So You Want to Buy a Stake in a Private Equity Manager?

September 25, 2017

Over the past 30 years, we have seen explosive growth in private equity, both in the number and types of funds and in the enormous allocation of capital to the asset class. Along the way, we have witnessed different cycles of M&A activity involving private equity businesses or teams. The first wave of M&A in private equity started in the early 2000s and generally involved the sale or spin-off of managers and funds owned and sponsored by banks, insurers and other non-manager owners (such transactions, the "**Captive PE Deals**"). These transactions typically involved the sale or divestment of control of the manager and were often driven by conflicts with the parent organization or (more recently and later in the cycle) regulatory considerations applicable to the parent (*e.g.,* capital constraints or the Volcker Rule). Thereafter, many of the larger sponsors (*e.g.,* Blackstone, Carlyle, etc.) sold passive stakes to sovereign wealth funds that were used to strengthen their balance sheets in anticipation of going public and expansion into other alternative asset management businesses (such transactions, the "**Anchor PE Deals**").

In the current M&A environment for private equity managers, there are, generally speaking, two types of transactions one sees most frequently. The first (so-called "**Passive PE Manager Investments**") involves small and passive stakes in sponsors (usually for ~10% and often, but not always, involving primary investments) by funds that have been set up for this purpose (*e.g.,* Neuberger Berman's Dyal Capital and Goldman Sachs' Petershill) or sovereign wealth funds or family offices. Generally speaking, these deals are closer in type and issues in many, but not all respects, to the Anchor PE Deals. The second type of transaction (so-called "**Liquidity PE Manager Deals**") involves the sale of control of a sponsor through full acquisition (*e.g.,* Fortress/Softbank) or the taking of a larger (typically minority) stake in a secondary sale. As a general matter, these deals are closer in type and issues in many, but not all respects, to the Captive PE Deals.

Two weeks ago, the ***Wall Street Journal*** reported on the intense interest in purchases of stakes in private equity managers. Presumably, this interest has been prompted, in part, by the consistent successes of private equity as an asset class over a sustained period of time, and the opportunity for market players to buy in to private equity firms at a time of relatively low market returns elsewhere. Further, with the inevitable likelihood of generational change in top management at many sponsors on the horizon, there are many reasons to believe that M&A activity involving private equity firms will continue at notable levels for the foreseeable future.

Below we address the key deal points that are likely to come up in Liquidity PE Manager Deals, as these transactions can raise significant and complex conflict issues between the new owner/investor, on the one hand, and the fund sponsors, on the other, that must be mediated in order for these transactions to be successful. We plan to address the issues that are more particular to Passive PE Manager Investments in a future memo.

Liquidity PE Manager Deals

General

The sale of a stake in a Liquidity PE Manager Deal is often a liquidity event for the founders and key investment professionals. The economic terms of the deal, including valuation and the size of the stake sold, will tie in to a number of the points discussed below (*e.g.,* the bigger the ownership stake, the greater the focus on governance rights and conflict-type/retention issues; the higher the price, the more likely the investor's concern about an indemnity for the seller's reps and warranties and an adjustment for failed consents, etc.). The outcome on all of these issues will, of course, turn on relative leverage in the negotiations. The founders and key professionals will strongly desire that the proceeds be treated as long-term capital gain, a conclusion that can require careful tax planning to achieve.

Lock-Up of Sale Proceeds: Retention vs Tax Treatment

The investor will no doubt be laser-focused on retaining the manager's key leadership and investment professionals after the closing. The investor may propose, for example, the escrow of a portion of the purchase price for some period of years and a requirement that the professionals continue to invest for some period substantially the same amount in firm funds as they had been investing previously (also known as "eating your own cooking"). These investor protections are often further buttressed by the restrictive covenants discussed below.

The escrow and some of the other retention devices (*see* "Restrictive Covenants" below) often present tax issues, as they can create a risk for the participating investment professionals/owners of ordinary income treatment on all or a portion of the deal proceeds.

