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Transfer of Limited Partnership Interests

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February 2015

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GENERAL PROHIBITION ON TRANSFER OF LIMITED PARTNERSHIP INTERESTS

General Prohibition on Transfer

- A typical private partnership prohibits its limited partners (“LPs”) from transferring limited partnership interests unless:
 1. the partnership's general partner (“GP”) consents to the transfer;
 2. the transfer is not contrary to the partnership’s limited partnership agreement (“LPA”) and does not violate law; and
 3. certain conditions precedent are satisfied prior to the transfer.

1. GP's Consent Required

- LPs typically are prohibited from transferring their limited partnership interests unless the GP consents to the transfer.
- For example, an LPA may say:

“No LP may directly or indirectly sell, transfer, assign, hypothecate, pledge or otherwise dispose of or encumber all or any part of such LP's limited partnership interest (including, without limitation, any right to receive distributions or allocations in respect of such interests and whether voluntarily, involuntarily or by operation of law) without the prior written consent of the GP, the granting or denial of which shall be in the GP's sole and absolute discretion.”

2. The Transfer must not be Contrary to the LPA and must not Violate Law

- The LPA also often prohibits LPs from transferring limited partnership interests in any manner:
 - contrary to the LPA; or
 - that violates or causes the partnership or GP to violate:
 - the Securities Act of 1933;
 - the Securities Exchange Act of 1934;
 - the Investment Company Act of 1940; or
 - the laws, rules, regulations, orders and other directives of any governmental authority.

3. Conditions Precedent must be Satisfied prior to the Transfer

- The LPA typically also provides that any transfer by an LP is subject to the satisfaction of several conditions precedent. Those conditions often include:
 - providing the GP with advance written notice of the transfer;
 - the selling LP or proposed transferee agreeing to pay all the partnership's and GP's expenses in connection with the transfer;
 - the selling LP or proposed transferee delivering a legal opinion relating to the transfer;

3. Conditions Precedent must be Satisfied prior to the Transfer (continued)

- the transfer not posing a material risk that the partnership will be treated as a “publicly traded partnership” for US tax purposes;
- complying with any rights or first refusal; and
- the partnership having received from the proposed transferee:
 - documents pursuant to which the proposed transferee agrees to be bound by (i) the LPA and (ii) the partnership’s subscription agreement (including the representations, warranties and acknowledgements therein);
 - a suitability statement; and
 - a counterpart of the LPA executed by the proposed transferee.

REPRESENTING THE SELLING LIMITED PARTNER

LP View of the General Prohibition on Transfer

- Most LPs accept restrictions on transferability of limited partnership interests because a typical partnership:
 - distributes profits and invested capital to its LPs promptly after the partnership realizes each investment; and
 - has a limited life (commonly 10 – 12 years), at the end of which the partnership distributes remaining profits and invested capital to its LPs.

LP View of the General Prohibition on Transfer (continued)

- However, sometimes an LP needs early liquidity. This could be because the LP has experienced a change in its:
 - cash flow needs;
 - asset allocation needs;
 - strategy; or
 - regulatory environment.

The Sale Process

- An LP that wants to sell its limited partnership interest (“Seller”) should carefully consider the sale process, including:
 1. the value of the limited partnership interest;
 2. the timing of the potential sale;
 3. the number and quality of potential buyers (“Buyers”);
 4. the use of intermediaries; and
 5. the preparation and negotiation of legal documents relating to the potential sale.

1. Value of the Limited Partnership Interest

- A Seller's limited partnership interest often sells at a 20% to 50% discount to the fund manager's most recent valuation of the partnership's portfolio companies. This is because, among other things:
 - the partnership adds a layer of management fees and carried interest (discount for anticipated costs);
 - Buyers cannot readily confirm the value of the partnership's portfolio companies (discount for risk of inaccurate valuation); and
 - limited partners cannot force the sale of portfolio companies (discount for illiquidity).

1. Value of the Limited Partnership Interest (continued)

- The amount of the discount also may depend on the partnership's:
 - portfolio company status;
 - remaining capital commitment;
 - management team; or
 - sector.

2. Timing of the Potential Sale

- The sale process typically takes several months. The timing depends in part on:
 - the commitment of the Seller;
 - the commitment and experience of Buyers; and
 - whether there are any rights of first refusal with respect to a sale of the Seller's limited partnership interest.

2. Timing of the Potential Sale (continued)

- Seller typically explores the potential sale with Buyers before discussing the potential sale with the GP and seeking the GP's consent to the sale.
- Sometimes the Seller discusses the potential sale with the GP beforehand because the Seller wants the GP's assistance in finding Buyers (and GPs may provide such assistance to reduce the risk of the Seller's default).

3. Number and Quality of Buyers

- A Seller typically will sell its limited partnership interest by negotiating with:
 - one Buyer (if the interest is relatively small); or
 - three to five Buyers (if the interest is relatively large).
- Negotiating with a limited number of Buyers:
 - provides Buyers with incentive (i) to complete due diligence and (ii) to substantiate the sale price;
 - enhances confidentiality; and
 - reduces the GP's burden because:
 - the GP will determine whether to consent to the sale; and
 - Buyers may wish to speak with the GP.

