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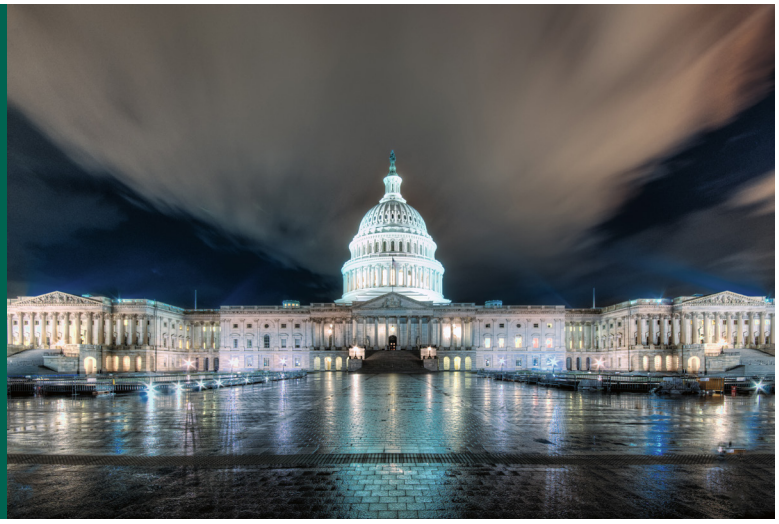

ILLIQUID FOR LONGER: PRIVATE EQUITY FUNDS AND FINANCIAL OPINIONS

By **Nathan C. Hoelscher** | Manager, Atlanta

There has been a meaningful disruption in the typical life cycle of a private equity ("PE") fund investment. Market conditions have created an environment that is not conducive to optimal exits of portfolio companies. This new era of "illiquid for longer" has resulted in record-high holding periods and a shifting dynamic between sponsors and investors. Increasing pressure from investors for liquidity has prompted sponsors to pursue alternative pathways to liquidity, such as continuation vehicles and dividend recapitalizations. However, with a temporary solution for liquidity comes new litigation risks and legal issues surrounding transaction fairness and solvency. These risks can be mitigated by a financial opinion from an independent valuation expert.

The Clock Is Ticking

PE holding periods have reached a record high of 5.4 years[1] as exit opportunities remain constrained and PE sponsors face challenges realizing liquidity.

Traditionally, PE buyout funds operate on a 10-year life cycle, with optional one-year extensions. Funds launched between 2015 and 2018, now 7 to 10 years old, have entered the "harvesting" phase, when fund investments are realized. This cohort includes over 3,300 funds globally, with more than half based in the U.S.[2] As 2019 funds begin harvesting in 2025, the number of funds approaching maturity will accelerate, particularly given the fundraising surge that began in 2019. With exit activity only beginning to rebound, PE sponsors face mounting pressure to divest their portfolio companies before the fund timeline runs out.

Currently, over half of all active PE funds are six years old or older,[3] extending past the midpoint of a theoretical fund life. Another 13.8 percent of active funds will reach their 10-year term within the next two years, totaling 1,607 funds that must wind down or seek an extension.[4]

Despite a rebound in PE exits in 2024, the exit/investment ratio remained historically low,[5] underscoring the imbalance between dealmaking and exits. This prolonged misalignment threatens to disrupt the PE cycle. As PE sponsors grapple with aging portfolios and limited exit windows, many may hesitate to take on new assets, prioritizing liquidity and investor returns.

Alternative Pathways to Liquidity

PE investors face a new reality: the era of "illiquid for longer," a structural shift where capital remains tied up well beyond traditional timelines. This is driving fund managers and investors to rethink liquidity solutions in this asset class.

A private equity fund is typically organized as a partnership between two parties: general partners ("GPs") and limited partners ("LPs"). The GPs are the sponsors and the managers of the fund, making investment decisions and managing portfolio companies. They also contribute a small portion of the fund's capital and earn fees and a share of the profits. The LPs are the investors in the fund and often include pension funds, endowments, family offices, and high-net-worth individuals. They provide the bulk of the capital but have a passive role in the fund's operations. LPs expect to receive returns over the life of the fund, during which the GPs invest in companies, grow the investment, and eventually exit those investments.

