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Our mission is to connect and influence key market participants by promoting the sectors, strategies and deals that will drive investment returns and meet societal needs. With headquarters in New York and Singapore, GPCA includes LAVCA, the Association for Private Capital Investment in Latin America.

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Looking for the Exit? Evaluating Global Liquidity Trends and Legal Considerations for Maximizing Value in Tail-End Funds

By Noah Schottenstein, Partner and Head of Investment Disputes and Special Situations Practice, Stone Hilton

Introduction

Investment in private funds has surged over the past decade, but realizations have not kept pace with expectations. As traditional exit activity remains muted compared to historical averages, there has been a corresponding growth in funds across the globe with illiquid assets that are approaching or have surpassed their planned lifespan, i.e., tail-end funds. The first part of this article provides an overview of global market trends for tail-end funds. The second part of this article discusses potential legal strategies for investors seeking to maximize the value in tail-end funds.

Global liquidity trends

There is estimated to be over USD1t of assets in tail-end funds across the globe. Despite recent recoveries in the global M&A and IPO markets, the value of assets in tail-end funds continues to grow at a rapid pace, with a 20.6% CAGR over the past five years. Growth occurred across all regions and private market asset classes, but was most pronounced in private equity funds, where the average age of tail-end funds has now reached 14 years and nearly 20% of assets have been held for 7+ years. The explosion of secondary markets has provided funds with new sources of liquidity, but nowhere near enough to make a dent in this backlog of assets.

There are also significant variances across regions to consider. The growth in liquidity activity has primarily occurred in North America and Europe. By contrast, activity in other regions has remained effectively flat. According to GPCA transaction data, the only standout was China's IPO market, which has been rebounding from a historic low in 2024. Other major countries (e.g., India and Brazil) and regions saw slight declines in transaction volume on an aggregate basis, but with an overall uptick in value due to a number of large, high-value deals.

This seems to suggest that, outside of crown-jewel transactions, funds are going to continue holding more assets for longer. But historical trends indicate that longer holding periods do not translate into better returns for underperforming funds. The value obtained over the longer holding period is typically not worth the opportunity cost compared to liquidating and reinvesting in new assets. The current push by institutional investors for liquidity appears consistent with these patterns. The question of how these tensions are going to be resolved is now immediate and acute.

Legal considerations

Most closed-end fund structures were not designed for this new era of long and illiquid holding periods. The typical

terms in fund governing agreements fail to contemplate the challenges and changed circumstances that can arise for tail-end funds. In turn, this can result in unintended conflicts in economic alignment, confusion over rights or other obstacles to either working out or winding up the fund. Although many tail-end fund situations can be managed without controversy, when a difficult circumstance arises, limited information and the lack of clear legal guidance can make these situations very challenging to resolve. The following are suggestions to help navigate the pitfalls that can arise in this environment.

Proactive engagement: an ounce of prevention is worth a pound of cure

Effective and cooperative engagement can be the key to maximizing fund value in these situations. It is critical for investors to understand the emerging risks that a portfolio is facing and develop a strategy for addressing those risks. Open communication around issues such as risk monitoring/red flags, exit planning, regulatory constraints and long-term economic alignment can help set the foundation for success. To that end, identifying

and addressing legal ambiguities in advance helps ensure that, if a problem does arise, everyone has settled expectations around questions such as “what can be done?” and “when should we do it?”

Check your assumptions — things are not always what they seem

There are many assumptions and heuristics that investors rely upon but that can become problematic in a distressed scenario. Consider the following examples:

Interest alignment

The standard management fee/carry structure helps align interests when times are good. But consider a scenario where a tail-end fund is stuck with a troubled asset. Given the prevalence of management fee step-downs after the investment period ends, in a scenario where carry looks unlikely, the investors and manager may no longer be fully aligned. Alternative structures may be needed to help ensure the value of the fund is maximized.

Valuations

The reliability of interim valuations has been the subject of a long-running debate in the trade press. But when a fund gets into trouble, this can quickly turn into a fiduciary concern. Although the contours of investment fiduciary duties vary by jurisdiction, it typically requires fiduciaries to exercise due care and act upon reasonable information. A fiduciary faced with making decisions relating to the disposition of investments needs to understand how fund assets are being marked and whether current marks are reliable given the scenario.

Debt and insolvency laws

Debt has become common across regions, asset classes and fund structures. But this can create material complications in a distressed scenario, both in terms of speed of action and potential solution constraints. It is vital for investors to understand all leverage points, the terms of debt instruments and the potential application of insolvency, bankruptcy or asset recovery laws.

Unconventional structures

Most fund transactions are variations on a common set of forms and conventions. This is entirely reasonable when underwriting regular investments — why incur the costs and risks of a novel transaction structure? The ordinary thus becomes the default perspective for most investment professionals. Sometimes, however, modern problems require modern solutions. Consulting with advisors who specialize in troublesome scenarios can help identify problems and solutions with which mainstream investment professionals may not be familiar.

Dispute procedures

In developing any strategy, it is also important to consider the practical impact of substantive governing law and the selected dispute resolution procedures. Given the extra-contractual nature and the substantial variations across jurisdictions, it can be easy to overlook these potential strategic benefits or impediments. Examples include assumptions about the enforceability of certain contractual terms, access to discovery, the speed at which the process can be conducted, the ability to enforce judgments effectively, third-party rights, public disclosure requirements, statutes of limitations/repose, regulatory requirements and the potential for secondary liability.

The human element

Economic alignment alone may not be a panacea. Don't forget that there can be a variety of legal, commercial, social and personal factors that contribute to an evolving situation. Problems can influence human behavior in unexpected ways, and even people with the best of intentions can react in ways that make a situation worse.

Develop an action plan — remember that time is money

Investors should think through how to react to distressed scenarios and be prepared to implement an action plan when the need arises. Being caught flat-footed or getting bogged down in the decision-making process can materially impact investment returns. Delays in dealing with problems can limit the ability to use legal terms to generate solutions or otherwise diminish the value that can be recovered. Early action almost always produces better results.

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