3. Number and Quality of Buyers (continued)

- A Seller should ensure that Buyers:
 - have the financial resources to complete a sale and fund any remaining capital commitments; and
 - will be acceptable to the GP.

4. Use of Intermediaries

- A Seller may use an intermediary to sell its limited partnership interest. Typically, the intermediary's role is limited to:
 - contacting Buyers;
 - assisting with due diligence;
 - assisting with negotiations or the auction process; and
 - assisting with the closing of the sale.
- Generally, the intermediary's fee:
 - may be between 1% and 5% of the sale price; and
 - is paid by the Seller.

5. Legal Documents

- The sale process typically involves preparing and negotiating the following legal documents.

Document	Typical Parties
confidentiality agreement	Buyer and Seller
purchase and sale agreement	Buyer and Seller
assignment and assumption agreement	Buyer and Seller
counterpart of LPA	Buyer and GP
GP's consent to transfer	GP
Buyer's representation letter	Buyer and GP
legal opinion (may be waived by GP)	Buyer's or Seller's counsel
waiver of rights of first refusal (if any)	GP and/or other LPs
waiver of Seller's default (if any)	GP

5. Legal Documents (continued)

- The purchase and sale agreement includes:
 - a description of the limited partnership interest;
 - the purchase price (adjusted for contributions and distributions since the partnership's most recent financials);
 - representations and warranties (including (i) Seller's ownership of the interest and (ii) no liens or other encumbrances on the interest);
 - covenants (including Seller remaining liable for returns of past distributions);

5. Legal Documents (continued)

- closing conditions (including execution and delivery of other legal documents);
- indemnification; and
- confidentiality.
- The closing of the sale typically occurs promptly following the satisfaction of the closing conditions.

REPRESENTING THE GP AND THE PARTNERSHIP

GP and Partnership Considerations

- A GP and partnership that is considering consenting to the transfer of a limited partnership interest should carefully consider:
 - legal issues; and
 - economic issues and other issues.

1. Legal Issues

- Some of the most important legal issues in connection with the Seller's sale of its limited partnership interest to a Buyer relate to:
 - the Securities Act of 1933:
 - the Buyer must be contacted in a non-public manner to fit within the so-called Section 4(a)(1 and ½) exemption; and
 - the Buyer must be an accredited investor under Regulation D);
 - the Investment Company Act of 1940 (e.g., exemptions from investment company status);

1. Legal Issues (continued)

- the Employee Retirement Income Security Act (e.g., requirements with respect to pension fund investors);
- the Internal Revenue Code:
 - Section 7704 states that a partnership with interests that are “readily tradable on a secondary market” is considered a publicly traded partnership and taxed as a corporation;
 - the partnership can avoid being a publicly traded partnership by falling within the safe harbor in treasury regulation Section 1.7704-1:
 - if there is nothing similar to a secondary market, all transactions are exempt under the Securities Act of 1933 and there are less than 100 partners; or
 - interests representing 2% or less of the partnership’s capital or profits are traded in any one fiscal year; and

1. Legal Issues (continued)

- complying with any rights of first refusal relating to transfers of interests:
 - GP may have the power to waive the rights of first refusal; and
 - GP may have duty (i) to send out notice of right of first refusal and (ii) to administer the exercise of rights of first refusal.

2. Economic and Other Issues

- Sometimes, LPs are unable to satisfy their remaining capital commitments.
- GPs often will not waive an LP's remaining capital commitment.
- Therefore, the GP may assist the LP in selling its interest to reduce the risk of the Seller's default.
- GPs should consider the financial condition, reputation and quality of the Buyer.

GENERAL PARTNER CONSENT AND MARKET TERMS

General Partner Consent and Market Terms

- GPs often consent to the Seller's transfer of its limited partnership interest, particularly if:
 - the Seller is at risk of defaulting with respect to its capital commitment; and
 - the Buyer is in good financial condition, has a good reputation and is of satisfactory quality.
- GPs frequently waive the condition precedent of delivering a legal opinion relating to the transfer.

REPRESENTING THE BUYER

Representing the Buyer

- A Buyer considering purchasing a limited partnership interest should carefully consider the sale process, including:
 - due diligence with respect to the limited partnership interest, the partnership, the GP and the partnership's portfolio companies;
 - the value of the limited partnership interest:
 - the interest often sells at a 20% to 50% discount to the fund manager's most recent valuation of the partnership's portfolio companies because of discounts for (i) anticipated costs, (ii) risk of inaccurate valuation, (iii) illiquidity and (iv) the results of the due diligence investigation;

Representing the Buyer (continued)

- the timing of the potential purchase:
 - the sale process typically takes several months and depends in part on (i) the commitment of the Seller and (ii) whether there are any rights of first refusal with respect to the sale of the limited partnership interest;
- the number of other prospective Buyers:
 - a limited number of prospective Buyers provides each prospective Buyer with incentive to (i) complete due diligence and (ii) substantiate the purchase price; and
- the preparation and negotiation of legal documents relating to the potential purchase.

Representing the Buyer (continued)

- These considerations are similar to those of a Seller considering the sale of its limited partnership interest, as discussed above.
- Buyers typically do not use intermediaries to purchase limited partnership interests.

QUESTIONS AND COMMENTS

Further information

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