But as once-passive LPs grow impatient for liquidity, the dynamic between LPs and GPs has shifted. LPs are understandably anxious about capital locked in aging funds, particularly as the overall PE market has slowed distributions. LPs are pressing for cash returns, forcing GPs to consider alternative liquidity strategies beyond the typical outright sale or initial public offering of a portfolio company. Many LPs have their own liquidity needs or allocation targets, and if private equity realizations lag, LPs may become over-allocated relative to other asset classes, creating pressure to rebalance their portfolios.

LPs also are increasingly interested in receiving cash distributions from older funds before committing to new fundraising efforts, putting pressure on GPs to accelerate exits and demonstrate performance.

This dynamic has paved the way for GPs to develop alternative interim measures to bridge the liquidity gap. Two prominent strategies have emerged: GP-led continuation vehicles and dividend recapitalizations. Each offers a way to return some cash to LPs and extend the investment's timeline without a full exit.

Continuation Vehicles

Continuation vehicles are special-purpose funds, or vehicles that allow a GP to move one or more portfolio companies from an existing fund into a new entity, typically backed by secondary investors.

In a continuation vehicle, the GP offers existing LPs a choice: sell their stake in the portfolio company (or companies) for cash or roll their interest into the continuation vehicle, which will hold the asset(s) for a longer period. The GP usually remains in control of the asset(s) in the new vehicle, often securing additional time—and possibly fresh capital from new LPs—to maximize value before an eventual exit. Essentially, it is a structured way for GPs to offer an exit to LPs without exiting, selling assets from one entity to another that they also manage.

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This mechanism has increased in popularity in recent years as a solution for assets that GPs believe are not ready for traditional acquisitions or public offerings. Rather than extend the fund or sell an asset at a suboptimal price, a GP can use a continuation fund to generate partial liquidity for LPs while still retaining upside in the asset.

From the LPs' perspective, continuation funds are a mixed blessing. On the one hand, they offer a valuable option for liquidity when no better exit is available. On the other hand, LPs are wary of conflicts of interest. They must trust that the GP is not simply rolling assets on terms that favor the GP or new investors at the expense of existing LPs.

Dividend Recapitalizations

A dividend recapitalization, or "dividend recap," is a financing technique whereby a company incurs new debt to pay a cash dividend to its shareholders (often equal to the proceeds of the new debt less deal fees). While the transaction alters the company's capital structure,

it does not inherently change the enterprise value ("EV") of the business because EV equals equity value plus debt minus cash. When a company issues new debt in a dividend recap, its cash balance increases by the same amount. As the dividend is paid, cash decreases, and equity value is reduced by the amount of the dividend. The increase in debt is offset by the decrease in equity, leaving EV constant.

In the context of a PE investment, a dividend recap allows a PE sponsor to extract liquidity from its investment and return money to its fund investors without selling the company outright and exiting the investment. That is, the PE fund sells a portion of its equity, providing an interim payout to LPs (and to the sponsor itself), while continuing to own the investment. This strategy can be attractive to sponsors because the GP realizes part of the paper gains in cash, boosts the fund's track record with a distribution, and puts cash in the hands of LPs to invest in new "vintages," or iterations of the fund.

BEING ON BOTH SIDES OF THE TRANSACTION CREATES AN ENVIRONMENT WHERE A CONFLICT OF INTEREST CAN ARISE, EXPOSING THE GP AND PE FUND DIRECTORS TO CLAIMS OF FIDUCIARY DUTY BREACH.

Despite high interest rates, dividend recaps by sponsors increased in 2024 to over $900 billion, their highest dollar volume in the past 25 years.[6] In a less-than-ideal debt market, sponsors relied on dividend recaps to get cash out.

When executed prudently, dividend recaps can be a win-win. LPs get immediate liquidity, and the fund retains its ownership of the company, which can thrive if the new debt load is manageable. Although the EV and the ownership remain the same, the financial risk profile of the company, however, has changed because it is now more leveraged. Critics of dividend recaps argue that they enrich shareholders while burdening the portfolio company and its other stakeholders with additional risk. To this effect, some high-profile bankruptcy cases have cited aggressive dividend recaps as a contributing factor to the company's collapse.[7]

New Solutions Bring New Risks

Although continuation funds and dividend recaps offer solutions to the illiquidity problem, they also introduce additional legal risks.

