
ARTICLE

THE RISE OF PRIVATE EQUITY CONTINUATION FUNDS

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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

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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 that private equity managers have strong incentives to establish continuation funds 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.

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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 “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 But 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;⁴ but had it been in today’s landscape, it may have had

¹ See generally BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (detailing the leveraged buyout of RJR Nabisco by a private equity firm).

² See Floyd Norris, *Fund Books Loss on RJR After 15 Years: A Long Chapter Ends for Kohlberg Kravis*, N.Y. TIMES (July 9, 2004), <https://www.nytimes.com/2004/07/09/business/worldbusiness/fund-books-loss-on-rjr-after-15-years-a-long-chapter.html> [https://perma.cc/ZMN9-UFSH] (“The \$25 billion deal captured the public imagination and provoked talk that leveraged buyouts could only grow larger.”); Brad Meikle, *August, 1989: RJR Investment Gets Underway*, BUYOUTS (Aug. 7, 2006), <https://www.buyoutsinsider.com/august-1989-rjr-investment-gets-underway/> (“The RJR Nabisco acquisition serves as the defining deal of the era.”).

³ *Id.* This total also includes losses on Borden Inc., for which KKR traded its ownership stake in RJR Nabisco. It is difficult to calculate KKR’s concrete loss, though, given the fees it has taken over the years.

⁴ Meikle, *supra* note 2.

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,⁵ with continuation funds now its latest development.⁶

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 ten-year fund term. In the past, funds' investments were expected to be liquidated once the fund term lapsed.⁷ 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.⁸ Limited partners that invested in the legacy fund can either roll their interests into the continuation fund or exit.⁹ For new investors, continuation funds offer the opportunity to invest in more “mature” and visible assets and to reinforce their relationship with the sponsor.¹⁰ 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.¹¹ In 2021, these transactions reached their highest volume in history, estimated at around \$65 billion in deal value, representing a 750%¹²

5 See Elisabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095, 1100 (2019) (“[P]rivate equity firms appear to be responding to their newly competitive environment . . . by switching tactics to drive returns and even branching out into new asset classes.”).

6 See, e.g., 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> [<https://perma.cc/WYC6-JWNW>].

7 See *infra* Section I.A.

8 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> [<https://perma.cc/P9LG-V8ZU>].

9 *Id.*

10 *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> [<https://perma.cc/KT6E-YKNN>].

11 See Caroline Pimpaud, Bahya Bouharati & Nelly Rugambage, *LP-Led Secondaries: Trends, Opportunities and Key Considerations*, DLA PIPER (Nov. 10, 2023), <https://www.dlapiper.com/en/insights/publications/2023/11/lp-led-secondaries-trends-opportunities-and-key-considerations> [<https://perma.cc/5B4J-TGYB>].

12 See *infra* Figure 2.

increase since 2016.¹³ According to market experts, these funds are here to stay and to grow.¹⁴

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.¹⁵ 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.¹⁶ 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.¹⁷

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 they have trusted with their investments up to that point? Do these investors have the power to fend for themselves or is 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

13 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> [https://perma.cc/2SA5-R8S7].

14 See, e.g., *id.*; 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> [https://perma.cc/8JUF-88G5].

15 Sebastian McCarthy & Mark Latham, *Amundi CIO: Parts of PE Are Like a Ponzi Scheme*, PRIV. EQUITY NEWS (Jun. 1, 2022, 3:48 PM), <https://www.pnews.com/articles/elements-of-private-equity-resemble-a-ponzi-scheme-amundi-cio-warns-20220601?mod=topStories> [https://perma.cc/QHA5-RPJC].

16 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> [https://perma.cc/53AX-RMFJ].

17 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63206, 63210-11 (Sept. 14, 2023) (codified at 17 C.F.R. pt. 275 (2023)). The reforms include other provisions aimed at improving the efficiency, competition, and transparency of the activities of private funds' advisers that are unrelated to continuation funds.

sponsors, including additional management fees, an option to receive an additional carry in the future, an opportunity to control the fund's assets for a longer period, and in the case of early-stage continuation funds, the benefit of a fast crystallization of carried interest.

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.¹⁸

Assessing how this conflict unfolds in practice is challenging due to data limitations. While in theory one group of investors (either sellers or buyers) could sometimes have the upper hand—and sometimes the lower hand—our analysis suggests that the sponsor almost 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, the latter of which are 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.¹⁹ 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 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 enable fund sponsors to retain assets beyond the customary ten-year fund term and exacerbate the information asymmetry problem in the private equity industry.

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

¹⁸ See *infra* note 145 and accompanying text.

¹⁹ See *infra* notes 157–163 and accompanying text.

leading market participants, all with first-hand experience with continuation funds, and who together participated in over eighty-five 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 a small minority of all investors express significant interest in continuation funds.²⁰ We also examine the convention that in an industry in which investors rarely use litigation to enforce their rights, nonlegal 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 by 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 fully cure the structural biases generated by continuation fund transactions.

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.

²⁰ 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/> (finding that 6% of respondents indicated "[a] great level of interest" in continuation funds from their investor base, while 24% indicated "[a] moderate level of interest" and the remaining 70% indicated "no interest" or "[a] small level of interest").

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 conventional deference given to sophisticated players' contracting in the private equity industry. 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.²¹ Virtually all private equity funds organize their funds as limited partnerships, in which investors—usually institutional investors and wealthy individuals—are limited partners (LPs), and the private equity firm, also referred to as the sponsor, serves as the general partner (GP).²² 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.²³ By contrast, the LPs have a minimal right

²¹ See, e.g., Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSPS. 121, 124-25 (2009).

²² *Id.* at 123.

²³ See, e.g., DEL. CODE ANN. tit. 6, § 15-404(b), (c) (2018); UNIF. LTD. P'SHIP ACT §§ 302, 402, 406 (2001).

to participate in day-to-day operations or challenge the GP's decisions.²⁴ Nor do LPs owe any duties to the fund.²⁵

The limited partnership agreement (LPA), negotiated between the GP and the LPs, governs the relationship between the investors and the fund.²⁶ The LPA typically includes provisions on voting rights, access to information, and transfer restrictions.²⁷ 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 functions are reviewing conflicts of interest and waiving restrictions in the LPA.²⁸

Private equity funds have long been heralded as a successful asset class.²⁹ This success is generally attributed to their superior governance structure, which includes several complementary mechanisms.³⁰ First, private equity sponsors provide strong financial incentives to managers of their portfolio companies to improve performance metrics.³¹ Second, the sponsors closely monitor management behavior and use the large amount of debt placed on portfolio companies as a disciplinary mechanism.³² Third, the sponsors possess financial, operational, and industry-specific expertise and benefit from their experience from previous transactions.³³ Finally, by removing

²⁴ See Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 266-70 (2010) (“[T]he default rules regarding management of limited partnerships centralize decision making power in the hands of the general partner”); 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 W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. ON REG. 67, 74 (2020) (“Managers typically have extremely broad discretion to select investments”); James C. 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.”).

²⁵ See UNIF. LTD. P'SHIP ACT § 305(b) (2001) (“[A] limited partner does not have any duty to the limited partnership or to any other partner”); see also *id.* §§ 302, 303(a) (“A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the partnership”).

²⁶ Harris, *supra* note 24, at 275.

²⁷ Magnuson, *supra* note 24, at 1857.

²⁸ See *infra* subsection III.D.1.

²⁹ See, e.g., 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> [<https://perma.cc/7GRW-X4L7>].

³⁰ Magnuson, *supra* note 24, at 1853 (“[S]cholars have argued that private equity's primary appeal, and its greatest advantage, lies in its unique governance structure.”); see also *id.* at 1849, 1853-64 (describing this unique governance structure).

³¹ *Id.* at 1849.

³² See, e.g., Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 131-32, 139 (2014) (“[T]he most effective form of monitoring by private equity firms is an indirect one—namely, the disciplining effect of the very high leverage that they impose on their portfolio companies.”); Magnuson, *supra* note 24, at 1860 (describing the same).

³³ See de Fontenay, *supra* note 32, at 131 (“Private equity firms also make available to their portfolio companies financial and industry/operational expertise”); Magnuson, *supra* note 24,

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.³⁴

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.³⁵ Both features are effective mechanisms to align the interests of private equity firms and their investors.³⁶ 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.³⁷ 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.³⁸ The carried interest compensation system is considered effective at aligning the interests of the GP and the LPs. Since a large part of GP’s returns is proportional to those of the LPs, the GP is motivated to maximize value for other LPs.³⁹

The 2% management fee is charged to cover the costs of managing the fund and does not depend on the underlying companies’ performance;

at 1849, 1860-61 (“[T]he private equity model benefits from, and indeed is centered around, the gathering and deployment of expertise—financial, operational, and industrial.”).

³⁴ See de Fontenay, *supra* note 32, at 133 (finding that taking companies private lowers compliance and reporting costs and prevents shareholder suits); see also Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, HARV. BUS. REV. (Sept. 2007), <https://hbr.org/2007/09/the-strategic-secret-of-private-equity> [<https://perma.cc/L5VY-H5YQ>] (detailing how private equity firms take underperforming public companies private, improve their performance, and then sell for a gain).

³⁵ See Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3, 6 (1999); Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2010).

³⁶ See *infra* notes 37, 42-45 and accompanying text.

³⁷ Magnuson, *supra* note 24, at 1866-67; Clayton, *supra* note 24, at 76.

³⁸ Magnuson, *supra* note 24, at 1873.

³⁹ See William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 495 (1990) (“[T]he carried interest component of compensation is large in relation to the other components [so] venture capitalists have incentives to engage in activities that increase the value of the carried interest, which . . . benefits the limited partners.”); Heather M. Field, *The Return-Reducing Ripple Effects of the “Carried Interest” Tax Proposals*, 13 FLA. TAX REV. 1, 35 (2012) (“[T]he GP’s return is directly proportional to the return that the fund assets produce for the LPs.”); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1089-90 (2003) (arguing that the fixed terms of these funds ensure bad investment decisions by a GP “will be punished through the reputation market”).

instead, it is based on the total capital committed.⁴⁰ Finally, GPs often invest their own funds in what is termed as capital contribution, often 1% of the total capital.⁴¹ 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.⁴²

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.⁴³

Limited duration. Another significant feature of private equity funds, and central to this Article, is the limited duration of the funds.⁴⁴ Private equity funds typically last for ten years with “extensions of several years” that “are often possible.”⁴⁵ 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 between three and five years.⁴⁶ 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.⁴⁷ 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.⁴⁸

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.⁴⁹ In

⁴⁰ 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 raise and invest as much capital as possible, potentially leading to excessive risk-taking. See Magnuson, *supra* note 24, at 1866 n.86.

⁴¹ Harris, *supra* note 24, at 287 (“In the usual case, the fund manager contributes 1% . . .”).

⁴² See Magnuson, *supra* note 24, at 1866-67 (noting ways in which “agency costs reinsert themselves into the process”).

⁴³ 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 simply not trigger the carried interest. See Harris, *supra* note 24, at 285; Magnuson, *supra* note 24, at 1871-72; Jarrod Shobe, *Misaligned Interests in Private Equity*, 5 *BYU L. REV.* 1437, 1457-58 (2016).

⁴⁴ PAUL A. GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 3-5 (1999).

⁴⁵ *Id.* at 5.

⁴⁶ William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 *VA. L. & BUS. REV.* 249, 260 (2017).

⁴⁷ Magnuson, *supra* note 24, at 1856, 1899. 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. Clayton, *supra* note 46, at 260.

⁴⁸ Clayton, *supra* note 46, at 260.

⁴⁹ See, e.g., GOMPERS & LERNER, *supra* note 44, at 19; Gilson, *supra* note 39, at 1089-90; David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 *COLUM. BUS.*

such funds, the GP has full control over the management of the fund's assets, but only for a finite period.⁵⁰ The limited duration forces the GP to raise new capital periodically.⁵¹ This constant need to raise capital exposes private equity funds to frequent reputational pressures and to the disciplinary power of capital markets.⁵² GPs that engage in opportunistic behavior or fail to establish a positive track record could face greater difficulty and increased costs in raising capital.⁵³

Second, the limited duration imposes a market check on the GPs' valuations. GPs have significant control over investments' valuations during the fund's lifetime.⁵⁴ Therefore, when GPs delay the liquidation of their investments, they have more room to conceal or overstate performance metrics. The limited duration ensures unbiased valuations at the fund's end.⁵⁵

Third, the limited duration of the funds also reflects the understanding that a GP's skills might not always be superior to the skills of 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.⁵⁶

Finally, the finite duration limits GPs' ability to maintain underperforming portfolio companies just to generate additional management fee income.⁵⁷

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).⁵⁸ Additionally, liquidating assets

L. REV. 363, 378-79. The limited duration of the fund ensures the market will evaluate every few years whether the GP's investment decisions favored risk over expected returns and reward the GP accordingly. Gilson, *supra* note 39, at 1089-90.

