What Attorneys Need To Know About Restructuring A Zombie Fund
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Of all the ugly work attorneys do, some of the most difficult is within the world of restructuring. Riddled with lies, loss and the potential for litigation, restructuring requires a delicate balance on the parts of all players.

The restructuring of zombie funds are among the most interesting and precarious in this field. These vintage investments are high-fee private equity, venture capital or hedge funds that are not delivering returns or monetizing assets as an optimal course of action in returning capital to investors. An attorney representing fund managers has to balance the threat of investor litigation against the client's objective of continuing to manage, and therefore bring in substantial fees from, a nonperforming fund while investor returns are compromised.

Zombie funds sit for years, silently awaiting return on capital as fees rack up and investors, stuck in an investment with no potential for liquidity, become progressively frustrated due to inaction. In these situations, the investors typically have insufficient rights to to push for change or monetization since investment documentation often is favorable to the fund manager. This limits the ability of investors to terminate the fund manager.

From time to time, investors (usually institutional investors such as pension funds or fund of funds) will seek a basis, contractually or otherwise, to effectuate change. In such event, investors approach fund managers with threats of termination or litigation based on allegations of mismanagement, malfeasance or fraud.

While zombie fund restructurings don't happen often, when they occur, there are significant challenges for attorneys to navigate given the large asset base, complicated litigation issues and urgent need for monetization strategies. Attorneys representing either side are faced with the same issues — they need a restructuring-focused financial adviser to review the fund's financials and remaining assets in order to calm the waters and develop an agreeable plan. This restructuring professional will provide transparency that will serve as a base for productive conversation between the manager and key investors.

When selecting an adviser, the adviser's experience dealing with various asset classes, fund managers and investors is key in light of initial questions these experts will need to ask. These questions include: What is the current value of the fund's assets? Are there monetization plans to harvest value? Has there been a "hold vs. sell" analysis to determine whether it is preferable to maintain the assets for long-term appreciation as opposed to selling for immediate monetization of value and return of funds to investors?

Investors often lack the power to authorize a restructuring expert, due to the way the fund was formed and the desire to not fund costs out of their own pockets. In these cases, the restructuring expert requires the support of the very person under question — the fund manager — who can utilize remaining funds to pay for the outside review on behalf of all stakeholders. The adviser must provide transparency for investors while collaborating with the fund manager. While these two aspects may appear fundamentally misaligned, together they provide the basis for resolution and optimization of returns to investors.

Clearly, managers are loathe to bring in a third party to review fund operation and assets, turning over many stones in the process. A restructuring is liable to significantly compromise a fund manager's economics and, in more significant circumstances, cause the manager to face termination. For the manager, the value proposition of a third-party review is the opportunity to avoid litigation and any adverse reputational impact, which could harm future fundraising.

Oddly, the process is most efficient when highly troubled. When things are at their worst (e.g., large-scale government investigations, actual fraud, etc.), investors will immediately push for change of control. A fund manager is often receptive to the retention of a restructuring professional in the situation where he or she is attempting to limit significant exposures.

Successful zombie fund restructurings advance the monetization of key assets. In the absence of agreed monetization strategies, a restructuring will likely devolve into litigation, which will dissipate investor recoveries. This is why the first step in every zombie fund restructuring is an assessment of the underlying value of fund assets. When a restructuring professional is given the latitude to assess the situation, devise a strong plan and implement monetization, these funds can result in a long-awaited return of capital.

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