

Private equity GP-led secondary fund transactions

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During the last few years, General Partner-led (GP-led) secondary transactions have evolved and are no longer just associated with General Partners trying to dispose of lingering assets that have become hard to sell. Increasingly, GP-led secondaries are used to create for both private equity fund sponsors and their limited partners, liquidity solutions with more attractive valuations than regular dispositions of funds' assets. It is expected by many market participants that such GP-led secondary transactions will become increasingly popular.

This article addresses certain key issues associated with GP-led secondary transactions and the [guidelines released by the Institutional Limited Partners Association](#) (ILPA) for sponsors and limited partners to consider when assessing a GP-led process to restructure a fund's portfolio (ILPA Guidance).

GP-led secondary fund transactions

Other than a direct sale of a fund's remaining assets to a secondary investor, there are three types of GP-led secondary transactions:

- **GP-led tender offers:** The General Partner tenders all or a portion of the existing limited partner interests to a buyer who could be an existing investor or an affiliate of the General Partner.
- **GP-led fund restructurings:** The General Partner enters into an agreement with a secondary buyer to purchase all or a portion of the assets of the fund for an agreed price. Investors are provided with options to: (i) sell their fund interests and receive a pro rata portion of the cash purchase price, (ii) roll their pro rata share of their fund interests into a special purpose vehicle established to purchase the fund's assets and managed by the General Partner, or (iii) engage in a combination transaction that involves a partial sale and a partial roll-over of the limited partner's interests in the fund.
- **Stapled secondaries:** Stapled secondaries are a hybrid of a fund restructuring or a GP-led tender offer and a primary offering. Stapled secondaries offer investors the opportunity to either (i) increase their commitment (with an additional commitment from the buyer) to allow the General Partner to make follow-on investments, or (ii) participate in the General Partner's next fund.

Key issues to consider

Conflicts of interests

- **Valuation of the assets:** The General Partner is frequently on both sides of the transaction in GP-led fund secondary transactions. On the one hand, the General Partner owes fiduciary duties to the investors in its existing fund which entails maximizing the value of the remaining assets. On the other hand, resetting the economics in the new vehicle and the receipt of a carried interest will be tied to the value of the assets, creating an incentive for the General Partner to agree to a lower price. The General Partner or its affiliate may also participate as a buyer, which also creates an incentive for the General Partner to lower the price.
- Providing the right price which limited partners would consider attractive is key. Certain investors may not be looking just to exit the fund, they will be looking for an attractive price and if the discount is too large, they would not agree to sell. A third-party valuation and/or a fairness opinion should be obtained to give comfort to the existing investors.
- Additionally, limited partners should inquire whether the General Partner has obtained sufficient capital to redeem limited partners that are looking to sell their interest and at the same time to achieve the value creation goals of the special purpose vehicle.
- **Regulatory scrutiny:** The Securities and Exchange Commission is focused on GP-led secondary transactions and in particular on how conflicts of interest and disclosure to limited partners are handled by the General Partners. They are also focused on valuation of the assets subject to the transaction, allocation of transaction fees, expenses and broker fees and whether such transactions are conducted in accordance with the underlying agreements.
- **Limited partner consent:** Generally, the General Partner should obtain the limited partner's consent or the consent of the fund's advisory committee (LPAC) even if the fund documents do not require such consent. In certain situations, LPAC members may be reluctant to approve a fund restructuring, as this is not a typical role of an advisory committee, or the LPAC members may be conflicted and abstain from voting (and certain partnership agreements are unclear as to whether abstention counts as approval).
- Consistent with the ILPA Guidance, it is important from an investor relations stand point, and to ensure a successful transaction, to involve the LPAC as early as possible in the transaction process and to provide as much information to limited partners as possible to assist them to understand the rationale of the transaction. Additionally, General Partners should be aware that a GP-led tender offer transaction may have shorter notice requirements.

Tax considerations

- **Tax-free rollover:** Investors need to evaluate whether a roll-over is structured to be tax-free, or whether it may be tax-free for some investors but not for others. Even where the roll-over is generally expected to be tax-free, the General Partner may not provide any explicit comfort on the tax-free nature of the roll-over and investors will, therefore, need to consult with their own tax advisors to make sure they agree with the General Partner's approach.
- **Tax structure:** Typically, the fund's investments will continue to be held in the same manner as they were held previously, and therefore investors that were comfortable with the existing tax structure should generally be comfortable with the structure after the roll-over. The General Partner should coordinate with its existing investors prior to confirming the structure subsequent to the roll-over.
- **Tax protections:** Some tax specific covenants contained in the investors' side letters or other documents may carry over to the special purpose vehicle after the roll-over but this is not always the case. Investors may need to negotiate for covenants that are still relevant in light of the assets held by the roll-over vehicle, such as a covenant to avoid effectively connected income (for non-U.S. investors), unrelated business taxable income (for tax-exempt investors), commercial activity income (for non-U.S. governmental investors), and covenants regarding how to structure future exits (such as covenants to sell shares of tax blockers).