50 See Metrick & Yasuda, *supra* note 35, at 2309 ("The typical fund has a lifetime of ten years.").

51 See *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.").

52 See GOMPERS & LERNER, *supra* note 44, at 240 (claiming perpetual need to raise capital "puts pressure on young venture capital firms to establish a reputation and raise a new fund within a short, predetermined time").

53 See Sahlman, *supra* note 39, at 513.

54 Harris, *supra* note 24, at 278.

55 *Id.*; Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 14 (2008).

56 Cf. Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 606-07, 610-11 (2017) ("This structure might well reflect recognition that, many years down the road, a general partner's skills might no longer be superior or even adequate.").

57 Magnuson, *supra* note 24, at 1859.

58 Harris, *supra* note 24, at 280.

when the term of the fund ends may not always be optimal for investors. On some occasions, companies can generate higher 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.⁵⁹

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.⁶⁰ 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.⁶¹

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.⁶² But some scholars have recently criticized this view. They argue that private equity contracts do not respond satisfactorily to agency conflicts⁶³ and contest the superiority of private equity returns over public market returns, emphasizing the complex nature of assessing the overall success of private equity.⁶⁴ 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.⁶⁵

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

⁵⁹ See *infra* Section II.B.

⁶⁰ Clayton, *supra* note 24, at 75 (listing potential forms of manager self-dealing).

⁶¹ William W. Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703, 710 (2022).

⁶² *Id.* at 755.

⁶³ See, e.g., Clayton, *supra* note 24, at 78 ("One line of criticism argues that the compensation arrangements set forth in LPAs . . . actually create serious conflicts of interest." (footnote omitted)).

⁶⁴ See, e.g., Ludovic Phalippou, *An Inconvenient Fact: Private Equity Returns and the Billionaire Factory*, 30 J. INVESTING, Dec. 2020, at 11; JOHN COATES, THE PROBLEM OF 12: WHEN A FEW FINANCIAL INSTITUTIONS CONTROL EVERYTHING 87-88 (2023).

⁶⁵ See, e.g., Clayton, *supra* note 24, at 70-71 (hypothesizing the benefits of greater protections).

they overly interfere with the ability of the GP to successfully manage the fund. Second, LPs may have received a discount in exchange for not including a term in the LPA.⁶⁶ 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.

But scholars have recently proposed more nuanced explanations for the absence of governance protections. The main explanation raised in the literature is coordination problems.⁶⁷ 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.⁶⁸ This conflict of interest among investors also arises when investors with significant bargaining power receive preferential benefits through co-investment opportunities,⁶⁹ access to alternative investment vehicles with better returns,⁷⁰ or unwritten “gentlemen’s agreements.”⁷¹

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.⁷² Many LPs also have limited

⁶⁶ See, e.g., Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 545 (2003) (“Firms that maximize profits face the canonical ‘contracting problem’ of ensuring both efficient ex post trade and efficient ex ante investment in the subject matter of the contract.”); Clayton, *supra* note 61, at 745 n.179 (including fee discounts as an example of a consequence of large investor bargaining).

⁶⁷ See generally, e.g., Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327 (2010); Stephen Kim Park & Gerlinde Berger-Walliser, *A Firm-Driven Approach to Global Governance and Sustainability*, 52 AM. BUS. L.J. 255 (2015).

⁶⁸ 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*, 14 HARV. BUS. L. REV. 71, 97 (2024) (discussing issues imposed by side letters); Clayton, *supra* note 24, at 105-06 (same); Elizabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. 907, 959-61 (2023) (same).

⁶⁹ de Fontenay & Nili, *supra* note 68, at 931-35. 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. *Id.* at 934 n.136.

⁷⁰ 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).

⁷¹ See *supra* note 68.

⁷² Magnuson, *supra* note 24, at 1906 (“In order for investors to assess the risks of their investment, and to mitigate agency costs, investors must be provided with full information about partnership terms, side arrangements (if any), and fund activities and performance.”).

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.⁷³

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 for strong protections because of the personal career concerns of their investment officers.⁷⁴ Given that strong governance protections 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.⁷⁵

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.⁷⁶ But selling private equity assets when the term of the fund ends, typically within ten years, may not always be optimal.⁷⁷ In such cases, the GP can establish a continuation fund to acquire one or more portfolio companies from the legacy fund.⁷⁸

⁷³ Clayton, *supra* note 68, at 113-16.

⁷⁴ Clayton, *supra* note 61, at 740.

⁷⁵ See Clayton, *supra* note 68, at 107-08 ("Diluting restrictive covenants could thus be viewed as an indirect—and inefficient—way to make price adjustments that is less likely to attract the scrutiny of an internal manager's superiors and thereby raise fewer concerns about censure and career risk.").

⁷⁶ See *supra* notes 44-59 and accompanying text.

⁷⁷ See *infra* Section II.B.

⁷⁸ 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> [<https://perma.cc/FM3Z-9L6M>]; see also CLIFFORD CHANCE, "DECODING" THE SECONDARIES MARKET: PART IV: CONTINUATION FUNDS 2 (2020), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/09/decoding-the-secondary-market-part-IV-continuation-funds.pdf> [<https://perma.cc/BX5V-8TXW>] (asserting that, with additional capital, GPs can establish continuation funds for additional acquisitions) [hereinafter CLIFFORD CHANCE 2020].

Continuation funds are typically set to last up to six years.⁷⁹ In most cases, LPs of the legacy funds have the following options when a continuation fund is created: (1) selling their interest in the existing fund and receiving a pro-rata share of the purchase price; (2) rolling over their interest into the continuation vehicle; or (3) in some cases, both.⁸⁰ 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.⁸¹ The GP may also request that rolling investors provide additional capital commitments to the continuation fund.⁸² On a *status quo basis*, the LP participates in the continuation fund on substantially the same economic

⁷⁹ Keith Button, *The Rise of Continuation Funds*, Mergers & Acquisitions (Mar. 7, 2022), <https://www.themiddlemarket.com/feature/the-rise-of-continuation-funds> [<https://perma.cc/NQH5-K6FN>].

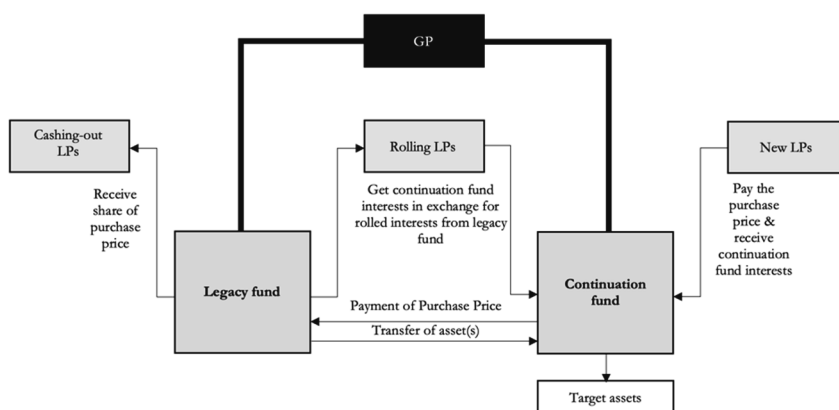
⁸⁰ CAP. DYNAMICS, GP-LED SECONDARIES RESHAPING THE LANDSCAPE FOR INVESTORS, FUND MANAGERS, AND PORTFOLIO COMPANIES 3 (2022), https://www.capdyn.com/Customer-Content/www/news/PDFs/Capital_Dynamics_-_GP-led_Secondaries.pdf [<https://perma.cc/38ZK-FFFQ>].

⁸¹ ILPA, GP-LED SECONDARY FUND RESTRUCTURINGS: CONSIDERATIONS FOR LIMITED AND GENERAL PARTNERS 4 (2019), <https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-Restructurings-Apr-2019-FINAL.pdf> [<https://perma.cc/G8JE-3DQU>] [hereinafter ILPA 2019]; Sebastian McCarthy & Lina Saigol, *Private Equity Turns to Continuation Funds to Keep Hold of Trophy Assets*, FIN. NEWS (Nov. 24, 2021, 8:24 AM), <https://www.fnlonon.com/articles/private-equity-turns-to-continuation-funds-to-keep-hold-of-trophy-assets-20211124> [<https://perma.cc/56FR-2UHF>]; CLIFFORD CHANCE 2020, *supra* note 78, at 4.

⁸² CLIFFORD CHANCE 2020, *supra* note 78, at 3. When rolling investors commit additional capital to the continuation fund, their economic terms will typically be aligned with those of new investors. See Interview with Participant 13 (Jan. 11, 2024).

terms, and the GP's carried interest is not crystallized.⁸³ Figure 1 below illustrates a typical structure of a continuation fund.⁸⁴

Figure 1: A Continuation Fund Structure



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

⁸³ The “pure” status quo option involves transferring assets from a legacy fund to a new fund without changing the fund terms. But 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 (2023), <https://ilpa.org/wp-content/uploads/2023/05/Continuation-Funds-Considerations-for-Limited-Partners-and-General-Partners.pdf> [<https://perma.cc/U697-QB85>] [hereinafter ILPA 2023] (“LPs must be provided the option to participate in the new structure with no change in economic terms i.e., a ‘status quo’ option.”). Continuation funds also involve complex tax considerations; but a detailed discussion of these issues falls beyond the scope of this Article. For further reference, see Rafael Kariyev & Samuel D. Krawiecz, *Continuation Funds: Tax Considerations*, TAX NOTES (Dec. 11, 2023), <https://www.taxnotes.com/tax-notes-federal/mergers-acquisitions-and-reorganizations/continuation-funds-tax-considerations/2023/12/11/7hk22>.

⁸⁴ See also Dylke et al., *supra* note 8; Ted Cominos & Cristina Audran-Proca, *Let the Good Times Roll – Continuation Funds and Their Appeal to GPs and LPs*, EVERSHEDES SUTHERLAND (Dec. 8, 2022), <https://www.eversheds-sutherland.com/en/global/insights/let-the-good-times-roll-continuation-funds-and-their-appeal-to-gps-and-lps> [<https://perma.cc/V2Y5-A3LS>].

lifespan.⁸⁵ 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.⁸⁶ Market conditions could also significantly affect exit decisions, as traditional exit options may not be viable in challenging markets.⁸⁷ 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.⁸⁸ 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.⁸⁹

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.⁹⁰ 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.⁹¹

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 rolling their investments into the continuation fund.⁹² Rolling LPs gain continued exposure to assets with which they are familiar

⁸⁵ Miriam Partington, *HV Capital Launches Germany’s First Continuation Fund of €430m*, SIFTED (Feb. 16, 2022), <https://sifted.eu/articles/hv-capital-continuation-fund> [<https://perma.cc/C9W3-NBTX>].

⁸⁶ *Private Equity’s New Trend*, *supra* note 10.

⁸⁷ *Id.*

⁸⁸ Debbie Reeve & Michelle McNaney, *The Rise of Continuation Funds*, AZTEC GRP. (July 14, 2022), <https://aztec.group/insights/the-rise-of-continuation-funds> [<https://perma.cc/R97B-79HK>].

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Madeline Shi, *Continuation Funds Drive GP-Led Secondaries Wave*, PITCHBOOK (Feb. 1, 2022), <https://pitchbook.com/news/articles/continuation-funds-GPs-secondaries-private-equity> [<https://perma.cc/SXD5-AKSV>].

⁹² 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, when some LPs were content to stay invested while others wanted an immediate exit).

(with potential that cannot be fulfilled during the original fund's lifetime) and reinforce their relationship with the GP.⁹³

For incoming LPs, continuation funds offer an opportunity to invest in more “mature” assets for a shorter period than the portfolio company's lifecycle.⁹⁴ They enjoy full visibility of the asset they are buying into and the ability to develop a GP relationship.⁹⁵

C. *The Growing Prevalence of Continuation Funds*

Continuation funds have been one of the most popular trends in the private equity world over the last few years.⁹⁶ 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 a bad reputation and were considered a means of restructuring underperforming assets.⁹⁷ Starting around 2010, continuation funds were used for distressed assets that were struggling in the aftermath of the global financial crisis.⁹⁸ Sponsors who could not raise a successor fund would use continuation funds to maintain fee generation.⁹⁹ 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.¹⁰⁰

“*Crown jewel*” funds: The shift occurred around 2015 when sponsors and their advisors realized that continuation funds could be a useful tool not

⁹³ Button, *supra* note 79; *Private Equity's New Trend*, *supra* note 10.

