of LPs that objected to the fund's formation and invite the largest LPs to serve on the LPAC that oversees and approves the transaction. This proposal will empower the selling LPs and assure them a seat at the LPAC table. To further mitigate potential conflicts of interest, a requirement for recusal may be implemented for LPAC members whose interests do not align with those of the *selling* LPs, including members inclined to roll over their investments or participate in the bidding process.

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[292] Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light*, 99 B.U. L. REV. 1459 (2019).
[293] *See supra* Section III.B.
[294] *See supra* note 254.
[295] *See supra* notes 217–226 and accompanying text.

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4. Transaction Costs

As we explained earlier, while the GP derives significant benefits from continuation fund transactions, the GP does not incur any of the costs associated with it.[296] 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. In addition, LPs electing not to participate should incur no cost.[297]

We support this recommendation. In our view, it has two major advantages. *First*, it will lead to a 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's decision-making. When the GP does not incur any costs of the transaction, their 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.[298] The proposal will mitigate this tendency (at least partially) by causing the GP to internalize some of the transaction costs.

5. Implementation.

To put these proposals into action, two main approaches can be considered. The first is to promote the proposed solutions via *private ordering*. LPs can push for incorporating these solutions into LPAs, utilizing platforms like the ILPA to overcome collective action problems. In industries dominated by sophisticated investors, private ordering is often the preferred approach. However, LPs' collective bargaining power is limited when the incentives of different LP groups do not align.[299] As our analysis suggested, a continuation fund transaction often involves two groups of LPs with conflicting interests. Consequently, the more sophisticated LPs, which are likely to participate in continuation fund transactions, are expected to be less inclined to seek changes to the current structure of continuation funds.[300]

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[296] *See supra* Section II.D.3.

[297] *ILPA, Continuation Funds 2023, supra* note 73, at 10.

[298] *See supra* Section II.D.3.

[299] Fontenay & Nili, *supra* note 59, at 979–81.

[300] Other factors contribute to the challenge of amending LPAs. Path dependence, for instance, plays a role wherein early adoption of certain private equity fund contracting conventions persists despite their suboptimal nature due to factors like network benefits, herd behavior, and anchoring effects. Magnuson, *supra* note 19 at 1890–95.

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The second approach involves *regulatory intervention by the SEC*. While the SEC has recently adopted new rules concerning continuation funds, these rules have certain shortcomings.[301] The alternative avenues we explored above could be considered by policymakers to achieve a more effective outcome.

Conclusion

Forming a continuation fund became a mainstream option in private equity. However, continuation funds' popularity contrasts starkly with the frustration of many investors. Based on a systematic analysis of the web of conflicts of interest that continuation funds generate and qualitative data from interviews with market participants, this Article provides new insights into the theoretical and policy debates around continuation funds. It also opens the door to a more robust discussion regarding the limits of investor power in mitigating market frictions in the private equity world. We hope regulators, market participants, and academics will take up the challenge.

[301] *See supra* Section III.E.

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Appendix A

Interview List		
Participant Number	**Date Interviewed**	**Background**
1	January 9, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
2	January 25, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
3	January 26, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
4	January 27, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions
5	February 6, 2023	A partner at a leading law firm, specializing in representing GPs and LPs in continuation fund transactions
6	January 18, 2023	A director in an investment management company that invests in continuation funds as an LP
7	January 27, 2023	An officer in an investment management company that invests in continuation funds as an LP
8	January 27, 2023	An officer in an investment management company that invests in continuation funds as an LP
9	January 30, 2023	An officer in an investment management company that invests in continuation funds as an LP
10	January 30, 2023	A partner at a mid-size law firm, specializing in representing LPs in continuation fund transactions
11	April 10, 2023	Two officers in a trade association for LPs
12	June 28, 2023	A partner at a leading law firm, specializing in representing GPs in continuation fund transactions

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