- **Tax withholding:** U.S. withholding taxes may apply both to investors getting cashed out and to roll-over investors, unless certain exemptions apply. Such exemptions will typically require either the investor or the General Partner to provide certifications that comply with IRS rules. General Partners may be asked by investors to certify as to the mix of assets that generate effectively connected income or that such assets are treated as United States real property interests for tax purposes. Some General Partners may be reluctant to provide such certifications given that they need to be provided under penalties of perjury.

Revised partnership agreement and general transaction terms

As partnership agreements are not drafted in anticipation of GP-led fund transactions, the terms of the agreements will have to be modified.

- **Economics:** The General Partner may seek to obtain revised economic rights, such as carry, management fee and clawback mechanics to provide an incentive to the investment professionals to continue to manage the assets. However, when setting up the carry arrangements, limited partners may be reluctant to agree to provide additional carry for underperforming investments. In such situations, General Partners should consider providing a carry based on tiered performance milestones.
- In other circumstances (as also mentioned in the ILPA Guidance), it may be preferable to maintain the status quo for existing investors, (i.e., the same terms in the new vehicle as in the existing fund). This can also be achieved by offering to the roll-over investors the option between two waterfalls in the new vehicle (which can be coupled with additional guarantees in relation to any potential General Partner clawback that may be lost as a result of the restructuring).
- It may be necessary to ensure transaction fees are shared with existing limited partners as part of their roll-over options. It may also be necessary for the General Partner to consider whether the allocation of transaction expenses and financial advisor's fee incurred by all deal participants are addressed in a fair manner and whether it is fair for selling and non-rolling investors to bear a portion of such fees.
- **Upper arrangements:** The General Partner should take into account the allocation of carry and clawback at the "upper tier" levels if the fund structure involves former employees or professionals expecting the GP-led transaction to generate a liquidity event that might crystallize carry or justify the release of previously escrowed carry proceeds.
- **Sunset date:** Limited partners may consider requesting a sunset date is included if the transaction is not consummated for any reason.
- **Liability:** Rolling limited partners should consider requesting that (i) their liability and indemnification obligations are capped by an amount, and (ii) that a time limitation is imposed on such liabilities. Limited partners should also inquire as to the nature of any reserves held back by the General Partner to ensure repayment of liability and the details involving any litigation or regulatory proceedings with respect to the portfolio companies subject to the transaction.
- **Reporting and consultation:** Depending on the type of the transaction, the limited partners should consider requesting additional reporting and notice requirements and inquire about a plan of liquidation of the assets to be transferred to the special purpose vehicle.

ILPA's Guidance on GP-led fund transactions

Since more limited partners consider GP-led transactions to provide liquidity to maximize the value of a fund's assets and therefore provide benefits for both fund sponsors and limited partners alike, the ILPA Guidance provides considerations and recommended best practices to guide limited partners and fund sponsors in the process of such transactions.

Limited partner engagement and the role of the LPAC

Consistent with current business practices, the ILPA Guidance recommends the General Partner engage the LPAC as early as possible in the process. ILPA recommends the LPAC be presented with a clear rationale behind the proposed transaction and the outlook for the fund's investments, the amount of capital required, projected time to realization and the reasoning the restructuring is preferable to a simple fund extension. ILPA also recommends that any conflicts of interest are mitigated as early as possible in the process.

Disclosures

ILPA recommends that the LPAC, and the limited partners, should be provided with sufficient information and disclosure to make informed decisions with respect to any consents being sought and elections being made in connection with a GP-led fund transaction.

In particular, ILPA recommends that General Partners provide the LPAC and limited partners with (i) the same diligence information that is provided to the acquirer, including data room access for diligence materials, (ii) access to the General Partner, transaction advisor and portfolio company management, (iii) materials that would allow the LPAC to determine whether the process for pricing the deal was fair (potentially including a fairness opinion), (iv) clear disclosure of any conflicts that may have affected the transaction price, and (v) clear disclosure of any fund terms that will be different post-transaction for both rolling limited partners and acquirers.

Structure of the process

ILPA recommends that limited partners be afforded sufficient time to thoroughly evaluate the proposed transaction—no less than 30 calendar days. In cases where investors do not respond to an election in the time provided, such investors should be treated as if they have elected to participate in the restructuring, with no change to their economic terms, as opposed to having elected to sell their interests.

Further, where follow-on capital is expected to be called, investors should not be compelled to participate in follow-on capital and any resulting dilution of existing investors should be done on a fair and reasonable basis.

ILPA recommends that expenses should be allocated to those parties that benefit from the transaction, and specifically, that the General Partner should bear a portion of the expenses where the General Partner will benefit disproportionately from the transaction, (e.g., in a stapled secondary transaction). ILPA makes some specific expense allocation suggestions, including that expenses for acquirers and rollover limited partners be capped and subject to monitoring for reasonableness.

ILPA also recommends limited partners should have a status-quo option, where the limited partners can participate in the new structure with no change in the economic terms and no obligation to participate in follow-on investments.

Advisors to the transaction

ILPA recommends that the General Partner engage experienced advisors to solicit bids for the relevant assets, which engagement should be reviewed by the LPAC, and the LPAC should have the right to appoint separate experienced legal and specialist advisors to offer counsel on the structure of the process, transaction terms, valuations and any requested conflicts waivers.

To discuss these issues, please contact the author(s).

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

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