⁹⁴ See Mark Cooper, *How Continuation Funds Can Provide Bespoke Solutions for All Sides*, PERE (Apr. 1, 2024), <https://www.perenews.com/how-continuation-funds-can-provide-bespoke-solutions-for-all-sides/>.

⁹⁵ *Private Equity's New Trend*, *supra* note 10.

⁹⁶ See 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> [<https://perma.cc/U9KY-4HZL>].

⁹⁷ See Madeleine Farman, *PE Zombie Funds Reinvented for 'Crown Jewel' Strategy*, S&P GLOB. MKT. INTEL. (Sept. 13, 2021), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/pe-zombie-funds-reinvented-for-crown-jewel-strategy-66278877> [<https://perma.cc/S3VB-GUH7>].

⁹⁸ See, e.g., *id.* (noting examples from Warburg Pincus LLC and BC Partners).

⁹⁹ Donald H. Lennard & Jeannette M. Anthony, *To Be Continued: The Case for GP-Led Secondary Funds*, DEMARCHE ASSOCS. (May 2021), <https://www.demarche.com/whitepaper/to-be-continued-the-case-for-gp-led-secondary-funds/> [<https://perma.cc/YWR7-YYWE>].

¹⁰⁰ Cf. Farman, *supra* note 97. (discussing improvements in secondaries transactions for LPs and factors influencing their decision to roll or sell).

necessarily just for distressed assets, but also for high-performing assets that they wanted to hold for longer periods due to unfavorable market conditions.¹⁰¹ It also allowed for additional infusions of capital when the GP could no longer raise funding from the legacy fund investors.¹⁰² This practice has accelerated due to COVID-19, which made scheduled exit windows for portfolio assets less viable.¹⁰³ As a result, continuation funds have gained more and more traction, quickly becoming entrenched in the private equity ecosystem.¹⁰⁴

Data collected over the past eight 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 five-year period. In 2021, these transactions reached their largest volume in history, estimated at around \$68 billion in deal value, and have since sustained a robust volume.¹⁰⁵ Importantly, market participants estimate that these transactions will continue to form a substantial part of the private equity market.¹⁰⁶

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 market volume, now

101 PITCHBOOK, U.S. PE BREAKDOWN 2021 ANNUAL 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.”).

102 Lennard & Anthony, *supra* note 99.

103 CLIFFORD CHANCE 2020, *supra* note 78, at 2; *see also* Button, *supra* note 79 (finding that many portfolio companies’ sales and cash flows were affected by COVID-19).

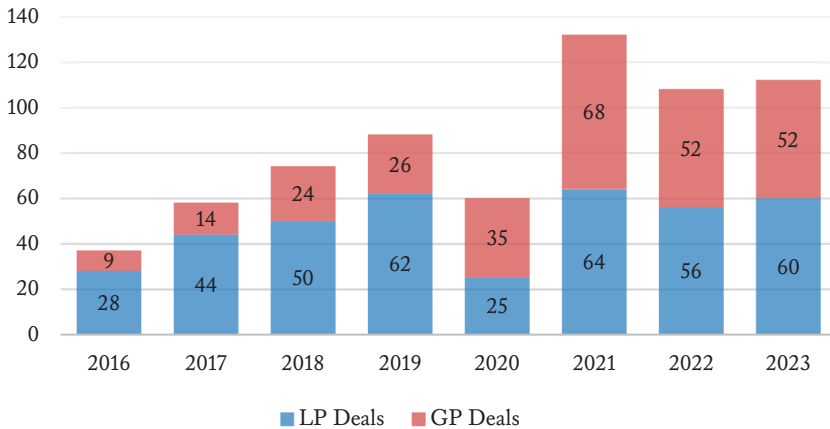
104 Reeve & McNaney, *supra* note 88; Cominos & Audran-Proca, *supra* note 84.

105 JEFFERIES, GLOBAL SECONDARY MARKET REVIEW 7 (2023), https://www.jefferies.com/CMSFiles/Jefferies.com/files/IBBlast/Jefferies-Global_Secondary_Market_Review-January_2023.pdf [<https://perma.cc/K6HC-3BJ8>]; John M. Caccia, Greg Norman & Anna Rips, *How Good Governance Frameworks Can Optimize Outcomes in Continuation Funds*, PRIV. EQUITY L. REP. (Mar. 15, 2022), <https://www.pelawreport.com/18868111/how-good-governance-frameworks-can-optimize-outcomes-in-continuation-funds.shtml> [<https://perma.cc/L8E2-CNYV>]; CLIFFORD CHANCE 2020, *supra* note 78.

106 *See* Reeve & McNaney, *supra* note 88; Cominos & Audran-Proca, *supra* note 84; LAZARD PRIV. CAP. ADVISORY, SPONSOR-LED SECONDARY MARKET REPORT 2021 13 (2022), <https://www.lazard.com/media/olyhhtz3/lazard-sponsor-led-secondary-market-report-2021.pdf> [<https://perma.cc/DVG3-HZ7G>] [hereinafter LAZARD 2021].

account for almost 50% of the overall volume of secondary deals,¹⁰⁷ sometimes outpacing LP-led deals.¹⁰⁸

Figure 2: Secondary Transaction Volume by Year (\$ bn)¹⁰⁹



A continuation fund is only one type of secondary transaction conducted by GPs. Other types include tender offers,¹¹⁰ portfolio strip sales,¹¹¹ and stapled transactions.¹¹² But continuation funds are by far the most common type of GP-led secondary transaction.¹¹³ In 2021 and 2022, continuation funds represented 83% and 85% of these transactions, respectively.¹¹⁴ In addition, some continuation funds are beginning to be created earlier in a fund's

¹⁰⁷ See CAP. DYNAMICS, *supra* note 80, at 2.

¹⁰⁸ Cari Lodge, *LP-Led Secondaries: The Core of the Secondaries Market*, CF PRIV. EQUITY (Sept. 26, 2022), <https://www.commonfund.org/cf-private-equity/lp-led-secondaries-the-core-of-the-market> [<https://perma.cc/5B4J-TGYB>].

¹⁰⁹ JEFFERIES, *supra* note 105, at 3.

¹¹⁰ A GP-led tender offer is "a coordinated option for LPs to obtain liquidity through a market-priced tender offer for fund interests [that] is typically triggered by a group of LPs having indicated an interest in liquidity." CAP. DYNAMICS, *supra* note 80, at 4.

¹¹¹ 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 (2019), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2019/10/decoding-the-secondary-market.pdf> [<https://perma.cc/YBK6-LK45>] [hereinafter CLIFFORD CHANCE 2019].

¹¹² 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.*

¹¹³ Shi, *supra* note 91.

¹¹⁴ JEFFERIES, *supra* note 105, at 7; Shi, *supra* note 91; LAZARD 2021, *supra* note 106.

lifecycle,¹¹⁵ a practice that also raises some investor concerns. In 2022, 60% of GP-led transactions involved funds aged between one and six years old, with 20% of those falling within the one-to-three-year age range.¹¹⁶

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.¹¹⁷ For example, in 2021, single-asset continuation funds accounted for 52% of all transactions led by GPs, compared to 38% in 2020.¹¹⁸ Multi-asset continuation funds accounted for 31% and 34% of all GP-led transactions in 2021 and 2020, respectively.¹¹⁹

Finally, while the use of continuation funds is a global development, the North American market is, by far, the most active region,¹²⁰ with 71% of total GP-led transactions that closed in 2021 (249 out of 350 transactions) coming from this area.¹²¹ The majority of this volume stemmed from large continuation fund transactions.¹²²

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: “[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.”¹²³

115 Alicia McElhane, *As Continuation Funds Plague LPs, Investors Search for a Solution*, INSTITUTIONAL INV. (June 13, 2023), <https://www.institutionalinvestor.com/article/2bsts917gtgnemdxpuns/portfolio/as-continuation-funds-plague-lps-investors-search-for-a-solution> [https://perma.cc/S8NK-CEQ4].

116 EVERCORE PRIV. CAP. ADVISORY, 2022 SECONDARY MARKET SURVEY RESULTS 8 (2023), <https://indd.adobe.com/view/b50985c1-3819-4a23-849b-7d66e545df09> [https://perma.cc/9A6Y-PXAE]; LAZARD PRIV. CAPITAL ADVISORY, 2022 SECONDARY MARKET REPORT 7 (2023), <https://www.lazard.com/media/40nledua/lazard-secondary-market-report-2022.pdf> [https://perma.cc/6AHS-GD2C]; (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.”).

117 EVERCORE, *supra* note 116, at 8.

118 LAZARD 2021, *supra* note 106, at 4.

119 *Id.* at 7. Similar distributions were observed in 2022. See JEFFERIES, *supra* note 105, at 7.

120 LAZARD 2021, *supra* note 106, at 4.

121 *Id.*

122 *Id.*

123 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/> [https://perma.cc/Q7J6-X8YF].

D. Continuation Funds' Web of Conflicts

The continued growth of continuation funds has also drawn the attention of large institutional investors and regulators.¹²⁴ While some investors and the SEC have expressed concerns about this rising trend and its reasons,¹²⁵ 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 examining 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).¹²⁶ But 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.¹²⁷ 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 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

¹²⁴ 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/> [<https://perma.cc/2TM9-ESHN>] (“[B]etween GPs and LPs was top of mind for investors and in what could be a pivotal year for infrastructure fundraising in 2023 GPs considering such vehicles would do well to keep this in mind.”); Wong & Wong, *supra* note 6 (“Regulators are also starting to pay attention to conflicts of interest in these transactions.”).

¹²⁵ See *supra* notes 15–17 and accompanying text.

¹²⁶ CAP. DYNAMICS, *supra* note 80, at 9 (“Management fees [in continuation funds] typically range from 0.50% to 1.25%.”); Tim Jenkinson, Hyeik Kim & Michael S. Weisbach, *Buyouts: A Primer* 105 (Fisher College of Bus. Working Paper 2021-03-018, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3964770 [<https://perma.cc/M392-Q9C4>].

¹²⁷ 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).

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.¹²⁸ 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.¹²⁹ Therefore, a continuation fund might enable the GP to do less but get paid more.

An option to receive additional carry. Furthermore, the GP can receive additional carried interest when the portfolio company is sold at the end of the continuation fund's lifespan if the continuation fund sells its asset at a profit.¹³⁰ And while the carried interest in continuation funds may be lower than in regular funds,¹³¹ 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.¹³² 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.

Resetting carry terms. GPs could also use a continuation fund to meet a specific carry hurdle rate and therefore collect the 20% carried interest once

128 See CAP. DYNAMICS, *supra* note 80, at 9 (“Tiered carry structures are normally used and the standard 20% carry is not achieved by the sponsor unless certain hurdles are met.”); Amy Carroll, *The Complex World of Management Fees*, PRIV. FUNDS CFO (Oct. 3, 2022), <https://www.privatefundscfo.com/the-complex-world-of-management-fees/> (“Many investors look for the management fee to start with the first investment and they look for it to terminate at the end of term.”).

129 See generally Cooper, *supra* note 94.

130 José Gabriel Palma, *Financialization as a (It's-Not-Meant-to-Make-Sense) Gigantic Global Joke* 15 (Cambridge Working Papers in Econ. 2211, 2022), <https://api.repository.cam.ac.uk/server/api/core/bitstreams/8abfa04d-b1df-4870-97fc-79bf7f337d31/content> [<https://perma.cc/SEU6-S5US>].

131 Adam Le, *Investors Push for Greater Alignment in Continuation Vehicles Versus Blind-Pool Funds*, SECONDARIES INV. (Apr. 20, 2022), <https://www.secondariesinvestor.com/investors-push-for-greater-alignment-in-continuation-vehicles-versus-blind-pool-funds>. The carried interest in continuation funds can also be higher than in regular funds. Wong & Wong, *supra* note 6 (“Managers will frequently push for a super carry.”).

