Key trends in venture capital funds: increasing use of LP transfers

Marie T. DeFalco, Co-Chair, Investment Management Group at Lowenstein, explains how secondaries, continuation funds, and US PTP regulations affect the venture capital industry.

As the venture capital landscape continues to mature and evolve, participants and practitioners in the US have likely noticed a steadily increasing incidence of transfer requests by LPs and the prevalence of other, more comprehensive secondary transactions. What are the reasons for this increase and what are the regulatory, tax, and practical considerations?

Almost all fund agreements require LP transfers to be approved by the GP of the fund. Historically, those requests have been infrequent – often caused by the gift, estate planning, or death of an LP, or a change in the LP's financial circumstances. Provided the transferee meets the relevant suitability standards of the applicable fund, GPs are inclined to approve the transfers with as little fanfare as possible. Few want to broadcast that LPs are opting out of the fund or that any LP is having financial difficulty. As the average runway length to exit of many funds' portfolio companies has gotten longer, and the funds' terms correspondingly extended by multiple years, more LPs have been looking for buyers to meet their internal liquidity needs. Others are seeking to implement a different product mix or to diversify their portfolios, given the length of time from first investment in particular funds. Some things to consider are whether side letter provisions and holding periods transfer with the interest, who will pay the costs of transfer, and who will be responsible for any potential LP claw-backs and tax liabilities. Also worth considering is whether the transferee will be admitted as a full LP or remain an 'unadmitted transferee' – entitled to economic benefits but without voting or information rights.

The funds themselves face similar issues as the LPs. They may want to optimize their portfolios by divesting underperforming assets or rebalancing their exposure to specific sectors or stages of development. Many have run out of term extensions and are happy to arrange for the sale of interests or remaining portfolio company shares to a secondary fund. The secondary funds – whose investors profit from the outset, at least on paper, since the funds buy at a discount – are a quickly growing segment of the fund industry. They are particularly attractive to investors seeking maximum diversification, exposure to traditionally 'closed' funds, or access to sought-after assets without waiting out traditional fund cycles.

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Another solution for funds that have reached the end of their extension periods is a continuation fund. In a typical construct, LPs are given the option, at the end of the life of a fund with remaining assets, to cash out or to roll over their LP interests into a new vehicle, the continuation fund, that will hold the remaining portfolio company assets. Continuation funds are typically much more concentrated in just a few portfolio companies than the original fund from which the rollover occurs. Those few companies are often the most promising of the original fund's portfolio, which the portfolio manager believes could be very profitable if afforded more time to mature.

One of the trickiest regulatory issues restricting transfers in the US or affecting US taxpayers is the Internal Revenue Service's publicly traded partnership (PTP) regulations. Classification as a PTP could cause a fund to be taxed as a corporation, rather than as a partnership, which is generally undesirable. A PTP could be any fund partnership, the interests of which are traded on an established securities market or 'the substantial equivalent thereof.' Frequent transfers risk being classified as creating that substantial equivalent. Most transfers to affiliates are excluded from consideration, as are 'bulk transfers'. The transfers causing the funds the most trouble with PTP regulations are the frequent smaller transfers for consideration.

Another regulatory issue to confront is Internal Revenue Code section 1446(f). It is designed to ensure tax withholding on consideration paid to non-US transferors but requires that all transferors produce documentation certifying their status or that the parties otherwise comply with specific exemption or withholding requirements.

All signs point to a continuation of these trends, as the maturation of the industry progresses, barring a significant economic shift.

Marie T. DeFalco is Co-Chair of **Lowenstein**'s Investment Management group, which represents investment management clients throughout the US and internationally. Marie specializes in structuring business transactions from both a business and tax perspective. She particularly focuses on venture capital funds; joint ventures; and shareholder, limited partner, and limited liability company agreements.