When a continuation vehicle is launched, the GP is the seller (as manager of the existing fund) and the buyer (as manager of the continuation vehicle). Being on both sides of the transaction creates an environment where a conflict of interest can arise, exposing the GP and PE fund directors to claims of fiduciary duty breach.

These intrinsic conflicts mean these deals must be handled with care to maintain LP trust and to withstand legal scrutiny. From a fiduciary duty perspective, LPs in the selling fund can argue the GP has a conflict of interest and must demonstrate that the transaction is entirely fair, both in process and price, to the investors. In continuation vehicle transactions, GPs owe fiduciary duty to the LPs.[8] This duty requires GPs to act in the best interests of the LPs.

In a dividend recap, if the company subsequently becomes insolvent or files for bankruptcy, that dividend could be scrutinized as a fraudulent transfer, with potential liability for the recipients and the directors who authorized it. Fraudulent conveyance is a transfer with intent to hinder, delay, or defraud any creditors or a transfer where the creditor received less than a reasonably equivalent value in exchange.

Dividend recaps can be challenged by creditors as fraudulent transfers under U.S. federal bankruptcy law, which provides for the disgorgement of the dividend if it is proven that the company became insolvent because of such transfer or obligation or if the company incurred debt that was beyond its ability to repay. While federal law sets a lookback period of two years for voiding fraudulent transfers, state laws might extend the time frame, with many states allowing disgorgement of dividends up to four years back.

In a typical scenario, a company that borrowed to pay a dividend may later default on its debt and end up in bankruptcy. The creditors or bankruptcy trustee will then sue the PE fund (and possibly company insiders) to recover the dividend as a fraudulent transfer, arguing the company received nothing of value in exchange and was weakened to the point of insolvency. This is a sobering prospect for sponsors because it undermines the point of the recap (the permanent return of cash) and exposes sponsors to litigation years after the fact.

Mitigating the Risks

Faced with the dual risks of fiduciary duty breach and fraudulent conveyance in these alternative liquidity pathways, PE sponsors are increasingly turning to valuation professionals to support the integrity of their transactions.

Fairness opinions and solvency opinions are two distinct types of analyses that, in different contexts, serve as important evidentiary defense. Engaging reputable independent experts to deliver these opinions can significantly reduce legal exposure for GPs and directors by showing that decisions were informed by third-party analysis and met objective financial criteria.

Fairness Opinions

A fairness opinion is a valuation analysis by an independent valuation professional opining that the terms of a transaction are fair from a financial perspective to shareholders.

Fairness opinions are most often associated with mergers and acquisitions, but they are equally applicable to private transactions where fiduciaries must take an independent perspective on value. In the context of a PE continuation vehicle, the typical mandate is for a valuation professional to opine that the price being paid for the portfolio assets is fair to the selling fund's LPs. The opinion may address fairness to the buying fund as well.

To prepare a fairness opinion, a valuation professional will perform a fundamental valuation analysis of the subject assets. This usually involves employing multiple valuation methods to arrive at a range of value. The valuation professional then compares the agreed-upon transaction price to this assessment to conclude whether the price falls within a range that could be considered fair. The opinion letter typically states that, as of the date of the opinion, the consideration to be received by the selling fund is fair from a financial point of view to the selling fund's investors.

PE SPONSORS ARE INCREASINGLY TURNING TO VALUATION PROFESSIONALS TO SUPPORT THE INTEGRITY OF THEIR TRANSACTIONS.

LP associations have recently called for greater transparency and investor protections in GP-led deals. In 2023, the Institutional Limited Partners Association ("ILPA") issued best practice guidelines urging that any GP-led restructuring process be transparent, involve oversight by a limited partner advisory committee ("LPAC"), and include a fairness opinion from an independent financial advisor.[9] ILPA's guidance emphasizes that the LPAC should have enough information to assess whether a fair price was obtained, noting that a fairness opinion from an independent financial advisor may be helpful in this context.