132 *Options Pricing*, MERRILL, <https://www.merrilledge.com/investment-products/options/options-pricing-valuation> (last visited Feb. 14, 2023) [<https://perma.cc/2FZW-UVMX>].

the continuation fund realizes the returns on that specific asset.¹³³ Consider, for example, a legacy fund that has three underperforming assets and a successful asset that could generate some profits to the GP, but these profits are not large enough to offset the losses stemming from the three other underperforming assets, preventing the GP from meeting the carry threshold of the legacy fund. The GP could transfer the asset with the potential to generate profits from the legacy fund into continuation funds, effectively resetting the transferred asset's potential for carried interest. This maneuver provides the GP a new opportunity to earn carry on previously non-qualifying investments that were unlikely to meet the thresholds for distributing carry interest to the GP.

Extended control. Continuation funds also enable the private equity sponsors to control the fund's assets for extended period of time, while deviating from the traditional ten-year timeframe and delaying a real market check on GPs' valuations.¹³⁴

"Double down" on successful investments. Continuation funds also provide the GP with an opportunity to increase its economic exposure to successful portfolio companies. If the legacy fund has some high-performing assets, the GP can double down on these successful investments by transferring them to a continuation fund and providing up to 10% of the investor commitment to this newly established fund.¹³⁵ An equity investment enables the GP to capture 100% of the gains from such investment instead of just the 20% carried interest.

Carry crystallization in early-stage continuation fund transactions. When a continuation fund is established early in the life cycle of the legacy fund, it enables the GP to crystallize its carried interest immediately upon closing this early-stage deal, taking some money off the table.¹³⁶

To be clear, the GP receives that carried interest even though the portfolio company was not sold to another buyer 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 at a relatively early stage of the fund's lifecycle also provides the GP with partial liquidity to compensate retiring

133 See Interview with Participant 8 (Jan. 27, 2023).

134 See, e.g., Harris, *supra* note 24, at 278, 280-81.

135 See *infra* note 252.

136 When a continuation fund is established late in the fund's life cycle to avoid a sale of the portfolio company, the crystallization of the carried interest is not considered as a benefit from the perspective of the GP, because in the event of a "real" exit towards the end of the fund's life cycle, the GP will also crystallize the carried interest and take some money off the table. Such benefit is only relevant to situations where the continuation fund is established relatively early in the fund's lifecycle.

partners of the GP.¹³⁷ 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.¹³⁸

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.¹³⁹ Thus, the GP, as a fiduciary to both the legacy fund and the continuation fund, must act in the best interest of each group of LPs and maneuver within a web of complex and conflicting loyalties.¹⁴⁰ 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.¹⁴¹

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.¹⁴² In Delaware, where most private equity firms are formed, fiduciary duties can

137 Continuation funds provide only partial liquidity to the GP because the LPs buying in the continuation funds often want the GP to make significant commitments to the continuation fund, either by rolling a significant fraction of the GP's carried interest or by providing up to 10% of the investor commitment to the continuation fund. *See infra* subsection III.D.2.

138 *See generally* 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 43, at 1454-55.

139 Gregg Gethard, *LP/GP Alignment at Risk from Proliferation of Continuation Funds, Subscription Lines: Report*, BUYOUTS (Oct. 31, 2022), <https://www.buyoutsinsider.com/lp-gp-alignment-at-risk-from-proliferation-of-continuation-funds-subscription-lines-report/> [<https://perma.cc/NHA9-7FTJ>]. But according to the ILPA, as a general principle, continuation fund transactions should maximize value only for existing LPs. ILPA 2023, *supra* note 83, at 4.

140 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, *supra* note 24, at 77-78, 82 (discussing managers' legal fiduciary duties).

141 Interview with Participant 5 (Feb. 6, 2023).

142 Clayton, *supra* note 24, at 77.

be modified or even waived entirely by an LPA's terms.¹⁴³ As we will show, the GP often receives a waiver from the LPAC approving the establishment of a continuation fund.¹⁴⁴ 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 among 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.¹⁴⁵ LPs tend to sell their interests for various reasons, which will be discussed in Section 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.¹⁴⁶ 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,¹⁴⁷ it may seem reasonable that the GP would have an interest in overvaluing the assets in order to receive a higher carried interest.¹⁴⁸ 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.”¹⁴⁹

¹⁴³ *Id.*

¹⁴⁴ See *infra* subsection III.D.1.

¹⁴⁵ 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.” See RAYMOND JAMES, 2023 SECONDARIES OUTLOOK SURVEY 13 (2023), https://www.raymondjames.com/-/media/rj/dotcom/files/corporations-and-institutions/investment-banking/industry-insight/rjpc_2023_secondaries_outlook_survey_report.pdf [<https://perma.cc/EM4L-MZHN>]. 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*, INSTITUTIONAL INV. (June 13, 2023), <https://www.institutionalinvestor.com/article/b8z2xxofp7ywh6/As-Continuation-Funds-Plague-LPs-Investors-Search-for-a-Solution> [<https://perma.cc/8P6T-YWUD>].

¹⁴⁶ Hope, *supra* note 78.

¹⁴⁷ See Magnuson, *supra* note 24, at 1855–56.

¹⁴⁸ See Healthy Markets Ass'n, Comment Letter on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 10–11 (Apr. 15, 2022), <https://www.sec.gov/comments/s7-03-22/s70322-20123868-280038.pdf> [<https://perma.cc/TS54-VWDB>] (“[T]he greater the valuations of the securities, the greater the potential fees for the adviser.”).

¹⁴⁹ See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63206, 63352 (codified at 17 C.F.R. pt. 275 (2023)).

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.¹⁵⁰ 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. But even without resolving this difficult question, it is clear that by making the GP a servant of two masters, continuation funds distort the high 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 GP Almost 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 (either 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, almost 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 receive the additional private benefits outlined in subsection II.D.1 (including additional management fees, the benefit of extended control, and in the case of early-

¹⁵⁰ Reeve & McNaney, *supra* note 88 (“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.”); CAP. DYNAMICS, *supra* note 80, 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.”).

stage continuation funds, the benefit of a fast crystallization of the carried interest), and thus will almost 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).¹⁵¹

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.

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

In this Section, we show that the incentives 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.¹⁵²

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.¹⁵³ In recent years (2020–2022), more than 75% of GP-led

¹⁵¹ 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. See Interview with Participant 13 (Jan. 11, 2024) (stating that most of their clients establish continuation funds between fundraisings).

¹⁵² See Cooper, *supra* note 94.

¹⁵³ See LAZARD 2021, *supra* note 106, at 9 (“Secondary market GP-led transactions continued to include i) unfunded commitments to generate follow-on capital for portfolio companies (particularly when a sponsor has depleted unfunded capital) or ii) primary staple commitments to support an ongoing fundraiser[.]”).

transactions included LPs offering follow-on capital, and more than 24% included a stapled commitment.¹⁵⁴ 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.¹⁵⁵

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.¹⁵⁶ Evidence shows that the private equity industry has evolved over the years from being “mercenary” to being a more collaborative culture of “clubbiness.”¹⁵⁷ Indeed, a record of 442 deals among private equity firms worth a total of \$62 billion were completed in 2021.¹⁵⁸ As Harvard professor Josh Lerner explained, “When you have repeated relationships, you are just not going to go to war with the same ferocity.”¹⁵⁹ This new web of relationships among private equity competitors, which is cozier than ever, supports our hypothesis that the GPs’ 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

¹⁵⁴ EVERCORE, *supra* note 116, at 8.

¹⁵⁵ See 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> [<https://perma.cc/W7YM-UDBH>] (explaining a conflict could emerge if sponsors opt for lower offers with stapled commitments, depriving LPs of the best price); Button, *supra* note 79 (“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.”).

¹⁵⁶ See PITCHBOOK, *supra* note 101, at 41 (“Some firms prefer to bring in another sponsor to provide capital, expertise, and price discovery.”); JEFFERIES, *supra* note 105, at 7 (“Many investors chose not to evaluate transactions involving sponsors they did not already have a meaningful relationship with.”); LAZARD 2021, *supra* note 106, at 15 (noting the concentration in GP-led transactions). We examined the identities of investors in ten prominent continuation funds. Those cases illustrate that sophisticated 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.

¹⁵⁷ 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> [<https://perma.cc/GRW3-P3CQ>].

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*; see also COATES, *supra* note 64, at 92 (“[T]hrough club deals, secondary buyouts, and lobbying through trade groups, [private equity firms] function less like rivals than allies.”).

not treat all LPs equally.¹⁶⁰ LPs with better past performance and better outside options are more likely to have access to alternative investment vehicles (including continuation funds) with above-average market returns than those with lower past performance.¹⁶¹ 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.¹⁶² 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.”¹⁶³

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 ten-year limited duration restricts GPs' power to

¹⁶⁰ Lerner et al., *supra* note 70, at 375.

¹⁶¹ Lerner et al., *supra* note 70, 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, instead differentiating them based on their outside options.

¹⁶² RAYMOND JAMES, *supra* note 145, 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 PRIV. CAP. ADVISORY, SECONDARY MARKET SURVEY REPORT 5 (2023), <https://www.williamblair.com/Insights/William-Blair-Private-Capital-Advisory-Inaugural-Secondary-Market-Survey-Report> [<https://perma.cc/3L6F-YF8V>]; JEFFERIES, *supra* note 105, 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.”); see also LAZARD PRIV. CAPITAL ADVISORY, 2023 SECONDARY MARKET REPORT 10 (2024), <https://www.lazard.com/research-insights/lazard-2023-secondary-market-report/> (“GP-led pricing fell in 2023 versus 2022 . . .”) [hereinafter LAZARD 2023].

¹⁶³ Le, *supra* note 145 (alteration in original); see *Are LPs Missing the Boat? Examining GP-Led Secondaries in the Private Equity Market*, UPWELLING CAP. GRP. 5 (2022), <https://upwellingcapital.com/wp-content/uploads/2022/10/Continuation-Vehicles-Research-Report-2022-Upwelling-Capital-Group.pdf> [<https://perma.cc/ZT7V-SB9Q>]. In Section I.D, we suggested that GPs may be overcompensated through management fees and carried interest in continuation funds. One might argue that if the new investors in continuation funds are indeed more sophisticated, why would they agree to these economic terms? The answer is twofold. First, new investors benefit from continuation funds, and they understand that for GPs to establish them, the deal must be economically attractive for the GPs; otherwise, it will not happen. Second, GPs have alternative ways to compensate and favor their preferred investors, which are not tied to fees.

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. But 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.¹⁶⁴ 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.¹⁶⁵ 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 portfolio companies are sold in an arms-length transaction.¹⁶⁶ But continuation funds allow GPs to delay this crucial "market check" on their valuations.

While continuation fund transactions often involve new investors, these transactions do not impose the same market check as traditional exits.¹⁶⁷ In a conventional exit, the GPs' interest in selling at the highest possible price 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.¹⁶⁸ 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.¹⁶⁹

¹⁶⁴ See subsection II.D.3.

¹⁶⁵ 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. But 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. See Chris Witkowski, *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/>.

¹⁶⁶ See *supra* notes 54–55 and accompanying text.

¹⁶⁷ See *supra* notes 153–155 and accompanying text.

¹⁶⁸ See subsection II.D.4.

¹⁶⁹ Lerner et al., *supra* note 70, at 361.

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. But they both rely heavily on their respective counsels and financial advisors for negotiations and drafting. One of us has shown elsewhere that “[o]utside counsel for private equity sponsors and investors tend to draw from a very small set of elite law firms that specialize in private equity practice,” and most tend to focus primarily on sponsor-side or investor-side work.¹⁷⁰ This also applies to financial advisors.¹⁷¹ As a result, these advisors are the purest repeat players in the private equity industry:¹⁷² they set market standards and derive significant economic benefits from developing the continuation fund practice.¹⁷³

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 (1) the assets are sold to the continuation fund and (2) 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 in recent years,¹⁷⁴ there is much more paid work for advisors. One investor even noted that GPs are often surprised to hear investors' negative reactions to continuation funds, because GPs are surrounded by advisors who have strong interests in these

¹⁷⁰ See de Fontenay & Nili, *supra* note 68, at 966.

¹⁷¹ See, e.g., Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27, 37-42; Ali Imran Naqvi & Annie Sabater, *Morgan Stanley Top Financial Adviser on Private Equity Deals in 2022*, S&P GLOB. MKT. INTEL. (Feb. 24, 2023), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/morgan-stanley-top-financial-adviser-on-private-equity-deals-in-2022-74454264> [<https://perma.cc/B7GK-KQP5>].