Fund Consents

Depending on the size of the stake sold to the investor and the investor's degree of control, consent may be required from each fund's investors on a fund-by-fund basis (usually by reference to a stated percentage in the fund documents that may be required to approve a sale of the manager or, by analogy, the amendment of the underlying fund documents). The negotiation will focus on risk allocation in several respects: is positive or negative consent required or deemed necessary on a business level; should obtaining consents with respect to all or a certain percentage of AUM (or specific clients) be a condition to closing or should the investor have to close regardless; and should the failure of any fund consent and any resulting loss in AUM lead to a price adjustment and, if so, on what basis (*e.g.,* dollar-for-dollar, with a deductible or tipping basket, or with a deductible and a catch-up mechanism)?

Post-Close Governance and Compensation

Depending on the size of the stake sold, the private equity manager and the investor will need to strike the right balance so that the manager retains sufficient autonomy to preserve its culture and investment approach/decision-making, while allowing the investor adequate oversight and participation in key governance decisions. Governance areas that will draw particular focus in this negotiation will be: leadership and succession planning; capital allocation and new products; and perhaps most controversially, overall compensation schemes (which must balance team incentives with the investor's desire for equity participation).

Indemnity by the Sellers for the Sale Transaction

The higher the sale price, the more likely the investor will seek to negotiate for indemnity protection. Private equity professionals, however, are in the business of avoiding tail liability on their sell-side M&A transactions. The outcome may be a combination of a higher focus on due diligence, a limited indemnity for knowing and intentional fraud for items covered by the reps and warranties and/or rep & warranty insurance.

Investors with negotiating leverage or with particular concerns may be able to secure indemnity protection (in whatever form agreed) backed by proceeds received by the seller and reinvested in the PE funds or backed by other credit support. Again, the outcome will turn on relative leverage in the negotiation.

Retention

Post-closing retention is a key investor concern in Liquidity PE Manager Deals as they are often wealth creation/realization events for the senior investment professionals/owners. The investor will typically wish to review the manager's compensation programs (particularly carried interest, vesting terms, coinvestment and other long-term incentive plans) to determine their treatment in connection with the transaction, and whether the appropriate incentives will remain in place post-closing. Key issues to consider under any existing or replacement compensation programs include the allocation of carried interest and other plan participation, ongoing vesting requirements, the treatment of plan participants under “good leaver” and “bad leaver” scenarios, and the extent to which key leadership and investment professionals are subject to restrictive covenants (*see* next paragraph).

Restrictive Covenants

An important focus for the investor in seeking to protect its investment and further its retention goals will be negotiating to obtain appropriate post-closing covenants from the seller group. These covenants may include: a non-compete; a prohibition on pursuing investment opportunities that had been identified at that firm; a non-solicit of employees and clients; a restriction on the use of track record; and other customary restrictions such as non-disparagement and confidentiality.

Investor’s Fund Commitment

In a competitive process, the PE manager is likely to bundle the investor’s acquisition of a stake in the manager with a requirement for a sizeable commitment by the investor in the manager’s future funds. In return, the investor will seek to negotiate the economics that will apply to those fund commitments.

Liquidity for the Investor

Unfortunately, no marriage can be assured to be everlasting. A tricky part of the negotiation will be the investor’s future ability to exit from its investment. The range of outcomes in these negotiation can vary greatly (*e.g.,* free transferability, no transferability, no transferability for a period of time, no transferability to a specified list of transferees or type of transferees, a right of first offer or a right of first refusal after a restriction period or some combination of the foregoing).

*   *   *   *   *

Liquidity PE Manager Deals tend to be intensely challenging transactions involving exceptionally bright negotiators on both sides of the transactions and individuals, on the sponsor side, who are (understandably) focused on issues that directly implicate their personal wealth, autonomy and lifestyle. As is evident from the above, the deal issues and solutions are complex, quite different from typical M&A transactions and necessarily bespoke to the particular circumstances.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

John D. Amorosi	**212 450 4010**	**john.amorosi@davispolk.com**
Neil Barr	**212 450 4125**	**neil.barr@davispolk.com**
John A. Bick	**212 450 4350**	**john.bick@davispolk.com**
Ron Cami	**650 752 2008**	**ron.cami@davispolk.com**
Mary Conway	**212 450 4959**	**mary.conway@davispolk.com**
Jeffrey P. Crandall	**212 450 4880**	**jeffrey.crandall@davispolk.com**
Louis L. Goldberg	**212 450 4539**	**louis.goldberg@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Michael Mollerus	**212 450 4471**	**michael.mollerus@davispolk.com**