Fairness opinions mitigate litigation risk by demonstrating process integrity and a fair price. They will not make a bad deal good, but they will make a

reasonable deal easier to defend. For PE sponsors navigating continuation vehicles, a fairness opinion serves as a prudent safeguard. While not legally mandated in every instance, it is a widely recognized best practice for mitigating conflicts and reinforcing fiduciary integrity.

Solvency Opinions

Fraudulent conveyance claims related to dividend recaps center on allegations that the company was left insolvent because of the transaction. Specifically, these claims allege that the company was:

1. insolvent at the time of the transaction,
2. left with unreasonably small capital, or
3. burdened with debt beyond its ability to pay.[10]

To counter the potential claims, PE sponsors can demonstrate the company's solvency, capital adequacy, and ability to repay its debt by obtaining a solvency opinion preceding the transaction.

A solvency opinion is an expert analysis concluding that after a proposed transaction, the company is, and is expected to remain, solvent. Solvency opinions are often obtained in transactions involving a significant amount of debt, such as dividend recaps.

Solvency is assessed in three tests in a solvency opinion:

1. Balance Sheet Test
2. Adequate Capital Test
3. Cash Flow Test

The balance sheet test evaluates whether a company's total assets exceeded its total liabilities at the time of the transaction. In a dividend recap, this test helps demonstrate that the company was not insolvent when it issued the dividend.

The adequate capital test analyzes whether the company retains adequate capital to continue operating its business and absorb foreseeable risks at the time of the transaction. In a dividend recap, this test helps counter the argument that the company was left with "unreasonably small capital," a key element of fraudulent conveyance.

A SOLVENCY OPINION IS AN EXPERT ANALYSIS CONCLUDING THAT AFTER A PROPOSED TRANSACTION, THE COMPANY IS, AND IS EXPECTED TO REMAIN, SOLVENT.

The cash flow test assesses whether the company can meet its financial obligations as they come due over a reasonable forecast period. In the context of a dividend recap, the cash flow test evaluates whether the company will have sufficient liquidity to service new and existing debt, pay operating expenses, and maintain working capital.

These three tests, collectively referred to as the solvency tests, correspond to the definitions used in fraudulent transfer statutes. A company must pass all three tests to be considered solvent.[11]

Directors have a duty to ensure a dividend does not render the company insolvent. By obtaining a solvency opinion, the board creates a record that it exercised due care and good faith in considering the dividend. If a solvency opinion is obtained from a qualified, independent valuation firm and it concludes the company will be solvent post-dividend, the directors who relied on that opinion have a strong defense against claims of fraudulent conveyance or fiduciary duty breach. If later challenged in court, the contemporaneous solvency analysis can serve as evidence that the company was not believed to be insolvent and that there was no intent to defraud creditors.

However, a solvency opinion is not an absolute defense. If the solvency analysis was based on false or unreasonable information, the opinion is in jeopardy of being excluded in court. It is critical that company management provides complete financial information and realistic financial projections to the valuation professional conducting the solvency analysis and does not conceal or underestimate liabilities.

The cost of a solvency opinion is marginal compared to the dividend amount and the potential liability. Specialized valuation firms offer solvency opinion services and emphasize their independence and analytical rigor, often with committees reviewing each opinion to ensure quality.

Summary

When conflicts or solvency are at issue, independent opinions serve as key evidence of proper conduct. Fairness opinions help demonstrate that a continuation vehicle transaction was completed at a fair price, refuting allegations of self-dealing. Solvency opinions help demonstrate that a dividend recap did not drive a company into bankruptcy, countering allegations of creditor harm. They are not mere box-checking exercises and, in many instances, are what determines whether a lawsuit proceeds and a PE sponsor is held liable.

PE sponsors navigating the challenges in the era of "illiquid for longer" must balance the needs of investors for liquidity against their duties to act in the best interests of those investors. Continuation vehicles and dividend recaps have emerged as important tools to bridge the gap when traditional exits are elusive. Used wisely, they can create value or at least buy time, allowing GPs to wait for a better market or to return capital in the interim. But these strategies inherently carry elevated legal risks. To mitigate these risks, private equity firms increasingly lean on the expertise of independent valuation professionals to provide fairness and solvency opinions.

About the Author

Nathan C. Hoelscher is a manager of our firm. He can be reached at (404) 475-2318 or at nathan.hoelscher@willamette.com.

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