¹⁷² Casey Sullivan, *Private Equity Firms Are Locked in a Power Struggle with Their Investors, and Lawyers Are Raking in Cash No Matter What*, BUS. INSIDER (Sept. 20, 2021, 5:30 AM), <https://www.businessinsider.com/private-equity-lawyers-investors-legal-war-2021-9> [<https://perma.cc/MW2B-ZZPH>] (citing a New York-based placement agent 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).

¹⁷³ For example, leading firms like Wachtell, Lipton, Rosen & Katz join industry leaders in discussing trends. See Victor Goldfeld, Mark Stagliano & Anna D'Ginto, *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/> [<https://perma.cc/25CY-F46E>].

¹⁷⁴ See JEFFERIES, *supra* note 105, at 2 (reporting that 2021 saw record global secondary volume with 2022 as runner-up).

transactions taking place, and therefore keep focusing on one side of the story, the upsides, while downplaying the downsides.¹⁷⁵

We do not suggest that legal and financial advisors are the sole drivers behind the rise in continuation funds. But 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.

* * *

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 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. Indeed, some LPs we interviewed explained that once the carry is crystallized, the GP does not have to re-earn it, and it is no longer subject to a clawback provision that enhances the alignment of interests.¹⁷⁶ 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.¹⁷⁷ Our interviews and recent data support this analysis, painting a picture of substantial skepticism towards continuation funds among the overwhelming majority of LPs,¹⁷⁸ with survey results revealing a small minority of LPs expressing significant interest in such funds.¹⁷⁹

¹⁷⁵ See Interview with Participant 9 (Jan. 30, 2023) (“[A]ll [GPs] are hearing from their advisors is how great it is. They are surprised that the negative thing they hear about it is from the LPs.”).

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*; Interview with Participant 7 (Jan. 27, 2023).

¹⁷⁸ Chris Witkowsky, *Continuation 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 the alignment of their relationships with GPs.”).

¹⁷⁹ See Farman, *supra* note 20 (reporting only six percent of LPs had great interest in continuation funds).

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 the Appendix.

To identify interview subjects on the sponsor side, we reviewed law firm memoranda 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 ten years of experience, and often significantly more. To encourage candid and detailed responses, the interview participants were promised anonymity.¹⁸⁰ 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

¹⁸⁰ The authors retained copies of each interview transcript or detailed notes with personal information removed.

involved in over eighty-five GP-led transactions during 2022 (with the aggregate transaction volume exceeding \$60 billion).

Finally, it is important to stress that we did not rely on the interviews as our sole 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.¹⁸¹ 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.¹⁸² 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.¹⁸³ We discuss these major challenges below.

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.¹⁸⁴ 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.¹⁸⁵ In such a situation, there is a concern that the GP may use its informational advantage

¹⁸¹ We reviewed and analyzed eighteen 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.

¹⁸² See *supra* Section II.B.

¹⁸³ See, e.g., Le, *supra* note 145 (“For every year an LP forgoes rolling into a [continuation vehicle], they give up an extra 15 percent-plus gain over the long run.” (alteration in original)).

¹⁸⁴ See *GP-Led Secondary Transactions: A “New-Fashioned” Way of Achieving Liquidity*, PAUL WEISS (Oct. 2017), <https://www.paulweiss.com/media/3977412/20ct17-pfs.pdf> [<https://perma.cc/8HEK-AH5P>] (recognizing the problem of asymmetrical information between GPs and LPs and the prisoner’s dilemma selling LPs face); Interview with Participant 6 (Jan. 18, 2023) (noting the information GPs provide is sometimes limited).

¹⁸⁵ See Harris, *supra* note 24, at 277-78 (describing the fund manager as having the best information as when an investor should exit, and full control over that information); Magnuson, *supra* note 24, at 1881-82 (contrasting the limited information private equity investors are entitled to with the rigorous SEC requirements for disclosures of public corporations).

strategically.¹⁸⁶ This asymmetry of information 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, making it more reasonable to cash out. They may also lack some information that is provided to the LPAC or the new lead investor.¹⁸⁷ 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.¹⁸⁸ In addition, LPs lack information regarding continuation funds’ returns. Major data vendors do not collect systematic information about their performance, focusing instead on traditional funds.¹⁸⁹ 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 with no experts in GP-led secondary transactions.¹⁹⁰ As explained in our interviews, the lack of expertise is one reason these investors elect to invest in private equity in the first place. They pay lucrative compensation to the GP, so that the GP will make these complex buy, hold, or sell decisions for them.¹⁹¹ But in the continuation fund

¹⁸⁶ See generally Douglas Cumming, Andrej Gill & Uwe Walz, *International Private Equity Valuation and Disclosure*, 29 NW. J. INT’L L. & BUS. 617 (2009) (discussing strategic nondisclosure of performance information related to investments that have not yet been exited by private equity firms).

¹⁸⁷ See Interview with Participant 9 (Jan. 30, 2023) (requiring a fairness opinion might prevent the issue of the LPAC not sharing information they have); Interview with Participant 6 (Jan. 18, 2023) (“[B]ut you don’t know what the other LPs are doing, and sometimes the information provided by the GP is limited.”)

¹⁸⁸ Interview with Participant 6 (Jan. 18, 2023); see also 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.”).

¹⁸⁹ Lerner et al., *supra* note 70, at 361.

¹⁹⁰ 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 (Feb. 6, 2023) (“[T]he GP is in the best position to know what direction those portfolio companies are tending because the GP has access to more current information than the LPs.”); Fiona McNally, *Frustrated LPs Await New Guidance on GP-Led Secondaries*, PRIV. EQUITY WIRE (Apr. 29, 2022, 6:59 AM), <https://www.privateequitywire.co.uk/2022/04/29/314174/frustrated-lps-await-new-guidance-gp-led-secondaries> [<https://perma.cc/Z3HF-6SD3>] (explaining that pension plans that manage significant amounts of capital often have small teams).

¹⁹¹ Interview with Participant 3 (Jan. 26, 2023); Interview with Participant 5 (Feb. 6, 2023).

context, this responsibility shifts once again from the GP to the LPs.¹⁹² 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.¹⁹³

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. New LPs, who typically specialize in secondary transactions, are often willing to pay the transaction price, which indicates the expected profitability of the transaction and allows legacy fund LPs to follow their lead.¹⁹⁴ 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.¹⁹⁵ Hence, the price new LPs are willing to pay for a particular transaction is not a sufficient indicator. Additional factors contribute to legacy LPs' hesitation to follow buyers' lead, such as time constraints due to institutional requirements, liquidity needs, and different risk tolerances.

Lack of time. LPs often have only ten to twenty days to decide whether to cash out or roll over their stake to continuation funds. For many of them, it is difficult or unrealistic to make a well-informed choice in such a narrow timeframe.¹⁹⁶ This problem is further aggravated as continuation funds gain

¹⁹² Le, *supra* note 145 (explaining that LPs must make the decision about continuation fund opportunities).

¹⁹³ See 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> [<https://perma.cc/M9TS-BKKS>] (“[M]any of them opt to just sell: to make an informed decision it would be necessary to perform a specific asset-level due diligence that these investors are not used to.”); Alicia McElhaney, *Private Equity Firms Say These Funds Hold Their ‘Crown Jewels’ — But Most Investors Are Opting Out*, INSTITUTIONAL INV. (Dec. 13, 2022), <https://www.institutionalinvestor.com/article/2bstlpu1773oaz2wciio/corner-office/private-equity-firms-say-these-funds-hold-their-crown-jewels-but-most-investors-are-opting-out> [<https://perma.cc/AH4W-U6L7>] (“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 2023, *supra* note 83, at 3.

¹⁹⁴ See Pimpaud et al., *supra* note 11.

¹⁹⁵ Lerner et al., *supra* note 70, at 360–61.

¹⁹⁶ See ILPA 2023, note 83, at 3; Sonia R. Gioseffi, Yasho Lahiri & Aaron J. Russ, *Breaking Up Is Hard to Do, So Let’s Stay Together: An Analysis of Issues in Continuation Funds*, 28 INV. L., Nov. 2021, at 6, https://marketingstoragerags.blob.core.windows.net/webfiles/IL_Gioseffi-Lahiri-Russ_1121.pdf [<https://perma.cc/3682-A2XE>] (“[T]he 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.”).

popularity; LPs are now required to make this type of decision at least two or three times a month and to review and analyze long and complex documents within a narrow timeframe.¹⁹⁷ 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.¹⁹⁸ These require additional layers of approvals, including by their board of trustees, before making additional investments.¹⁹⁹ Receiving the appropriate approvals takes time, especially if the board of trustees does not meet often, and without them, the LP is prevented from investing in the continuation funds.²⁰⁰

Lack of status quo option. LPs may also avoid rolling over their investments due to the lack of a status quo option.²⁰¹ When LPs are given only an option of rolling over their investments if they contribute new capital or accept revised economic or governance terms, some LPs perceive it as coercive.²⁰² This is especially true when the continuation fund is established early in the life of the legacy fund.²⁰³ Although the reset terms may sometimes appear

197 Interview with Participant 5 (Feb. 6, 2023) (“[Y]ou [the 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.”).

198 ILPA 2023, *supra* note 83, at 9 (“Some LPs may have institutional legal requirements, such as ERISA or other statutes, mandating additional layers of review.”).

199 *Id.* (“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?*, *supra* note 163, at 5 (“LPs do not have a process for executing CV transactions, mostly amongst those institutions with more structured investment policies and processes that require a consultant engagement and board of trustees’ approval.”); ILPA 2023, *supra* note 83, at 9.

200 McNally, *supra* note 190 (“[T]here are several LPs that, by default, are not able to participate at all. If their board meets every month and the request comes to them with only ten days to complete it, they can’t participate . . .”).

201 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> (explaining that the lack of a status quo option could seem coercive); see Adam Le, *GPs Are Strengthening Their Skin in Game with Continuation Funds*, SECONDARIES INV. (Feb. 21, 2023), <https://www.secondariesinvestor.com/gps-are-strengthening-their-skin-in-game-with-continuation-funds-william-blair/> (“Status quo options, where LPs have the option to retain their stake under the same economic terms from the existing fund, re-emerged in LP rollovers, with 19 percent of deals offering this.”).

202 Witkowsky, *supra* note 201.

203 See *id.* Some continuation funds are beginning to be created earlier in a fund’s lifecycle, a practice that also raises some investor concerns. See *The Evolution of Private Market Secondaries*, PITCHBOOK (Apr. 20, 2023), https://files.pitchbook.com/website/files/pdf/Q2_2023_PitchBook_Analyst_Note_The_Evolution_of_Private_Market_Secondaries.pdf. 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. See EVERCORE, *supra* note 116,

advantageous at first glance, rolling LPs may lose benefits they successfully negotiated in the legacy fund, such as preferred returns or hurdle rates.²⁰⁴ 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.²⁰⁵

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 desire to maintain an appropriate level of portfolio diversification.²⁰⁶ 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.²⁰⁷ 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.²⁰⁸

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, because some of them have no plans to remain in the same workplace three or four years down the road.²⁰⁹

All together, our analysis and insights from the interviews may explain why sophisticated investors are “forced” to sell their stakes under unfavorable conditions. Contrary to the theory that celebrates contractual freedom in the

at 8; LAZARD 2022, *supra* note 116, at 7 (“Only a minority of transactions in today’s market are taking place on fund vehicles that require the additional time to liquidate their portfolios.”).

²⁰⁴ See ILPA 2023, *supra* note 83, at 6.

²⁰⁵ Witkowsky, *supra* note 201.

²⁰⁶ 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.”).

²⁰⁷ See Hope, *supra* note 78; 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) (explaining that liquidity events in the private equity portfolio are one reason an LP may not roll over into the continuation fund).

²⁰⁸ Jessica Hamlin, *GP-Led Secondaries Are Having a Moment — But Don’t Discount the Traditional Market*, INSTITUTIONAL INV. (Oct. 4, 2022), <https://www.institutionalinvestor.com/article/b2022zq08nfrzz/GP-Led-Secondaries-Are-Having-a-Moment-But-Don-t-Discount-the-Traditional-Market> [<https://perma.cc/4N9B-JWH8>] (“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 106, at 14.

²⁰⁹ Interview with Participant 5 (Feb. 6, 2023) (noting 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, given that they are not planning to stay in the plan for three or four years).

private equity context, continuation funds provide additional evidence that even sophisticated investors with an “election option” face difficulties in protecting their interests.²¹⁰ 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 wanted to sell.”²¹¹

C. Testing the Role of Reputation and Ongoing Relationships

Parties in long-term ongoing relationships often rely on nonlegal sanctions to maintain cooperation and deter misbehavior.²¹² The private equity ecosystem shares similar characteristics.²¹³ The parties in an investment fund enter a long-term contract spanning ten or more years with a blind pool of investments and strong dependency on the sponsor to navigate the fund throughout its life cycle.²¹⁴ 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.²¹⁵ It

²¹⁰ Clayton, *supra* note 24, at 113 (arguing that the smaller investors in a fund have less bargaining power).

²¹¹ McElhaney, *supra* note 193. The situation where legacy LPs are pressured to sell their holdings due to described constraints places them in a “take-it-or-leave-it” position akin to that of shareholders in mergers and acquisitions. In these transactions, shareholder rights are often confined to voting and statutory appraisal rights, leaving them with only the basic value of their shares and no participation in any deal surplus. See Ryan Bubb, Emiliano Catan & Holger Spamann, Shareholder Rights and the Bargaining Structure in Control Transactions (June 12, 2023) (unpublished manuscript), <https://www.ecgi.global/sites/default/files/Paper%3A%20Shareholder%20Rights%20and%20the%20Bargaining%20Structure%20in%20Control%20Transactions%20%28Ryan%20Bubb%2C%20Emiliano%20Catan%2C%20Holger%20Spamann%29.pdf>. Additionally, Oliver Williamson’s concept of the “fundamental transformation” illustrates the risks inherent when one party becomes locked into a relationship post-investment, potentially facing opportunistic behavior from the other party who may renegotiate terms to their advantage. See Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233 (1979).

²¹² See, e.g., Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 63 (1963) (describing norms that make resorting to courts less necessary); cf. Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 886 (2000) (arguing that a reminder of ongoing relationships will encourage good behavior). For a review of how parties might design a flexible framework to foster collaboration in complex long-term relationships, see David Frydlinger, Oliver Hart & Kate Vitasek, *A New Approach to Contracts*, HAR. BUS. REV. (2019), <https://hbr.org/2019/09/a-new-approach-to-contracts> [<https://perma.cc/XB5F-N3LV>].

²¹³ 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) (arguing that the importance of contracts in the industry is not their legal enforceability, but the legitimacy they give to the ongoing relationships).

²¹⁴ See de Fontenay & Nili, *supra* note 68, at 922.

²¹⁵ See ILPA, ILPA PRINCIPLES 3.0: FOSTERING TRANSPARENCY, GOVERNANCE AND ALIGNMENT OF INTEREST FOR GENERAL AND LIMITED PARTNERS 5 (2019) (“The ILPA

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 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.²¹⁶ 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 receive additional management fees and carried interest.²¹⁷ They explained that these concerns, along with time, knowledge, and liquidity considerations, may lead them to cash out.²¹⁸ On the other hand, several LPs have underscored that their decision to roll their investment is 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.²¹⁹

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 a GP, including the degree to which the GP wishes to maintain a relationship with them.²²⁰

As described in subsection 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. These multiple interactions increase LPs' trust in GPs, encouraging them to roll over their stake or invest

Principles . . . were first published in September 2009 to encourage discussion between [LPs and GPs] regarding the alignment of interests in private equity fund partnerships.”)

²¹⁶ See *supra* note 116 and accompanying text.

²¹⁷ Cf. Interview with Participant 9 (Jan. 30, 2023) (arguing that GPs needing more time for an investment could simply extend the life of the fund rather than establish a continuation fund).

²¹⁸ See *supra* Section III.B. Agency problems may also incentivize LPs to cash out. See 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).

²¹⁹ See 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 and, conversely, that 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, the more likely they are to “take cash off the table”); Interview with Participant 9 (explaining that an LP might cash out if it has low confidence in a fund manager).

²²⁰ A recent survey supports this view, showing that the majority of investors are skeptical about continuation funds, with only 6% expressing a great level of interest in these funds and 57% expressing a moderate level of interest. See Farman, *supra* note 20.

in continuation funds on the secondary market.²²¹ In contrast, smaller LPs have limited interactions with the GP,²²² and their ability to retaliate if the GP misbehaves may be limited. As a result, sponsors care less about maintaining the relationship, and they are more likely to cash out.

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.²²³

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.²²⁴ No market player wants to be the investor that has a bad reputation among GPs as one that takes them to court.²²⁵ LPs could still express their discomfort by threatening not to invest with the same GP in the future,²²⁶ but if the GP is well-performing, such a threat could be less credible for small LPs competing for attractive investment opportunities. Therefore, the effectiveness of nonlegal 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 (1) subjecting the initiation of these funds to the approval of the LPAC, (2) requiring the sponsor to reinvest its profits into the continuation vehicle, and (3) using a competitive bid. It also assesses their effectiveness in addressing continuation fund conflicts.

²²¹ Large LPs with long-term relationships with GPs also seek specific protections through side letters aimed at ensuring that “their often no-fee, no-carried interest co-investments won't be ‘dragged’ into a continuation fund that would charge them new fees.” 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/> [<https://perma.cc/SBV6-XB9X>]. Some also want the right to greenlight the continuation fund deal. *Id.*

²²² McNally, *supra* note 190 (explaining that pension plans that manage significant amounts of capital often have small teams).

²²³ *See* Interview with Participant 2 (Jan. 25, 2023) (relaying that there are rumors of threatened litigation but no knowledge that it is ever commenced); Interview with Participant 3 (Jan. 26, 2023) (expressing the opinion that lawsuits are rare); Interview with Participant 8 (Jan. 27, 2023) (describing LPs as not having the resources to engage in litigation and risk reputational harm).

²²⁴ *See* Interview with Participant 7 (Jan. 27, 2023); Interview with Participant 8 (Jan. 27, 2023).

²²⁵ *See* Interview with Participant 8 (Jan. 27, 2023).

²²⁶ *Id.*

1. Approval by LPAC

The LPAC is an advisory committee consisting of representatives of LPs chosen by the GP.²²⁷ Most LPACs include the largest LPs in the fund²²⁸ or LPs with longstanding relationships with the GP.²²⁹ The most common functions of an LPAC include reviewing and resolving any conflict of interest in advance and waiving certain restrictions in the LPA.²³⁰ While regulators do not mandate the use of LPACs,²³¹ they “have become fixtures of PE funds, with 95 percent of funds having one.”²³² 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.²³³ Indeed, our interviewees confirmed that when a GP initiates a continuation fund, the standard practice is to turn to the LPAC.²³⁴

227 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/>.

228 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. VISTRA, PRIVATE EQUITY FUND GOVERNANCE 3 (2017), <https://www.acg.org/sites/files/Vistra%20Private%20Equity%20Research.pdf> [<https://perma.cc/U3L2-WWN8>].

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

230 See Robert Seber, *LPAC by Design: Six Recommendations for GPs to Define LPAC Features During Fund Formation* 2, in PRIV. EQUITY L. REP. (2020), https://media.velaw.com/wp-content/uploads/2020/03/02120713/PELR_LPAC-by-Design-Six-Rec.pdf [<https://perma.cc/NMT2-6W3J>]; Dylke et al., *supra* note 8.

231 Wilson, *supra* note 229.

232 Seber, *supra* note 230, at 1.

233 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>.

234 Interview with Participant 2 (Jan. 25, 2023) (“[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) (“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) (“It's usually a request from an LPAC to [establish the continuation fund].”); Interview with Participant 5 (Feb. 6, 2023) (“[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 2023, *supra* note 83, at 6-8.

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 LPs, which is more agile in its decision-making, than the full investor base.²³⁵ Additionally, the GP would be comfortable sharing sensitive information with the LPAC that it may otherwise be reluctant to disclose to a larger body of LPs.²³⁶ Therefore, at least on its face, the use of an LPAC seems a creative solution devised by sophisticated parties to handle conflicts efficiently.

Interviewees on the LP side, however, 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, two interviewees 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.²³⁷ 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.²³⁸ 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.²³⁹ 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.²⁴⁰ Alienating the GP by asking hard questions or derailing the deal will jeopardize this goal.²⁴¹

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 with other members, as they are still required to vet the transaction on behalf of the LPs that elected to cash out and have opposing interests.²⁴²

²³⁵ Boghssian & de Ste Croix, *supra* note 227 ("Having witnessed the inefficiency of LPACs approaching 20 members, we would strongly advise all parties to limit the number of appointments made.").

²³⁶ *Cf.* ILPA 2019, *supra* note 81, at 6 (discussing how the GP and LPAC should strive to share all relevant information with the LPs).

²³⁷ Interview with Participant 8 (Jan. 27, 2023); Interview with Participant 7 (Jan. 27, 2023).

²³⁸ Interview with Participant 8 (Jan. 27, 2023).

²³⁹ Interview with Participant 8 (Jan. 27, 2023); Interview with Participant 7 (Jan. 27, 2023).

²⁴⁰ Interview with Participant 8 (Jan. 27, 2023).

²⁴¹ *See 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 3 (Jan. 25, 2023).

²⁴² *See* Wilson, *supra* note 229.

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.²⁴³ In that sense, "the LPAC is not the equivalent of a board of directors."²⁴⁴ 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.²⁴⁵ Therefore, for a transaction of such significance, another interviewee claimed that "an LP vote will be more fair."²⁴⁶ 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.²⁴⁷ Along those lines, another survey reveals growing concerns among LPs when the LPAC is stacked with GP allies, as LPAC members seem overly inclined to approve the GP's preferred course of action.²⁴⁸ For this reason, the survey mentions that there are certain key matters, such as those related to the investment period and term, that some LPs would prefer all LPs vote on rather than just the LPAC.

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 continuation fund transaction.²⁴⁹ One interviewee noted that, typically, when the GP does not roll over its carried interest to the

243 See Clayton, *supra* note 24, at 105; Interview with Participant 5 (Feb. 6, 2023).

244 Seber, *supra* note 230, at 2.

245 Interview with Participant 8 (Jan. 27, 2023) ("In some calls it was strongly alluded to by the GP that they will remember who raised issues and how they voted.")

246 Interview with Participant 9 (Jan. 30, 2023).

247 VISTRA, *supra* note 228, at 4.

248 *Should LPs Be Worried About LPACs?*, Private Equity Merger, MORGAN LEWIS (Aug. 2014) https://www.morganlewis.com/pubs/2014/08/pem_shouldlpsworryaboutlpacs_august2014 [<https://perma.cc/CG88-5KFR>].

249 *Navigating the Nuances of Continuation Funds*, DEBEVOISE & PLIMPTON (Dec. 2020), <https://www.debevoise.com/insights/publications/2020/12/navigating-the-nuances-of-continuation-funds/> [<https://perma.cc/4TLK-8X5T>]. 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 2023, *supra* note 83, at 4, 11.

continuation fund, or rolls over just 50% or less of it, there could be some investor pushback to the deal.²⁵⁰ Indeed, in the past few years, many GPs have signaled their confidence in their continuation fund deals by increasing their skin in the game,²⁵¹ either by rolling a significant fraction of their carried interest or by providing up to 10% of the investor commitment to the continuation fund.²⁵²

A GP's decision to increase its commitments in continuation funds certainly improves the alignment of interests with the LPs rolling over their stakes to the continuation fund and with the new LPs investing in the continuation fund. But such commitments do not align with and in fact aggravate the conflicts of interest between the GP and a large group of LPs—those cashing out.²⁵³ When the GP has a significant financial interest in the new fund, this financial interest and the additional considerations detailed in subsection 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

²⁵⁰ Interview with Participant 3 (Jan. 26, 2023).

²⁵¹ 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/>.

²⁵² 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. *Continuation Vehicles – Six Month Snapshot of the Key Terms of Continuation Vehicles*, PAUL HASTINGS SECONDARIES PRAC. RSCH. (May 13, 2022), <https://www.paulhastings.com/insights/attorney-authored/continuation-vehicles/> [<https://perma.cc/3H8J-V3P2>]; see also LAZARD 2023, *supra* note 161, at 15 (“In 2023, ~85% of respondents reported that the average GP commitment size was at least 5% of the total deal size; 33% of respondents reported above 10% of the total deal size.”). Another study conducted by the Aztec Group found that “[i]n 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.” Reeve & McNaney, *supra* note 88. 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 145, at 8; JEFFERIES, *supra* note 105, at 7 (“[C]ontinuation 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 116, at 8.

²⁵³ 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. McElhaney, *supra* note 145.

could negotiate an arms-length price with the GP.²⁵⁴ 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.²⁵⁵ If the GP considers none of the proposals good enough, it will suggest to the LPs to keep the asset in a continuation fund and ensure that the transaction price matches the highest bid it received.²⁵⁶ 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.²⁵⁷

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.²⁵⁸ 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. But 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.²⁵⁹ LP interviewees also complained that the information provided by the GP in those situations is limited, and they are asked to decide whether to cash out or roll over without knowing what other legacy fund LPs are doing.²⁶⁰

Interviewees on the LP side 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,²⁶¹ which could extend well beyond the

²⁵⁴ ILPA 2023, *supra* note 83, at 11-12.

²⁵⁵ See Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 4 (Jan. 27, 2023); Interview with Participant 7 (Jan. 27, 2023).

²⁵⁶ Interview with Participant 7 (Jan. 27, 2023).

²⁵⁷ Interview with Participant 2 (Jan. 25, 2023); Interview with Participant 6 (Jan. 18, 2023); see also *supra* note 156 and accompanying text.

²⁵⁸ See 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).

²⁵⁹ See Interview with Participant 7 (Jan. 27, 2023).

²⁶⁰ See Interview with Participant 6 (Jan. 18, 2023).

²⁶¹ See Witkowsky, *supra* note 221 (describing special protections bargained for by large LPs); Interview with Participant 6 (Jan. 18, 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).

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).²⁶² 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.²⁶³ In line with the analysis provided in subsection II.D.4, one interviewee worried 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.²⁶⁴

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 the process includes 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 essential to consider alternative routes they did *not* follow. 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. But 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.²⁶⁵ Consequently, pre-clearance provisions are rare in the marketplace.²⁶⁶ 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.²⁶⁷

²⁶² See Interview with Participant 7 (Jan. 27, 2023) (noting the conflict such transactions create between the large investor with a broad relationship with the GP and the smaller LPs invested in legacy funds).

²⁶³ Gioanni, *supra* note 155.

²⁶⁴ See Interview with Participant 7 (Jan. 27, 2023) (questioning why LPs would care about small LPs in legacy funds over the prospect of larger, broader investment relationship).

²⁶⁵ See, e.g., Witkowsky, *supra* note 233 (“It’s almost impossible to predict all the details and specifications of these deals, they are very bespoke transactions, so [it’s hard] to incorporate all the material terms and issues . . .” (alteration in original)); ILPA 2023, *supra* note 83, at 4, 6 (recommending as best practice that LPACs continue to review conflicts and that GPs avoid pre-clearance provisions); Interview with Participant 6 (Jan. 18, 2023) (noting they push strongly against pre-consent provisions in original LPA agreements); Interview with Participant 7 (Jan. 27, 2023) (noting that while older fund agreements did not address continuation funds, they are now pushing back on attempts by GPs to build the ability to do continuation funds into new LPAs from the start).

²⁶⁶ See Witkowsky, *supra* note 233 (reporting no known deals relying on pre-clearance provisions to have gone to market as of February 2023).

²⁶⁷ Cf. ILPA 2023, *supra* note 83, at 4 (identifying “maximiz[ing] value for existing LPs” as a general principle for continuation fund transactions).

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 this 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.²⁶⁸ According to the SEC, the new rules aim to provide an “important check against an adviser’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.”²⁶⁹

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.²⁷⁰ One interviewee explained that fairness opinions are usually reserved for assets sold below the Net Asset Value (NAV) or when their valuation is uncertain.²⁷¹ But the SEC

²⁶⁸ See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63206, 63259-60 (Sept. 14, 2023) (to be codified at 17 C.F.R. pt. 275 (2023)).

²⁶⁹ *Id.* at 63257, 63216 n.99. 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. Form PF; Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers; Requirements for Large Private Equity Fund Adviser Reporting, 88 Fed. Reg. 38146, 38162 (June 12, 2023) (to be codified at 17 C.F.R. pts. 275 & 279 (2023)).

²⁷⁰ See Interview with Participant 2 (Jan. 25, 2023) (objecting to unnecessary fairness opinions because the fund will bear the costs); Interview with Participant 5 (Feb. 6, 2023) (lamenting the possibility of wasting hundreds of thousands of dollars on fairness opinions); Interview with Participant 4 (Jan. 27, 2023) (noting the SEC reforms are unnecessary for sophisticated investors).

²⁷¹ See Interview with Participant 2 (Jan. 25, 2023) (noting fairness opinions add little value when a competitively-bid price is already close to or above par value); see also Cravath, Swaine & Moore, Comment on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 4 (Apr. 11, 2022) (“[A]n opinion should only be required in the absence of any other external, independent and reliable indicator of value.”), <https://www.sec.gov/comments/s7-03->

mandates a fairness opinion or valuation opinion for *all* continuation fund transactions, even with complete bid processes or prices at or above the NAV.²⁷² In those situations, interviewees believe 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.²⁷³ 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.²⁷⁴ In such a situation, the financial advisor has strong incentives to provide an opinion that would please the sponsor. Otherwise, one interviewer opined, that advisor may not be selected to give the next opinion.²⁷⁵ 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.²⁷⁶ Securing future opinions may require these repeat

22/s70322-20122969-279330.pdf [https://perma.cc/66GC-SZTL]; Interview with Participant 3 (Jan. 26, 2023) (“I have not done a deal without a fairness opinion.”).

272 Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, 88 Fed. Reg. 63206, 63259 (Sept. 14, 2023) (to be codified at 17 C.F.R. pt. 275 (2023)) (In the final rule, the SEC noted concerns about the costs of fairness opinions and responded that the option to negotiate for a valuation opinion instead, as allowed by the rule, might reduce those costs.)

273 See, e.g., Steve Nelson, CEO, ILPA, Comment Letter on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 13-14 (Apr. 25, 2022), <https://www.sec.gov/comments/s7-03-22/s70322-20126586-287243.pdf> [https://perma.cc/BLC3-AHQC] (“LPs generally deem fairness opinions to offer procedural comfort but not true assurance of fair pricing of the transacted assets.”); Nicholas Fusco, President & CEO, ApeVue Inc., Comment Letter on Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews 3 (Apr. 25, 2022) (“[T]he idea of adding fairness opinions to all advisor led secondaries would drastically increase likelihood of lawsuits (as investor recourse) towards those offering the ‘opinion,’ and again drives up the cost of this opinion as fewer firms would consider offering them”), <https://www.sec.gov/comments/s7-03-22/s70322-20126607-287257.pdf> [https://perma.cc/P8AX-T42W]. *But see* Healthy Mkts. Ass’n, Comment on Private Fund Advisers, *supra* note 148 (urging SEC to adopt its fairness opinion requirements without undue limitation).

274 See Interview with Participant 8 (Jan. 27, 2023).

275 See *id.*

276 See, e.g., Interview with Participant 7 (Jan. 27, 2023) (suggesting there is a “business” of fairness opinions and little chance of a negative opinion being written); Interview with Participant 9 (Jan. 30, 2023) (asserting fairness opinions are not truly independent); 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).

players to please their clientele at the expense of LPs.²⁷⁷ Therefore, they argue that fairness opinions cannot be considered truly objective.²⁷⁸

This dynamic is not unique to the private equity context, and concerns regarding the objectivity of fairness opinions have been raised in other contexts.²⁷⁹ But in other transactional contexts where lawsuits are common, the objectivity of the fairness opinion is subject to a court examination.²⁸⁰ 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.²⁸¹ 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 continuation fund transaction 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.²⁸² As one LP interviewee noted, he does not see how a fairness opinion would help the other LPs in these situations.²⁸³

²⁷⁷ Cf. Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083, 1088 (2022) (observing a similar phenomenon of “auditioning bias” in the context of bankruptcy directors appointed by shareholders to “facilitate a graceful exit”).

²⁷⁸ ILPA does not endorse the use of fairness opinions as a standard policy but acknowledges their potential benefits for selling LPs in certain instances, especially because the NAV is determined by the GP. See ILPA 2023, *supra* note 83, at 12.

²⁷⁹ See, e.g., Bebchuk & Kahan, *supra* note 171, at 53 (“Investment banks face conflicts of interest that lead them to use their discretion to render pro-management fairness opinions.”); Andrew F. Tuch, *Fairness Opinions and SPAC Reform 1799* (Wash. Univ. in St. Louis and ECGI Law Working Paper No. 703/2023, Aug. 2023), <https://ssrn.com/abstract=4419151> [<https://perma.cc/T8UJ-XWVM>] (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” of ensuring fairness to public shareholders). *But see* Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV., Mar. 2015, at 23 (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).

²⁸⁰ See Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1559 (2006) (discussing use of fairness opinions in mergers and acquisitions context).

²⁸¹ See *supra* notes 223–226 and accompanying text.

²⁸² See Interview with Participant 8 (Jan. 27, 2023).

²⁸³ See *id.*

Therefore, while the SEC places trust in fairness and valuation opinions, market participants (especially on the LP side) remain more skeptical of their value. In their view, these opinions are not worth the paper they are written on.²⁸⁴

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 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*

There are three key arguments in support of the market outcome perspective 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.²⁸⁵ Economic theory suggests that under specific circumstances, price discrimination increases the overall social welfare by eliminating monopoly deadweight loss.²⁸⁶ As one of us has shown elsewhere, private equity price discrimination results in the powerful and largest LPs receiving access to better deals than

²⁸⁴ See 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, likely a repeat player, to have them write a fairness opinion); Interview with Participant 9 (Jan. 30, 2023) (stating that the person that gets paid for a fairness opinion cannot be considered truly independent).

²⁸⁵ See William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249, 255 (2017).

²⁸⁶ 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).

smaller, less sophisticated LPs.²⁸⁷ 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.²⁸⁸ Therefore, the efficient price discrimination perspective²⁸⁹ 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.²⁹⁰ 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, investors lacking the sophistication to negotiate effectively with sponsors may be less compelled to invest in private equity and are free to direct their resources to other asset classes. The prevailing lack of LP protections could thus 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.²⁹¹ A GP that earns a reputation for mistreating investors will have difficulties in finding new investors. As Professor Steven Kaplan has noted, if GPs "behave badly in one deal, they will be treated differently in the next deal."²⁹² By contrast, a positive reputation can increase future funding from existing

²⁸⁷ See de Fontenay & Nili, *supra* note 68, at 933-35 ("Contrary to many other instances of price discrimination, fee discounts in private equity result in the largest and wealthiest investors paying less than what smaller investors pay.").

²⁸⁸ *Id.*

²⁸⁹ See Clayton, *supra* note 285, at 254.

²⁹⁰ See *supra* note 66 and accompanying text.

²⁹¹ Cf. generally Matthew D. Cain, Antonio J. Macias & Steven Davidoff Solomon, *Broken Promises: The Role of Reputation in Private Equity Contracting and Strategic Default*, 40 J. CORP. L. 565 (2015) (finding reputational concerns drove private equity firms to incur non-trivial losses before walking away from acquisitions).

²⁹² Gara, *supra* note 157; see also Gregory W. Brown, Oleg R. Gredil & Steven N. Kaplan, *Do Private Equity Funds Manipulate Reported Returns?*, 132 J. FIN. ECON. 267, 280 (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* 4-5 (Univ. Conn. Sch. Bus. Research Paper, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4271808 [<https://perma.cc/JK54-8K5G>] (finding that the disclosure of misconduct reduces firms' ability to raise capital).

investors and perhaps convince new investors to shift resources.²⁹³ Further, 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. 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.²⁹⁴

B. *Continuation Funds as a Market Failure*

In contrast with the market outcome view, the market failure view highlights the potential failures associated with continuation funds. In particular, it suggests that continuation funds impose significant efficiency costs (as outlined in subsection II.D.5), that they are a costly form of price discrimination, and that reputational forces and the possibility of 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.²⁹⁵ But when such differential treatment is conducted in an opaque and nontransparent 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 subsection II.D.5. In this regard, we note that explicit discrimination between investors, by providing large and sophisticated LPs with better investment terms, offers similar efficiency

²⁹³ 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?* 149, 188, in *BROOKINGS PAPERS ON ECONOMIC ACTIVITY MICROECONOMICS* (Martin Neil Bailey, Peter C. Reiss & Clifford Winston eds., 1998) (explaining that the ability to raise new capital is also positively affected by age and size); Steve N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 *J. FIN.* 1791, 1792 (2005) (finding fund flows are positively related to past performance); Ji-Woong Chung, Berk A. Sensoy, Léa Stern & Michael S. Weisbach, *Pay for Performance from Future Fund Flows: The Case of Private Equity*, 25 *REV. FIN. STUD.* 3259, 3260 (2012) (finding lifetime incomes of GPs depend on their current fund performance).

²⁹⁴ See Laura Benitez, Silas Brown, David Ramli & Bloomberg, *\$8 Trillion Private Equity Industry Faces 'Real Cultural Change' as Sources Say Investors Are Pulling Funding amid a Deal Apocalypse*, *FORTUNE* (Jan. 16, 2024, 2:04 PM), <https://fortune.com/2024/01/16/private-equity-industry-8-trillion-limited-partners-cultural-change-funding> [<https://perma.cc/XDZ9-SS2X>] (discussing how current financial conditions give greater power to LPs to make future fund investments contingent on the release of older funds).

²⁹⁵ See *supra* notes 286–288 and accompanying text.

advantages²⁹⁶ and could be employed by sponsors without incurring the overall costs associated with continuation funds.

The Limits of the Reputation Market. The efficiency of reputation markets depends heavily on the quality of the information that LPs can obtain and analyze before making investment decisions.²⁹⁷ 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.²⁹⁸ 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.²⁹⁹

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.³⁰⁰ 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. This information gap explains why less sophisticated LPs face challenges in identifying opportunistic behavior by GPs and punishing the untrustworthy ones.³⁰¹

²⁹⁶ See de Fontenay & Nili, *supra* note 65, at 975-76. Though price discrimination is readily occurring in private equity markets, most price discrimination is indirect, through informal agreements. *Id.*

²⁹⁷ See Magnuson, *supra* note 24, at 1900 (“[R]eputation can only constrain a party’s behavior if the party believes that others will receive information about the party’s past behavior and base their decision making on that past behavior.”).

²⁹⁸ See James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 332-33 (2009) (noting that a fund manager’s performance and behavior are only revealed over time). For recent empirical support, see, for example, Robert S. Harris, Tim Jenkinson, Steven N. Kaplan & Ruediger Stucke, *Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds* 15 (Univ. Chi., Becker Friedman Inst. for Econ. Working Paper No. 2020-167, Mar. 2022), <https://ssrn.com/abstract=2304808> [<https://perma.cc/XVT4-GCAQ>] (finding final fund performance was imperfectly predicted by interim performance).

²⁹⁹ See, e.g., Brad M. Barber & Ayako Yasuda, *Interim Fund Performance and Fundraising in Private Equity*, 124 J. FIN. ECON. 172, 194 (2017) (“[L]ow reputation GPs appear to upwardly manage valuations at the time of fundraising.”); Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACAD. MGMT. PERSPS. 45, 49 (2021) (finding that, unlike public corporations, “poorly performing GPs have opportunities to hide poor returns so that their reputations are not tarnished”).

³⁰⁰ See *supra* footnotes 193-194 and accompanying text.

³⁰¹ For empirical support, see Blake Jackson, David Ling & Andy Naranjo, *Catering and Return Manipulation in Private Equity* 33 (Dec. 15, 2022) (unpublished manuscript), <https://ssrn.com/abstract=4244467> [<https://perma.cc/95ZE-4B69>] (finding that LPs do not punish GPs for manipulating IRRs by refusing to commit capital to subsequent funds); Vladimir Atanasov, Thomas Hall, Vladimir Ivanov & Katherine Litvak, *The Impact of Public Pension Funds and Other Limited Partners on the Governance of Venture Capital Funds* 3, 20 (Nw. Pub. L. Rsch. Paper No. 17-32; Nw. Pub. L. Rsch. Paper No. 17-20, Dec. 16, 2017), <https://ssrn.com/abstract=3088998>

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.³⁰² Recent empirical evidence shows that many investors experience difficulty gaining access to top-tier firms' alternative investment vehicles,³⁰³ and top GPs involved in misconduct still find it relatively easy to attract new investors.³⁰⁴ 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 doing so comes at the expense of other investors.³⁰⁵

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 before LPs consider reducing their allocations to private

[<https://perma.cc/SE6H-UX65>] (finding that public pension funds are actually more likely to invest in VCs that were defendants in lawsuits, possibly due to internal agency problems).

³⁰² See Clayton, *supra* note 24, at 97-98, 109-10 (suggesting that many investors in private equity may not get the benefits of competitive markets when the largest investors can negotiate for individualized benefits).

³⁰³ Lerner et al., *supra* note 70, at 359-61.

³⁰⁴ Yina Yang, Private Equity Limited Partner Responses to Advisory Misconduct by General Partners 3 (Oct. 25, 2022) (unpublished manuscript), <https://ssrn.com/abstract=4223588> [<https://perma.cc/PP9F-JM22>] (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* 35 (Sept. 2023) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4361582 [<https://perma.cc/VCH4-YPBJ>] (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).

³⁰⁵ See Shobe, *supra* note 43, at 1482-83 ("Managers have an incentive to take risks when their reputation is poor because the benefit of possibly salvaging their reputation is higher than the risk of further tarnishing an already damaged reputation. Managers have less to lose, economically and reputationally, when a fund is already performing poorly.").

equity. But the persistent investments in private equity cannot be solely attributed to diversification benefits.³⁰⁶

Institutional investors, as agents of beneficial investors, also face agency problems,³⁰⁷ with studies showing how internal agency problems lead to suboptimal behavior in private equity investments, particularly among public pension plans.³⁰⁸ 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.³⁰⁹ 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.³¹⁰

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 subsection 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 Section undertakes this task.

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

³⁰⁶ Francesco Franzoni, Eric Nowak & Ludovic Phalippou, *Private Equity Performance and Liquidity Risk* 67 J. FIN. 2341, 2371 (2012) ("At times of liquidity crises, these investments may not offer the risk diversification that investors expect from them.")

³⁰⁷ See generally Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017).

³⁰⁸ See, e.g., Clayton, *supra* note 68, at 35-36 (describing studies identifying internal agency problems resulting in suboptimal behavior within institutions investing in private equity funds).

³⁰⁹ See Phalippou, *supra* note 64, at 12-13 (asserting that the notion that private equity consistently outperforms public markets is perpetuated by industry professionals, including investment teams, external managers, and consultants); Batt & Appelbaum, *supra* note 299, at 49 ("[L]imited partners hold a disproportionate level of risk in any investment and have insufficient access to information needed to assess how well the PE partners are carrying out their fiduciary responsibilities.")

³¹⁰ See Phalippou, *supra* note 64, at 12 ("The concept that the net-of-fees performance of PE funds is superior to that of public equities constitutes the sine qua non condition for continued employment of at least 100,000 people.")

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.³¹¹

Below, we explore several potential avenues for addressing continuation funds' 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 the transaction rationale, the solicitation process, the bids received, and any conflicts of interest (such as highly favorable financial conditions for new LPs).³¹² The ILPA also recommends that LPs be given at least thirty 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.³¹³

We express 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 additional information (such as 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.

But 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

³¹¹ See generally ILPA 2023, *supra* note 83; *supra* Section III.E.

³¹² See ILPA 2023, *supra* note 83, at 6-8.

³¹³ See *id.* at 4, 9.

decisions are already very long and often contain around 200 pages or even more.³¹⁴ Since the resources and attention of many LPs are limited, they are likely to have difficulties with reviewing and digesting lengthy disclosure statements and forming an investment recommendation in a timely manner. Additionally, due to the rise of continuation funds, many LPs receive multiple disclosure documents each month, 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 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.³¹⁵ One possible avenue, strongly supported by some LPs we interviewed, is to provide the legacy fund LPs with a status quo option.

The “pure” status quo option involves transferring assets from a legacy fund to a new fund without changing any of the fund terms. But 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 receive an option to roll over their investment to the continuation fund in a manner that is closest to a “pure” status quo. A key focus would be maintaining specific key 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, and no crystallization of the GP’s carried interest with respect to the rolling

³¹⁴ Interview with Participant 5 (Feb. 6, 2023).

³¹⁵ See ILPA 2023, *supra* note 83, at 10 (defining status quo option to avoid disadvantaging rolling LPs). According to a recent survey, only 19% of transactions include the status quo option for LPs. See Le, *supra* note 201; see also ILPA 2023, *supra* note 83, at 10-11.

LPs.³¹⁶ The GP would also have to honor side letters and maintain all other benefits that were initially afforded to the rolling LPs.³¹⁷

An important advantage of the status quo option is that it eliminates LPs' concerns that they are being squeezed by the GP, putting them in a losing proposition scenario: rolling over to a continuation fund on new, and often inferior, terms or cashing out at a price or time that could be unfavorable to them. Another advantage of maintaining existing economic and governance terms in the continuation fund 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 absent a pressure to not roll over due to less favorable terms.

But 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. 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 seek a minimum size of exposure as a condition for participating in the transaction."³¹⁸ Consequently, rolling LPs must be diluted.³¹⁹ 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 fund³²⁰ 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

³¹⁶ 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.

³¹⁷ *Cf.* 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).

³¹⁸ *Id.*

³¹⁹ *Id.*; see also Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 64 (2006).

³²⁰ See *supra* note 203.

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.³²¹ LPAC members could also have different incentives than the LPs that elect to cash out.³²² Presenting to the LP base the proposal to establish a continuation fund ensures that such a proposal will move forward only if a majority of the LP base perceives it as value-enhancing. This will mitigate the concern that the GP would use the continuation fund vehicle for 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). But while the early-stage vote on the continuation fund initiation represents a step toward 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. 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 votes would count as “no-votes.”³²³ 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 “no-votes.” Finally, the voting threshold for preventing fund formation could be increased to a

321 See *supra* notes 238–241 and accompanying text.

322 See *supra* subsection III.D.1.

323 Interview with Participant 5 (Feb. 6, 2023).

supermajority. All together, 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 solution.³²⁴ 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.³²⁵

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 concerns that the advisors would seek to please their clientele at the expense of LPs.³²⁶ 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.³²⁷ 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

³²⁴ Cf. Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light*, 99 B.U. L. REV. 1459, 1464 (2019) (describing role of proxy advisors in public markets).

³²⁵ See *supra* Section III.B.

³²⁶ See *supra* note 279.

³²⁷ See *supra* notes 238–248 and accompanying text.

interests do not align with those of the selling LPs, including members inclined to roll over their investments or participate in the bidding process.

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.³²⁸ 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.”³²⁹ In addition, LPs electing not to participate should incur no cost.³³⁰

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, its tendency to initiate continuation fund transactions increases, and there is an enhanced risk that the GP will initiate these transactions even when they do not serve the interests of all LPs.³³¹ 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. But LPs’ collective bargaining power is limited when the incentives of different LP groups do not align.³³² As our analysis suggests, a continuation fund transaction often involves two groups of LPs with conflicting interests. Consequently, the more sophisticated LPs, which are likely to participate in

³²⁸ See *supra* subsection II.D.3.

³²⁹ See ILPA 2023, *supra* note 83, at 10.

³³⁰ See *id.* at 10 (“In cases where the transaction does not ultimately proceed, costs incurred by the GP to solicit offers after the LPAC has approved a process should be considered a fund expense.”).

³³¹ See *supra* subsection II.D.3.

³³² de Fontenay & Nili, *supra* note 68, at 980 (“[W]hile ILPA action is more likely in areas where investors collectively suffer from lack of data or lack of awareness—where ILPA can be effective—it is less likely when investors’ incentives are misaligned.”).

continuation fund transactions, are expected to be less inclined to seek changes to the current structure of continuation funds, including in the form of contractual protections.³³³

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.³³⁴ The alternative avenues we explored above could be considered by policymakers or market participants to achieve a more effective outcome.

CONCLUSION

Forming a continuation fund became a mainstream option in private equity. But 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.

³³³ 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. See Magnuson, *supra* note 24, at 1890-95.

³³⁴ See *supra* Section III.E.

APPENDIX

Interview List

Participant	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 as an LP
7	January 27, 2023	A director in an investment management company that invests as an LP
8	January 27, 2023	A director in an investment management company that invests as an LP
9	January 30, 2023	A director in an investment management company that invests as an LP
10	January 30, 2023	A partner a mid-sized law firm, specializing in representing LPs
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
13	January 11, 2024	An advisor in a financial advisory firm, specializing in advising GPs in continuation fund transactions